

CANADA AND THE GLOBAL FINANCIAL CRISIS: A MODEL TO FOLLOW?

O CANADÁ E A CRISE FINANCEIRA GLOBAL: UM MODELO A SEGUIR?

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Abstract: Canada is generally argued to have fared well during the global financial crisis. This article considers the Canadian response using a policy network approach. During the crisis, the policy network was united and cohesive. Canada did suffer a major crisis of its own, referred to as the asset-backed commercial paper crisis. The policy network's swift response helped minimize risks and consequences. Canada's policy network is effective which helps explain Canada's strong performance. The article's conclusion, though, raises concerns that success may prevent the policy network from learning, adapting and preparing for the next crisis.

Keywords: Canada, Financial Crisis, Policy Network, Policy Reform, Securities Markets

Résumé: Le Canada s'est comparativement bien tiré de la crise financière internationale. Cet article étudie la réponse canadienne à la crise. L'approche par les réseaux est utile pour expliquer les politiques publiques du secteur financier au Canada. Durant la crise, le réseau était uni et fort. La crise du papier commercial fut, toutefois, l'une des pires crises financières de l'histoire canadienne. Le réseau agit rapidement pour minimiser les risques et les conséquences qui en émanèrent. Le réseau est efficace ce qui aide à expliquer la bonne performance relative du Canada. Dans la conclusion, le succès du Canada est, toutefois, remis en question ainsi que la préparation du réseau à une crise future.

Mots-clés: Canada, Crise financière, Marchés de l'investissement, Politique publique, Réseau de politique publique

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The global financial crisis from 2007-2009, with effects to be felt for years to come still, has generated countless books from popular and academic presses, articles, conferences, and continues to shape current and future research agenda. Financial services sector crisis are not new (REINHART; ROGOFF, 2009) and tend to follow similar patterns. Howard Davies (2010), former chair of the British Financial Services Authority, provides a complete summary of key contentions and issues relating to the most recent crisis. States have not all been affected in the same way. The United States and Great Britain, for instance, faced the potential collapse of their financial services sector. Canada and Australia fared much better. National governments faced with similar, though not identical situations, responded differently to global pressures.

This article focuses specifically on Canada, often presented as a crisis success story (KRUGMAN, 2010). Canada is deemed to have performed well; the government did not formally come to the rescue of any of the country's major banks, though it did support them during the worst of the crisis. *Euromoney* (AVERY, 2009) named Jim Flaherty, Minister of Finance of the year in 2009. Canadian officials still argue the country is a model to emulate. Canadian claims of success should, however, be nuanced. During this period, Canada experienced the worst financial crisis of its history, referred to as the asset backed commercial paper (ABCP) crisis. What is intriguing about the ABCP crisis is not so much that it occurred – the commercial paper contained assets from the US subprime market – but the way in which it was resolved. Canada's financial services sector policy network was able to come together and agree on a market-based solution to minimize losses associated with the perturbation.

How has the Canadian government responded to the global financial crisis? How is the country's overall resilience to be explained? The chapter argues that Canadian financial services sector policy is best understood, as partially evidenced in the resolution of the ABCP crisis, using a policy ne-

network approach. The Canadian network is relatively effective, small, flexible and cohesive – a policy community. It proved adept in facing troubled times. In the United States, in stark contrast, the policy network is large, divided, and prone to open conflict – an issue network. Canadian success has many explanations, discussed later on in the chapter. The network approach offers a compelling account of Canadian financial services sector policymaking. Most importantly, the policy network approach speaks to the role of actors in policymaking, their interests, their resources and how these actors interact. Good policy on its own is not enough; actors need to concur on objectives, instruments and methods of implementation. The policy network approach provides an opportunity to study politics pre and post policy.

The chapter is divided in two sections. First, the policy network approach is discussed, especially as it relates to financial services sector policymaking. Second, the Canadian case is analyzed. The Canadian response to the global financial turmoil and the ABCP crisis are discussed in details. For ease of comparison, reference to the US case is made when appropriate. The conclusion offers a reflection on future prospects for Canada.

The analysis provided in this chapter is based on the available existing literature including primary and secondary sources.

Financial Services Sector Policymaking and Policy Networks

Policy networks provide a well-established way by which to understand policymaking, and the approach is applicable across policy fields including in finance. A network can be defined as,

... a set of informal and formal interactions between a variety of usually collective public (state) and private actors, who have different, but inter-

dependent interests. Operating in a more or less institutionalized setting, these actors are engaged in horizontal, relatively non-hierarchical discussions and negotiations to define policy alternatives, or formulate policies, or implement them. (COLEMAN, 2002)

Despite many criticisms, the concept has demonstrated staying power. Policy networks allow researchers to determine actors involved in policymaking, and to focus on their preferences and interests, their resources, and to consider types of interaction inter and intra-network. Networks are fluid and power struggles between actors influence decision-making. Policy network analyses continue to offer powerful explanations of public policies and outcomes.

There are various policy networks models. Marsh and Rhodes (1992) present the British variant of policy network studies, which is now well-established. Speaking to different types of policy networks, they refer to a continuum where there are tightly knit policy communities on the one extreme and loosely-affiliated issue networks on the other. The type of policy network influences decision-making and policy choices. Actors in tightly knit communities are more likely, even when they disagree, to have built a confidence-based relationship. There is likely to be a mechanism by which to attend to actors' differences. In policy communities, decision-making is likely to be consensual. Actors are bound to be more reasonable because they must continue to work with one another. Policy choices, in turn, are expected to reflect the interest of the community as a whole – a compromise. The situation differs when considering issue-based networks. Such networks are likely to be populated by adversarial coalitions (SABATIER; JENKINS-SMITH, 1993). Loosely affiliated networks have a large diffused membership. Actors have varied preferences, reflecting their interests and resources. Policymaking is, thus, political, open and contentious. Decision-making is likely to be hierarchical, and the weight of actors in the process will vary. Policy decisions will reflect interests and preferen-

ces of the most powerful actors. Canada's financial services sector policy network is closer in this typology to a policy community while the United States' network resembles an issue network.

Policy networks are particularly relevant to the study of financial services sector policymaking. Beyond the classification above, there are specificities of finance policy networks to consider. Most importantly, institutions shape network, so that how a state finances its economy will have an impact on actors involved and the decision-making process. Zysman (1983) long ago identified basic models; the United States largely relies on securitization, while France has long depended on its banking sector to support economic activities; Canada, in turn, possesses a mixed system with a strong banking sector and relatively active capital markets. Canada's policy network is dominated by its five large banks, which all help shape policy and practices. Though stock markets long operated like private clubs, they also favour broad, popular, participation. As such, the United States' policy network in the financial services sector is more open and inclusive.

The relationship between governments and financial services sector actors needs to be carefully considered. Porter (2003), for instance, argues that financial services sector policy represents a fusion of public, private and technical authority. Finance is inherently complex, and experts are bound to play an important role in policymaking. De Goede (2001) describes the rise of modern scientific finance. That being considered, there has also been a politicization of finance over many years, especially in Canada (ROBERGE, 2006). Financial services sector policy has historically revolved around finance departments, central banks and a few key market actors. Public policy was traditionally low-key and technocratic. The globalization of finance, market de-segmentation, and a host of other factors have expanded policy networks, increasing the likelihood for friction. There is greater consumer interest, especially in the field of banking,

though influence should not be overstated (for the EU, see MCKEEN-EDWARDS; ROBERGE, 2007). Generally speaking, there is interdependence in the network between governmental actors, financial firms and experts. The complex dynamic needs to be untangled and will vary across states.

Admittedly, the policy network approach in finance could lead to a simplified view of financial services sector policymaking. The alleged Wall Street-Washington complex is often said, especially in the mind of the general public, to account for close connections between private sector actors, regulators and politicians whom are all said to be in cahoots to the detriment of the greater good. There is no particular reason to believe, however, that market and public actors automatically share the same, or even similar, interest. In tracing the history of Wall Street, Van der Yeught (2009) describes how a frustrated Washington is always playing catch up to New York. Admittedly, there is a greater risk of regulatory capture as a result of the technical complexities of the field (ETZIONI, 2009). The policy network approach actually assists in untangling the complex web of relationships. The use of the policy network approach helps to break down the apparent monolithic club. The argument, of course, is not that policy decisions always reflect the public interest, broadly defined. Rather, the policy network approach accounts for the multiplicity of actors and interests in the process, which in turn helps explain policy decisions and outcomes.

Before proceeding, it is important to specify that the argument in this chapter is not that policy communities are necessarily better than issue networks, that they always lead to better policies and outcomes, or that they are better suited to address financial crises. The argument proposed is not value-based. Each network type has its advantages and disadvantages. Policy communities can at times ignore the public good. In Canada, the

close-knit nature of the community raises, as is to be discussed later, potential problems due to actors' inability to learn and adapt. Issue networks can encourage transparency and a democratic debate. In the context of the global financial crisis, Canadian financial services sector policy – the interaction between actors – is best understood as reflecting characteristics of a policy community.

Canada

Canada's financial services sector came out of the global financial crisis largely unscathed. Yet, Canada did go through its worst financial crisis in history, the ABCP crisis, a fact that is too often ignored. This section first considers Canadian policy, before discussing the ABCP crisis and its resolution. The Canadian situation is best analyzed by considering the particulars of its financial services sector policy network.

Background and Financial Services Sector Policy in Canada

Financial services sector policy in Canada is of divided jurisdictional authority. Banks are of federal jurisdiction; securities and investments firms are under provincial jurisdiction; insurance is of mixed responsibility; and, trusts are of provincial authority. The Canadian financial services sector underwent drastic changes from the 1980s onwards. The Canadian system had operated according to pillars, clearly delineated from one another. Government policy facilitated the dismantling of these pillars starting in 1987 when it allowed Canadian banks to own investment firms. Later in 1992 banks were allowed to own insurance firms and trusts. As a result of these policies, the country's large five banks became dominant actors across pillars. Coleman (2002a) argues that concurrently there was a centralization of political, supervisory and regulatory authority to the federal

government since banks fall under its jurisdiction. The last bank failures in Canada occurred in the 1980s and since then the system has been quite sound.

In the late 1990s, the Canadian government undertook a lengthy review of financial services sector policy, leading to the adoption of Bill C8 in 2001. The legislation focused on competitiveness and consumer protection (ROBERGE, 2006). Prior to, Canadian Imperial Bank of Commerce and Toronto Dominion, on the one hand, and Royal Bank and the Bank of Montreal, on the other, proposed to merge. The merger debate engulfed Canada through most of 1998. The banks' proposals were turned down, some have argued strictly for political, populist, reasons (HARRIS, 2004). The banks' arguments for merging were that they would profit from economies of scale, be in a better position to respond to clients' needs, and be more competitive internationally. The general public mistrusted the banks. The Canadian government in turn wanted to be sure that the Canadian marketplace would be properly served, a real concern if Canada were to go from five to three major banks. In hindsight, the political decision to turn down the merger may have helped shield Canadian banks from the global crisis that occurred ten years later. Canadian banks are generally not perceived as global players, and more as regional and national entities. Bill C8 had many objectives, one of which was to try to make the market more competitive through the entry of new firms. That being said, foreign firms who want to come to Canada must still obtain approval for a subsidiary, and cannot simply open a branch. Subsidiaries are largely treated like any other Canadian bank by the regulator. As such, the Canadian marketplace has, in this respect as well, largely been shielded from large foreign firms, including US and British firms that came under fire during the global crisis. Equally important, Bill C8 created the Consumer Financial Agency of Canada (FCAC) to ensure Canadian consumers were better protected. Predatory lending practices, such as those seen in the US, did not take

place in Canada, Financial services sector policy in Canada does not please everyone, but there appears to exist an equilibrium between whole-of-system considerations, and those of individual firms and consumers.

The globalization of financial markets has affected Canada, but policy responses have reflected domestic considerations. Williams (2009) argues that globalization has brought about policy subsystem adjustments, so that policy responses reflect as much external impetus as actors' priorities in the policy arena. Presented in this way, actors in the subsystem use the pressure from the external to call for or justify a policy reform that they already favour. For instance, the Canadian government recently attempted, after forty years of inertia, to create a national securities commission. As noted just above, provinces have jurisdiction over securities markets, and they have always been reluctant to abandon this policy field. The federal government's plan was deemed unconstitutional by the Supreme Court of Canada. What is of interest is that the central government justified its attempted intervention by arguing Canadian markets needed to be better protected in light of the global financial crisis. Changes in policy parameters can provide an opportunity opening up a policy window for the adoption and implementation of a particular policy.

At the time of the global financial crisis, Canada had established practices. It is beyond the scope of this paper to assess Bill C8, though the legislation provides some evidence suggesting that sound policy helped Canada avoid the worst of the crisis.

The Canadian Response

The Canadian financial services sector was fairly stable leading up to 2007, when problems on global and US markets first appeared. As the situation evolved, the Canadian government took fairly restrained measu-

res to ease the credit crunch, buying, for instance, up to \$125CAD billion of mortgage bonds (TEDESCO, 2009) to increase banks' liquidity and capacity to lend. The Canadian Centre for Policy Alternatives (MACDONALD, 2012) has called it a bailout and argues that without this help three of the country's five banks would have been insolvent. The Canadian federal government undoubtedly aided the country's banks, but it did so in a way that was very low key and that ensured strong market confidence in all financial services sector institutions. The federal government also sought to address administrative concerns, amending the Bank of Canada Act to give the Bank more powers in managing the crisis. The government promised to strengthen the Office of the Superintendent of Financial Institutions (OSFI), the federal financial services sector supervisor and regulator. Comparative to many of its OECD counterparts, the Canadian government only had to take limited action to protect the country's financial services sector.

Many reasons have been provided to explain Canadian resilience. Above and beyond sound financial services sector policy, three explanations are usually offered as it relates to the Canadian case. First, John Chant (2010) in a presentation at Rutgers University, and many others, has emphasized Canadian monetary policy as the primary difference between the Canadian and the American experience. Credit has never been as easy to obtain in Canada as was the case in the US. Second, Canadian banks are said to be fairly prudent and tend to be risk-averse. Canadian policy has tended to favour prudence over risk and innovation so that Canadian banks have never been as adventurous as their counterparts elsewhere. Third, Canada's mortgage market is structured so as to minimize changes of mortgage defaults. These explanations, especially when combined, shed some light on the Canadian experience. The policy community's effort in working through the crisis adds a necessary complement to traditional explanations.

As noted, Canada's financial services sector policy network is a small, integrated community. It is unified and fairly cohesive, facilitating policy response and adjustment. In relation to bank supervision and regulation, Minister Flaherty (Canada, 2010) refers to Canada's 'coordinated regulatory approach'. There are two broad committees that consider policy issues and address supervisory and regulatory issues, the Senior Advisory Committee (SAC) and the Financial Institutions Supervisory Committee (FISC). The committees have the same membership, though their mandates differ. The SAC is chaired by the Deputy Minister of Finance and considers matters of policy relevance. The FISC is chaired by the Superintendent of Financial Institutions and is concerned with supervisory and regulatory issues. The committees are composed of the Department of Finance, OSFI, the Bank of Canada, and the Canadian Deposit Insurance Corporation (CDIC). Both committees meet about quarterly, though the FISC met more regularly during the worst of the crisis. The same actors are present on the Board of Directors of the CDIC. The Office of the Auditor General (2010) suggests that there is enough evidence to believe that committees' work allow for pertinent information to be shared. Canada does not have a systemic risk regulator, as now exists in the European Union and the United States. The absence of such a regulatory body means the onus is on the whole of the network, a difficult situation. John Crow (2009), a former Governor of the Bank of Canada, specifically recommends that the Bank be strengthened further to be in a better position to manage crisis situation and address systemic risk. Despite this limitation, the IMF (2008) has commended Canada for its 'effective and nearly unified framework'.

There is also some evidence to suggest that there exists in Canada a strong working relationship between the government and private sector actors. The Department of Finance and OSFI have established good working relationships with the country's major financial institutions. Julie Dickson

(as quoted by FREELAND, 2009), Superintendent at OSFI, notes that she can reach, if need be, everyone in the network in a couple of hours. She also personally attends board meetings of the major banks at least once a year.

Canada's success has allowed it to play a preeminent role in discussions about the governing of the international financial system. The country co-chaired the G20 in 2010 giving it a platform to influence reform proposals. Canada, for instance, has firmly opposed a bank tax, a topic that never formally made it onto the agenda of the G20 Toronto meeting in June 2010. Whether Canada has been a force promoting or impeding progressive change in financial services sector governance is, evidently, open to debate.

Canada is not the only country with a relatively small financial system, a key factor in explaining network coherence. Ireland, also, only possesses a few key financial players, yet the country was severely hit by the financial crisis. Ross (2009) describes the cronyism that permeated the Irish system, something that does not seem to plague the Canadian financial services sector policy network. The key consideration when analysing the Canadian case is that possessing good institutional infrastructure, and supervisory and regulatory practices matters just as much as having the right policies and rules. The former is quite likely, in fact, to lead to the latter.

The ABCP Crisis

The Canadian picture, however, is far from perfect. The ABCP crisis demonstrates that there was still some turbulence in the Canadian financial services sector marketplace. The ABCP crisis represented one of the most, if not the most, daunting challenge in the history of the Canadian financial

services sector. The collapse of the ABCP market could have had devastating effects for financial firms, large institutional investors, and small investors alike. Had the ABCP crisis not been properly resolved, Canada would have surely felt the global financial crisis more severely.

The \$35 billion Canadian ABCP market froze in August 2007 when it became apparent that the alleged safe product was, in fact, quite risky since some of the paper was tied to US mortgage-backed securities. Up until that time, the product had been considered safe since it has received a top rating from Canada's only credit rating agency, Dominion Bond Ratings Services (DBRS). It is of interest that US credit rating agencies had refused to give the product a rating because of the particular structure of the ABCP note as sold in Canada. On 13 August, Coventree Inc. was unable to find buyers for its maturing notes. The market, which had steadily been growing, had to be frozen to avoid its total collapse. A Coventree Inc. email communication in July had already enunciated concerns about the exposure of ABCP notes to the US subprime market. Coventree Inc. continued to sell notes after that email, and its practices have been investigated by the Ontario Securities Commission (Greenwood, 2010). The scope of the crisis went much beyond Coventree Inc., however, impacting the whole of the financial services sector. For instance, Dundee Bank of Canada was rescued in September of that year by the Bank of Nova Scotia, one of Canada's five large banks. The largest institutional investor in ABCP notes was the Caisse de dépôt et placement du Québec which at the time the market froze owned almost \$13 billion worth of notes (VAILLES, 2009). The Caisse is a Québec crown corporation tasked with making profitable investments with the funds of public and private pension and insurance plans and organizations. The ABCP crisis threatened the stability of Canada's financial services sector.

To respond, the Montréal Group later renamed the Pan-Canadian

Investors Committee for Third Party Structured ABCP, a private sector *ad hoc* group, was formed. The group was headed by Purdy Crawford, a well-established industry insider. The objective of the group founded on 16 August was to stabilize non-banks ABCP notes. The group's initial accord was known as the Montréal Proposal and reflected a standstill agreement which allowed in the subsequent months the market to settle. In December, the Committee reached further agreement in principle to the effect that 30 and 60 days notes be restructured into long-term notes of up to nine years. Though the plan would be adjusted thereafter the result of diverse pressures and considerations, especially by small investors, the core of the proposal remained the same. The Committee also needed to consider how the plan was going to be approved by the investors and implemented. The plan became subject to the Ontario Companies' Creditors Arrangement Act, thus, the restructuring became court supervised. Though the procedure is unusual – the situation after all did not reflect a company bankruptcy – the court's help was deemed essential for the proposal to be approved by creditors and acted upon (MYERS; ABISCOTT, 2009). In late April 2008, shareholders voted 96% in favour of the restructuring plan, which would finally be endorsed by the court in June of that year. The court's decision was challenged on the account that the plan did not allow note holders to sue for fraud firms that had sold ABCP, but the appeal was rejected (CA-RHART; HOFFMAN, 2009). The federal government, along with Ontario, Québec and Alberta's provincial governments, provided a senior funding facility to help sustain the agreement. In December 2009, Scotia Capital Inc., CIBC World Markets, and National Bank of Canada agreed to pay \$138.8 million to settle regulatory allegations by the Ontario Securities Commission; an amount that has been considered insufficient by some due to the harm done to the Canadian marketplace as a result of this crisis (MIDDLEMISS, 2009). For its part, Canaccord Capital Inc., who had been a major seller of the product, agreed to pay back clients who had purchased

the notes (MAVIN, 2008).

The ABCP crisis raised supervisory and regulatory issues. The ABCP market was largely unregulated and it grew unchecked. John Chant (2009), thus, argues that the crisis was predictable and preventable. Among loopholes utilized, Canadian and foreign banks sponsored ABCP conduits, but they did not need to provide liquidity unless there was major market disruption. Banks also kept the conduits off their balance sheet to avoid capital requirements. OSFI has been accused of having failed to properly supervise large banks as it pertains to their role in the ABCP market. OSFI's response has been that its role is to focus first and foremost on banks' solvency, not on market behaviour, and that many of the firms selling this type of product are not federally regulated entities (Canada, 2008). Provincial authorities, for their part, seem to have been oblivious to the coming crisis, for which, admittedly, they were not alone.

The members of the policy network involved in the ABCP market were able to find together a solution to avoid a worst market collapse. Support for the process and approved plan were not unanimous. Small investors in particular felt cheated in the resolution of the crisis. They believed they had purchased a safe product, akin to a guaranteed investment certificates (GIC), only to find out that the product was a lot more risky. They suffered important financial losses in the crisis. The new notes have been trading, more or less, at a 40% discount to face value (GREENWOOD, 2010). Protection for small investors in the investment business is a long running concern, above and beyond the ABCP crisis, in Canada. Purdy Crawford himself has acknowledged that the restructuring plan was not perfect, but that it nonetheless reflected 'the art of the possible' (quoted by GREENWOOD, 2009).

Concluding Remarks

The global financial crisis was as much a failure of politics as a failure of markets (FRIEDMAN, 2009), but it did not unfold everywhere in the same way. Canada was relatively successful in avoiding the worst of the crisis. The country fared well for many reasons including sound policy. The crisis highlighted the country's domestic political dynamics. The Canadian financial services sector policy community is unified and cohesive; it was well-suited to confront this particular challenge.

Financial services sector crisis are more recurrent than before (YAMASHITA, 2011). The past, clearly, provides no guarantee for the future, and Canada is not immune from the next crisis. Livesey (2012) forcefully argues that Canadian banks, especially, have their share of problems and that Canadian customers are not well protected and served. To what extent does the Canadian network take care of its own before it takes care of the public good? There are no major financial services sector reforms forthcoming in Canada. The next legislated review of the Bank act was scheduled for 2012; there are no signs suggesting an important policy overhaul. Canada is to implement Basel III, the newly revised international regulatory framework for banks. Canadian policymakers and regulators, though, appear unlikely to lead or innovate in this policy field. Williams (2012) suggests that the discourse of success has prevented actors' from learning. He argues that the Canadian system is plagued by much incoherence, but that there is little political appetite for fixing it, especially in light of the country's good fortunes. Stephen Harris (2010), for his part, goes further suggesting that policymakers shirked their responsibility in this policy field. Referencing the ABCP crisis, Harris notes that OSFI and provincial regulators closed their eyes to new market developments and have been unwilling to assume their share of the blame. The major market disruption that ensued, as a result of this unfettered activity, particularly harmed, as

noted above, small individual investors – the people with the least recourse. From this perspective, Canadian success came as much by chance as by design.

If there is one recommendation that appears essential, it is that a full-blown policy review should now be held, inclusive of all actors. It has been more than a decade since a review of Canadian financial services sector policy took place. Globally, regionally and domestically, there has been a lot of change since that time. There both exists new knowledge and new challenges. Questions of systemic risk and ‘too big to fail’, as well as many other critical issues, are just as pertinent in Canada as elsewhere and require full analysis. Canada’s fate, when another crisis shakes the financial world, is hard to predict. Canada’s policy network in this field could help, once again, soften the blow. The cost of policy and regulatory inaction, even potentially of falling behind, however, could be quite high. Such review processes have taken place almost everywhere else. Beyond the political rhetoric and simple claims of success, Canada now needs to consider, reflect upon and give due consideration to policy reforms, so as to ensure the country is ready when the next crisis happens. Policymakers, emboldened by success, have not shown so far that they are interested in carrying out a review.

There will be another crisis, probably sooner rather than later. It is not a matter of ‘if’ but ‘when’. Let us hope that misplaced pride does not mean that Canada is going to fall faster and harder the next time around.

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