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# Measures of Investor Confidence in Capital Markets

## BUILDING A SAFE AND RESILIENT CANADA

In the pre-crisis culture, no regulator saw its job as protecting the economy or financial system as a whole. In the post-crisis culture, there is an understanding that all reforms must be accompanied by constant monitoring of potential vulnerabilities in the financial systems and heightened readiness to respond to any new fault lines that may appear.

In the years leading to the global financial crisis of 2007-2008, risks increased in the financial system to levels now understood to be dangerous on a global scale. Rising asset prices in the United States (US), particularly in housing, concealed the lack of transparency and weakening of credit underwriting standards. These masked the growing leverage throughout the financial system and behaviour that courts and governments are now, in some cases, judged to be criminal.

There was some high level recognition that all was not right. “The G20 committed in 2008 to a fundamental reform of the financial system as a safer, more resilient source of finance that better serves the real economy.”<sup>1</sup> Shocks of the global financial crisis have had a significant impact on consumer and business confidence, especially when they happen globally.

This paper reviews open source literature regarding the governance of, and practices followed by, the financial markets in Australia, the United Kingdom (UK) and the US, and compares these practices to Canada. It looks at the measures used to build more resilient financial institutions and bolster investor confidence. Each country reviewed has established legislation and practices that were intended to promote accountability, responsibility and transparency, while encouraging innovation.

The global financial crisis underlined how important liquidity is to the financial system. It has also provided forceful reminders that liquidity is largely dependent on

trust. When confidence (trust) was eroded, liquidity disappeared. The erosion of confidence was shown in the collapse of credible residential mortgage-backed securities. For example, Northern Rock was one of the first of several banks that fell into illiquidity in 2007 and then insolvency in 2008 after other banks would no longer lend to it.<sup>2</sup> When the news of Northern Rock’s failed strategy caused its depositors to withdraw their funds, the bank had to be saved by the UK Government with £1.4 billion of taxpayers’ money.<sup>3</sup> The larger and more important consequence was the erosion of public trust in the entire system.

In the case of Lehmann Brothers, once the fourth largest investment bank in the US, breakdowns of trust, combined with the misuse of financial leverage, played a central role in its collapse. The Lehmann collapse intensified the credit crunch and loss of confidence in all financial firms. This completed the transformation of situations that should have been manageable in more prudent times into a systemic financial crisis.

The Australian financial system weathered the financial crisis well.<sup>4</sup> Australian structural reforms ensured that macroeconomic conditions at the time of the crisis were favourable, while proactive measures and stabilizers buffered the economy from a sharp deterioration in global economic conditions.<sup>5</sup>

Similarly, the response of the Canadian authorities to the global financial crisis was swift and effective.<sup>6</sup> “The strength of the economy and the financial system at the onset of the crisis meant that no Canadian financial institution failed or required government support in the form of capital injection or debt guarantees.”<sup>7</sup>

The crisis was so deep and far reaching that the Financial Stability Board (FSB) had to go back to the

basic principles of financial regulation and supervision. This led to endorsement of 'Basel III' as the fundamental overhaul of international regulatory standards for banks, to substantially raise the quantity and quality of their capital and liquidity. Each FSB country has adopted rules to implement those new standards and is reviewing each other's practical implementation of the standards line-by-line in peer reviews.

The post-crisis response involved strengthening the systemic or macro-prudential orientation of regulatory and supervisory frameworks. Policy and regulatory initiatives have tightened regulatory standards and expanded the perimeter of regulation of the financial sector. These efforts have taken place domestically, regionally and globally. Global regulation has evolved with the set-up of new bodies to oversee European and international financial market regulation. At the European level, these include the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority. All are regulators in policy development and coordination across the European Union.

At the global level, the FSB and the International Organization of Securities Commissions (IOSCO) have responsibility for delivering consistency across different financial markets. The IOSCO principles on benchmarks are being used to increase the standards for transparency and governance, and ultimately increase investors' confidence. The FSB members are aligning with this approach.

Indices (predictive of investor confidence) remain fundamental since they may guide an investment strategy or reflect the state of an economy. However, there is an expectation that such indices be based on universally agreed principles of good governance, sound methodology and transparency to provide investors with an adequate level of protection and limit conflicts of interest or manipulation.

### Highlights

- No regulator saw its job as protecting the economy and financial system as a whole.
- Investment banks were permitted to opt for a

different regulator, and escaped the legal constraints on leverage. This 'pick and choose' ability was used by the banks to maximize their profits at the expense of the integrity of the whole system when the risks eventually proved unmanageable.

### Post-crisis culture

- The G20 committed to fundamental reform of the financial system to correct the fault lines that led to the global crisis.
- FSB members are implementing a broad range of policy reforms using strengthened common international standards that were designed to: apply to different national circumstances; address the problem of too-big-to-fail; work to prevent regulatory arbitrage so that all financial markets and products and participants are regulated or subject to oversight, as appropriate to the circumstances.

Koren, Elaine (2014). *Measures of Investor Confidence in Capital Markets: Annotated Bibliography*. Ottawa, ON: Public Safety Canada.

<sup>1</sup> Financial Stability Board. *Overview of Progress in the Implementation of G20 Recommendations for Strengthening Financial Stability*, September 5, 2013:47:3. Accessed November 15, 2014 from from: [www.financialstabilityboard.org/publications/r\\_130905c.pdf](http://www.financialstabilityboard.org/publications/r_130905c.pdf)

<sup>2</sup> Financial Stability Board. *Peer Review of the United Kingdom*, September 10, 2013:57:45-55. Accessed November 11, 2013 from: [www.financialstabilityboard.org/publications/r\\_130910.pdf](http://www.financialstabilityboard.org/publications/r_130910.pdf).

<sup>3</sup> Ibid.

<sup>4</sup> Financial Stability Board. *Peer Review of Australia*, September 21, 2011:44:5. Accessed November 19, 2013 from: [www.financialstabilityboard.org/publications/r\\_110926b.pdf](http://www.financialstabilityboard.org/publications/r_110926b.pdf)

<sup>5</sup> Ibid.

<sup>6</sup> Financial Stability Board. *Peer Review of Canada*, January 30, 2012:39:5. Accessed November 18, 2013 from: [www.financialstabilityboard.org/publications/r\\_120130.pdf](http://www.financialstabilityboard.org/publications/r_120130.pdf)

<sup>7</sup> Ibid.

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