

The London discount market: some historical notes

The first part of this article reviews briefly the history of the London discount market, from its origins in the early nineteenth century. The second part provides a more detailed account of the development of the market since the war.

Historical background

The origins of the discount market lie with the bill brokers. In the early nineteenth century, before there was a nation-wide branch banking system and before banks lent by overdraft, the brokers acted as intermediaries between, for example, merchants in industrial areas who wished to borrow on bills, and banks, usually in rural areas, with funds available for investment; they thus provided a convenient mechanism for meeting cash deficits in one part of the country from surpluses elsewhere. The role of the bill broker was strengthened after the financial crisis of 1825, when most of the large London banks had to seek accommodation from the Bank of England: the banks decided shortly afterwards to increase their most liquid assets by placing money at call with the bill brokers, enabling the brokers to enlarge their scope by holding bills as principals. In 1830, the Bank decided to extend to certain brokers a facility for discounting bills.

The first major change in the character of the market thus established took place during the second half of the century. The spread of branch banking and lending on overdraft led to the decline of the commercial bill as a means of financing domestic trade; but at the same time the foreign bill on London became the prime instrument for financing international trade. There was therefore a change both in the composition of the market's assets and, to some extent, in the range of those with whom the discount houses dealt.

The next change occurred during the First World War. The commercial bill was temporarily eclipsed as a means of financing international trade. At the same time, however, there was a great increase in the use of the Treasury bill – which had been little used since its introduction in 1877 – to finance the Government's borrowing needs: as a result the market, which had already been dealing in a limited way in Treasury bills, increased its holdings until they became its main asset. After the war the finance of international trade by bills recovered somewhat, but it never regained its previous importance; and until recent years Treasury bills remained the discount market's chief asset.

The next landmark in the evolution of the market occurred in the 1930's. The yield on Treasury bills had fallen appreciably, partly because of the cheap money policy adopted during the depression, and partly because of competition for a smaller supply of bills. But there was no corresponding reduction in the minimum rate at which the London clearing banks would lend to the discount houses. Thus a large part of the houses' resources was employed only at a loss. The clearing banks, recognising that the market fulfilled a useful function in smoothing out movements of funds within the banking system, agreed to reduce their minimum lending rate to the discount houses. They also agreed not to tender for Treasury bills for their own account and to refrain from buying bills from the discount

houses which had run for less than a week. For their part, the houses agreed among themselves to limit the size of their individual tenders for Treasury bills and to submit them at an agreed price. These measures reduced the pressure of competition at the tender; and led to a rise in the yield on Treasury bills sufficient to give the houses a return which exceeded the (reduced) cost of money borrowed from the banks.

The final change in the market to be noted by way of background occurred during the 1939-45 War. Commercial bill business again dwindled into insignificance. Moreover, Treasury bills provided only a marginal profit over the cost of borrowed money. The houses therefore turned to dealing in and holding short-dated government stocks, the supply of which had increased rapidly to finance the war. This development was officially encouraged, for the houses' activities helped to smooth the rapidly growing market in these stocks. Nevertheless, Treasury bills remained the market's largest asset, because the clearing banks would accept only a limited amount of bonds as collateral for their lending. The overseas banks in London, however, held large sterling balances which made them prominent lenders to the market at this time; and their requirements on collateral were less stringent.

Requirements on collateral are still a limiting factor on the composition of a discount house's portfolio. Against the funds which are borrowed, suitable security has to be lodged with the lender – who usually requires a small margin in excess of the amount borrowed, particularly when the security takes the form of bonds. The discount house's profit is made on the difference between what it has to pay for the borrowed funds and the running yield on the securities in which it has invested; profits are also affected by any changes in the value of the investments, which give rise to a capital gain or loss. In the choice of investments a house must reconcile profitability with eligibility as collateral; a house's portfolio is thus limited largely to Treasury bills, short-dated government stocks, commercial bills of suitable quality, and local authority bills.

The margin of security required by a lender is provided from a house's own capital and reserves. This restricts the size of the house's 'book' – that is, its total holding of investments. The prices of government stocks, even as short as five years (the normal maximum for bonds held by the discount market), fluctuate constantly; thus to maintain adequate security by means of bonds placed with a lender, a house must be prepared to increase the nominal amount of security pledged should the market value fall. Against such a contingency, the houses maintain part of their capital and reserves invested in unpledged securities.

Post-war changes in the market

By 1945, the difficulties of the 1930's and of the war years had led to so many amalgamations that there were only half as many houses as had existed twenty years earlier. The market effectively consisted of the eleven houses¹ which had discount facilities at the Bank of England and thus had access to the Bank as lender of last resort.

¹ Five were public companies (Alexanders Discount Company Ltd., Jessel, Toynbee and Co. Ltd., National Discount Company Ltd., Smith, St. Aubyn and Co. Ltd., and The Union Discount Company of London Ltd.); five were private companies (Allen, Harvey and Ross Ltd., Cater Brightwen and Co. Ltd., Gillett Brothers Discount Company Ltd., King and Shaxson Ltd., and Ryders Discount Company Ltd.); and one was a partnership (Seccombe, Marshall and Campion), which also acted as the Bank's agent. In 1944 these houses formally founded what is now known as the London Discount Market Association; however, a Committee had previously been in existence and active since 1914.

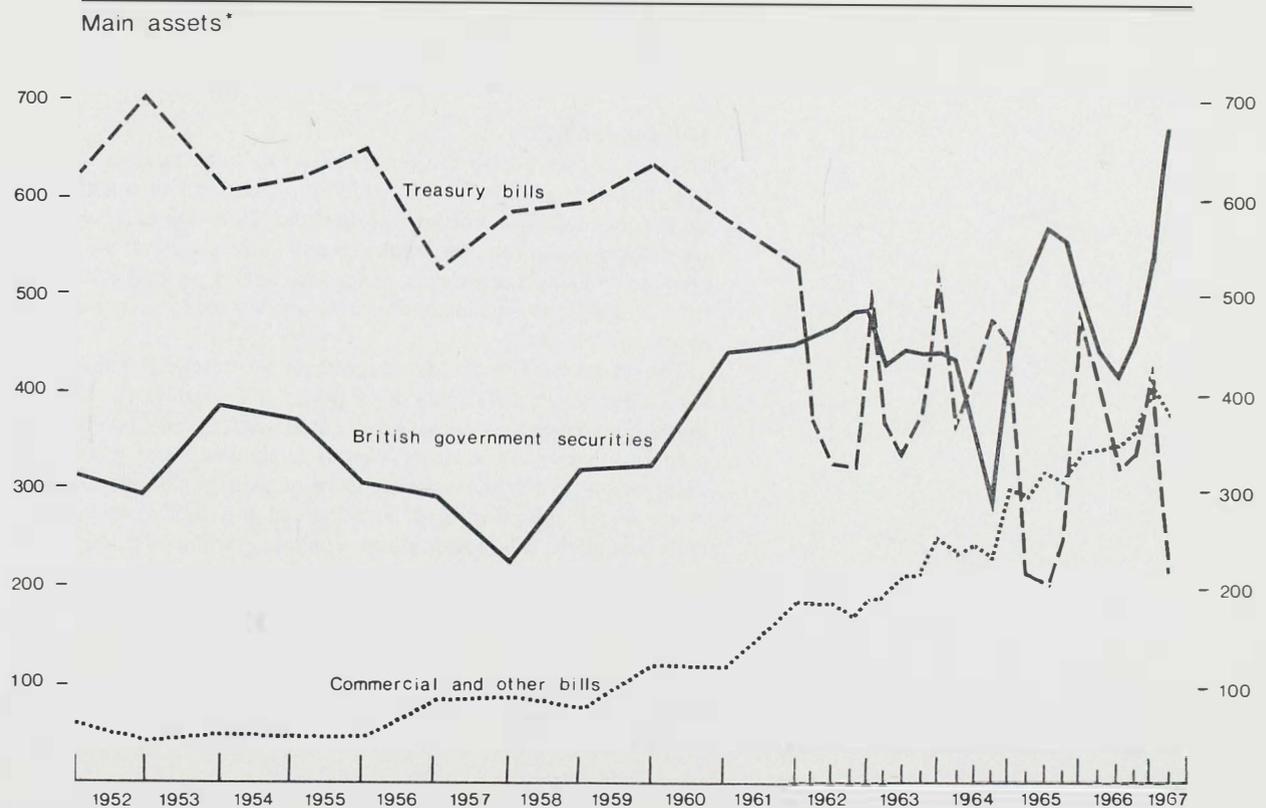
These houses had by then acquired substantial holdings of short bonds, amounting in 1945 to a third of their total assets, and felt themselves to be fully extended in that direction. The needs of post-war reconstruction, and the refinance of government debt created during the war, led to further growth in the issue of short-dated government stocks; and the authorities were anxious that the discount houses should continue to contribute to a smooth and orderly market in these stocks. They therefore allowed the houses to strengthen their position by raising fresh capital. By the end of 1947 the market had raised some £12 million, bringing its total published resources to nearly £30 million; since then, of course, its resources have grown substantially greater – largely from accumulated profits. Seccombe, Marshall and Campion became a private company, and a new house, Clive Discount Company Ltd., was formed as a private company and obtained discount facilities at the Bank. The other private companies, with the exception of Ryders Discount Company Ltd., became public companies.

Subsequently, Ryders Discount Company Ltd. became a public company (in 1954), followed by Seccombe, Marshall and Campion Ltd. (in 1956) and Clive Discount Company Ltd. (in 1959). The last mentioned company had merged in 1958 with Burn and Peace, a firm of 'running brokers' which had been undertaking a business similar to that of a discount house, but without access to the Bank as lender of last resort and so operating more as brokers and less as principals. Early in 1960 the market was increased to thirteen houses, when Gerrard and Reid Ltd. – a private company acting as a running broker, which had recently increased its capital substantially – was granted a discount account at the Bank. Soon afterwards, however, the number of houses fell to twelve again with the merger of Cater Brightwen and Co. Ltd. and Ryders Discount Company Ltd. to form Cater Ryder and Co. Ltd., one of the largest houses in the market. In 1962 the remaining private company, Gerrard and Reid Ltd., became a public company.

In recent years, some of the discount houses have extended their interests in order to obtain a stake in other financial markets. At the end of 1965, Clive Discount Company Ltd. obtained a controlling interest in Guy Butler and Co. Ltd., brokers in the inter-bank and local authority markets. In February 1966 Gerrard and Reid Ltd. acquired an interest in Long, Till and Colvin Ltd., a firm of brokers in the local authority market, and in June they bought a small interest in P. Murray-Jones Ltd., brokers in both markets. Also in June, following the issue in London of negotiable certificates of deposit denominated in dollars, Cater Ryder and Co. Ltd. announced that they would act as brokers in such certificates (though they would not take a position in them), thus obtaining an interest in this new aspect of the euro-dollar market. Later in the year a number of houses obtained exchange control permission to act as principals in the secondary market for London dollar certificates of deposit. In February of this year Cater Ryder and Co. Ltd. acquired the share capital of a firm of foreign exchange brokers, M. W. Marshall and Co.; later the same house announced that they were to form a wholly owned subsidiary, to act as brokers in the inter-bank and local authority markets.

Since the war, there has been a considerable change in the structure of the discount houses' assets. The clearing banks' collateral requirements became more flexible; and the discount houses' holdings of bonds increased, until in mid-1965 they accounted for nearly half of the market's total assets. Treasury bills (then at the

£ millions



* Before 1962, the figures are shown annually at December (see footnote a on page 156).

lowest level reached during the previous fifteen years) accounted for less than a fifth.

Holdings of commercial bills have grown from relative insignificance, until in March 1965 they became the market's second largest asset, after bonds. Expansion was more rapid during periods of credit restraint before 1965, when bill finance was less restricted than bank advances; and it was stimulated greatly after 1961, when the ad valorem duty on commercial bills was replaced by a fixed duty of 2d. More recently, the growth of commercial bill business has been restricted by the Bank's request that lending to the private sector should not increase by more than about 5% over the level of March 1965;¹ nevertheless, throughout most of the two years since March 1965 commercial bills have remained the market's second largest asset.

Another development from early 1964, of which the discount houses took advantage, was the issue by local authorities of negotiable short-term bonds. These bonds, of which some £210 million are currently outstanding, are not eligible security for advances from the Bank, and are accepted only in small quantities by other lenders; the scope for investment in them by the discount houses is correspondingly limited. The first issues were placed direct with the discount houses and other financial institutions; subsequent issues have been placed through the stock exchange also. The discount houses, by first making a market in the bonds, encouraged

¹ 1 June 1965 *Bulletin*, page 111.

their development and the subsequent growth in holdings outside the banking sector.

This article now describes more fully the developments of the past twenty years. Some figures of the houses' assets and borrowed funds, from 1951 onwards, are given at the end.

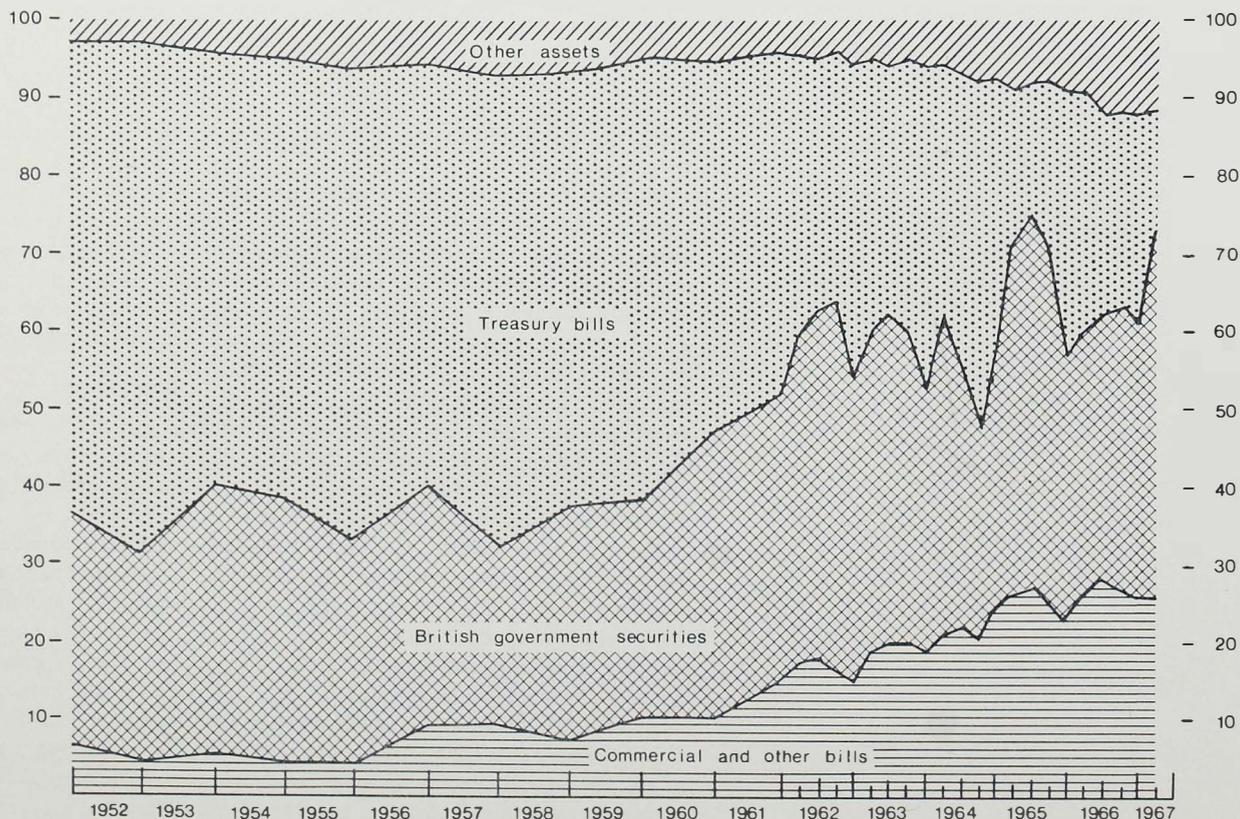
1945-October 1951

Throughout this period the tender rate for Treasury bills was held at a little over $\frac{1}{2}\%$, the rate at which the clearing banks lent money to the market. The houses' profit from Treasury bills was thus insignificant; but as the Bank always intervened in the money market – making cash available to ease shortages and so keeping rates stable – the smallness of profits was balanced by the absence of any risk of loss.

The situation in short-dated government stocks, however, was very different. In 1947, gilt-edged prices fell sharply. The increase in the houses' capital in that year, noted earlier, had been intended primarily to provide a larger margin of reserves; but it had been used mainly to finance an expansion of their books. Nevertheless, it enabled the houses also to withstand the fall in the value of their portfolios. This episode was a salutary reminder to the houses of the need to keep the life to final maturity of the securities in their books within prudent bounds; by the following year holdings of bonds – although still high in relation to available resources –

Per cent

Proportion of assets held in various forms*



* Before 1962, the figures are shown annually at December (see footnote a on page 156).

were of considerably shorter maturity. In 1949, as these holdings approached maturity, the market was able to realise some of them at a profit, and to take up some of the additional Treasury bills which were beginning to supplant Treasury deposit receipts.¹

By the end of 1950 it became apparent that, despite the earlier increase in its resources, the market's total book was over-extended; including contingent liabilities on rediscounts, it amounted to nearly £1,300 million – over forty times as great as published resources. Subsequently, the market reduced its book.

During this period, commercial bill business had begun to revive as trade returned to normal. By 1950 the recovery had progressed sufficiently for the Bank to apply more stringent standards to their sampling purchases.² This lead was followed by the banks, which became increasingly selective in the bills which they would accept as collateral security. The discount houses increased the rates at which they discounted bills, and reduced the proportion of acceptances in their portfolios which were not eligible as security for advances from the Bank. The quality of bills in the market improved substantially; and the emphasis was again placed on 'self-liquidating' bills, financing the movement of goods.

November 1951-December 1954

At the start of this period monetary policy again began to be used as an instrument of economic policy. For the discount market this meant that it could no longer rely on the Bank to relieve shortages of money by automatically buying Treasury bills at market rates. The houses had to be prepared to search for funds, and to take account of the possibility that they might be required to borrow at the Bank at penal rates to make up any deficiency. At the same time, in tendering for Treasury bills the market had to consider the possibility of changes in Bank rate, and thus in the rate at which money could be borrowed, during the life of the bills for which they were bidding. The houses continued their long-standing practice, since the 1930's, of tendering for a sufficient amount of Treasury bills to cover the tender but, after Bank rate had been raised to 2½% in November 1951, they substantially reduced their tender price – thus raising the rate – in order to cover themselves against the element of risk now involved in holding Treasury bills. The higher rate attracted outside competition at the tenders and, with fewer bills being offered following the issue of £1,000 million of 1½% Serial Funding stocks (in exchange for Treasury bills), the market's holdings fell.

To ease the transitional problems arising from the more active use of monetary policy, the Bank announced in November 1951 that they were prepared to make advances against Treasury bills at 2% *i.e.* ½% below the rate (Bank rate) which applied to other forms of security; and the clearing banks adopted a similar distinction in their rates for call money. As a result the difference between the rates which the market quoted for Treasury bills and for commercial bills widened.

The introduction of a policy of flexible interest rates also increased the risks of holding bonds. The increase in Bank rate in November 1951, and the subsequent rise to 4% in March 1952, were both accompanied by substantial falls in the prices of short bonds, particularly those with low coupons and at the longer end of the range. The market shortened the average life of its bond

¹ The banks were able to place funds, previously held in Treasury deposit receipts, at call with the market.

² See the article "Commercial bills" in the December 1961 *Bulletin*.

portfolio, thereby limiting capital losses if interest rates should continue to rise.

The higher margin obtainable on bills, and the opportunities for profit presented by fluctuations in bond prices, helped the market to withstand the change in monetary policy. It was also helped by the stable conditions after March 1952: Bank rate remained at 4% for eighteen months. The proportion of Treasury bills in the market's book increased from 60% at the end of 1951 to 70% at the end of the third quarter of 1952 and the proportion of bonds fell from 30% to just over 20%. Holdings of commercial bills also fell, partly as a result of the collapse of commodity prices during the second half of 1951, as the boom which had followed the outbreak of the Korean War came to an end.

In the second half of 1952 bond prices recovered strongly. The next change in Bank rate (the reduction to 3½% in September 1953) was largely discounted in advance, yields having fallen to a level which left an insignificant profit on call money secured by bonds. With this reduction in Bank rate, the Bank discontinued lending to the houses at below Bank rate against Treasury bills, giving the market less incentive to hold them. At the same time, 'outside' competition for Treasury bills at the tenders was growing; and even though the market bid up at the tenders – thus reducing the rate – its holdings fell to less than half its total assets. By May 1954, when Bank rate was reduced to 3%, the market's bond holdings were almost double the low figure which had been reached at end-September 1952, and the houses' annual turnover in bonds (more than £4,800 million) was over treble that in 1951, whereas turnover in Treasury bills was lower. Indeed, by the end of 1954 the houses were in the vulnerable position of having bond holdings some eleven and a half times greater than their published resources. The market had been adding to its inner reserves, so that the true position was less precarious; nevertheless, because the margin added to securities lodged as collateral for call money absorbed nearly all its resources, any reduction in bond prices would mean that the market had either to utilise further its resources or to reduce its book.

January 1955-August 1957

During most of this period interest rates were rising. Bank rate was raised from 3% to 3½% in January 1955, and to 4½% less than a month later. During 1956 Bank rate was again increased – to 5½%. For the discount market the principal problem was the effect on its portfolio of the fall in prices of short bonds.

In the early part of 1955, prices of some short bonds fell by as much as 10%; the fall continued for six months after the increase in Bank rate to 4½%. A decline of this order in the value of the discount houses' holdings would have roughly equalled the whole of their capital and published reserves. The market was able to mitigate some of the effects of the fall in prices; but published resources still fell by 20%, from £35 million to £28 million. Initially the houses were able to use their inner reserves, which had been built up in the profitable years. Moreover, the clearing banks unified their rates for money at call,¹ reducing the cost of 'basic' money

¹ From 1951 the clearing banks (following the example of the Bank of England) had varied the rates at which they would lend with the type of security offered. Since 1955 they have lent a sizable proportion of money known as 'regular' money (which is in practice unlikely to be called) at a 'basic' or other fixed rate, the more volatile balance being lent at rates appropriate to market conditions on the day. In neither case has the rate varied with the type of security. The basic rate is the lowest rate at which they will lend and is usually 1½% below Bank rate and so ½% above the rate they pay on deposit accounts. From 1955 until November 1958, however, the basic rate was 1¼% below Bank rate.

and enabling the market to increase its running profit, and some lenders were prepared to reduce the margin of security required against call money – releasing some of the houses' capital. The smaller houses, whose bond holdings were not large in absolute terms, were able to shorten their books sufficiently to prevent serious loss – and indeed they had begun to do so in advance of the rise in Bank rate: the larger houses, however, could not sell a comparable proportion of their very much larger holdings of bonds on an already falling market without depressing it unduly. Nevertheless, in the space of a year the market as a whole reduced its bond holdings by over £110 million, or by more than a quarter, from the peak level of September 1954.

This period of falling bond prices was the biggest ordeal the market had had to face since the return of a flexible Bank rate. The houses came through with differing degrees of success; those whose books included substantial holdings of low coupon bonds and bonds at the long end of the five-year range were hit hard.

The rise in interest rates in 1956 was not accompanied by similar difficulties. The increase had largely been discounted in advance: to avoid being forced to borrow from the Bank, the market had raised the Treasury bill rate closer to Bank rate than had previously been normal. Thus its holdings of bills yielded a substantial return over the cost of borrowed money; moreover, its selling rates for bills had not been increased to the same extent.

During 1956 the market's holdings of Treasury bills fell by some £130 million. Turnover, on the other hand, was greater – indeed it was greater even than in 1950, when the houses' holdings of Treasury bills had been over £250 million higher. Meanwhile, holdings of commercial bills nearly doubled in the course of the year, as borrowers who were prevented from obtaining bank advances because of credit restraint turned to bill finance.

September 1957-December 1959

In September 1957, Bank rate was raised by 2% to 7%, the highest for thirty-six years. However, the market was much better prepared for the increase than it had been on earlier occasions. By March 1957 bond holdings had been restored almost to the peak reached in 1954, but by September they had been reduced again, by well over a quarter. In addition, the market had shortened the average maturity of its holdings, and had switched into bonds with higher coupons which were subject to smaller changes in price for any given change in interest rates. By the end of 1957, holdings of bonds were lower than at the end of any other year since 1951. Treasury bill holdings, on the other hand, stood at £585 million, well over twice the seasonal low point earlier in the year. The growth in the market's holdings of commercial bills which took place during 1956 did not continue after the rise in Bank rate in 1957, because one of the exchange control measures taken at the time was a ban on the use of bills to finance trade between overseas residents, as well as on refinance credits.

Bank rate was reduced by 1% in March 1958, and thereafter in stages of $\frac{1}{2}$ % to 4% towards the end of November. Thus the period of greatest stringency was relatively short. A period of falling rates, such as that in 1958, gives the market an excellent opportunity to recover from the effects of a sharp increase in Bank rate. This is because, as Bank rate is reduced, the cost of borrowed money falls immediately; and this cheaper money is in effect used for some while to finance securities bought when yields were

higher. Moreover, a revival in demand for bonds, as prices recover, provides opportunities for successful jobbing and, especially in the longer bonds, for capital appreciation. In such circumstances it is in the market's interest to restore and lengthen its bond holdings before prices rise too much.

Consequently, by the end of 1958 bond holdings were some £100 million higher than a year earlier, and the market continued to increase them early in 1959 (the first year since 1950 in which Bank rate remained unchanged); by the middle of the year holdings of bonds exceeded those of Treasury bills. Treasury bills were less profitable, partly because the growth of outside competition forced the market to raise its bid at the weekly tender in order to obtain satisfactory allotments; and when in consequence the rate fell severely the houses were made to borrow at the penal rate from the Bank. Another factor was the smaller margin between the average cost of borrowed money and Bank rate; after the reduction in Bank rate in November 1958 the clearing banks reduced the proportion of 'regular' money lent to the market, and brought their rates generally closer to Bank rate.

In February 1959 the restrictions on the use of commercial bills for financing trade between overseas residents were removed, and the market's holdings began to rise again. In the second half of 1959 the market began to switch out of bonds into Treasury bills, for interest rates were rising overseas and the market anticipated an increase in Bank rate; and by the end of 1959 holdings of bonds had fallen back again to just over £320 million – the same as a year earlier. Holdings of Treasury bills, on the other hand, increased from around £400 million to £635 million during the last quarter of 1959. This seasonal peak was the last occasion to date on which the market's holdings of Treasury bills have exceeded £600 million.

January 1960-January 1964

This period saw another cycle of rising, and then falling, interest rates. Bank rate was increased to 5% in January 1960 and again to 6% in June. By the end of 1960 it had been reduced to 5% but it was raised again in July 1961, to 7%. Thereafter it was reduced by stages until January 1963, when it stood at 4%.

After the increase in Bank rate in June 1960 the market began to expect that the next move would be downwards and the houses reduced their tender rate for Treasury bills until, for most of them, the difference between the cost of their borrowed funds and the return on Treasury bills had disappeared. During 1960 the market once more built up its bond holdings so that, by the end of the year, they had reached a new peak, of £440 million. Early in 1961, the houses continued to buy bonds, expecting that Bank rate would be further reduced; but the pressure on sterling which developed in the spring brought these purchases to a halt and the houses started to sell. By the end of June their bond holdings were appreciably lower than at the start of the year. Meanwhile, commercial bill business was rising strongly again, having received added impetus from the reduction in stamp duty; in mid-1961 the discount houses' holdings of commercial bills amounted to over £200 million – easily the highest since the war.

The reduction in the market's bond holdings enabled it to accommodate without much difficulty the effect of the increase in Bank rate to 7% in July 1961; and by the end of 1961, as Bank rate was falling, the houses were once again adding to their holdings of bonds. Holdings of Treasury bills, on the other hand, were rela-

tively low, because fewer bills were being offered.

The period of falling interest rates after the autumn of 1961 was one of the most profitable for the discount houses since the war. The substantial holdings of bonds, acquired at a time when interest rates were relatively high, were being financed with funds borrowed at rates appropriate to the lower level of Bank rate; Treasury bill business, in the face of keen competition and smaller offerings at the tenders, did not increase substantially, and the market's holdings of bonds continued to expand. During most of 1962 the market held more bonds than Treasury bills, reflecting in part the extensive funding of government debt in that year.

The reduction in Bank rate in January 1963 was made the occasion for the revival of a technique which had not been used since before the war: the market was informed that the Bank might charge a rate higher than Bank rate for loans as lender of last resort, thus making it possible for the Bank to exert greater leverage on the Treasury bill rate and, if this seemed desirable because of the external monetary situation, to raise it to a higher level than would otherwise have been possible without increasing Bank rate – and thereby also affecting the level of other domestic interest rates. In consequence, the houses did not reduce their tender rate, after the reduction in Bank rate, as much as they might otherwise have been expected to do – because they were unsure of the cost of their marginal borrowed money should they need recourse to the Bank. The Treasury bill rate was therefore high in relation to Bank rate, and the market found it difficult to match particularly strong competition at the tenders which developed at this time; in March 1963, when the houses increased their bid to meet this competition, several were forced to borrow at $\frac{1}{2}\%$ over Bank rate – the only occasion on which this technique has since been used.

There were other causes for uncertainty in 1963, notably the breakdown in the negotiations to enter the European Economic Community; and as a result the discount houses held fewer bonds than in 1962, though still considerably more than their reduced holdings of Treasury bills. In partial compensation, the market's commercial bill business increased again, after remaining steady for much of 1962; and by the end of 1963 commercial bill holdings had reached a fresh peak of nearly £250 million. In order to sample the quality of trade bills in the market the Bank requested the houses to include some trade bills occasionally in the security lodged as collateral for advances; subsequently the Bank included such bills in their regular sampling purchases of commercial bills.

During the latter part of the period increased profitability enabled the market to build up its resources rapidly; but its book expanded rather more slowly. This was due partly to a desire not to become over-extended and partly to competition from other outlets for short-term funds, such as the local authority temporary money market and the inter-bank market, which were then developing rapidly.

February 1964 to date

In February 1964 Bank rate was increased to 5%. The market then assumed that the likelihood of being required to borrow at above Bank rate was reduced, and it therefore restored the margin between its tender rate and Bank rate to a more normal level. It was thus able to obtain a larger share of the bills offered at the tenders. Bond holdings were being reduced, as prices fell after the change in Bank rate, and at the end of the second quarter

holdings of Treasury bills again rose above those of bonds.

The market continued to sell bonds during the summer of 1964; there were uncertainties caused by adverse trade figures and by the impending general election, and expectations of a further increase in Bank rate grew. By the end of September the houses' holdings, at £288 million, were the lowest since 1958. After September, however, the market started to rebuild its bond portfolio, and during the final quarter of 1964 it rose by £150 million. Many of the houses had concluded at that time that a rise in Bank rate was unlikely; and the increase to 7% in November was for them unexpected. Consequently the market generally held substantial amounts of bonds, bought when Bank rate was 5%, which they had to finance with money borrowed at rates appropriate to a 7% Bank rate: this situation, which was a severe set-back to their profitability, continued unrelieved for an unprecedentedly long period – until Bank rate was reduced to 6% in June 1965.

The period of high rates coincided with a substantial reduction in the amount of Treasury bills offered at the tenders; receipts from external transactions reduced the Government's need for domestic finance. As a result, the market's holdings of Treasury bills fell, until by June 1965 they were barely £200 million – a mere 17% of its total assets. In these conditions the houses were obliged to look elsewhere for securities, and bond holdings were further increased, to £571 million by the end of June. Simultaneously, restrictions on bank advances led to a further growth in the demand for finance through commercial bills, and the houses' holdings of them rose to nearly £320 million.

In May 1965, the restrictions imposed on credit included the discount market directly, for the first time; the houses were asked by the Governor to limit the growth of their commercial bills.¹ To help meet the target the houses tended to increase their rates of discount for trade bills in relation to bank bills, and for bank bills in relation to Treasury bills. Even so, holdings of commercial bills continued to expand, and with higher profit margins the houses were able to recoup much of the loss which had arisen from the increase in Bank rate in the previous year. At the end of 1965 commercial bills were still above the target, although holdings were much less than those of Treasury bills – which had more than doubled in the second half of the year. Bond holdings had fallen to £500 million, and this fall continued during the first half of 1966. Thus, when Bank rate was increased to 7% in July 1966, the market's bond holdings were relatively low, and the houses did not suffer undue loss.

During the past six months, when official sales of gilt-edged stock have been very large, the amounts of bills offered at the tenders have been very small; in February 1967 the amount offered was the lowest since April 1945. The Bank were making frequent use of the new technique of lending to the market overnight,² for it became increasingly difficult for the Bank to purchase sufficient bills from the market to offset the large daily shortages of money. The market's holdings of Treasury bills fell right back – until by March 1967 they amounted to only £219 million. Commercial bill finance was subject to restraint; and the houses employed a rising proportion of their funds in short-dated government stocks. By the end of March 1967 the market's bond holdings

¹ June 1965 *Bulletin*, page 111. The limit was removed in April 1967, though the houses were asked to observe continued restraint on bill finance and to continue to pay regard to the Bank's guidance on priority borrowers.

² Described in the September 1966 *Bulletin*, page 215.

totalled £678 million, the highest ever – and over three times as great as holdings of Treasury bills.

Conclusion

This review has shown briefly how changes in monetary policy and in the composition of government short-term debt over the past twenty years have affected the business of the discount market: at the same time its older expertise in the art of bill-broking has enabled the market, particularly in recent years, to take advantage of the growth in commercial bill finance.

The development of parallel markets in short-term funds has also required considerable adaptation on the part of the discount houses: as described earlier, they are meeting this competition both by acquiring interests in firms operating in these markets and, in some cases, by dealing as principals. As markets change, so new opportunities for business arise; in the future further changes may well be necessary if the discount houses are to take full advantage of the opportunities opening to them.

Discount market: assets and borrowed funds^a

£ millions

	Total	Assets				Borrowed funds ^c						
		British government stocks	British government Treasury bills	Other bills ^b	Other	Total	Bank of England, Banking Department	London clearing banks	Scottish banks	Over-seas and foreign banks ^d	Other sources	
1951 Dec.	1,031	314	624	63	31	992	5	555	69	247	116	
1952 "	1,067	291	702	42	32	1,028	5	495	77	340	111	
1953 "	1,085	383	606	49	47	1,048	—	459	80	395	114	
1954 "	1,090	373	618	47	53	1,051	50	452	74	345	131	
1955 "	1,068	307	652	45	63	1,014	58	459	80	257	160	
1956 "	954	294	523	85	53	909	34	454	78	212	132	
1957 "	956	223	585	84	64	903	11	474	75	201	142	
1958 "	1,053	321	594	70	68	1,007	8	519	85	263	131	
1959 "	1,130	322	635	118	56	1,077	28	544	87	256	162	
1960 "	1,197	440	574	117	67	1,139	34	631	90	244	140	
1961 "	1,216	449	533	183	52	1,153	28	675	89	232	130	
1962 Mar.	1,058	458	371	181	48	995	16	589	66	191	133	
June	1,033	466	330	181	55	968	22	590	56	191	109	
Sept.	1,014	485	323	167	40	952	—	569	81	191	111	
Dec.	1,251	488	502	189	72	1,186	8	706	97	234	140	
1963 Mar.	1,036	428	366	194	48	970	8	600	53	173	136	
										Other domestic banks ^e	Accepting houses and over-seas banks ^f	Other sources
June	1,059	444	338	213	64	990	67	513	77	9	211	114
Sept.	1,095	440	381	216	59	1,022	—	554	68	26	237	137
Dec.	1,305	442	529	249	84	1,232	4	688	100	14	265	162
1964 Mar.	1,103	437	363	236	67	1,028	—	566	53	27	248	134
June	1,101	360	423	246	72	1,029	13	504	73	18	285	136
Sept.	1,078	288	478	230	82	1,004	—	554	69	29	243	108
Dec.	1,283	438	453	302	90	1,205	25	705	87	17	240	132
1965 Mar.	1,127	521	215	293	98	1,045	17	665	64	21	188	91
June	1,179	571	201	317	91	1,101	26	667	86	18	214	89
Sept.	1,214	558	252	309	95	1,138	—	693	91	35	224	94
Dec.	1,455	500	484	339	132	1,381	34	849	124	21	242	111
1966 Mar.	1,310	445	400	345	121	1,232	—	769	93	25	231	113
June	1,237	415	321	346	155	1,156	66	650	87	20	247	87
Sept.	1,302	456	333	358	155	1,219	5	822	78	22	193	98
Dec.	1,565	542	424	404	195	1,484	82	978	94	11	201	119
1967 Mar.	1,444	678	219	379	168	1,361	47	857	74	25	226	133

a The figures from 1951 to 1958 are taken from Table 10 of the statistical appendix to *Committee on the Working of the Monetary System: Principal Memoranda of Evidence, Volume 2*. Table 11 in the same appendix gives some quarterly and monthly figures of assets during the same years. Figures after 1958 have been published in this *Bulletin*. The figures relate to end-months (though up to 1958 those for assets are partly at other dates in December), and up to 1955 are partly estimated. Figures for March, June and September 1959 to 1961 were published in earlier issues of the *Bulletin*; but they related to mid-month dates and are excluded here.

b Including Treasury bills of the Northern Ireland Government.

c Excluding capital and reserves.

d Those banks whose main business is conducted outside the British Isles. Figures after 1958 differ slightly in coverage from those for earlier years; this difference is also reflected in "other sources."

e The banks listed as other domestic banks in the additional notes to Table 7 of the statistical annex. They were previously included among "other sources".

f The banks which contribute to Table 10 of the annex. They include some institutions which before June 1963 were included among "other sources".