Monetary Control: Detailed Arrangements Consequent on the Publication of the Green Paper 1980

File FEU/2/6/09

PART 1

30/4/1980 – 8/10/1980

Pages 1-18

MR MIDDLETON

Put on a file

+ Bridgeman Riley Gilmore
& Bradford ? who.

cc: Mr Bridgeman o/r
Mr Britton
Mr Riley
Mr Boote
Mr Shields
Mr Grice
Mr Williams

MONETARY CONTROL: DETAILED ARRANGEMENTS

I have asked the Bank whether they could supply some summaries of reactions to the liquidity paper for the MCC series (your minute of 30 April) but I think there will not be much on the institutional response for a time. At the moment, the analysts' papers are covering both sets of proposals but the BBA will take some time to sort out the replies of their membership. Moreover, we do have to recognise that, at the end of the day, the liquidity rules may look significantly different from those now proposed because of the consultation process and of changes in other control arrangements. Though I accept that the line may sometimes be a fine one, it remains the case that causation runs from other arrangements to liquidity criteria not in the reverse direction. Meanwhile, however, I am sure that we and the Bank can do occasional commentaries on papers which deal with the liquidity arrangements on the lines of my minute of 29 April. You might also think it worthwhile to circulate the attached paper which was presented at the Fulton Packshaw Seminar in the MCC series since it contains a quite good account of the underlying objectives. However, a number of the criticisms are not entirely well directed.

2. In your minute you also said you would like to see the cash ratio paper which has now been circulated with Mr Bridgeman's minute of 30 April to Mr Riley and me.

3. Broadly, HF1 and 3 have thought the proposals reasonable but we certainly want to discuss this draft with the Bank. We shall also need to submit it to the Financial Secretary. I had intended to draft a submission in consultation with Mr Riley and put it through you to the FST but it occurs to me to ask if you would like a prior discussion with us, now that the paper is round, or, indeed, to take the discussion with the Bank.

4. I do have one substantive comment on the paper. It is, quite simply, that I share Mr Grice's puzzlement about what special deposits are actually for.

5315

Indeed, in a world of cash ratios, liquidity norms and of floating exchange rates it is very difficult to be clear how one would recognise excess liquidity if one saw it. Surely it is not a sufficient answer to say that special deposits are always useful because one can release them when there is liquidity pressure? (After all if that is true what price the argument that special deposits are not liquid?) Do you think there is any mileage in leaving the future of special deposits more open in this document or has the Green Paper closed that option?

5. The other major issue is the percentage and the denominator for the cash ratio. As I read paragraph 2.3 of the draft paper the clearers will still have to maintain 1½% balances ("either their current agreed average ... or 1% of ELs whichever is the greater"). If this is so then the criticism in paragraph 3 of Mr Bridgeman's covering minute falls and I do not, myself, think that the differentiation could be made any greater than paragraph 2.3 appears to imply. If my interpretation is the right one then it will be easier to commend the arrangement to the Financial Secretary who, as you know, is reluctant to accept any proposals which would actually reduce costs presently being borne by the clearers.

6. Apart from "equity" there is, of course, another major argument which can be deployed in support of generalising the ratio across the system. It is simply that institutions may now only operate if recognised or licensed by the Bank of England and that as a condition of the supervision on which their continued operations rest then they should contribute (through a non-interest bearing deposit) to financing the central bank who provides this service. This argument is not new theory. It was agreed that fees for licences would not be charged in the way in which Government Departments ought to charge because the Bank is a profitable nationalised industry which finances the services it provides out of the income generated by its own operations in the banking sector. We would not consider repaying the Bank for their supervision of deposit-taking institutions since this is not a service to Government. But I think they will be reluctant explicitly to recognise that the balance represents some form of return for a service to financial institutions. I am doubtful about Mr Bridgeman's argument that "minimum balances which are a way of paying for banking services provided by the Bank ought to be excluded from the cash requirement". It seems to me that the two separate justifications for the same theme run rather happily together in this respect now that the statistical and Banking Act lists will

be the same. Presumably all institutions will be able to use their balances operationally now that the requirement for all is to be averaged.

7. Some other points are these:-

i) we would need to clarify the detail of the proposal at 2.3 to be sure what income it will generate for the Bank of England in comparison with income now;

ii) Mr Riley and I had a discussion with the Bank today and he may wish to comment further to you about the proposals on eligible liabilities;

iii) as to coverage and statistics, we are agreed that all LDTs must be included as well as recognised banks and that the "de minimis" limit should apply in both sectors if it is to exist at all. But that limit needs to be discussed further;

iv) on Mr Bridgeman's paragraph 9, I now agree that we should include the TSBs from the point at which the statistical change is made - which may not be at all quick;

v) I do wish to refer to the "Banking Sector" (Mr Bridgeman's paragraph 10). It is after all the "Banking Act" and it covers all LDTs as well as recognised banks so there is no need to invent cumbersome titles like the monetary institutions sector.

R.G.

MRS R E J GILMORE
30 April 1980

MR RILEY

cc: Mr Middleton
Mr Britton
Mr Ward
Mr Boote (with JMIS minute)

MONETARY CONTROL: CONSULTATION

Mr George's letter of 16 April and Mr Bridgeman's minute of 30 April.

2. As Mr Bridgeman says, Mr George's letter is entirely about the Green Paper and, in fact, I find it difficult to consider procedure on the liquidity paper until we have a clearer idea of the comments. It is a very different sort of consultation paper, in the sense that it is designed to establish new rules for reaching given objectives (ie a prudential level of liquidity) where there is an axiom that there must be new rules. I am clear that we should not take part in the discussions between the institutions affected and the Bank of England on what, precisely, the rules are to be. On the other hand the Bank already know that we wish to be kept in touch with the general line of comments and any major changes which they begin to evolve in the proposals as they stand. We will, I think, need a Treasury view before the paper goes out in a final form but for that we may need only to talk to the Bank and among ourselves when we have a general picuture of the comments which have been made. My point about CCC was merely a suggestion that we should not start hypothesising too soon. At present I have little to add to my minute to Mr Middleton on the David Lomax paper (I also did a short note for the Financial Secretary recently on a particular aspect, copy attached). Paragraphs 6 i. and ii. of Mr Bridgeman's minute are right as far as they go but are not the whole story - eg not all primary liquid assets depend on rediscount facilities - some are very short Exchequer liabilities.

3. I don't think I have any comments on the idea of a seminar except that, if it seems likely that the liquidity proposals will also be much discussed, then HF1 would like to be represented.

4. Perhaps we might discuss further when we have seen copies of the draft on the cash ratio etc. I think that that paper is going to attract a good deal of attention and consultation on it is more divided between HF1 and 3 and between the Bank and Treasury than is the case for either the consultation document or the liquidity paper.

R.G.

MRS R E J GILMORE

30 April 1980

8/5

FINANCIAL SECRETARY

cc Mr Hancock
Mr Bridgeman
Mr Boote

BANKING ACT : OVERSEAS BANKS

I understand that at lunch at the Swedish Embassy last week representatives of overseas banks raised some issues about the consultation documents put out by the Bank of England under the Banking Act.

2. The three papers were:-

i) the measurement of capital, issued in June 1979;
ii) foreign currency exposure, issued in November 1979; and
iii) the measurement of liquidity, which was published on the same day as the consultation document on monetary control (my submission of 19 March).

3. Consultations on all the papers are being organised through the British Bankers Association, which represents pretty well all groups of institutions who bank in London - including the overseas banks - and it will be some time before they have assembled all the comments and proposals for changes which the various groups of institutions may wish to make. Discussion will also become a good deal more intense when the paper on the cash ratio etc., promised in the monetary control document, is issued. We have just received a Bank draft and will submit to you shortly.

4. At present it seems most likely that issues under current discussion arise from the liquidity paper. The particular issue raised at lunch will depend very much on who was raising it : if it was a consortium bank(e.g. Nordic) then their likely worry is about the high co-efficients

proposed for liquidity cover for net maturity-certain liabilities at the near end of the spectrum and about the suggestion that it would be appropriate to require 100% cover for gross interbank liabilities up to a month (see paragraphs 14 and 16). Such requirements will cause banks who do considerable amounts of rollover business to increase significantly their holdings of those assets which will be classified as primary liquidity. It would affect British and consortium banks but not foreign branch banks in London since it is not the present intention that the liquidity norm should cover their currency based business (paragraph 28).

5. It was inherent in the development of the wholesale markets and of liability management that the old tests of liquidity should become less adequate and the main purpose of the liquidity paper is to propose a new integrated test which looks at a bank's future cash flow as well as the old "stock" concept (paragraphs 12 to 14). The proposed abolition of the reserve asset requirement also crystalised the view that prudential tests should look at the liquidity of the system as a whole, as well as the liquidity of an individual institution which might be relying substantially on assets held with other banks. In the light of these developments, and the extended scope of supervision under the Banking Act, it was logical that the Bank would develop more sophisticated tests of prudential operations and fairly clear that various groups of institutions would have to adapt in various ways to them (the accepting houses and finance houses are also substantially affected in various ways). Indeed, the set of tests proposed in this paper will not necessarily be the last word (paragraphs 5, 13 and 26). However, the proposals as a whole are open to representations from the banking system (indeed the paper explicitly recognises that existing statistics do not allow the Bank to judge all their possible effects) and, when conclusions are reached, institutions will be allowed ample time to make any changes in their business which the new tests entail. The approach is an evoluntionary one and groups of institutions cannot be sure at this stage what the outcome of the consultations will be.

R G.

MRS R E J GILMORE
21 April 1980

11.30

MRS GILMORE)
MR RILEY) copy to each

cc Mr Middleton (for information)
Mr Britton
Mr Boote
Mr Shields (no)
Mr Grice
Mr Williams

E George letter of 18 April

"MONETARY CONTROL: DETAILED ARRANGEMENTS"

I attach the revised version of this paper which Mr George sent over to me. It differs in a number of respects from the draft which you (Mrs Gilmore) circulated on 11 April. I understand from Mr George that it is subject to further redrafting, but this will be mainly to deal with its presentation, rather than its substance. Mr George will be getting in touch with you for a discussion on the substance in the coming week.

2. You may find it helpful to have the following comments.

Cash Ratio and Special Deposits

3. I agree with your reaction that the justification of the proposed arrangement being "more equitable" is thin. Moreover, while I think that it is certainly arguable that there can be more equitable arrangements than the present one, with a requirement imposed on the clearers alone, that does not necessarily point to the same cash requirement being imposed on all banks. In particular, it does not appear to be even handed between:-

i. the clearers, who have an operational requirement for some cash balance with the Bank of England, although not anything like as large as 1% or 1½%;

ii. other banks who at present hold cash balances with the Bank, who hold minimum balances as a means of paying for services provided to them by the Bank, and who will be allowed to counter that minimum balance towards the 1% new minimum; (the Bank are looking at this again)

iii. those banks and LDTs who do not at present hold balances with the Bank.

It is certainly arguable that the percentage for the clearers ought to be somewhat higher than that for other banks, and that minimum balances which are a way of paying for banking services provided by the Bank ought to be excluded from the cash requirement. This is the element in the proposals, since it involves an element of taxation, which is likely to cause the most difficulty, and could cause, say, some of the overseas banks to raise it at a political level. I therefore think that we ought to discuss with the Bank whether the present proposal is the one which is the most defensible. It is the point which we will have to put to Ministers - both in respect of any reduction in the burden on the clearers, and in respect of what size of cash base is necessary to give the Bank of England the income which it "needs".

4. You will notice that averaging is now to be allowed to all recognised banks and LDTs.

Eligible Liabilities

5. The immediate changes suggested to eligible liabilities seem, at first sight to be relatively minor. But HF3 will doubtless want to look critically at the various elements in it, and at the justification for using the "net inter-bank" position.

6. The most significant proposal in this section is the one which is tentatively of switching the definition of both money and eligible liabilities onto a residual life basis. At first sight, I would have thought that this was a sensible step, but clearly there would be problems of discontinuity in series, as and when the statistics on residual life become available.

7. HF3 will presumably also wish to consider the justification for the various other offsets.

Coverage and Statistics

8. As you know, I had at first thought that we could keep to the statistical list, and not extend the coverage to all LDTs. If that were done, then LDTs not on the statistical list would be treated as OFIs. However, you (Mrs Gilmore) had satisfied me that the interaction between the statistical list, what is netted out as "inter-bank" for the purposes of eligible liabilities and the liquidity calculations would mean that non-statistical list LDTs would be put at a significant disadvantage in meeting the liquidity requirements, since other banks would be more reluctant to grant them facilities. Given this, and the relatively small sums involved, I would now be ready to go along with what is proposed.

9. The other issues: the treatment of the trustee savings banks. You (Mrs Gilmore have I think suggested that they should remain out of the money numbers until such time as they are brought within the Banking Act. One of your reasons for this was parity of treatment with the National Savings Bank - indeed, because of defunding the NSB investment accounts are going to have to be moved from the OFI's category to the public sector debt category. However, I would have thought that it was justifiable to move the TSBs now since they are already providing a far wider range of services, akin to those of banks, than are being provided by the NSB - notably cheque accounts, personal loans etc. I would have thought that there was a reasonable case for making the change in respect of TSBs now, rather than having another break in the monetary statistics in a few years time.

10. Finally, I would support the idea of continuing to refer to the enlarged banking sector as the banking sector, rather than as the monetary institutions sector.

P.P. S. Wilkes
J M BRIDGEMAN
30 April 1980

MRS GILMORE) copy to each
MR RILEY)

cc Mr Middleton
Mr Britton
Mr Ward
Mr Shields
Mr Williams

MONETARY CONTROL: CONSULTATION

I have had a preliminary discussion with Mr George on his letter of 16 April attached, in which he sets out the Bank's proposals for carrying forward the consultations on the Green Paper. I should be grateful if you would consider this further with the view to a submission to Mr Middleton on my return. The letter is entirely in terms of the Green Paper: we will need to consider any links to the consultations on the liquidity paper and on the cash requirements paper.

2. In general, I would have thought that we might go along with what is proposed for the banks, for the Stock Exchange, the FHA, and also with the Channel Islands and the Isle of Man.

3. As far as the banks are concerned we will, I think, find somewhat different views from different associations within the BBA - although those differences may emerge more strongly on the other two papers. We would presumably wish to be associated with the discussions with particular associations on the Green Paper as well as the BBA.

4. The real problem comes with organising a discussion with the City analysts and with the academics. The Money Study Group meeting may go over some of the ground, but it would clearly not fully serve our purpose. Mr Middleton and I are agreed that we will need some form of discussion with these people organised by us, which is formally part of the consultation process. Moreover, while it might be prudent to delay deciding on the precise form of it before the Money Study Group meeting, I think that we ought to have agreed in principle with the Bank whether to have such a further consultation, and to let this be known before the Money Study Group meeting.

5. My initial thought is that we ought to think in terms of a whole day seminar, to which would be invited the City analysts and academics who

14521+

have written on this subject, including those such as Professor Bain who have commented to the Select Committee on it, and also including not only the economists but some of the operators from the banks - say one of each from each clearer. We would need to have a fairly clearly defined agenda focussing in turn on each of the main issues which have arisen in the debate so far, for example the demand side versus supply side misunderstandings, the nature of the lender of last resort facility and so on. This would probably require a fairly carefully worked out issues paper circulated in advance, not unlike the papers which Mr Middleton circulated before the Chancellor's seminar on the Medium Term Financial Plan. However this is a very preliminary view, and I would welcome the comments of others.

6. The discussions on the liquidity paper will be primarily for the Bank. But there is a question as to whether we ought to be expressing a Treasury view on the issues raised in it. If I have understood Mrs Gilmore correctly, there are two distinct issues:-

i. the way in which banks and licensed deposit-taking institutions are to assess their needs for liquidity - the Bank's proposals on this could have quite a significant effect on the present practice of some banks, such as the accepting houses;

ii. the assets which banks can regard as primary liquidity, which depends on the practice of the Bank in providing, or not providing rediscounting facilities, and not on the liquidity paper as such.

The first will probably have some effect on the practices of the banks, for example affecting their readiness to find certain types of loan rather than others. What those effects will be, may be very difficult to foresee - Mrs Gilmore rightly pointed out that the consequences of Competition and Credit Control was very different indeed from those which were foreseen by the Bank and the Treasury. But we probably ought to discuss with the Bank whether they foresee any significant shifts in the pattern of the facilities offered by banks resulting from the way in which the liquidity requirement for different degrees of maturity mis-match is specified.

7. The second is certainly an area which we will need to discuss with the Bank, probably in the context of the questions which are arising about the consequences for the banking system of the structural shift in their balance sheets from loans to the public sector to loans to the private sector: for example, one issue will be whether the Bank wish to continue to limit the extent to which commercial bills count as liquidity Another area which we will need to consider is the possible implications for the local authority debt market - this will have to be discussed in the Local Authority Borrowing Committee in due course. You will need to consider how this fits in with our objectives on the one hand of trying to lengthen the average length of local authority debt, and on the other to reduce their borrowing from the banking system which is not in liquid form.

S. Wilkes
PP J M BRIDGEMAN
30 April 1980

11.

(1)

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

16 April 1980

J M Bridgeman Esq
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Michael,

We have been considering how the process of consultation on the Green Paper might best be carried forward amongst the financial institutions. I am writing to let you know our suggestions.

As regards the banks, the most convenient method would probably be for us, on behalf of the Treasury and Bank, to ask the BBA if they would be prepared to organise consultations among BBA members. We have used this procedure for consultations on the various prudential papers, and it would clearly simplify matters if the BBA were to act as a filter for views of individual banks and other banking associations. If of course there were points on which individual associations, such as the CLCB, wished to consult us, we would express a readiness to receive them.

For the Stock Exchange, we suggest that the Governor should ask the Chairman at their next regular meeting how the Stock Exchange would like to handle any consultations.

We will need to talk to the authorities in the Channel Islands and the Isle of Man soon about the technical paper on Monetary Control which we are now drafting. This would provide an opportunity for asking them whether they wish to express any views on the Green Paper.

The Finance Houses Association mentioned the question of consultations at a recent regular meeting in the Bank and said that they would like to revert once they had collected their thoughts. No further action seems necessary with them for the time being.

As regards other financial associations such as the Building Societies Association, British Insurance Association, National Association of Pension Funds, I believe that the Treasury sent copies of the Green Paper to these groups and you may have views on whether, and if so how, these groups should be approached.

Finally there are the city analysts, e.g. Gordon Pepper, Tim Congdon, etc., and the academics. A Money Study Group meeting has now been fixed for 16 May, which will discuss the Green Paper, with the Treasury and Bank being represented. Many of the main city analysts and interested economists will attend that. In addition there is to be the Panel of Academic Consultants meeting in the Bank on 18 April, but with the audience being invited and of small number, the discussion private, and the subject matter broader, this latter should only marginally be seen as part of the consultation. We doubt, however, whether the MSG meeting by itself would be regarded by either city analysts or economists as providing sufficient consultation. Perhaps we could discuss together what further occasions, if any, should be organised to allow analytical and academic views to be fully aired. It might, however, be sensible to wait until after the MSG meeting, by which time also several of the various city analysts will have responded in public print to the Green Paper, before deciding on our next steps on the front.

Perhaps we might pursue this when you have had a chance to collect Treasury views.

Yours sincerely,

Eddie

MRS GILMORE

cc Mr Middleton
Mr Bridgeman (o.r.)
Mr Britton
Mr Boote
Mr Shields
Mr Williams

MONETARY CONTROL: CONSULTATION

I don't have very strong feelings on this, but I would have thought that there was advantage in trying to keep the consultations on the three papers - the monetary control paper, the liquidity paper, and the detailed arrangements paper - as separate as possible, and making this clear to participants in consultations we organise. Certainly if we organise a seminar on the Green Paper then we should make it clear that the liquidity proposals and the detailed arrangements are <u>not</u> on the agenda, although doubtless HF1 would want to be represente anyway. There is quite enough to talk about on the Green Paper itself, and even though some of the proposals in the other papers have implications for monetary control these can be discussed separately.

2. I think Mr Bridgeman's idea of a seminar on the Green Paper is a good one. We probably need to be seen to be actively consulting even if, for example, most of the people we would wish to invite attended the MSG meeting and made their views clear, or submitted comments in writing. However, I suspect that we will get most from meetings with individuals or small groups. The seminar would simply be a means of flushing out ideas we would wish to follow up later in more detail, and therefore it may be that we could get away with less than a day. In any event I think we need to wait until after the MSG meeting before we decide on this.

CJR

C J RILEY
6 May 1980

171/5

MR BRIDGEMAN

cc Mr Middleton
Mr Britton
Mrs Gilmore
Mr Boote
Mr Shields
Mr Grice
Mr Williams

MONETARY CONTROL: DETAILED ARRANGEMENTS

Rosalind Gilmore's minute of 30 April to Peter Middleton records our agreement with most of the proposals in the latest version of this paper. Our meeting with the Bank was extremely helpful, and we received clarification and reached agreement on a number of points, including the following (in addition to those mentioned by R.G.):

(i) As regards back runs of monetary data it makes no difference whether we go for the wider definition (including all LDTs) or the narrower one (excluding them all). This is so because current statistical reporting records inter-bank positions only on the basis of the current statistical list. Unless the present list is retained breaks in the series are inevitable, and we therefore go along with the wider definition.

(ii) We agreed it would not be right to take this opportunity to add other items from PSL - e.g. NSB deposits - as suggested in my minute of 24 March. In order to avoid reopening the question of the appropriate monetary aggregate, which was temporarily closed by the Green Paper, we must stick to changes resulting more or less inevitably from the Banking Act.

(iii) Monetary statistics on the new basis are unlikely to be available until the December quarter, and possibly not even then.

(iv) The de minimis limit will probably have to be informally indexed, but formal indexation or formal non-indexation would lead, unacceptably, to continual changes in coverage. The Bank will be looking further at this, and the current draft will certainly need to be changed.

172/5

(v) There was majority view in favour of calling the new sector the "monetary institutions" sector, in order to avoid the confusion which would inevitably result from defining a "banking sector" which included institutions other than banks. On this vitally important issue most of us therefore have a different view from Rosalind Gilmore and yourself.

2. There are, however, two issues of substance on the definition of eligible liabilities which we would need to consider further:

Term of Deposits

We agreed at the meeting that there would be great advantage in harmonising the definitions of £M3 and ELs in this respect. Given the philosophy underlying our currently preferred monetary statistic, defined in terms of institutional boundaries rather than by type of asset, this points to including deposits of all maturities in ELs rather than restricting the scope of £M3. The current draft leaves open the possibility of a one year residual maturity criterion, and although we probably don't need to close that option off at this stage I think the all maturities option is definitely preferable, not least because it avoid the distortions which could result from switching over a maturity boundary.

Total Sterling Resources versus £M3

Paragraph 1.3 of the draft suggests, sensibly enough, that there would be advantage in adopting arrangements which would require least revision should a form of Monetary Base Control be adopted at some stage. This points to the use of £M3 as the basis for the proposed cash requirement, rather than an ELs definition which also includes non-resident sterling deposits and resources obtained by switching into sterling, and we need to consider whether arguments for the use of total sterling resources are overriding. We are looking into this further, but as I understand it the main reason for staying with total sterling resources is that it avoids distortions which might result from switching out of £M3 into other, unpenalised, deposits, or reclassifying depositors. Also there is a problem in that it is not possible to measure any one individual bank's contribution to £M3 because of lack of direct information on CD holdings. However, I'm still not absolutely sure that we need to retain the definition ELs in its current form, given that we are controlling money and not credit.

3. As regards the minor changes to the ELs definition proposed, we see no reason to dispute them.

CJR

C J RILEY
6 May 1980