

File FEA/0000000509, Part D – Monetary Base Control

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PART 1

20/8/1981 – 22/10/1984

Pages 1-18

MR DAVIES

cc Mr Middleton —
Mr Monck o.r.

MINIMUM LENDING RATE

In your absence on a Spanish assignment, the Financial Secretary asked to see me to discuss your submission of 20 August. He was content with the draft reply to Mr Wainwright but expressed unhappiness at the substance of what is being proposed. He feels that the Bank's base rate has too strong an official connotation and is inconsistent with our efforts to withdraw from promulgating an official market rate.

2. I defended the current proposals on the following grounds:

(i) The Bank's base rate follows not leads market rates.

(ii) It would not be published directly by the Bank but would be passed to the Law Society who would then advise their members.

(iii) It would be used only for existing contracts.

3. The FST was not convinced and suggested an average of clearers' base rates. I rehearsed the lawyers objections to this - lack of an official connection which the Courts might seek to match that in the outgoing MLR, uncertainty about the future structure of base rates etc. (The FST considered the latter a double edged argument - if the Bank had to exercise judgement in devising its rate it was more difficult to say it had no policy content.)

3. There is potential for great embarrassment. We have allowed the Bank to enter discussions in good faith with the Law Society and it would be very difficult for the Treasury now to argue that the Bank's base rate was unacceptable.

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4. I think we need to restate the case for the FST and to explain why we have acquiesced the Bank's proposal. The suggestion of the Bank's base rate was first made in Mr Middleton's submission to the Chancellor of 6 August. In addition we have set certain conditions under which the Bank can offer their base rate i.e. that when first promulgated it be accompanied by a statement that it had no policy content - see Mr Monck's minute of 7 August.

5. Can you prepare a submission on these lines?

AT

A TURNBULL
20 August 1981

1. MR TURNBULL ^{AT 21/8}
2. FINANCIAL SECRETARY

cc Mr Middleton
Mr Monck o.r.

MINIMUM LENDING RATE

I am sorry that I was not available yesterday afternoon to discuss my submission about the demise of MLR. I understand you told Mr Turnbull that whilst you were content with the terms of the draft reply to Mr Wainwright you had some doubts about the Bank's proposal to notify the Law Society of changes in their Base Rate to enable them to recommend it as a substitute for use in existing contracts.

2. The possibility of using the Bank's Base Rate as a substitute rate for MLR in contracts was referred to by Mr Middleton in paragraph 3 of a note to the Chancellor dated 6 August (copy attached). You will see that Mr Middleton describes the rate as something which is essentially an average of clearers base rates. Subsequently Mr Monck discussed the precise way in which the rate was adjusted by the Bank with Mr Somerset. They describe their objective as being to keep the rate closely in line with clearers' base rates only moving it after a majority of the clearers had moved theirs. In almost all circumstances, therefore, moving the rate is not a judgemental act. It would be, I suppose, if two moved and two did not. The rate is not published at the moment, but because of the way it is set it could not be described as secret.

3. In these circumstances Mr Monck agreed that the Bank might suggest the use of their base rate to the Law Society, provided that they made it clear, both to the Law Society and, in due course, publicly in some appropriate way, that the Bank's base rate has absolutely no policy content about the authorities wishes on short-term interest rates and that it is based entirely on the base rates of the four main clearers, moving only after they move and strictly in line with the majority.

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These conditions were well understood by the Bank. In fact the wording in the first sentence of this paragraph is taken from an internal Bank minute from Mr Somerset to the Deputy Governor. Mr Monck made it clear also that he was not giving formal Treasury approval, but thought discussions with the Law Society could sensibly proceed on the basis that the proposal was worth pursuing, and we saw no overriding objections to it.

4. Since then the Bank have kept us in close touch with their discussions. I attach a record of the latest meeting, on 17 August. You will see from this that the Bank made it clear that they do not intend to publish an alternative rate to which market attention will be drawn, and that the rate would be published, if at all, by the Law Society. They also point out that the rate should not be used in future contracts. Page 3 describes the next step as being for the Law Society to take Counsel's opinion. We understand that instructions to Counsel are in preparation.

5. We have always argued that this problem was one for the contracting parties and not for the authorities to solve. We asked the Bank to make this clear to the lawyers. We were not negotiating with them. There could also be no question of our publishing a rate which might gain status as some kind of official alternative to MLR. This would be quite contrary to the objectives of the new arrangements. Equally, it seemed sensible to try to help the Law Society, given the risk of public criticism, and the possibility that we would be accused of provoking a lot of costly litigation. A Law Society recommendation could also be useful for the small number of legislative cases I referred to yesterday. The Government is of course also party to many contracts.

6. We believe the Bank have stuck closely to the instructions we gave them, and that what they have offered the Law Society does not materially damage our interests, or detract from the

merits of the new system. There do seem to be quite serious objections from a legal point of view to the use of an average of clearers' base rates, or another market rate. The Law Society's initial bid was for an alternative rate published in legislation since they believed that the 'official' element was an essential feature of the existing MLR.* We have of course resisted suggestions of this kind. But it is hard to dispute their view that the Courts would not regard an average rate, or an interbank rate as an acceptable substitute. It may well be that Counsel will not accept that the Bank's base rate is an acceptable substitute, but we think it is a reasonable proposal, and one which we could accept if the Law Society agreed it.

7. I am sure that the Bank interpret what we have said to them so far as tacit acceptance of the idea, though it is fair to say that we have not formally approved it. If you were to conclude that use of the Bank's base rate in the manner suggested were not consistent with the new arrangements we would need to inform the Bank, and through them the Law Society, very quickly.

Howard Line

H J DAVIES
21 August 1981

see copy of 5/8/81 not attached.

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Rylie or
Mr Burns
Mr Monck
Mr Turnbull
Mr Shields
Mr Davies
Mr Kemp
Mrs Gilmore
Mr Ridley
Mr Cropper
Mr Cardona

STATEMENT ON MONETARY CONTROL

1. If we are to achieve the main objective of the new arrangements - to depoliticise interest rates and thus allow them to change in a rather more timely way - it is important that commentators should not focus on any particular rate as an indication of a Government or Authorities desired rate. Different parts of the market will look at different rates. So as far as the press is concerned we shall wish to direct attention to the whole spectrum of interest rates rather than one particular rate. The Bank will publish rates in the parts of the market where they have in fact dealt after the event, and this will provide the main basis for day to day comment. But there will be no single rate that will provide a definite pointer to the central point of the undisclosed band.
2. As far as the public is concerned, much the same considerations apply. Everyone will be interested in base rates and mortgage rates. The former do no more than provide a guide to the direction in which deposit and lending rates will move. People will be more interested in the actual rates they receive on deposits of different sorts and pay on loans of different sorts. We do not wish to get in the position of saying that the Government has changed these rates; that will be the banks own decision.
3. There are some specific interests. For example the lawyers are looking for a rate to replace MLR in contracts. This is up

to them - most likely they will wish to go for something which is an average of base rates. This already exists in the shape of the Bank of England's own base rate which follows clearers' rates and which is used by the Bank to adjust the rate at which they lend to Nationalised Industries. It is completely market determined and cannot be taken as an indication of specific decisions by the Authorities or as an official rate in the sense of a rate which indicates policy intentions.

4. All this really amounts to saying that some parts of the market will look at some rates, others at others, and it is highly desirable that this should happen.

5. I believe you are also concerned that commentators will point out that interbank rates are currently well above the existing MLR or 12%. They are also of course above the Bank's recent dealing rates for very short maturity bills. There is no complete answer to this. But we can make the point that the rise in interbank rates occurred while MLR was still there, largely though not wholly as a result of high American rates and fears about the inflationary effect of pressure on sterling; it is also helpful that interbank rates fell yesterday and were still low this morning. Flexibility works both ways.

E. A. Clarke

pf

P E MIDDLETON
6 August 1981

MINIMUM LENDING RATE

1 Marshall (President of the Law Society) and Jacomb (Chairman, City Capital Markets Committee) called on DHFS yesterday afternoon to continue the dialogue on possible substitutes for MLR, in the context of its use as a reference rate of interest in contracts.

2 Having stated that the decision no longer continually to post MLR had now been taken, to take effect from 20 August, DHFS offered them copies of the paragraph referring to the contract problem which the Bank would include in its Note to Editors accompanying today's Press Release. Both visitors agreed that it gave a clear indication of the Bank's awareness of the problem, but that it did not place the Bank under any obligation to find a solution.

3 In their formal approaches to the Bank, both Jacomb and Marshall had indicated that legislation to provide a proxy for MLR in existing contracts was the only sure way to provide certainty in a situation where there would, in their view, be considerable confusion. Equally, both expressed doubt as to whether this could be achieved and it was made clear to them that HMT, having seen their letters, were not prepared to adopt such a suggestion.

4 Their proposed alternative course of action involved the Bank undertaking to publish retrospectively an average of bill dealing rates. DHFS indicated that this suggestion was too vague as it stood: the Bank bought Treasury, LA and commercial bills of varying maturities, all at different rates of discount and possibly, for any single category/maturity, at different rates on separate occasions on the same day; to avoid a complicated and potentially distorting averaging process, it would be best to refine their choice and select a particular instrument of a given maturity; but even so there would be periods when the Bank would have no need to buy bills and there was no guarantee that when they did act, the Bank would be

dealing in the selected instrument. This elicited the suggestion by Jacomb that the rate at which the Bank bought seven day eligible bills would provide a satisfactory equivalent; the term was akin to that for which MLR had been used (ie a rate for lending up to seven days) and eligible bills now formed, as he understood it, the most widely used instrument in market support activities, thereby offering the greatest chance of a representative rate.

In support of the general argument for the use of bill ^{buy} discounting rates, he noted that, in any future case where contracting parties failed to agree on a substitute for MLR, legal argument would in all probability focus on the function of MLR as the rate at which the Bank had supported the market. DHFS remarked that, by changing the method by which the Bank intervened in the market, the purpose which MLR had been designed to fulfill no longer existed, and that in this sense there was, in the Bank's view, no precise successor to MLR. He also pointed out that it was the Bank's practice currently to publish twice daily the rates at which bills had been purchased and MDKWF mentioned that in due course these press releases would specify the volume of and rates at which each category of bills of a given maturity had been purchased by the Bank. Was it therefore necessary for the Bank to do anything further?

5 Both Jacomb and Marshall were of the opinion that it would be unrealistic to expect the contracting parties themselves (or their legal representatives) to delve through this mass of information in order to determine the rate most appropriate for their purposes. The wished the Bank to publish a rate because

- (a) it would represent something "official" which the Bank had done as part of its market management activities;
- (b) the statement would itself carry the authority of the Bank;
- (c) as a consequence it would prevent many disputes between contracting parties;

(d) even where disputes reached the Courts, the Bank's statements, as endorsed by the Law Society, would provide formidable evidence for one party - though this presumed, as DHFS pointed out, that the Bank would be willing to provide expert evidence in support of such a claim.

6 DHFS therefore wondered whether some alternative might be more acceptable and suggested either a) clearing bank base rates - which it could be demonstrated, had moved in line with MLR over the last decade; or b) the average rate of discount at the TB tender - on which MLR had been precisely fixed for about six years until May 1978.

Both of these suggestions met with a critical response: neither appeared to have a certain future and Jacomb was clear that whilst logic would suggest that the evident relationship of both rates to MLR could lead one to suppose that future trends of either would give a general indication of how MLR might have behaved if it were still a published rate, the legal argument would centre around the purpose and function of MLR (quoting in support Counsel's opinion obtained at time of the replacement of Bank Rate in 1972) which inexorably brought him back to bill rates and his proposal for the Bank to report to the Law Society on a Friday afternoon, for the week ending, the average of buying rates for seven day eligible bills, for publication in the following week's Law Society Gazette. (They would, if pushed, accept a monthly rate.)

7 This degree of precision, whilst welcome, prompted the caution that the discussion was concerned with hypotheses rather than practicalities: any decision would have to be taken after appropriate consideration and could not be allowed to prejudice the aims of the new approach to monetary control.

8 It was agreed that each side would consider the points made by the other and that a further meeting in the early part of next week would be appropriate, bearing in mind the need for agreement (or disagreement) to be registered by 20 August. Marshall is visiting the USA until 5 September and Cronnel of Norton Rose will act in his absence.

NOTE FOR RECORD

	The Deputy Governor	
Copies to	Mr Fforde	Mr Drake
	Mr Blunden	Mr Quinn
	Mr Coleby	Mr Foot
	Mr George	GPS
	Mr Somerset	

MINIMUM LENDING RATE

Jacomb (Chairman, City Capital Markets Committee) and Cronnel and Gibbons (City Solicitors' Company, representing the Law Society in the absence of the President) called on DHFS (MDKWF and NK also present) to continue discussions about a possible proxy for MLR after 20 August in existing legal contracts. DHFS opened the meeting by saying that, regretfully, the Bank did not consider that the suggestion made at the previous meeting (that the Bank should publish on Friday afternoon the average rate at which they had bought eligible bank bills of up to 7 days maturity during the previous week) was an acceptable solution. There were two reasons for this.

First, there was no guarantee that the Bank would buy such bills during any one week's operations in the money market - indeed, because of the modified way in which we proposed to manage the money market in future, we might not buy one week bills for a month (which was understood to be a fall back position for them). Second, we were very reluctant, as a matter of policy, to publish such an average rate, even retrospectively because of the danger that it would enable the press and commentators generally to identify (or try to identify) apparent changes in the rates at which we were operating in the market. Admittedly, these rates would be published twice daily but they would be an amalgam of different instruments and maturities and would not focus, as the Law Society wanted, on our buying rates for short paper. It would, of course, be open to the Law Society themselves to work out an average from our twice daily operations; the lawyers, however, did not think that this would be practicable.

In the brief discussion that followed, Jacomb and the lawyers expressed disappointment at the Bank's decision but said that they fully understood the reasons for it; indeed, if the Bank were not to lend to the market, or buy short bills, it would be very difficult to find any solution in following that route.

DHFS then suggested the Bank of England's own Base Rate as a possible solution. This was the base which we used for arriving at the rate we charged for overdrafts or advances to our commercial customers and was used in just the same way as the commercial banks used their base rates. Indeed, as a small bank, we kept our base rate very closely in line with the clearers' base rates, only moving our rate after the majority of the clearers had moved theirs. Our rate was not published and it was regarded as "private" between the Bank and its customers; nevertheless DHFS would be willing to advise the Law Society in writing (and any other professional bodies who so requested) what our rate was and whenever we changed it, so that they could advise their members in, for instance, the Law Society Gazette. This would have the presentational advantage for us that there would always be a clear time lag between a change in base rates by the clearers, with its attendant publicity, and the subsequent publication of our own move into line with the clearers.

In making this suggestion, DHFS admitted that it might not be acceptable because the idea of using an average of clearing bank base rates, which he had suggested at an earlier meeting, had been rejected by the lawyers on the grounds that it was not sufficiently 'official'. He pointed out, however, that though the Bank's Base Rate was effectively identical to the average of the clearers' base rates, in practice it was a direct descendant of Bank Rate which had been not only the rate used for official lending in the market but also the rate used by the Bank and by the clearers as the base for arriving at lending rates to commercial customers. MLR and Base Rate, as direct descendants of Bank Rate, could therefore be said to be very close relatives and, in practice both had moved very closely together, though with a tendency for changes in rates to lag a little behind changes in MLR in the period up to 1978 when MLR was tied to the average rate of discount at the weekly Treasury Bill tender.

There was another possible disadvantage - the Bank could not guarantee always to have a Base Rate; there had been some speculation in the press recently that the clearers would be moving away from linking their lending rates, at least to large customers, to their base rates and using LIBOR instead. Having given that warning, DHFS said that in his personal view the clearers would probably go on with a base rate, if only for lending to smaller commercial and personal customers, and that he thought the Bank would too. But he warned strongly against the use of the Bank's Base Rate in future contracts and expressed the hope that the Law Society would do all they could to get their members to persuade their clients not to fall into the same trap again. The best solution would be for the parties to decide, but the Bank would be prepared, to provide information to the Law Society, if that would be helpful, on a given market rate, such as the 7 day LIBOR as quoted by the four main clearers.

The lawyers appeared receptive to this proposal, although Jacomb feared that, even if it was endorsed by the Law Society, there would always be some who would take advantage of the suspension of MLR to cause difficulties and claim frustration of contract, particularly in cases where large sums of money were involved and where a small difference in rates could have significant financial consequences. In such circumstances, the Courts might try to find a closer equivalent to MLR in the Bank's market operations, such as bill buying rates, which Bank officials might be subpoenaed to verify.

It was agreed, however, that the next step would be for the Law Society to seek Counsel's opinion on the problem and the proposed solution, which could be used in support of a Law Society recommendation. In this context, DHFS offered the Bank's help in drafting instructions to Counsel, in particular on technical matters relating to Bank Rate, MLR and the Bank's Base Rate. As the opinion would clearly not be available before the next issue of the Law Society Gazette on 26 August (with a printer's deadline of 21 August), it was agreed that a short note should be inserted in that issue to the effect that discussions with the Bank on the MLR problem were continuing. It was also agreed that a draft of this note should be shown to the Bank in advance, and that in the meantime everything possible should be done to avoid further references to the discussions with the Bank in the national press.

Finally, Jacomb took the opportunity to say that he would now withdraw from the discussions with the Bank and leave the matter in the hands of the Law Society, as he felt that he had done all that he could to ensure that an acceptable solution was being sought. DHFS thanked him for his assistance and it was left that the next moves would be for the Law Society, on the draft notice to be inserted in the next edition of the Law Society Gazette and on the draft instructions to Counsel.

CHANCELLOR

HW Smeeth

- cc Chief Secretary
- Financial Secretary
- Minister of State (C)
- Minister of State (L)
- Sir D Wass o/r
- Mr Rylie
- Mr Burns o/r
- Mr Middleton o/r -
- Mr Monck o/r
- Mr Britton
- Mr Turnbull o/r
- Mr Kemp o/r
- Mr Gilmore
- Mr Ridley
- Mr Cropper
- Mr Cardona

STATEMENT ON MONETARY CONTROL: MARKET INFORMATION

Mr Jenkins' minute to Mr Middleton of 11 August asked for our comments on the Financial Times' call for the authorities to make more information available on the criteria for setting interest rates and on their actions in the market. The FT complained in a leader that 'the monetary picture in Britain is now so foggy and the authorities' views on the relative importance of various monetary indicators so ambiguous, that it is hard for financial markets to settle on an appropriate interest rate structure without further guidance on the Government's intentions!

2. Although the complaint centres on the absence of information about the criteria for setting interest rates there is evidence that the attack on our attitude to the information sprang in part from a misunderstanding about the nature of the information which the Bank will make available on a day to day basis. The new system of Reuters announcements was not described at the Bank's press conference on 5 August. There is an Aide Memoire dated 13 August describing the few daily releases to the market and their contents. In addition, starting with the September edition, the Bank's Quarterly Bulletin will contain an extended discussion of its market operations in the public quarter, in a new section entitled "The Operation of Monetary Policy". It is intended to point out, however, that even this retrospective description will not include information about the level or width of the band, nor will it explain in any detail why rates were allowed to rise or fall on any particular day.

3. In part, of course, the answer to the Financial Times is that a new feature of the new system is uncertainty about the authorities interest rate interventions. This is a prerequisite if the market is to be allowed a greater role. There can be

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question, therefore, of our policy and the amount of the rate. We take different factors into account. We can also agree that the range of rates, and regularly reaffirming the policy of the rate policy. When the statement of the Federal Reserve was the possibility of criticism. We did not, however, give a description of the factors to be taken into account. It is unwise to attempt to expand on this description. There has been very little adverse comment in the short period since the new system. The Financial Times has so far not returned to the charge.

Handwritten signature

3. 1947

1. 1947

13th August
AIDE MEMOIRE

Information on the Bank of England's operations in the money markets

- 1 With effect from 20 August 1981, the Bank will be employing a revised method of communicating to the markets the morning forecast and the operations undertaken both before and after lunch.
- 2 The changes will involve the effective disappearance of the 'Beaufort' Scale (last revised in April 1979) which has hitherto been used to describe in bands of £100 mn the forecast for the day, the main factors involved and the size of the operations undertaken by the Bank.
- 3 Announcements will be made at the following times (approximate) -
 - (i) 9.45 am to cover the normal morning forecast;
 - (ii) 12 noon, or earlier if available, for a revised forecast (if necessary);
 - (iii) 12.40 pm for details of any operations undertaken prior to lunch;
 - (iv) 2.40 pm for details of any operations undertaken after lunch.
- 4 These announcements will be transmitted to the markets via the regular press agencies with which the Bank has regular contact viz Reuters, Extel and A P Dow Jones. In the case of Reuters the Bank will be using its own 'pages' on the Reuter Monitor for transmitting the information direct to the markets (the relevant pages are RTCA, RTCB, RTCC, RTCD).
- 5 Instead of the 'Beaufort' Scale, the Bank will in future be expressing forecasts, factors, and operations undertaken in actual figures. While aiming for a high degree of accuracy in the daily forecast, the Bank recognises that precision of information, particularly on the very large sums of money flowing between Government and the markets is probably not possible at this stage of the day. To reflect this high likelihood of variation, the total forecast and the contribution of cheques & bills will be

described approximately. Thus the expression 'about £200 mn', means an initial shortage or surplus in the range £175 - £225 mn; if the figures move outside that initial range by no more than £25 mn, no revised forecast will be published. If they move by a larger amount, the revised figure will be announced according to the original formula.

6 Individual factors contributing to the day's position such as maturing bank bills or the unwinding of a 'repo' transaction will be expressed in precise terms. The figure for 'Exchequer transactions' will include the net effect of Government revenue (including sales of gilts and an estimated figure for applications for any new gilt issue on offer) and Government disbursements (including any purchases of stock).

7 Open market operations will also be expressed in precise figures together with the range of rates dealt in and the maturities of the bills purchased/sold. The maturities will be expressed in terms of bands which are as follows:-

Band 1	=	up to 14 days
Band 2	=	15 - 33 days
Band 3	=	34 - 63 days
Band 4	=	64 - 91 days

Bank of England

13 August 1981