

SO WHAT IS NEXT?

Recently I came across a letter I had written to Donald Macdonald, then Minister of Finance, about a Bill just tabled in Parliament which had the financial industry in an uproar. I bought a copy of the Bill and quickly saw what the frenzy was all about. It proposed to enable the mortgagor to shorten the term of the mortgage loan to the disadvantage of the lender. I had sent a draft of my letter to the Minister's office with a request that they would review it and remove any part of the draft that they felt was inappropriate. A few days later I got a phone call – “Don't change a word” – so I sent it off. It is a long letter and I have taken out a number of paragraphs that I feel to be irrelevant from the copy reproduced as an addendum, but it remains self-explanatory. Several weeks later I got a phone call that the Bill had been withdrawn.

It was quite clear then that communication and discussions between the private sector and the public had been inadequate; and quite possible that the Department of Consumer and Corporate Affairs had not discussed the proposed changes in mortgage terms with the Department of Finance or the Superintendent of Insurance before tabling the Bill. The letter was written

forty-five years ago, and I have been wondering whether the public and private sectors communicate any better today. Where do ideas for improvements originate and how do they find their way into legislation.

The history of political structures and taxation is fairly sparse and simple. The English revolution of 1688 (The Glorious Revolution) had created a balance between the king, the aristocracy, and the common people. A significant transfer of power from the monarchy to parliament took place. The 18th century, known as the Enlightenment, was an era when efforts were made to increase the wellbeing and happiness of the people. Improvements in agriculture and the use of reason, intelligence and knowledge of the sciences make the 18th century interesting.

Few periods in Scotland's history were as important as the last half of the 18th century. In 1700 the country was floundering and in 1707 it negotiated a union with England, greatly extending its trading rights. By 1745 it was beginning to flourish, and with English help, repelled the highland rebellion. Scotland at this time was one of the most literate nations in Europe. In the 16th century John Knox, the Scottish reformer, had preached that every child

had to be able to read the Bible or they would not go to Heaven, but would end up in Hell. This had a most beneficial effect on education. By 1750 a significant effort was being made to improve the excellence and reputation of the universities. At the end of the century Edinburgh was referred to as “The Athens of the North”. Its university professors, with those of Glasgow, were recognized as being equal to any in Europe. Among many distinguished names was that of the political economist Adam Smith. He had published his “Theory of Moral Sentiments” in 1759 and in 1776 the “Inquiry into the Nature and Causes of the Wealth of Nations”. In this, Adam Smith demonstrated that the wealth of a nation, its “progress of opulence” depended on the division of labour in different sectors of the economy and the unobstructed workings of a free market. The book became instantly famous.

Edmund Burke was born in Dublin in 1730. He was a friend of Adam Smith and one of the greatest political thinkers ever. He conceived the political party as a group jointly united by specific principles on which all were agreed in order to best promote the national interest. Parties remained united over the long term, while factions got formed and disintegrated from issue to

issue. Burke also believed that political parties would elevate the low esteem in which politicians were held in his day. Of course, there were flaws. He well understood that human nature dictated that politicians would be chiefly interested in getting their party re-elected, never mind the national interest. The century ended with the French Revolution, throwing Europe into turmoil.

In 1803 England adopted the principle of collecting personal income taxes at the source which proved very productive in collecting revenues needed for costs of the Napoleonic wars. The incorporated company, in a form we would recognize today, surfaced in the United Kingdom with the Companies Act of 1862, which prohibited associations of more than 20 persons from carrying on a business for gain without registering under the Act. At or about the same time, the concept of limited liability was introduced. A company making use of it was required to add “limited” to its name, put up a sign on its premises, and signify it on all letters and documents. Companies with unlimited liability were still permitted, but it was the development of the limited liability company that provided the financial muscle to power the industrial revolution. By the first quarter of the 20th century, the growth in

numbers of these companies was one of the more striking phenomena of the day.

The earliest provision for corporate taxes, that I am aware of, lies in the Finance Act of 1920 in the U.K. The maximum rate was a fairly modest 10% and only companies with limited liability were taxed. As far as I can make out, taxes on corporate earnings, net of wear and tear and the rent of premises, were levied after allowing for the deduction of interest on debentures or permanent loans secured by mortgage; dividends on preferred shares; and royalties. Such deductions were not allowed if they benefited a controlling interest.

By the onset of war in 1939, the double taxation structure of corporate dividends in use today had been adopted. Debenture interest was issued before taxes were assessed. Dividends on either common or preferred shares were not deductible, providing a tax incentive to issue corporate debt rather than equity. The only significant change since then was the adoption of capital gains tax in 1971.

On the other hand, in 1915 Einstein published his paper on relativity and in the 1930s penicillin was discovered, Turing built the first computer and solid-state electronics replaced the valve. The war acted as a catalyst, creating a wide range of new technology and ended with the atomic bomb. In the 50s, the DNA structure was discovered, and fibre optics pioneered. In the 1960s man walked on the moon. By the 1970s it was quite clear that a new era of rapidly advancing science and technology was in full swing. The energy that created advances such as the internet and artificial intelligence now needs to be applied to matters such as the gap in the standard of living between rich and poor, the complexity of the Tax Act and the uncertainty of health and retirement benefits. We need a new bout of enlightenment.

ADDENDUM

MORGUARD TRUST COMPANY

MICHAEL BOYD, Chairman of the Board

December 13, 1976

The Hon. Donald S. Macdonald
Minister of Finance
Ottawa

Dear Minister:

I write both in sorrow and in anger. In sorrow that the essential nature of financial intermediation in Canada is so little understood in Ottawa other than by those Departments of Government which report to you; and in anger that prior to the tabling of Bill C-16, so little recognition was accorded to the views and expertise of those mortgage institutions who are regulated by you and who are so largely responsible for the effective deployment of the nation's savings.

The role of the mortgage institution is to serve as an intermediary between lenders and borrowers. It is the saver who is the lender and not the intermediary. And it must follow, as the night the day, that efficient intermediation will benefit both saver and borrower, while any increase in the cost of intermediation must result in the saver receiving a lower return on his moneys and the borrower paying a higher price for his loan. Thus, it is imperative that if the intermediation process is to be complicated to achieve a social goal, the costs to the borrower and saver be carefully assessed.

Furthermore, a fundamental principle of intermediation is to match the essential terms and characteristics of assets with liabilities. Any bank, trust company or loan company who foregoes this principle will incur risks that must be considered unacceptable in an economically unstable world. The proper matching of assets with liabilities is not easy in as much as the

expectations of savers are largely molded by historical patterns as are the expectations of borrowers. The intermediary has to confine his structure within these patterns which themselves are constantly evolving under the pressures of economic and legislative events.

In addition, the different types of intermediary attract savings in different ways and for different purposes. The pension fund manager deploys savings that are deducted monthly from pay rolls; the banker from savers with an essentially short-term viewpoint; the trust and loan companies largely from savers looking to the medium term to give them as high a return as possible without locking up their funds for longer; while the life insurance companies offer savers a wide variety of contractual plans, often stretching over many years.

The saver has a large number of institutions competing for his dollar, but financial intermediaries seeking deposits must purchase a commodity of extreme rate sensitivity in that the Canada Deposit Insurance Corporation equates the credit of most deposits. Similarly, most mortgages are insured against default under policies issued by Central Mortgage & Housing Corporation or by one of the private mortgage insurance companies, with the result that to a great extent the mortgage institution is placing a saver's dollar in an asset that also takes on the nature of a commodity. Canadian financial institutions are thus forced by the very nature of the mortgage market to be efficient.

It is not the purpose of this letter to refer to specific sections of Bill C-16 but rather to voice more fundamental concerns. However, you perhaps may not realize how difficult it is for us to grasp some of the inferences inherent in new legislation if these inferences have not been made explicit over a period of prior discussion and consultation.

If it is proposed to permit the borrower to repay a conventional mortgage loan at the end of three years, we have to infer that it is felt in Ottawa that this will not cause undue difficulties in the matching of trust companies' assets and liabilities; or that it is considered desirable to encourage the reduction of the term of Guaranteed Investment Certificates from five years

to something shorter; or that the banks, with shorter term liabilities, will become more active and compensate for any harmful effects the legislation will have on trust company intermediation. Similarly, we can infer that Ottawa feels this will have no effect on the approach that pension fund managers take to mortgage investment; or that the effect on the mortgage market of discouraging pension funds will not be significant.

It is not hard for us to recognize that legislation relating to the provision of information to borrowers and savers may lie within the domain of the Department of Consumer and Corporate Affairs. But how are territories in Ottawa defined? For it is also not hard for us to realize that one departmental mandate may overlap another; and without intelligent co-ordination the results will not be to the betterment of Canada.

It seems to me that the way you and the principal civil servants who report to you have tackled the revision of the Bank Act is exemplary. We have been able to study the White Paper embodying your proposed amendments and have been encouraged to forward submissions and to speak directly and pertinently to the relevant officials. I do not imagine for one minute that when the Bank Act is finally amended it will suit everyone. But I do not see how it can fail to be a better piece of legislation given the willingness of your Department to indulge in discussions with the private sector long before the Bill reaches the confines of a Parliamentary Committee room. For I feel that a Parliamentary Committee is absolutely the wrong forum to revise the many complexities abounding in the interaction between saver and borrower. Technical complications should be solved and out of the way long before legislation reaches a Parliamentary Committee. Then the essential merits of a Bill can be debated by those on whom the voter has conferred that responsibility in the light of any given Government policy.

I hope that Ottawa has not lost sight of the fact that one of the essential keys to providing superior legislation affecting the intermediation process is the necessity for an historical perception of the evolution of past legislation, so that future action can be implemented smoothly to the benefit of borrower and saver. Most important of all is the realization that communication demands an integrity of purpose. It demands an effort to be made by two or

more parties beyond merely establishing the fact that they have sat down in the same room.

I hope you will not take this letter with a grain of salt to make it more palatable. It has not been written tongue in cheek, and I ask to be heard not merely listened to. This is a personal letter in the sense that I have not consulted with any of my partners or colleagues, but it is not personal in the sense that I write as the chairman of a company that is actively engaged from coast to coast in originating mortgage loans, and which I believe has played a useful and invigorating role over the last decade in helping develop the mortgage market in Canada as we know it today.