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"Policy Capacity, Evidence-Based Policy-Making and Institutions: Canadian Regulatory Responses to the Finacial Crisis"

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Abstract: This paper explores the Canadian response to the financial crisis from the perspective of policy capacity. While Canada's regulatory reforms in response to the financial crisis have been limited, this paper explores the role of both existing institutional arrangements and the analytical capacity of the agencies involved, in impeding effective "policy learning" in relation to the crisis. Canadian supervisory and policy-making capacity are fragmented amongst different agencies, whose effectiveness is weakened by the competing jurisdictional agendas of the key federal and provincial regulators over the securities industry. When combined with the significant differences in the capacities of staff in those agencies to learn from broader events, the lack of a programmatic reform effort is understandable. The paper offers a preliminary assessment of a survey of Canadian public policy professionals, building on prior research which has examined the skills and capabilities of government policy analysts (Howlett and Newman 2010,Wellstead, Stedman and Lindquist 2009).

Acknowledgment: The survey data presented in this paper was collected as part of a SSHRC collaborative CEI research project between 2009-2011.

I- Introduction:

Evaluating the capacity of policymakers to engage in evidence based policy-making remains one of the most intractable problems in policy studies. While "good" policy requires effective learning, much of the policy literature highlights institutional and political obstacles, contributing to a general pessimism regarding the role of policy analysis in improving the quality of government. Whether based on the limitations to rational decision making (Lindbolm 1979), or "garbage cans" replete with different policy ideas in search of problems (Cohen, March and Olsen 1972), or "discourse intuitionalism" and its break with any sense that policy analyses involves seeking "effective" advice at all (Schmidt 2008), much of the policy literature has reinforced a view that governments' policy analytical capacities are fundamentally limited - at least in terms of their ability to engage in evidence-based policy learning. This, in turn, may have contributed to an empirical deficit in this area. Scholars have failed to examine capacity more closely as many see it as a tangential question in explaining patterns of policy change and continuity. While this is problematic in that significantly more can be said about capacity, more to the point it is a crucial question for policymakers. If governments want "good" policy advice in the face of complex problems, improvements in existing capacity are essential.

Unfortunately, much of what we know about policy capacity is limited to incomplete surveys and anecdotal evidence. Political scientists have rarely tried to systematically investigate the basic ability of policy professionals to provide evidence based policy advice. While recent research has explored this question from the perspective of the skills and capabilities of policy analysts - defined as "analytical capacity" (Oliphant and Howlett 2010, Howlett and Newman 2010), it remains the case that the knowledge policy makers bring to effective learning in their domains will be impeded by both these kind of "cognitive" questions (the complexity of this issues involved and the research capacities and skills of policy analysts) and more explicitly political considerations such as institutional and jurisdictional limitations of leading agencies.

In Canadian financial services, studies of governance arrangements have raised doubts about relations amongst key policymakers and the ability of the sector to implement major policy changes. Most research has highlighted the role of federalism, and the degree to which finance is a divided jurisdiction in mitigating effective policy design. Other research has suggested weak federal government governance due to the disinterest of the Bank of Canada in questions of industry regulation (Coleman 1996). Others have noted the weakness of the federal Office of the Superintendent of Financial Institutions (OSFI) in policy debates given the Provinces' key role in regulating the securities industry (Roberge 2005, Harris 2010) and the weakness of the Department of Finance in guiding policy given the high level of political interference in key policy debates in the sector (Harris 2004). Despite these challenges, the sector has managed to successfully adapt to globalisation (Coleman and Porter 2004) without generating some of the policy failures encountered in other jurisdictions.

This paper offers a preliminary examination of some of the key challenges confronting policymaking capacity in relation to the financial services and the financial crisis. The paper combines an overview of the institutional problems confronting the regulation of the financial industry (in particular the on-going jurisdictional struggles between the Federal and Provincial Government over who is responsible for the soundness of Canadian financial markets), with an assessment of the resources those governments have deployed in support of policy analysis, based on a recent survey of Canadian policy professionals. Ultimately, the fragmentation of supervisory responsibility in Canada, combined with generally weaker policy capacity at the provincial level suggests the need for institutional reform.

Public Policy Capacity and Policy Learning

Understandings of policy "learning", the extent to which policymakers in a particular domain might be able to adapt to new issues, events and the availability of new information have tended to emphasize two sets of factors. They stress the "analytical capacity" of policymakers in leading government agencies, in terms of their accumulated knowledge, skills and their willingness to meaningfully engage with new information on one hand, and the structure of the policy subsystem – the relationship between those agencies and the broader universe of policy actors on the other. Indeed, as Howlett, Ramesh and Perl 2009 argue Hall (1993) and Sabatier (1987) both highlight that conventional thinking about policy learning suggests effective learning, the kind of learning that generates programmatic responses to real problems, the kind associated with Hall's notion of "social learning", requires that policymakers have sufficient analytical capabilities in an environment in which the policy-making environment is both "open" to new actors or new policy ideas and "integrated" to the extent that policy research organizations can disseminate new ideas to relevant authorities. However, if analytical capacity in a sector is limited and governance arrangements are not integrated or conducive to learning and disseminating new advice, authorities will fail to respond in a programmatic fashion to new challenges; an environment in which expertise is devoted to "fire fighting" rather then more systematic research.

Figure 1 - Typology of Policy Capacity

		Policy Analytical Capacity	
		High	**Low**
Governance Arrangements	**Integrated**	**Effective Policy Capacity** Able to meet long-term challenges	**Analytically-Impaired Policy Capacity** Insufficient knowledge and expertise = focus on incremental change (?)
	Non-Integrated	**Structurally-Impaired Policy Capacity** Departmental policy struggles and incoherence (?)	**Ineffective Policy Capacity** Policy failures and short-term fire-fighting

As suggested by Figure 1, sectors that have integrated governance arrangements but limited analytical capacity will also struggle with effective learning as no matter how well organized the channels for disseminating policy advice might be (or how much appetite there might be for new ideas), agencies simply lack the ability to produce the advice necessary for significant policy changes. Logically, one might expect an analytical process marked by limited incrementalism, given limited ability to look at previously unpracticed ideas. Conversely, in a sector where analytical capacity might be high, but governance arrangements are less integrated, a number of outcomes seem possible. For example, in an environment where there are competing institutions charged with overlapping mandates, analytical capacity may be used "badly" to support competing agencies broader agendas. Less instrumentally, agencies may simply recommend contradictory policies in the absence of coordination. Ineffective governance arrangements could also be conducive to "passing the buck" on dealing with complex new challenges, as ambiguity about responsibilities may create an environment where agencies assume "someone else" will deal with the issue. Finally, in this type of environment, it might also be logical to suggest that there is more scope for politisization of analytical capacity. If the sector is poorly integrated and therefore lacks internal coherence on policy problems there is greater scope for analytical capacity to be used for more explicitly "political" purposes.[1]

In the past "analytical capacity" has proven difficult to study. Little systematic effort has been made to study the nature of policy work inside government. There is very little information available on existing analytical capacity even in a sector as large and as important as finance. Reviewing the exiting literature suggests that we know very little about the scope of the research activities in different organizations, the amount of analytical resources those agencies may have at their disposal and the competency of their policy analysts. While Figure 1 suggests a basic distinction between "high" and "low" analytical capacity, the task of interpreting the level of analytical capacity in any sector is difficult, particularly in relation to specific policy problems.

Assessing the quality of governance arrangements is somewhat easier then analytical capacity, at least in relation to finance, as a considerable amount is already known about the basic structure of responsibilities and relationships in the sector. However, as will be discussed below, the problems associated with the financial crisis likely pose unique challenges for the federal division of responsibilities in the sector – the sector may be well "integrated" in relation to some issues but not others.

II - The Policy Challenges Exposed by the Financial Crisis:

The financial crisis has provided a "focusing event" for reform initiatives, and the sustained international efforts to promote a coordinated set of policy changes to address regulatory shortcomings exposed in the crisis create a unique opportunity to examine policy capacity and leaning as financial authorities, stung by the massive costs of the crisis seem more open then ever to discussion of new policy ideas regarding the proper regulation of the industry. However, the ability of Canadian regulators to adapt to new ideas regarding the financial services sector has been impeded by the existing fragmentation of regulatory responsibilities – that institutional and jurisdictional limitations, left over from the process of deregulation, have permitted Canadian regulators to avoid more serious discussion of regulatory changes, in an environment where both the current government and leading private sector firms have little appetite for serious policy change.

Despite constant self-congratulation regarding the success of Canadian firms in weathering the financial crisis, at the time, Canadian regulators denied responsibility for overseeing the activities and financial instruments which caused the collapse of so many banks around the world (Williams 2009, Harris 2010). Three years latter, with exception of the Bank of Canada's consistent support for the new capital adequacy standards being developed by the BCBS for the G20, Canadian regulators have

[1] As will be discussed below, in the finance case, analytical capacity is thought to be quite high (at least at the federal level). However the continuing provincial insistence on regulating the securities industry, combined with poor provincial analytical capacity suggests that the Canadian financial services sector is also, effectively, poorly resourced.

often done little more than echo the government's desire to block any other "aggressive" reform initiatives.

The "Lessons" of the Financial Crisis

Prior to the crisis, the dominant thinking had been that the deregulated and globalised "new financial architecture" in which self regulation and new financial instruments which helped banks hedge against risk and diversify their asset bases had created a sounder environment for banking. Virtually overnight a new policy image began to emerge. The failure relating to the financial crisis was systemic. Banks were engaged in ridiculously risky activities. Rating agencies were reveled to be little more then shell institutions with limited research to back up the solid credit ratings they had been giving the Asset Backed Securities (ABS) – referred to as Asset Backed Commercial Paper (ABCP) in Canada - at the centre of the crisis and industry self regulation appeared to be unworkable in light of incentives which rewarded risk at the expense of prudence. New policy ideas about regulatory reform have been supported by state actors in those jurisdictions that found themselves on the financial hook for the mess and by a variety of international institutions charged with promoting cooperation and coordination in bank regulation – the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB), and crucially the G20 (Helleiner and Pagliari 2009). The perceived shortcomings of existing policies were relatively quickly translated into a confusing welter of proposals, in various jurisdictions. While much of the focus for international cooperation has been on improving capital adequacy standards (perhaps the politically "easiest" response), states have also investigated limits on the involvement of commercial banks in securitized finance (which many believe was the core cause of the crisis; See Taylor 2008, or Roubini and Mihm 2010), new taxes on banks that were "too big too fail", reform of the "non bank" sector to bring those institutions under prudential standards, and major internal regulatory centralization to more effectively provide "macro-prudential" oversight of an ever more complex industry.

Post crisis, it is hard to conclude that commercial bank involvement in securitized finance, by diversifying bank's activities, has made them more secure. The fact that the more "securitized" a bank was, the more likely it was to run into trouble, seems hard to ignore (See for example Reguly 2009). Indeed many regulatory officials were caught off guard by the extent to which banks were holding securitized assets.[2] The existing policy image assumed banks would sell securitized assets to third parties, reap the commissions from creating or trading the products and move on. Instead, banks showed an alarming tendency to either transfer those assets to subsidiaries or to continue to carry obligations to buy them back if the assets turned sour (Goodhart 2008). More to the point, many of these continued obligations were off balance sheet, meaning they were not covered by banks' existing capital adequacy. If the assets did turn sour, banks could find themselves in big trouble. Far from making banking more secure, the blurring of commercial and investment banking made it difficult for regulators to judge banks' actual risk. While there are various explanations for why so many banks overexposed themselves to ABS (see Crotty 2009 for an extended discussion) the bottom line is that bank holdings of securitized assets were a key reason why so many banks ended up requiring bailouts, *despite being in compliance with existing national capital adequacy regulations*. By allowing banks to trade these products without requiring that they have appropriate capital reserves,

[2] The total stock of securitized loans going into the financial crisis is estimated to have been as much as USD $20 Trillion. The collapse of the US asset-backed securities, which initially fell by as much as 40% in value in late 2007 and early 2008 as many US mortgages became untenable, hit a number of international banks hard as many were operating close to, or below, the lines of international capital adequacy standards (their "core", or safe, capital comprised of shareholder equity and credit sound loans was too small a percentage relative to the amount of riskier assets they were holding). Ultimately this led banks in the spring and summer of 2008 to huge writedowns, record losses, and in some cases, to collapse.

assuming that they would not be foolish enough to expose themselves to insolvency should market conditions change, or that they had sufficiently insured themselves against loses through complex instruments like credit default swaps, regulators created the conditions that lead to the crisis. Combined with poor behavior by credit rating agencies and compensation schemes that punished prudent business strategies, many banks simply did not act wisely.

The Financial Crisis in Canada

Outside of the unified public front presented by industry and government that Canada "avoided the financial crisis", the lessons being drawn in other jurisdictions are applicable in Canada as well. While it is the case that no major Canadian firm failed during the crisis and that therefore the large publicly-funded rescues evident elsewhere were not necessary, it remains the case that Canadian investors and financial institutions lost billions (pension funds were particularly hard hit), deficiencies were exposed in existing regulation, and the country was driven into recession. More to the point, despite the dominant "framing" in Canada - that it illustrated the superiority of existing Canadian regulatory rules - it was not those rules but rather prudent business strategies that prevented Canadian firms from being embroiled in the crisis (Ireland and Webb 2010). Basically, it could be argued that the crisis did not really test Canadian regulatory institutions as Canadian banks had simply decided not to overexpose themselves to toxic ABS as banks in other jurisdictions did.[3] As Harris (2010) notes, many of the same financial instruments at the centre of the crisis in the Untied States were increasingly common in Canada. Canadian banks' trading of more exotic financial instruments was growing rapidly. Likewise, rules regarding mortgages had been substantially relaxed.[4] However, these activities came latter to the Canadian market, never became as prevalent and were always dominated by Canada's five "big banks", all reputed to be conservative institutions in terms of their orientation towards risk (Ireland and Webb 2010).

Lessons for Regulators?

In terms of what the crisis suggested about existing regulatory responsibilities, many of the same problems observed in the US were evident in the new and growing Canadian ABS (or "ABCP") market. When global markets began to express doubts about much of the ABS in circulation in 2007, about $32 billion worth of those type of assets "froze" in the Canadian market. While a negotiated settlement was eventually worked out to contain the "knock on" risks posed by the potential of a complete collapse of these assets – in part financially backstopped by the Department of Finance as one piece of its successful crisis management strategy, the ABS collapse was still the largest financial disaster in Canadian history. Billions were lost.[5] Similar to US experience, DBRS, the only credit rating agency active in the Canadian ABCP market, is widely regarded to have acted poorly, giving triple A credit ratings to problematic assets.[6] Provincial securities regulators also failed to require adequate disclosure statements about the nature of those assets (Chant 2008). More alarmingly, Canadian ABS were sold to retail investors, who clearly lacked the ability to judge their

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[3] One possible explanation for the more conservative natured of Canadian banks focus on the structure of the market itself given the fact that Governments since the 1990s have blocked further conglomeration. By both blocking foreign entry and by preventing aggressive mergers, the ogopolistic Canadian market has never developed the competitive incentives towards risk taking that other more deregulated markets have (Ireland and Webb 2010, p. 95.) Essentially the "conservative culture" of Canadian banks may have a lot to do with the lack of "cut throat" competition in the domestic market. Regardless many suspect that it might be the culture of bank prudence in Canada rather then effective regulators, which explain Canada's recent success.

[4] For example, prior to the US melt down, zero-equity mortgages were becoming more common.

[5] A recent study by Moody's Investment Services estimated that Canadian banks have lost almost $22 billion in potential dividends as a result of write downs etc associated with the crisis.

[6] For some of the salacious background details on the relationship between DBRS and the Canadian issuers of ABC see, National Post, "The architects of ABCP", Monday January 14, 2008.

soundness – this is particularly concerning given potential conflicts of interest as a large institution like one of the big banks acting as an investment advisor to clients may find itself in some "tricky" conflicts of interest in recommending ABS. Indeed, fines relating to the settlement of the ABS mess totaled close to a quarter of a billion dollars.[7] Finally, as will be discussed below, despite the central role of the federally-regulated banks in the ABS market, the Office of the Superintendent of Financial Institutions (OSFI), Canada's prudential regulator, refused to recognize any regulatory responsibility for overseeing their ABCP activities – both before and after the crisis. OSFI also has no oversight of the Canadian Mortgage and Housing Corporation which insures many of the mortgages held by Canadian banks. There are similar risk to the Canadian systems as those exposed by the Fannie Mae and Freddie Mac collapses in the US. Finally, it is also crucial to note that had Canadian bank's been caught up more deeply, the cost of rescuing one or more of those institutions would have been proportionately higher in Canada given industry concentration (Nivola and Courtney 2010).

Thus, many of the conclusions drawn elsewhere about the limitations of existing fragmented regulatory arrangements are equally applicable in Canada, it just has not been as widely recognized, in part because many believe that whatever the problems, Canada's higher capital adequacy standards ensured that no bank was sufficiently at risk of collapse. Industry participants and government officials simply insist that these rules insured that Canadian banks were "conservative" in relation to their involvement in securitization. In light of the extent to which those standards generally proved to be illusory elsewhere given the unforeseen consequences of securitization and off balance sheet activities, it seems a stretch to suggest that the standards simply "worked" in Canada.[8] Indeed prior to the crisis, Canada's big banks were actually more prudent then they were required to be, maintaining capital adequacy levels in excess of the regulatory minimum. Nothing OSFI was doing in relation to capital standards would have prevented Canadian banks from being more heavily involved in the toxic US-ABS market had they wanted to be.[9] In fact, RBC, one of Canada's largest banks did get heavily involved in the US subprime mortgage business in 2000, but sold off its US subsidiary, RBC Mortgage, to New Century Mortgage in 2005. New Century went bankrupt in 2007. This again illustrates the extent to which the good performance of Canadian firms had more to do with good management then good regulation. RBC could have been caught up far more deeply in the US ABS market then was the case, but they got out of the market before the meltdown.[10]

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[7] The penalties resulted from evidence that financial services firms, including some of the big banks, knew that the ABS were increasingly questionable, but continued to recommend them to their clients (the implication being that the banks might have been reducing their own exposure by unloading the paper). This mirrors lessons from the United States that there are potential conflicts of interest when commercial banks that provide securities advising also get directly involved in creating ABS and trading on their own account.

[8] Its also worth noting that Spain was likewise once seen as a "success story" because none of its banks failed during the crisis (meaning its regulatory system must be better . . . or so the argument went). However, in the wake of the Greek financial crisis last summer's European "Bank Stress Test" exercise revealed that Spanish banks were some of the most troubled in Europe.

[9] For example, Canadian capital adequacy rules have the same problems relating to the underestimation of "off balance sheet" activities that existed in other jurisdictions. See, Nick Le Pan, "Canadian System and the Financial Crisis," Presentation to the Woodrow Wilson/Brookings Institution, June 23, 2009. Furthermore Canadian rules are enforced on a case by case basis. The Superintendent, when pressed, has allowed firms to go below minimum standards. During the financial crisis, Manulife Financial was allowed to go below necessary capital requirements providing the firm with a "lifeline" to survive the crisis. See Tara Perkins "Nobody's Savior", Globe and Mail, April 20, 2009.

[10] See Perkins, Tara, "Legacy at the Crossroads," Globe and Mail, August 16, 2009. Much of the growth in banks' holdings and obligations relating to "off balance sheet" securitized assets occurred after 2004 (Blundell-Wignall,

The bottom line is that Canadian industry and Canadian officials have tended to ignore the lessons about regulatory problems because no major Canadian institution failed. In turn, officials constantly claim that the success of the Canadian system can be attributed to marginally higher capital adequacy standards. So much so that they frequently argue that the only reforms necessary in response to this crisis are that the rest of the world should just adopt Canada's standards. The real risk of this argument is that while it is probably wrong, it has also helped deflect attention from other areas of concern. The question is to what extent this reflect problems with existing policy capacity.

III - Governance Arrangements – Integrated Policy Making in Finance?

Financial services policy-making has evolved considerably in recent decades largely due to globalization and industry deregulation. Prior to the Mulroney Government's decision to deregulate the financial services industry in the 1980s, the sector was segmented into different industries. The mortgage and trust industry and the securities industry were provincially regulated and outside of federal jurisdiction. Banking, under the *Constitution Act* (1982), was a federal jurisdiction. Market segmentation had been pursued to achieve a number of different policy goals (Harris 1999). In particular, it kept commercial banking (dominated by the "big banks" separate from investment banking (the "securities industry"). It also established distinct policy domains for financial services as federal policymaking focused almost exclusively on banking, while provincial authorities where responsible fro regulating investment functions relation to the securities industry. Prior to deregulation, federal banking policy was described as a highly integrated policy community (or "subgovernment") in which only the leading industry participants, and the Department of Finance, played a significant role in policymaking (Coleman 1996). Policy developments were guided by a close set of informal personal relations between industry and government officials (Harris 1999) that supported a tight consensus in policy goals.

Deregulation altered policymaking dynamics (Williams 2009). In the private sector, the banks immediately emerged as the leading players in the new environment as they grew rapidly in size and profitability. They came to dominate the securities sector, took over the remaining second tier of local (trust company) banks and began to further diversify their operations into insurance. Despite this emerging market dominance, post-deregulation policymaking has become far more complex as policy debates were increasingly "politicized" (Harris 2004, Williams 2004). A number of previously uninvolved, or unimportant, players emerged as key stakeholders leading to a far more open and public set of policy debates. By expanding the powers of federally-regulated banks, allowing them into the securities sector and potentially allowing them to fully participate in the insurance sector, the federal government blurred existing policy domains expanding the range of influential subsystem participants (Williams 2009). In this environment, despite some relatively small developments, policy change and regulatory reform since the deregulation period has proven difficult.

Most importantly, repeated proposals for the creation of a national securities regulator have gone nowhere – despite broadly accepted analyses that this is a "good idea" in light of the growing complexity of the industry. During deregulation the federal government promised some sort of plan to regulate the newly integrated securities industry, and has continued to pursue a variety of strategies to get the provinces to agree to federally-coordinated reform of securities regulation -

Atkinson, and Lee 2008). While many banks increased their exposure in the run up to the crisis, it appears Canadian banks were doing the opposite.

indeed the federal government would like to assert *Constitutional* jurisdiction over the sector.[11] However several provinces have jealously defended their remaining tenuous control over the securities industry (Roberge 2005), even in light of the lessons of the recent financial crisis in which their "supervision" appears to have been inadequate (Harris 2010, Williams 2010).

While many have become embittered by the "gridlock" in the sector, the broader point is that the prospects for serious policy changes of any type have been poor as subsystem actors have pursued irreconcilable agendas. The insurance industry simply wants to defend its turf from the banking industry. Consumer and small business groups have sought various consumer protection initiatives such as the regulation of service fees on debit cards and credit cards. The provinces have defended their jurisdiction over the securities industry even though many lack the capability to fulfill this role effectively; while the Federal government has sought to expand its power relative to the provinces.

Against this broad context, it does seem nonetheless that governance arrangements in the finance could be well integrated, except in those areas like securities industry regulation where ongoing constitutional struggles have undermined effective policy capacity (Harris 2010, Williams 2010). The Department of Finance is undoubtedly the central agency in the sector. It has a central coordinating role over other regulatory and policymaking institutions. Indeed, since the financial crisis, this role has been formalized as a Finance Assistant Deputy Minister now chairs FISC – which is the central committee tasked with coordination of the different Canadian finance authorities - FISC brings Finance together with the Bank of Canada, the Canadian Deposit Insurance Corporation, The Office of the Superintended of Financial Institutions, and if, it is ever created, a representative of the national securities regulator. FISC is intended to be a central "clearing house" for broad issues relating to finance. Through these kinds of mechanisms, Finance is well supported by its associate federal agencies in policy analyses – in particular the Bank of Canada and OSFI.

Again, it is important to note that despite considerable evidence of integration, there is one major shortfall relating to federal-provincial relations. Essentially the provinces' insistence that they maintain jurisdiction over the securities industry has led to both duplication of responsibilities between federal and provincial authorities, and also a "missing seat" at the FISC table as there is no national securities regulator to oversee the securitized aspects of modern finance - the governance arrangements appear to facilitate effective analytical capacity except in those areas requiring federal and provincial cooperation and coordination; in those areas governance arrangements are not integrated, and in fact are often quite conflictual.[12]

IV - Assessing Analytical Capacity

As alluded to above, assessing "analytical capacity" is a bit nebulous. On the surface, it seems reasonable to suggest that analytical capacity on financial services issues is quite high, at least at the federal level. A review of the budgets of key federal agencies suggest that the Department of

[11] When the federal government allowed federally-regulated banks into the securities business they claimed the *Constitution* was fuzzy on the issue. Federal authorities maintain to this day that the *Constitution* could actually be interpreted as giving the federal government the power to regulate the sector. See Gray and Kitching (2005). Provincial securities authorities are currently awaiting a court ruling on this issue that may have considerable implications for the future of Federal oversight of the sector.

[12] Indeed in the mismanagement of the regulation of the securities at the centre of the $32 billion Asset Backed Commercial Paper market collapse exposed by the global financial crisis, there has been considerable finger-pointing and accusations by both levels of government, highlighting how broken the arrangements are in that sector.

Finance, OSFI and the Bank of Canada should all have considerable capacity in this sense in terms of staff resources. Furthermore, the policy advice and support offered to Finance by the BoC and OSFI seems particularly valuable in that staff are encouraged to see themselves as serious researchers (Bank staff are notable for publishing their own research findings for example). Furthermore staff budgets have grown considerably over the last decade; OSFI in particular has seen a significant increase. Furthermore, several recent survey projects have illustrated that policy staff at central Federal agencies have considerably more "capacity" in terms of their training, education, time and research competencies to engage in more sophisticated policy analysis then is the case for other types of government agencies (See for example, Wellstead et al. 2009). Indeed these kind of "cognitive" capacities for policy analysis seem to be much higher in the larger, more formalized "policy shops" that exist in the Federal Government's central agencies.

On the other hand, there is considerable reason to question the provinces' analytical capacity, which is particularly relevant here given their insistence that they should regulate the increasingly complex securities sector. As one recent study of provincial analytical capacity concluded:

> Provincial and territorial analysts, like their federal counterparts, are highly educated . . . . But they do not tend to have a great deal of formal training in policy analysis and mainly work in small units deeply embedded in provincial and territorial ministries . . . . They lack substantive knowledge in the areas in which they work and of formal policy analytical techniques and tend to bring only process-related knowledge to the table. They also tend to work on a relatively small number of issue areas, often on a "firefighting" basis . . . . [They] can be thought of as working in an interactive "client-advice" style somewhat removed from the traditional "rational style promoted by . . . policy schools. (Howlett and Newman 2010)

This general pattern is likely to be pronounced in finance. While provincial finance ministries are quite large and well staffed, their mandates are much narrower then the Federal Department of Finance, and they are not supported by the high quality satellite agencies charged with particular policy roles that serve the federal government – provincial securities regulators, for example, in some instances are virtually "shell" organizations with little permanent staff and analytical capacity.

Survey data collected for a SSHRC CEI project on the capacity of Canadian policymakers tends to support this conclusion.[13] As Tables 2-4 illustrate, suspicion about differences in the training and education of officials in the two levels of government are evidenced in the survey. Generally, Provincial officials are not as well educated, are less likely to have training in the social sciences and policy analysis, and are broadly more likely to have a training background in business administration (this is not true of those who work in finance agencies specifically, though the samples get quite small for that category in any event).

[13] The survey, completed in 2010, was directed to government policy analysts and administrators working in federal and provincial government policy analysis. Aside from examining the officials' knowledge of climate change adaptation challenges, it also sought information on their research experience, competencies, educational backgrounds and most interestingly, the organization of their policy related research activities in government. A total of 636 officials completed the survey, of which 185 (29%) worked for the federal government. Within the overall total,. 15% of the respondents self-identified as working in a "finance-related" agency.

Table Two
Education levels in the Public Service, by Level of Government

	Non-Finance Related Agencies		Finance-Related Agencies	
	Provincial	Federal	Provincial	Federal
High School	2.41%	0	6.38%	0
College-Tech School	10.69%	0.85%	6.38%	0
University	33.10%	27.12%	27.66%	11.11%
Graduate or professional degree	53.79%	72.03%	59.57%	88.89%

Table Three
Differences in Type of Education, by Level

	Non-finance related agencies		Finance-related agencies	
	Provincial	Federal	Provincial	Federal
Business or Administration	12.42%	5.95%	25.00%	26.00%
Computing Science	0.67%	2.16%	0.00%	0.00%
Engineering	7.76%	3.24%	2.41%	6.67%
Natural Sciences	24.61%	35.14%	1.20%	0.00%
Social Sciences	12.20%	21.62%	16.87%	33.33%

Table Four
Number of Post-Secondary Policy-Specific courses undertaken, by Level of Government

	Non-finance related agencies		Finance-related agencies	
	Provincial	Federal	Provincial	Federal
None	35.32%	45.71%	34.88%	0
One	13.19%	8.57%	11.63%	0
Two	16.60%	7.62%	6.98%	33.33
Three or More	34.89%	38.10%	46.51%	66.66%

There also appears to be statistically significant differences in the basic organization of policy analytical work at the federal and provincial levels (Tables 5-8). Generally provincial policy analysts are more likely to see their role as involving negotiation with stakeholders, short term "firefighting" and are less likely to use evidenced based approaches; it might be fair to suggest provincial officials are more commonly engaged in process related activities, while there is more scope for actual policy research at the federal level.

Table Five
Types of Analytical Policy Work Involved With, by Level of Government

	Provincial	Federal
Appraise policy options	2.95	2.56
Brief high-level decision-makers	2.16	1.78
Collect policy-related data or info	.	.
Conduct policy-related research	.	.
Conduct scientific research	1.85	2.63
Consult with decision-makers	3.16	2.93
Consult with the public	2.19	1.77
Evaluate policy processes	2.74	2.15
Evaluate policy results and outcomes	2.65	2.4
Identify policy issues	3.12	2.86
Identify policy options	2.99	2.7
Implement/delivery policies/programs	2.72	2.44
Negotiate with central agencies	2.11	1.62
Negotiate with program managers	2.46	2.27
Negotiate with stakeholders on policy	2.11	1.89

Numbers reflect mean use rating per group on 1-5 scale, where 1=never and 5=daily
"." Reflects no significant difference

* Provincial/Federal differences across Financial Agencies are statistically significant in appraisal of policy options (mean of 2.74 vs. 3.57); collection of policy-related data (mean of 3.61 vs. 4.36); conducting policy-related research (mean of 3.27 vs. 4.07); conducting scientific research (mean of 1.23 vs. 2.07) identification of policy issues (mean of 3.01 vs. 3.78); identification of policy options (mean of 2.82 vs. 3.64); and negotiation with central agencies (mean of 1.96 vs. 2.57)

Table Six
Differences in Timelines of Types of Tasks Dealt With, by Level of Government

	Provincial	Federal
Tasks demand immediate action (fire-fighting)	3.24	2.89
Short-term tasks (resolved in 1 month)	3.41	3.19
Medium-term tasks (1-6 months)	.	.
Long-term tasks (6-12 months)	.	.
Very long-term (ongoing for more than 1 year)	.	.

Numbers reflect mean use rating per group on 1-5 scale, where 1=never and 5=daily

Table Seven
Experience with Evidence-Based Approaches, by Level of Government

	Provincial	Federal
Have heard of evidence-based approaches	0.695	0.61
Use evidence-based approaches	0.684	0.767
Have access to academic & professional studies	0.82	0.934

Numbers reflect mean use rating per group on 0-1 scale, where 0=no and 1=yes

Table Eight
Support for Evidence-Based Approaches amongst users, by Level of Government

	Provincial	Federal
Required to use evidence-informed method	3.52	3.85
Provided with tools to implement method	3.18	3.47
Encouraged by managers to use method	3.45	3.75
Have access to relevant information and data	.	.
Evidence is used to inform decision-making	.	.

Numbers reflect mean use rating per group on 1-5 scale, where 1=never and 5=daily

Table Nine
Differences in Types of Analytical Tools Used for Policy Analysis, by Level of Governmen

	Provincial	Federal
Bayesian methods	0.96	1.23
Checklists	1.05	1.12
Cost benefit analysis	1.26	1.44
Cost-effectiveness analysis	1.29	1.46
Cross-impact analysis	1.19	1.39
Decision analysis	1.18	1.32
Economic impact analysis	1.36	1.51
Financial analysis	1.33	1.55
Multi-criteria analysis	1.34	1.48
Policy exercises	1.23	1.4
Preference scales	1.36	1.57
Problem mapping tools	1.34	1.48
Process influence diagrams	1.4	1.55
Ranking/dominance analysis	1.34	1.48
Social impact analysis	1.38	1.56

Numbers reflect mean use rating per group on 1-5 scale, where 1=never and 5=daily

* Provincial/Federal differences across Financial Agencies rarely statistically significant, with a few exceptions, in which federal financial agencies use the given tools more: Cross impact analysis (mean of 1.09 vs. 1.46); Fault-event trees (mean of 1.44 vs. 1.84); Markov-Chain modeling (mean of 1.29 vs. 1.77); and Social impact analysis (mean of 1.25 vs. 1.67)
* For all other analytical tools, no differences across two levels of government

Table Ten
Types of Information Sources Used in Policy Work, by Level of Government

	Provincial	Federal
Academic Research	3.08	3.41
Budget and Cost Data	2.79	2.72
Conference Presentations	2.67	2.87
Government Platforms	2.78	2.56
Newspapers and News magazines	.	.
Personal Experience	.	.
Personal Opinion	3.17	2.81
Professional Advice	.	.
Reports from Consultants	2.94	2.75
Reports from Foreign Governments	2.19	2.58
Reports from Industry	.	.
Reports from NGOs	.	.
Reports from other domestic gov	.	.
Reports from Think Tanks	.	.
Reports produced within your gov	.	.
Results of formal evaluation	.	.
Scientific Findings	2.79	3.34
Survey data	.	.
Workshops	.	.

Numbers reflect mean use rating per group on 1-5 scale, where 1=never and 5=daily
"." Reflects no significant difference

* Provincial/Federal differences across Financial Agencies rarely statistically significant, with two exceptions: reports from foreign governments used substantially more among federal financial agencies compared to provincial (mean of 2 vs. 2.75); and scientific reports used substantially more among federal financial agencies compared to provincial (mean of 1.64 vs. 2.5)

Finally, although many of the variations are small, there are statistically significant differences in the types of research tools the two groups report the use of (Table 9), and some more significant differences in key sources of information they identify as using in their policy deliberations (Table 10). It is interesting to note, for example that federal officials are more likely to rely on "academic research", "reports from foreign governments" and "scientific findings" in their analyses, while provincial officials are particularly reliant on "reports from consultants" and "personal opinion."

While it is hard to draw too much out of this in terms of what it means for financial services related policy analysis specifically, these findings seem to confirm broad suspicion about the different quality of policy analytical capacity across the two levels of government. In fact what emerges from this overview is a general sense that Canadian financial regulators have overlapping and competing responsibilities - indeed there are real ambiguities between provincial and federal authorities about who is responsible for evaluating the risks posed by issues like the development of the ABCP market - and this is combined with some sense that the provinces have generally weaker capacities (in terms of skills, staff resources, and connections to international sources of information) to conduct the necessary policy research to meet the challenges of complex financial markets.

Returning to Figure 1, if governance arrangements and policy capacity are poor, it seems likely that governments will fail to systematically learn from the financial crisis and serious evaluate regulatory reform proposals - it is a mix of factors prone to policy failure. In fact, to date Canadian authorities (OSFI and the provincial securities regulators in particular) have produced little in the way of serious analysis of the lessons of the financial crisis. Instead they have sought to avoid their responsibilities.

V– The Regulatory Response:

Despite the fact that Canadian regulatory structures had similar vulnerabilities to other jurisdictions and that the fallout form the crisis was large, the fact that no major firm failed has allowed a different response to emerge. Aside from the Bank of Canada, regulatory agencies and officials seem less interested in dealing with the problems exposed by the crisis then continuing with preexisting struggles over jurisdictional responsibilities. As time has gone on, Canadian officials have shown an increasing willingness to aggressively oppose the reform proposals of other countries. OSFI, echoing the Finance Minister, the Prime Minster echoing and the sentiments of the Canadian Bankers Association, the peak industry lobby, have suggested that the many of the proposals being promoted at the G20 and elsewhere are unnecessary. Indeed Canadian officials have been particularly fierce in opposing any new taxes on the industry or absolute caps on executive compensation. As the finance minister has put it:

> We are not about to impose new taxes on financial institutions in this country. We are not about to impose limits or terms on executive compensation in the financial institutions in Canada, for a very simple reason: Canadians did not have to put taxpayer's money into our financial institutions. We did not have to bail them out (quoted from Torobin 2009).

Nancy Hughes, the president of the CBA has argued simply that Canada must not get caught up in a "wave of regulation mania" as people should remember "how well our system works and how good we really are."[14] In this environment, many of the concrete proposals for reform discussed elsewhere have not been investigated and are explicitly opposed by the Canadian authorities. Some of them have simply not been seriously discussed because it is unclear which agency should be responsible for reforms.

Response of OSFI:

As Canada's prudential regulator, OSFI is primarily responsible for assessing risks in relation to firms' financial holdings and certain kinds of financial assets. OSFI's job is to make sure banks and insurance companies are sufficiently covered against potential liabilities. It also has an oversight role in assessing the long term soundness of pension funds. OFSI was hurriedly created during the process of deregulation in the 1980s when a number of smaller Canadian banks failed. Reporting to the Department of Finance, OSFI is charged with overseeing the soundness of all federally-regulated financial services firms (including the big banks and insurance companies). However, OSFI has traditionally been seen as weak and understaffed institution which has relied heavily on the banks to do the business of ensuring prudential standards themselves (Williams 2009). Adding to its challenges, in recent years the range of "risks" OSFI has ostensibly been monitoring has expanded considerably.

[14] Quoted from Bloomberg News, December 7, 2009.

As Harris (2010) argues, much of OSFI's response to the financial crisis has taken the form of denying its broad mandate to oversee the soundness of the industry, by instead self-limiting its mandate to enforcing existing capital adequacy standards however ineffective those standards might be. As Harris notes, OSFI did and said very little in the lead up to the crisis in relation to Canadian bank's rapidly growing involvement in the ABS market. When the financial crisis first broke and the Canadian ABCP problem appeared to threaten the soundness of some Canadian firms, many observers argued that it had failed as a *prudential* regulator. Julie Dickson, the current Superintendent, responded by denying that OSFIwas responsible for the ABCP market, passing the blame to the Ontario Securities Commission which she claimed should have been monitoring the situation more closely (DeCloat 2008). In the *House of Commons Finance Committee*, she argued that because no major bank had collapsed, OSFI had done its job, and that the ABCP problem was outside of her jurisdiction. Indeed this has been OSFI response to almost all aspects of the crisis – that OSFI enforcement of "better" Canadian capital adequacy standards had prevented any serious bank collapse (meaning OSFI had fulfilled its central role). Indeed despite the fact that much of the Canadian ABCP were held by the big banks she was supervising (or sold by them to their clients), she claimed it was outside of her responsibility because many of the smaller investment firms that created the paper were not federally regulated institutions (Brzezinski 2009). One can only wonder how that argument would have gone over had a major Canadian bank gone under because it held too much toxic ABCP?

As Harris (2010, p. 76.) notes in his harsh criticism of OSFI, its response to the crisis actually involves denying OSFI's legal mandate. However, it was good "institutional politics" as pointing the blame at provincial securities commissions supported the federal government's arguments that the mess was their fault and that this proved a single national securities regulator was necessary. From a prudential perspective, OSFI finger pointing at the securities commissions is worrying, given the larger lessons of the financial crisis. As other jurisdictions have learned capital adequacy standards themselves will not ensure banks remain sound in a crisis if poorly regulated new financial instruments have created unforeseen risks. Ironically, given the risks of this stance, despite initial criticism that seemed to re-emphasize exiting concerns that the OSFI was an under funded, understaffed and ineffective regulator, when the full scope of the crisis elsewhere became apparent, federal officials, and industry participants leant their support to the Superintendent suggesting that the higher capital adequacy standards that OSFI oversaw had played a big role in limiting the impact on Canada. In a sense, for institutionally self interested reasons, OSFI has tried to promote "learning" of the wrong lessons from the financial crisis, because a more serious assessment would reflect poorly on OSFI. Seeking to avoid responsibility for the ABS mess, they have helped reinforce the belief that all Canadian officials need to do is rely on Canada's existing capital adequacy standards.

Indeed, since the crisis, OSFI has gone further in support of the federal government's efforts to limit the scope of any new regulatory standards. For example, OSFI tried to help Canada's case against a bank tax – by promoting its own, poorly thought out "embedded contingent capital" (ECC) proposal to deal with the "too big to fail problem". OSFI suggested that instead of taxing banks to create a bailout fund, each individual bank should be required to issue a kind of security that could be converted into common equity if the bank ran into capital adequacy problems – this ECC would be in addition to whatever new capital requirements were ultimately set by the BCBS process. The proposal was widely lauded, even by the same Canadian banks that wanted the government to oppose a systematic bank tax, as the proposal was probably unworkable.[15] Regardless, the point here is that the OSFI has placed itself in the role of "seconding" the Canadian banks attempts to dull more strident global regulatory efforts and reveals the extent to which it has not seriously thought about the "too big to fail problem" and what the bailout of one of Canada's banks would actually mean to Canadian taxpayers.

Finally, despite "hanging its hat" on Canada's purportedly tougher capital adequacy standards, unlike the Bank of Canada, OSFI does not seem as concerned about what the Basel III regulations will eventually entail, instead moving as quickly as possible to reduce the *ad hoc*, higher standards Canadian banks have been voluntarily living with since 2008 (in relation to assets, Canadian banks have been holding over 10% "tier 1" capital to insure they remain sound until the financial crisis is "over"). The Canadian Bankers Association has pressured the federal government and OSFI to work towards a time frame for implementing new standards that will not result in them having to meet tougher standards before still fragile banks in other jurisdictions have to meet them – they have filled the business press with some rather odd information in relation to this goal.[16] However, what the banks really want is to be set free from the temporary tighter capital controls that were imposed on them during the crisis so they can take advantage of their position of strength to expand into other markets – something the OSFI has publicly said it would like to allow once they get a clearer idea of what Basil III will actually entail. In fact, as it is currently formulated (pending the next meeting of the G20 in South Korea), the Basel III package would require Canada to adopt minimum capital to asset ratios of 7% (during good economic conditions). Under the new accounting system for measuring capital, capital would have to be actual bank equity meaning that the new standards are likely to be more stringent then Canada's pre-crisis capital requirements, but less stringent than the 10% plus standard currently requested by OSFI. Also banks would have years to reach the new standards, meaning that in the interim Canadian banks will likely be allowed to go back to Canada's pre-crisis standards.[17]

Response of provincial securities regulators

The other side of the coin from OSFI has been the response of the provincial securities regulators. Unlike OSFI, despite their poor performance (see above) in managing the growth of the ABCP market, they have sought to maintain their jurisdiction and oversight over the sector – at least in some provinces. Indeed while provincial authorities have panned the federal governments' plans to assert regulatory responsibility over the securities sector, the provincial securities commissions, lead by the Ontario Securities Commission (OSC) - the largest and most important - have provided littel analysis of the crisis and lessons for Canadian regulations. Working with international authorities the provincial commissions have released a consultation paper outlining how they would tighten disclosure requirements in the ABCP sector. However the OSC, in a number of formal responses to the crisis has denied responsibility for the larger questions being discussed elsewhere. In one recent summation of its activities in response to the crisis to the Ontario legislature, the OSC reminded provincial officials that, "It is important to note that the Commission is a market conduct regulator and not a financial stability regulator," suggesting that it was OSFI's responsibility to deal with the bigger questions (Wilson 2009). Thus, despite changes to the disclosure rules, provincial securities

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[15] The proposal would have required that investors be willing to buy securities that would automatically become shares of a failing bank in any financial crisis – obviously an unattractive financial asset. For the Canadian Bankers Association critical response to this "well-intentioned" proposals see Boyd Erman and Tara Perkins, "Bankers cast doubt on tax alternative," Globe and Mail, June 8, 2010.

[16] See for example, Grant Robertson, "G20 rule means Canadian banks 'have to go first'," Globe and Mail, June 28, 2010.

[17] See for example Grant Robertson, "Regulator to take leash of banks," Globe and Mail, September 7, 2010.

commissions are unlikely to do a great deal about the basic informational and conflict of interest problems posed by securitized finance, particularly not when they frequently view themselves as being in a competitive situation in relation to one another, struggling to attract the securities business away from other provinces.

Furthermore, given that the securities commissions do not see their role as being one of overall macro prudential stability, they are unlikely to be overly concerned with the underlying risks posed to financial institutions involved in the holding of those assets provided basic conduct rules are not violated. To hammer home this point, fully three years after the crisis, provincial regulators are only now formulating proposals for what they might do to regulate discredited Canadian bond rating agencies.

To be fair, Federal officials have not tabled any serious analysis of what they would do about these issues either. While the federal government has tried to sell the idea that the crisis supports their claims for federal jurisdiction over securities (and a national securities regulator is probably a "good idea"), because several provinces (most crucially, Quebec and Alberta) have traditionally defended provincial jurisdiction, efforts to create a national regulator have always failed. Canada is one of the few jurisdictions in which the central government does not have control over the securities regulation - though the major industry players that might be undermined by riskier behavior are already federally-regulated and insured institutions.[18] It is also certainly the case that the crisis exposed the lack of macro oversight of the financial services industry (as the fines in relation to the ABS problem in Canada illustrate), it is not clear that in taking a larger jurisdictional role over the securities industry, that the government has serious plans to actually implement new, tighter regulations – at least they have not released concrete proposals. For example, while the federal government has agreed with G20/FSF communiqués which support improved regulation of credit rating agencies, it has never proposed how it would do this – would this be the responsibility of the new securities regulator (as it is currently the responsibility of provincial securities regulators), and if so what kind of regulations would exist? Rather than addressing the site of systemic risk, federal officials have simply joined in the finger pointing suggesting the problem lies with provincial securities regulation.

Other Unresolved Problems

The institutional and analytical capacity limitations of Canada's existing regulators have meant that a number of other policy lessons from the crisis have received little attention. For example, on institutional reform for the purposes of macro prudential regulation, the FSF and G20 push towards a reorganization of domestic regulatory structures has not drawn a great deal of interest. Aside from the initiative to create a national securities regulator, the Government claims that the current regulatory institutions are adequate. The argument is that the existing informal *Financial Institutions Supervisory Committee* (FISC) can serve this purpose, the only he reform being that in the future, Department of Finance officials will chair FISC instead of the OSFI (Carmichael 2009).

On bonuses and pay concerns raised in other countries, Canadian officials have shown that they recognize the problems with the pro-cyclical dynamics of bankers' compensation and have already informed the banks that they would have to abide by any international agreement that alters the system of executive bonuses. Unlike many other jurisdictions, officials have publicly rejected any discussion of "caps" on the size of compensation – a move supported by Canada's big banks - though again this does not seem to have involved a serious investigation of the issue. While

[18] For Flaherty's most pointed comments on the issue see, Perkins (2008c).

regulating employee compensation is certainly a complex issue, the fact is that Canada has seen a rapid escalation in bank bonuses. For example in 2009, incentive pay at Canada's big banks approached almost $10 billion dollars. Despite the fallout of the financial crisis, and loses being posted at some institutions, bonuses at the big six banks grew by 20%. As one bank critic noted, bonuses in 2009 exceeded the net profits and net taxes paid by the big banks, *combined* (Confidential Interviews).

VI- Conclusions:

Canadian responses to the financial crisis illustrate that while capacity in the form of knowledge about the challenges confronting the financial service industry might be high – particularly in terms of the Bank of Canada's leading and persuasive role in selling the tougher capital adequacy standards associated with Basel III, beyond that, Canadian regulatory agencies and the Department of Finance have embraced more bounded interpretations of the crisis.

> . . . with a multi-agency regulatory system at the federal level and dispersed securities regulation at the provincial level it is unclear who speaks for the system as a whole. It is not the central bank . . . , it is not OSFI (although OSFI does have the mandate to monitor system-wide activities), and it is not the provincial regulators. Indeed this decentralized structure allows bureaucrats to avoid responsibility for ensuring a safe and sound financial system. There is no authority representing the interests of Canadians generally. Each institution defends its own interests, while Canadians pick up the tab for errors or negligence.(Harris 2010, p. 77)

Throughout the process the OSFI has limited its observations to the prudential aspects relating to the soundness of Canada's major banks, choosing to deflect demands that it meet its responsibility for oversight of the industry as a whole. At the same time there is no national securities regulator, which means (given the OSFI's unwillingness to deal with securitization) that no agency has stepped forward to take responsibility for the poor oversight of the Canadian ABS sector (or to champion systematic new regulations) and no initiatives to better regulate rating agencies have bee seriously proposed. Instead, Canadian officials have resuscitated a decade long jurisdictional struggle over who should regulate the securities industry (with little discussion of what either level of government would do differently). Likewise, Finance, traditionally a close supporter of the interests of Canada's leading banks, has spent its efforts heading off any aggressive global regulatory initiatives that would impose new costs.

The point in all of this that whatever capacity governments' may have is not being well deployed in support of evidence based policy learning. Both Federal and Provincial authorities have failed to offer sustained analysis of the problems confronting Canadian regulators, in large part due to self interest and jurisdictional squabbling. Under the circumstance it should not be surprising that there has been little attention in Canada devoted to some of the reform proposals being discussed in other jurisdictions.

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