2. Monetary Control

Consultants

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS ON THE GREEN PAPER

Note by the Secretaries

Draft paper by David Lomax (presumably to be published shortly) "Consultative Documents on Monetary Control and The Measurement of Liquidity" 7 April 1980 is attached and circulated for information.

M L WILLIAMS
M D K W FOOT

H M Treasury
25 April 1980

ECONOMIC ADVISER'S OFFICE

7 April 1980
London

CONSULTATIVE DOCUMENTS ON "MONETARY CONTROL" AND "THE MEASUREMENT OF LIQUIDITY"

Introduction

1. The implication of these documents is difficult to assess, at both the detailed and global levels. The papers themselves are riddled with ambiguities and inconsistencies, and one has to examine in some critical detail the thinking behind them.

2. It must be emphasised that the apparent distinction between a paper on monetary control and another on liquidity is false and has no basis in logic or as regards the functioning of the monetary system. The liquidity paper is concerned not with one bank in isolation, but with setting up liquidity conditions which relate to banks holding each others' paper. The liquidity paper is thus defining a system rather than a behaviour pattern for individual banks. And since it is that system which will be operated on as the authorities deal in prime liquid assets, or make available cash, the liquidity system is intrinsically part of the monetary policy system. There have appeared in the press rather lurid details of alleged disagreements among policy makers in putting the new document together, and one perhaps too obvious conclusion would be that the "Monetary Control" paper was clearly drafted between the Bank of England and the Treasury, whereas the Bank of England may have managed to maintain a more unique jurisdiction over the liquidity paper on the grounds that it was concerned more with technical matters than with the broader implications of monetary policy.

3. The contrast can be sharpened somewhat further as we have on the one hand the monetary control paper setting out a cash ratio system with all banks being expected to keep a certain amount of cash with the Bank of England. This cash would be the fulcrum which the authorities would use to determine the level of interest rates, which in turn would influence the growth of the money supply.

4. But paragraph seven of the liquidity paper defines primary liquid assets - "as cash or those assets in whichever currency which are in all circumstances a ready source of cash, because the authorities stand ready either to purchase them or to accept them as collateral for last resort lending." In as far as these primary liquid assets fulfil that definition and are in all circumstances a ready source of cash, then the authorities have no fulcrum. In setting out their views on this, the authorities seem to be relying on a rather debased version of the concept of "lender of last resort". This concept meant originally that the central bank must lend willingly and on a large scale to save the banking system as a whole, should thre be a risk of failure of significant banks. The concept does not mean that the central bank is obliged to help every Tom, Dick or Harry who has become temporarily short of cash and can produce some eligible paper. It would be fully consistent with the classic definition of "lender of last resort" for the Bank of England to be much tougher on occasion regarding the terms on which it will deal in the money market. To make its views felt by dealing, say, on occasion at 50 per cent would be perfectly compatible with "lender of last resort" responsibilities. If the Bank of England becomes over committed to the very short term financial health of money market institutions, under a debased version of the doctrine of "lender of last resort", it undermines the whole of its monetary policy.

The Monetary Base

5. Discussion whether a monetary base system should be introduced has now reached a level characterised almost entirely by attitudinising, and it is clear that the Bank of England are not prepared to have anything to do with a system defined as a monetary base. Yet the system they propose, with each bank holding cash at the Bank of England which will be used as the fulcrum for influencing interest rates, could perfectly reasonably be discussed as a variant of a monetary base system if one so wished.

6. A more important issue relates to the clearing banks' attitude to the new system. It must be recognised that a totally permissive and flexible system is not feasible - it would soon be found inadequate for public policy purposes and be replaced by administrative controls such as the corset. The choice facing the banking system and the clearing banks is of the kind of restraints and controls they would prefer.

7. In this regard, one of the justifications for the more active use of monetary policy in recent years is to influence expectations, and hence the demand for money throughout society. One would expect that success in this matter would make the banks' tasks easier and so it would seem to be in the interests of the clearing banks for the Bank of England to make it abundantly clear that they intend to achieve the monetary policy objectives by as active a use of interest rates as is necessary.

8. The success of the new system would thus depend on the way in which the Bank of England deals in primary liquid assets as a means of influencing interest rates, making it more or less easy for cash to be obtained by the banking system. By leaving themselves with virtually only this particular weapon, the authorities are forcing themselves to use interest rates vigorously as a means of controlling the monetary system.

Echoes from the Past

9. A striking element in these papers, and in particular in the liquidity paper, is the harking back to the monetary practices of several decades ago. As one read reports in the press of the supposed issues being discussed between the Bank of England and the Treasury one could note that the Bank of England might be about to re-invent the pre-CCC systems. In the event the echoes of that time are remarkable The document gives explicit credence to the old 28% liquidity ratio, and the monetary techniques recommended go back even further. Before the 28% ratio became the operational ratio the banks had to keep an 8% cash ratio as the basis for control. But this had to be superseded by the 28% liquidity ratio, as the Bank of England had undermined the cash ratio by its overwillingness to create cash in exchange for the main liquid assets. Thus 28% (rather than the 8%) became the operational ratio (in turn being superseded by CCC). The new system proposed by the authorities is equivalent to the earlier 8% cash ratio system, and the lesson of history is that unless the Bank of England shows some caution or resistance in creating cash in exchange for primary liquid assets, the new system could be expected to break down in much the same way as the 8% cash ratio system did, leading both to administrative controls and to the requirement for a more composite reserve asset. In this regard the new proposed system could in some ways be worse than CCC. If there is no firm requirement for primary liquidity, but only a norm, then there would be nothing to stop the banking system unloading its prime liquidity onto the Bank of England at times of crisis. The

CCC system was bad enough, because reserve assets could be shifted in and out of the banking system: this possibility will still exist, yet the demand for reserve assets would be even more unpredictable if the banking system were able at times of crisis to offload liquid assets onto the authorities without limit in the short-term.

10. However, I am sure that these points above are well known to the authorities, who have nevertheless structured the paper as it has appeared. What are the strengths of this new system? In looking for the authorities motivation it is significant that thre are so many elements of deeply traditional Bank of England thinking in these papers. It seems most unlikely that papers could be prepared suffused with thinking going back 30 years or so, and yet that the new system would be operated in what one might regard as a totally new way. The elements os traditionalism in this paper, which are almost dominant, imply to my mind that the Bank of England is harking back to its most traditional practices and objectives, and is thereby aiming at a system which will enable it to achieve those in its own particular way. Two of the strongest traditional Bank of England objectives have been to have "administrative" control over the financial system (done in its own way rather than necessarily through formal rules), and to use interest rates as a main weapon of credit and economic control.

The New Liquidity Requirements

11. One of the effects of the liquidity controls being so onerous, and they are as far as I know widely regarded as being very demanding on merchant banks and other wholesale banks, given their normal balance sheet structure, will be to drive them into the arms of the Bank of England, who will always be engaged in private discussions with them regarding the acceptability or otherwise of their balance sheets. It gives them a much stronger lever over these banks than they have had in the past. Second, the interrelationship between wholesale banks' balance sheets and the mushrooming of inter-bank transactions which occur when banks try to bid funds from each other to acquire reserves, will be more complicated, and at times impossible. The mere taking in of these deposits will establish complicated multiplier structures regarding the amount available for purchasing liquid assets, and between the maturity structures of the interrelated asset and liability sides of various banks' balance sheets.

12. The liquidity structures set out in this paper are so complicated that it might be useful to have made an operations research model of this new system in order to examine some of its characteristics. It could be too complicated to establish a model which incorporated interest rate effects, but some of the internal multiplier characteristics of the model, and the effects of various disequilibria - cash shortage, shortage of reserve assets, the clearing banks placing less in the market or changing their desired maturity structure - on the demand for particular assets and on balance sheets could be explored only by such a model. (One wonders whether the authorities have done such an exercise). The much stronger multiplier requirements for primary and secondary liquidity relating to operations in the inter-bank market could have the effect that in periods of competition for funds the upward pressure on interest rates could be even greater than at present. Because of the multiplier effects the new system could have some characteristics similar to the corset, and it is very likely to force banks to give greater emphasis to asset rather than liability management. It will also have a major impact on the maturity structure of the wholesale banks' balance sheets, encouraging a significant lengthening of maturities, which is presumably a deliberate objective of the authorities.

Public Sector Subsidy

13. The complicated multiplier arrangements which are created when banks try to achieve liquidity by placing funds with each other may mean that on occasion interest rates will move to levels which indicate that banks are not willing to take the deposits which will provide other banks with liquidity. In that case banks will be forced to buy other assets providing secondary liquidity, of which many are liabilities of the public sector. Thus this new system could well guarantee a much greater flow of bank funds into the public sector, in effect as a subsidy, since the fact that the banks have to hold such paper will reduce the relevant interest rates.

Gold

14. As an incidental point, it is most surprising that gold be included as a secondary liquid asset. It has few such characteristics, and certainly is little more suitable than, say, copper or tin. However this will clearly help banks with gold investments, or which use it as a stock-in-trade. How will it be valued?

The New Control Concept

15. Thus my interpretation is that the Bank of England would like to create a kind of "funnel" or " arm -in-sleeve" system for controlling the banking system. The funnel consists of the discount houses, the clearing banks, and then the remainder of the banking system including mainly the wholesale banks. They hope to have created enough inter-relationships and linkages along this funnel between the different components of this banking system and their related requirements for certain prime liquid assets, bearing in mind that the clearing banks are the main net placers of wholesale inter-bank funds, that when the Bank of England pulls levers at the mouth of the funnel, in the money market, and in its dealings in primary liquid assets, the effects will be transmitted through these linkages to the entire sterling banking system. The pre-CCC system suffered from the fault that the Bank of England had some control over the discount houses and over the clearing bansk, but the new wholesale banks dealt almost entirely in a different range of liquid assets. CCC corrected this to some extent, but there was much too much scope for inflating balance sheets in transactions within the banking system, and in particular between the clearing banks and the wholesale banks. This new system creates much stronger structural linkages between different banks' balance sheets and as regards primary and secondary liquidity, and thus presumably in the Bank of England's eyes gives them a much firmer grip over what is going on.

16. If this works, it would be a solid achievement. A weakness could be the concept of a norm for primary liquidity, since this is an uneasy halfway house between on the one hand setting ratios to which the banks have to conform, and on the other hand letting the banks choose their optimum portfolio structure. Second, if it is to be used in a liberal manner this system can operate only through interest rates, which in turn means through the determination of the Bank of England to be difficult at times in turning prime liquid assets into cash. In as far as this new "funnel" concept may have the effect of forcing sharp increases in interest rates at times when the Bank of England create cash shortages, it could accustom the public and the government to more active use of the interest rate weapon.

The Indicator System - Weekly Statistics

17. The Monetary Policy paper refers to the bias for delay in implementing monetary policy, and outlines possible indicator systems which might be used to trigger changes in interest rates in response to untoward movements in £M3. I should like to make two specific comments on this. First the record in recent years, as mentioned many times in the two papers, is that specific rules and rigidities often lead to unwelcome and inappropirate developments. Second, when the authorities set a monetary target they must have at most times a view as to the most appropriate interest rate strategy. This would be unlikely to coincide with that produced by any formula, while the reliance on a formula implies that the authorities do not regard themselves as capable of putting into practice their own policy. I am of the view that the determination of the appropriate interest rate policy is a matter essentially for the authorities, who have the means and opportunity of bringing to public attention whatever evidence may be available as to the need or otherwise for changes in interest rates.

18. Issues of greater concern to the clearing banks arise, however, if we are moving to the use of weekly published money supply data. There are arguments for resisting this development quoting United States experience, on the grounds that it introduces much statistical "noise", and encourages excessive concern in the market with transient developments at the risk of perverse market movements. The Bank of England have the information themselves, which they are free to use in formulating and changing monetary policy and little would be gained by committing the financial markets to a perpetual and obsessive debate about weekly data.

The Clearing Banks' Retail Business

19. There are two specific points, which bring out the underlying artificial structure of these new arrangements, and on which the clearing banks if they so wished could have an excellent negotiating stance. These relate to the liquid asset requirements on retail sight deposits and on seven-day notice deposit accounts. It can be shown by statistical techniques that the vulnerability of a bank to movements of sight deposits depends on various quantitative factors including the behaviour pattern of those deposits, the number of those deposits and their average size, and the bank's own share of the deposit market. Thus if a bank had 100% of the current account market in a country there would be little risk of its losing liquidity through movements in those accounts. If the bank had only 1% of that market its risk would be much greater. Similarly, a bank which had £1 million deposits made up to 10,000 deposits of £100 each would be much less vulnerable to a liquidity crisis than a bank which had one deposit, of similar behavious partter, of £1 million. Propositions of this nature could be illustrated clearly if one were to set up an OR model of liquidity movements, and there is a case for the clearing banks to argue that their massive retail current accounts should merit a lower liquidity ratio than the 25% mentioned in the consultative document. Comparative data could be sought on the regulations in other countries - although one must admit that in the United States the cash reserve ratio upon current accounts is high, at 16%, although injustification it would be argued that in that country the banking market for current accounts is much more fragmented.

20. Whether or not one wished to deploy these arguments as regards current accounts - and in that case it would be reasonable although perhaps somewhat offensive to argue that large banks like Barclays or

National Westminster should carry a lower reserve ratio than the Yorkshire Bank or Williams & Glyn's - it might be difficult to demonstrate precisely what the appropriate liquidity ratio for current accounts should be. But a reasonably objective comparison could be made between the behaviour of seven-day notice retail deposit accounts and current accounts, which should indicate which was more vulnerable. The relative behaviour pattern of depositors in those two markets can be measured and we would expect seven-day notice deposit accounts to need less liquid backing. This could be proved, however, only by the appropriate statistical and OR tests.

21. I raise these points not necessarily because the clearing banks may wish to deploy them, but simply to indicate that the basis of calculation of these liquidity ratios is artificial, and in my view could best be interpreted as a means of setting up in effect a monetary control system rather than as justified by pure considerations of prudence. The attempt to justify these ratios by harking back to the 28% ratio, which in turn was the crystallisation of ratios employed in entirely different conditions many years earlier, is unconvincing.

The Cash Ratio

22. I would hope that the clearing banks would negotiate strongly for a uniform cash reserve ratio across the entire banking system. Or if not, and the clearing banks had to suffer a higher ratio, that all banks should have to hold the same cash ratio as against wholesale eligible liabilities. If this is not done there is a serious distortion of competition in the wholesale lending markets, which operate on fine margins. The clearing banks would be then unable to compete equitably in these markets and would be encouraged to create artificial balance sheets and organisational structures to deal with the differences in the reserve ratios.

Concluding Points

(1) The two papers define an integrated system of monetary control and, in particular, the liquidity paper should be interpreted as an integral part of the monetary policy system (paragraphs 1 - 4);

(2) Discussion about whether we should have a monetary base system has been reduced to semantics. The authorities are clearly not willing to create a system described in that way (paragraph 5);

(3) The success of the new system will depend almost entirely on the active use of interest rates, which in turn implies a willingness not to turn primary liquid assets into cash too easily (paras.6 - 8);

(4) The new system is a return to that <u>before</u> the pre-CCC system, when reliance was placed on the 8% cash ratio. But the new liquidity controls will enable the Bank of England to have a much tighter grip (the "funnel" concept) over the wholesale banks (paras.9 - 10, 15 - 16);

(5) There could well be a larger subsidy to the public sector, from the encouragement to hold such debt as secondary liquidity (para. 13);

(6) Wholesale banks will need to engage more in asset (rather than liability) management. The multiplier effects of the liquidity linkages between wholesale banks' balance sheets are very complicated and there might be a case for examining them by means of an OR model (paras. 11 - 12);

(7) The clearing banks could well have a case that the liquidity requirements on their retail business (and in particular on the seven-day notice deposits) are too high. Such a case would need to be made on the basis of the appropriate statistical analysis (paras. 19 - 21);

(8) It should be a major objective of the clearing banks to negotiate the same cash ratio over all the banks, among other things to achieve fair competition in the wholesale money markets (para. 22);

(9) Weekly money supply figures would not be desirable. An automatic indicator system could well produce undesirable effects. It is the responsibility of the authorities to carry out monetary policy, and to produce or highlight whatever evidence is available regarding the desirability of any change in interest rates (paras. 17 - 18);

(10) There are many specific points which individual market participants will wish to see changed. Some of these are very important for the health of particular markets and of London as a financial centre. But the total impact of these points on the way the whole system works and reacts can hardly be foreseen. Various anomalous behaviour patterns are likely to be revealed and need correction over time.

(11) It is surprising that gold has been designated a secondary liquid asset (para. 14).

Dr D F Lomax
Economic Adviser

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COMMENTS ON THE GREEN PAPER

Note by the Secretaries

Philips and Drew "Monetary Control and Liquidity" 14 April 1980 is attached and circulated for information.

M L WILLIAMS
M D K W FOOT

H M Treasury
25 April 1980

Phillips & Drew, Lee House, London Wall, London EC2Y 5AP
telephone 01-628 4444 telex 883236 883235 (bond dealers)

14 APRIL 1980

PHILLIPS & DREW

GILT-EDGED RESEARCH

A FORTNIGHTLY PUBLICATION

Monetary Control and Liquidity

The authorities published last month two papers, one, entitled 'Monetary Control' discussing the scope for improvement in the authorities' techniques for smoothing the path of monetary growth, the other, entitled 'The Measurement of Liquidity', setting out proposals for changes in bank liquidity requirements. The two papers are closely linked because one of the chief factors weakening the authorities' short run control over the monetary aggregates in recent years has been the development by the commercial banks of liability management techniques. The proposals for monitoring liquidity put forward by the Bank of England would, if fully implemented, severely curtail the scope of banks' liability management.

MAIN CONCLUSIONS

1. The authorities have laid down criteria for judging the merits of any proposed change in monetary control techniques. These criteria include the minimisation of disintermediation, the preservation of competition, the avoidance of prudential risks and compatibility with potential EMS commitments.

2. Within the framework of these criteria, we believe that the objections to monetary base control methods are insurmountable.

3. The adoption of an automatic link between money supply growth and official market intervention rates would probably add to the instability of financial markets and could require the frequent invocation of override powers, when the formula dictated interest rate changes that were inappropriate in the light of known future money market flows.

4. The Bank of England's proposals on liquidity, as they stand could have the unintended effect of encouraging a switch of business from London to overseas financial centres and of inhibiting competition between financial institutions within the UK.

5. Nevertheless, from the point of view of maintaining official monetary control, the authorities are likely to see some advantage in curbing the practice of liability management by the commercial banks. If current proposals for monitoring liquidity could be modified to reduce their potentially harmful side-effects, they would indirectly make a much more effective contribution to easing the problems of monetary management than would the adoption of monetary base control.

For further information please contact S.J. Lewis

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The joint Bank of England/Treasury consultative paper on monetary controls published last month, addressed primarily the problems of maintaining a smooth profile for growth in the money supply. Comments were invited on the relative advantages of monetary base control techniques and on the benefits to be gained from the authorities' adopting an automatic indicator system, related to movements in the monetary base or in sterling M3 to set the level of official market intervention rates. It was proposed that the Supplementary Special Deposits scheme should be phased out (the Chancellor has since announced that this scheme will lapse from June this year) and that the reserve asset requirement on banks should also be removed. The liquidity needs of banks should rather be monitored on a revised basis, which was set out in an accompanying Bank of England paper on the measurement of liquidity. Even if the authorities are not persuaded of the advantages of a switch to monetary base control or of the adoption of a formal indicator procedure, the proposed changes in the arrangements for bank liquidity, if fully implemented, are likely to have a substantial impact on the structure of the money markets.

At various points in the consultative paper, the authorities indicate the criteria which they apply in judging the merits of innovations in the practice of monetary policy. The criteria include:

1. The degree to which competition between banks, and between banks and other financial intermediaries, is impaired or enhanced.
2. The extent to which the new technique provides an incentive to disintermediation.
3. The prudential risks involved in the change of method.
4. The degree to which a new method of monetary control would be consistent with eventual membership of the exchange rate mechanism of the European Monetary System.

Critics of the present system might well accept these criteria less than whole heartedly. Disintermediation, for example, might be seen as part of the process whereby monetary policy is made effective. Similarly, the objectives of the EMS could be seen as being potentially incompatible with the achievement of a smooth long run deceleration in monetary growth in the UK. Nevertheless, the authorities' belief in the value of published monetary targets, a value which may be less apparent if disintermediation takes place on a large scale, and the responsibilities implied by EEC membership in the long term, which point to the UK's eventual inclusion within the EMS, validate, in the context of an official Green Paper, the criteria set by the authorities. It is on this basis that the methods of monetary base control should be discussed.

Granted the authorities' criteria, we believe that the objections to a monetary base control system are insurmountable. If the cash reserve requirement on banks were not mandatory there would be little reason to expect a close correlation between this cash base and the money supply even if the structure of the money market were radically reformed so that balances with the Bank of England became the only source of primary liquidity for the banking system. The example presented by Switzerland in recent years is apposite in this case. Although the Swiss authorities have controlled the supply of base money to the Swiss commercial banks the expansion in the M1 money supply target-variable has been far from smooth, with year-on-year growth in M1 varying in a range from 12% to − 6% in the past three years. If commercial banks' demand for monetary base is allowed to depend on prudential requirements it is unlikely to bear a close relationship with the level of total bank deposits but will be influenced primarily by the banks' perception of the likelihood of their requiring to have recourse to their reserves of liquid assets. The extent to which bad debts are expected to be incurred will be the key determinant of monetary base demand in such a system. This method, therefore, is inappropriate as a means of maintaining monetary control.

A mandatory cash reserve requirement on the banks based on lead accounting would, as the Green Paper suggests, create an incentive for banks to hold precautionary excess reserves. Variations in the level of these precautionary reserves might well be large enough to vitiate the authorities' monetary objectives. If, on the other hand, banks' cash reserve requirements were calculated on a lagged accounting basis, there would be significant risks of disintermediation, as banks sought to arrange business through channels not covered by official controls. The problem of disintermediation, indeed, is likely to be a serious objection to any system of control which aims directly at curbing the volume of a fixed range of either bank assets or bank liabilities.

The techniques for making automatic adjustments to market intervention rates seem to be regarded by the authorities with more favour than monetary base control methods. As the Green Paper rightly points out, such adjustments would be more appropriately triggered by deviations in the sterling M3 money supply variable from its targeted path than by movements in a monetary base measure.

The objections which may be raised against an automatic system fall broadly into two categories. First, there is the likelihood that expectations in the financial markets would become even more influenced than at present by short-term, and possibly erratic, changes in the monetary aggregates. Far from facilitating a smooth adjust-

ment in financial markets to the monetary target, the setting of an automatic link between the authorities' market intervention rates and short run changes in sterling M3 could heighten the instability of short-term interest rates. Secondly, there may be occasions, as in the first quarter of the current calendar year, when it is clear both to the authorities and to market participants that a reversal is likely in the flows of funds through the money market as a result, for example, of an expected change in the pattern of Exchequer receipts and payments. In such circumstances, the authorities might well override the automatic formula for setting intervention rates. An uneven pattern in money market flows is, however, the rule rather than the exception. The authorities, therefore, might frequently have to override the formula, weakening the power of such a formula to influence expectations beneficially. **For these reasons, it is difficult to make out a case in favour of the automatic adjustment of interest rates to money supply movements. We believe that a move in this direction would bring few advantages and could add to the instability of financial markets.**

The key problem facing the authorities in implementing monetary policy in current financial market conditions is the development by the commercial banks of liability management techniques. In the 1960's, the response of the commercial banks to a tightening of official policy was characteristically to sell relatively low-yielding money market assets, which indirectly raised loan rates relative to bank deposit rates and curtailed bank lending. In the 1970's, by contrast, the commercial banks have more often sought to maintain the level of their lending business in the face of a credit squeeze by bidding for deposits in the wholesale money markets. The development of the wholesale money markets over the past ten years has reduced the effectiveness of the authorities' attempts to control the money supply. It is against this background that the Bank of England introduced its paper on the measurement of liquidity.

In the paper, the Bank of England describes the present system for monitoring bank liquidity. This system has been applied only to the deposits of the UK branches of UK banks. It has not been applied to the overseas branches of UK banks or to the sterling business of the UK branches of overseas banks (except to the extent that monetary control techniques have had implications for liquidity for these banks e.g. through the reserve asset requirement). The authorities propose that the sterling business of overseas banks should be included within a new system of liquidity requirements but that the foreign currency business of overseas banks' UK branches should be subject to much looser surveillance provided that the parent authority is exercising sufficient control over its banks' operations.

For those banks subject to the present system, the Bank of England applies a ratio of 1:3 between a commercial bank's 'quick assets' and its total deposits. The authorities have also observed each bank's total net liabilities with a final term of three months or less and compared this with its holdings of negotiable instruments and firm standby facilities. For the foreign currency business which has been subject to control, the Bank has observed mismatched positions by comparing the total of foreign currency assets with total foreign currency liabilities. Finally, the reserve asset ratio has served a prudential as well as a monetary control purpose in requiring banks to maintain 12½% of their eligible liabilities in certain highly liquid 'reserve' assets.

The Bank of England has concluded that this system is inadequate for three reasons:

1. The present tests of liquidity overlap in their coverage (e.g. the 'quick assets' test and the reserve ratio requirement) and are incomplete (parts of the banking system are exempt from liquidity surveillance).
2. The present tests do not ensure that the banking system as a whole holds an appropriate amount of primary liquidity (i.e. cash or those assets which in all circumstances are a ready source of cash).
3. Liquidity requirements for prudential purposes should be expressed as norms not as minimum levels (as with the reserve asset ratio).

The Bank of England proposes what it calls an 'integrated' test of liquidity, so called because it combines a measure of the likely immediate liquidity needs of a bank with a measure of the needs for liquidity arising from unforeseeable difficulties in financing the bank's known future commitments.

To construct this measure the Bank distinguishes between maturity-certain liabilities and assets — e.g. fixed-term deposits and loans — and maturity-uncertain liabilities and assets — e.g. sight deposits, money at call and bank overdrafts. It is proposed that a liquidity requirement should be applied to the **gross** total of maturity — **uncertain** liabilities and to the **net** outstanding maturity-**certain** liabilities according to remaining term e.g. a bank's fixed term loans of 8 days or less outstanding would be substracted from its fixed term deposits of 8 days or less outstanding to arrive

at the deposit base subject to liquidity requirements). The one exception to the latter rule regarding maturity-certain liabilities would be that the **gross** fixed term deposits taken from **banks** with a remaining term of up to 1 month and **gross** irrevocable undrawn standbys given by banks would be included in the deposit base. Expected liquid asset cover is then calculated as follows:

	Expected Liquid Asset Cover
Gross Maturity-Uncertain Liabilites	25%
Gross Market Deposits from banks up to 1 month	100%
Irrevocable undrawn standbys given to banks	100%
Net liabilities on maturity- certain business	
Up to 8 days	90%
8 days to 1 month	75%
1 to 3 months	50%
3 to 6 months	25%
6 to 12 months	15%
Over 1 year	5%

It is proposed that liquid assets should be divided into two categories, 'primary' and 'secondary'. In the table below, we show definitions of these categories.

TABLE: LIQUID ASSET DEFINITIONS

Primary Liquid Assets	*Secondary Liquid Assets*
Cash	Market loans to banks up to 1 month*
Balances with Bank of England (not including Special Deposits)	Trade bills less than 3 months to maturity*
UK and NI Treasury bills	CD's less than 3 months to maturity*
LA bills and eligible bank billst	Money at call with money brokers and Gilt Jobbers.
Gilts with 1 year or less to maturity	Gilts with 1-5 years to maturity
Call money with discount market	Loans to LA's up to 1 month
	NI Govt. stocks up to 5 yrs to maturity
	LA and public corp. marketable securities up to 5 yrs to maturity
	Gold
	Irrevocable undrawn standby facilities

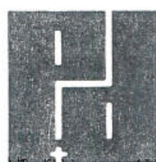
* in Sterling or foreign currencies
† eligibility subject to discussion

The Bank of England proposes that, of the liquid assets held against a bank's **sterling** deposit base, 40% should be represented by **primary** liquid assets. This will mean that for each bank, separate calculations of the liquidity requirement arising from its overall business and from its sterling business will be neccessary.

The following implications for markets should be noted:

1. To the extent there is an opportunity cost in holding liquid assets, UK banks may be expected to develop their business through overseas branches, where liquidity costs could be less.
2. The UK branches of overseas banks will lose the advantages which they have hitherto enjoyed in relation to their sterling business of being outside the scope of liquidity surveillance.
3. The inclusion of cash in the definition of primary liquid assets will give a competitve advantage to those banks which hold cash as a matter of course in their business transactions, that is, those banks, such as the clearing banks, with relatively large retail banking bases.
4. More generally, banks which raise deposits through current accounts and seven days notice to on-lend at fixed terms will be at a significant advantage over those banks who borrow at short fixed terms to lend at longer fixed terms.
5. The definition of primary liquid assets excludes, while the reserve asset definition included, money at call with Stock Exchange money brokers and gilt-edged jobbers. The latter institutions would not therefore be able to raise funds on as favourable terms as hitherto, and might well reduce the scale of their operations.
6. Because the liquidity requirement against fixed term deposits from non-banks is proposed to be considerably less onerous than on fixed term deposits from banks there is likely to be strong bank demand for deposits from commercial sources and a weakening of demand for inter-bank deposits which is likely to be reflected in interest rate differentials.

Although the proposed changes in liquidity requirements are likely to strengthen the authorities' control over the money markets there could be unintended effects on the extent to which business is channelled through offshore markets and hence on London's position as a financial centre and on the terms of competition between financial institutions within the UK. These aspects of the authorities' proposals are likely to be subject to further discussion in the months ahead.



PHILLIPS + DREW
Lee House, London Wall
London EC2Y 5AP
Telephone 01-628 4444
Telex 883236/883235 *(International)*
and 8814310 *(gilt-edged)*

E. P. Bazalgette
P. H. Swan DSO DFC
J. K. Taylor
M. S. Cohen FCA
P. W. Parker TD FIA
B. A. M. Cottrell
B. H. Fison FIA
G. T. Birks
P. M. D. Gibbs FCA
H. H. Sparks

M. G. Hall AIA
J. G. Simpson FCA
C. J. Lewis FIA
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A. R. L. Pearson
R. L. Lawrence
G. R. Gray
T. F. Brown FCA
P. J. Williams
T. W. Buckland
W. T. Seward

Associated Member
M. T. Holland

Consultants
H. R. Hall TD
A. F. Twist
R. J. Pincham