File FEA/0000000100, Part C – Monetary Base Control

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PART 12

8/7/1981 – 11/8/1981

Pages 207-225

Prudential considerations

14 The Bank has received the assurances required in its paper of 12 March "The liquidity of banks", and mentioned in the Chancellor's Budget Speech, that those institutions in the United Kingdom to whom the reserve asset ratio has applied will discuss with the Bank, in advance, changes in their policies for the management of their liquidity and its composition. The Bank is resuming discussions with the banks on the measurement of liquidity as the basis for continuing supervision.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who will become subject to cash ratio and Special Deposit requirements when they are authorised under the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) those banks in the Channel Islands and the Isle of Man which opt to join the cash ratio scheme described earlier in this paper;

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considera larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

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[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Institutions in the monetary sector having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other institutions will be asked to report only at end-calendar quarters.(1)

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 On 20 August 1981:

(i) the Reserve Asset Ratio will be abolished;

(ii) the acceptances of all banks in the first list (attached) of eligible banks will become eligible for discount at the Bank;

(iii) all the banks covered in (ii) above will begin to observe the undertakings set out in paragraph 11 above;

(iv) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(v) the Bank will receive the first deposits under the cash ratio requirement.

21 On this date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs on the monthly make-up days in the period January-June 1981 inclusive, ELs being defined on a transitional basis: ie calculated for 'statistical banks' as at present except that offsets will be allowed in respect of all lending to the discount market and all secured money

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(1) The TSBs will continue, for the time being, to make returns on the existing consolidated basis.

at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below). Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks as set out in paragraph 11 will take effect on 20 August 1981, based on the transitional definition of ELs and in respect of their level as at 15 July.

22 As soon as possible thereafter, (probably in respect of the make-up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the cut-off points for full statistical reporting will join the full reporting network. They will be asked to place cash deposits with the Bank when two months' figures have been obtained, if their ELs are £10 million or more on average.

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed (which is unlikely to be before the second half of 1982).

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(1) The Bank can calculate these offsets for listed banks from statistics already provided. The ELs of members of the LDMA will be calculated as set out in paragraph 6 above, except that no allowance will be possible in this transitional period for deposits by money-brokers and gilt-edged jobbers in the Stock

1. MR MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

c c PS/FST
Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie o/r
Mr Britton o/r
Mr Peretz
Mr Turnbull
Mr H Davies
Mr Coleby - Bank of England

THE LEVEL OF THE INTEREST RATE BAND

It is obviously important that we should begin the new monetary control arrangements with as much clarity about policy and decisions as possible between the Treasury and the Bank. For internal purposes a key element is the level of the band, although we are not of course disclosing it externally.

2. I have discussed with Mr Coleby at the Bank and agreed with him that the centre of the band, which is defined in terms of bill rates in the 0-14 day range, is 12½ per cent (plus or minus 1 per cent). 12½ per cent has recently been the rate at which the Bank has dealt in very short bills, though it has at times lent through the discount window at somewhat lower rates. Interbank rates are rather higher. 7 day rates have been 13 per cent or more since 21 July and 3 month rates round about 14½ per cent, though yesterday 7 day rates fell to 12⅜ as a result of an unexpected market surplus.

3. At present it seems reasonably likely that a band centred on 12½ per cent will last until 20 August when the new arrangements come into force, although this cannot be relied on. If a change seems desirable around that time we would if necessary consult the Financia Secretary, who I understand will be available then, at least on the telephone.

4. If there are any periods when Ministers cannot be contacted, as th annexed office notice suggests, you may wish to discuss with Sir Douglas Wass the possibility of leaving officials with contingent authority to raise the band either before or after 20 August, if th exchange rate situation seems to require it. Such a move might trigger an increase in bank base rates but that might happen anyway if the money market tightens up.

NM

N MONCK
5 August 1981

	Papers to Private Office by	Out of Office
CHANCELLOR	Close on Friday 7.8.81	11.8.81 - 31.8.81 17.9.81 - 30.9.81
CST	18.00 Friday 7.8.81	11.8.81 - 27.8.81
FST	-	31.7.81 - 31.8.81 During September in London 1 or 2 days per week
MST(C)	-	31.7.81 - 26.8.81 28.8.81 - 14.9.81
MST(L)	Noon on Tuesday 4.8.81	5.8.81 - 2.9.81
SIR DOUGLAS WASS	Close on 19.8.81	20.8.81 - 11.9.81

cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr. Ryrie - o/r
Mr. Burns
Mr. Monck
Mr. Turnbull
Mr. Shields
Mr. Davies
Mr. Kemp
Mrs. Gilmore
Mr. Ridley
Mr. Cropper
Mr. Cardona

MR. MIDDLETON

STATEMENT ON MONETARY CONTROL

It has been pointed out to the Chancellor that after today's announcement the press and the public will focus on another figure from the suspended MLR. Could you consider what figure they may focus on (would it for example be base rates, which are higher) and make recommendations.

JtR

(JILL RUTTER)
5 August 1981

9/8

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Ryrie 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

pp P E MIDDLETON
6 August 1981

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Ryrie o.r
Mr Burns
Mr Monck
Mr Turnbull
Mr Shields
Mr Davies
Mr Kemp
Mrs Gilmore
Mr Ridley
Mr Cropper
Mr Cardona

MR MIDDLETON

Are you going to do this?

STATEMENT ON MONETARY CONTROL

The Chancellor was most grateful for your minute of 6 August. He agrees with your assessment - but notes that Patrick Sergeant has re-invented bank rate. He would also be grateful for a comment in due course on the Financial Times' call for the Government to make more information available.

PSJ

P S JENKINS
11 August 1981

It has answered for me!

183/8

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

11 August 1981

MR TURNBULL c c Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Britton
Miss O'Mara

N J Monck Esq
H M Treasury
Parliament Street
London SW1P 3AG

This is in line with para 3 of Mr Middleton's minute "Statement on Monetary Control" to the Chancellor of 6 August.

N MONCK
12 August 1981

Dear Nick.

MINIMUM LENDING RATE

As promised, I enclose a copy of the note I have circulated in the Bank this morning on the possible use of the Bank's Base Rate as a proxy for MLR in agreements where MLR is used as a reference rate.

not attached

I also enclose a copy of the note for record of my meeting with the President of the Law Society and the Chairman of the City Capital Markets Committee last Tuesday.

Yours sincerely

David.

1083/8

11. 8. 81

THE DEPUTY GOVERNOR

Copies to Mr Fforde o/r
Mr Blunden
Mr Balfour
Mr Coleby
Mr Drake
Mr Quinn
Mr Foot
GPS
Mr Kemsley

MINIMUM LENDING RATE

After the discussion at lunch on Wednesday with Middleton, I spoke to Monck about the possibility of suggesting to the Law Society (and the City Capital Markets Committee) the use of the Bank's own Base Rate as a "proxy" for MLR. His initial reaction was that there was a danger of this becoming a substitute in the public mind, with possible political implications, for MLR, such that, if we increased our Base Rate, it could be interpreted, if not as a move to increase interest rates, at least as an official acceptance that they had risen. However, Monck undertook to speak to Middleton before he went off on leave, and he has now confirmed that the Treasury would not object to our putting this proposition to the Law Society, provided that we make 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 ratesand 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.

As you know, I have some reservations about use of our Base Rate in this way, partly because I think it will focus undue attention on this aspect of our banking business, which we normally keep out of the public eye, and partly because I see a danger in it being seen (as is indeed required by the Law Society) as an"official" rate, with the risk of press comment when it is raised or lowered, with the fact that it only changes after the clearers have moved ignored. Moreover, there must be some danger that bank base rates as such may be phased out, though more frequent movement and a different basis would not, I think, worry the lawyers.

However, provided the market operators have no fears on any of these cores, I would be happy to suppress my doubts and put it to the Law Society, with the suggestion that we should provide them with written notification whenever our rate changed, so that it could be published in the next weekly Law Society Gazette. Alternatively, we could offer to put an advertisement in the press, like the other banks, thus meeting the needs of the Royal Institution of Chartered Surveyors, who have also expressed concern (in their letter of 6 August) about the disappearance of a published MLR. On balance, I think I would favour letters to those bodies who have indicated interest, leaving it to them to pass it on to their members in whatever way they think appropriate.

In making this suggestion to the Law Society, I would point out to them that, prior to 1972, we used Bank Rate as the base for our customer lending, but started to use our own Base Rate for such lending when Bank Rate was succeeded by MLR for market operational purposes, making the point that both Base Rate and MLR were successors, for rather different purposes, of Bank Rate. I could also show that, since 1972, clearing bank base rates and hence our own Base Rate had in practice moved closely in line with MLR. I would at the same time tell them that their proposal that we should publish weekly the average rate during the preceding week at which we had purchased eligible bank bills of up to one week's tenor was not acceptable (a) because there could well be weeks when we had not purchased such bills and (b) because it was too close in our mind to the publication of an official market operating rate.

If you agree, I think I should speak to the Law Society (and Martin Jacomb) as soon as possible. I would not propose at this stage to involve anyone from the RICS.

MJB has drawn my attention to another important area in which MLR has an operational significance, namely the EMS, where the rate of interest applied to very short-term financing operations (in support of EMS interventions) and on net use of ECU reserve positions is, in accordance with Article 8.1 of the inter-Central Bank Agreement on the EMS, "the average of the official discount rates of all EEC central banks, weighted in accordance with their respective currencies' weights as derived from the ruling ECU central rates". The article goes on "This average shall be calculated once a month on the basis of the discount rates ruling on the last working day of the month....". Since this formula is part of an inter-central bank agreement signed by all the Central Bank Governors, the fact that the Bank of England will not have a discount rate to report at the end of each month should, strictly speaking, require an amendment to the Agreement. It will not be possible to achieve this before the end of this month, however, since the Central Bank Governors do not meet until September. Nevertheless, if we were to choose the Bank's Base Rate as the substitute for the old MLR, this might be considered so close a proxy by the other Central Banks as to avoid the need for amending the Agreement and would in any case give us a figure to report on 28 August which does least violence to the existing texts. I would therefore propose, with MJB's concurrence, that this be the rate notified to the BIS as Agent of the EMCF for the purposes of the inter-Central Bank Agreement on the EMS.

DHFS.

11 August 1981
D H F S

NOTE FOR RECORD

Copies to Mr Somerset
Mr Drake
Mr Foot

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 wh 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 b-

ealing 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 ~~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. They 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 the 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.

Room II
5 August 1981

11

THE LIFE OFFICES' ASSOCIATION

Which has established a joint standing committee with the Associated Scottish Life Offices

Aldermary House. Queen Street, London EC4N 1TP
Telephone: 01-236 1101 Cables: Lifoway London Telex: 885004

FINANCIAL SECRETARY
REC. 11 AUG1981
[redacted] PPS
CST
COPIES TO MSTC
MSTL
SIR D WASS
MR RYRIE
MR MIDDLETON
MR MONCK
MR TURNBULL
MR CARDONA

11 August, 1981

Nigel Lawson, Esq., M.P.,
Financial Secretary,
The Treasury,
Parliament Street,
London, S.W.1.

Dear Mr. Lawson,

MINIMUM LENDING RATE AND THE
CONSUMER CREDIT ACT 1974

I enclose, for your information, a copy of a letter sent to Mrs. Oppenheim expressing the life offices' concern about the implications for policy loans under the Consumer Credit Act 1974 if MLR is suspended.

Yours sincerely,

E. Wynn Owen

E. Wynn Owen
Chairman

THE LIFE OFFICES' ASSOCIATION
Which has established a joint standing committee with the Associated Scottish Life Offices

Aldermary House. Queen Street, London EC4N 1TP
Telephone: 01-236 1101 Cables: Lifoway London Telex: 885004

11 August, 1981.

The Rt. Hon. Mrs. S. Oppenheim, M.P.,
Minister of State for Consumer Affairs,
Department of Trade,
1 Victoria Street,
London SW1P.

Dear Mrs. Oppenheim,

MINIMUM LENDING RATE AND THE
CONSUMER CREDIT ACT 1974

The recent statement of the Chancellor of the Exchequer that Minimum Lending Rate will no longer be publicly proclaimed as from 20 August has given us cause for concern because of the implications this may have for certain lenders, including insurance companies, under the Consumer Credit Act.

The Consumer Credit (Exempt Agreements) Order 1980 exempts loans, such as policy loans, from being regulated under the Act where the rate of interest does not exceed the higher of Minimum Lending Rate plus 1%, or 13% per annum. If MLR is no longer operative then existing loans which include provision for variable interest rates (some linked to MLR) would be prejudiced.

In addition to existing loans, if MLR is suspended and is no longer adjusted in line with market changes, the insurance companies as lenders may well find it uneconomic to make new policy loans at a rate as low as 13% per annum which would be the effect if the regulations are not amended.

If MLR can no longer be used, then it needs to be replaced, for purposes of the Consumer Credit Act, by another variable interest yardstick reflecting current market conditions. Such variable index should be reasonably free from short-term fluctuations because of the administrative difficulties for both lenders and borrowers of making frequent changes in loan interest rates.

I might add that in the consultation with the Department of Prices and Consumer Protection over the then draft regulations in the mid-1970s, the life offices put up a strong case for a variable interest rate to be specified because at that time the proposal was that there should be a fixed rate only and that at 10% per annum. I am sure that you will agree that the history of interest rates since then has illustrated how inappropriate a fixed level would have been particularly at the rate of 10% then proposed.

The loan facility offered by life insurance companies to their policyholders is a valuable service, the cost of which can only be kept to the minimum if the loans continue to be exempt from regulation under the Act.

A copy of this letter goes to the Financial Secretary at the Treasury for information.

Yours sincerely,

E. Wynn Owen

E. Wynn Owen
Chairman