Control of bank lending: the Cash Deposits scheme

Between the end of 1958 and the end of 1967, sterling deposits with banks in Great Britain other than the clearing and Scottish banks rose from under £1,000 million to over £3,000 million, while their sterling lending to the domestic private sector rose by some £800 million (20% of the total increase in such bank lending). Because these banks have played a rapidly growing part in the extension of credit in sterling to private customers at home and to borrowers abroad, the authorities found it necessary to bring them within the scope of the quantitative limit on the growth of bank lending requested in the spring of 1965. Later, in the spring of 1967, when it became possible to release the clearing and Scottish banks from their obligation to observe a quantitative limit, it was thought inappropriate to take the same step for the other banks. For the clearing and Scottish banks the system of Special Deposits which was first brought into operation in 1960[1] was available as a reinforcement of guidance given by the Bank. No such alternative was available for the other banks and, as announced in the Budget speech of April 1967, it was necessary to work out suitable new arrangements for them, before they could be released from the quantitative limit.

New arrangements were drawn up during the summer of 1967; but before they had been fully discussed with and agreed to by the banks concerned it became necessary, as part of the measures taken at the time of devaluation, to intensify the existing quantitative limit. Discussions have however continued and the banks approached have now agreed to abide by the terms of the new arrangements – the "Cash Deposits scheme" – which are therefore now available for use when appropriate. The memorandum setting out the scope and terms of this scheme, on the basis of which the banks concerned have agreed to adhere, is reproduced after this note. For the time being, however, all banks remain subject to a quantitative limit on their lending – under the arrangements introduced in November 1967 (referred to in the memorandum) and modified on 23rd May.[2]

The banks to which the new scheme applies are numerous – about 150 – and very diverse in character. The scheme has been designed both to take account of this diversity, so that the banks concerned should remain as free as possible to continue to operate in their own ways in their own fields; and to preserve the position of London as an international banking centre in which, compared with most others, there is relatively little detailed official interference in the commercial banks' conduct of their business.

The diversity of the banks precluded bringing them within the system of Special Deposits, which seeks to influence the lending of the banks by bearing upon their liquidity. Such a

1 See "The procedure of Special Deposits" in the December 1960 *Bulletin*.
2 See "Credit restriction: May 1968" on page 120.

system can be effective for the clearing banks because they all work to the same liquidity ratios (presently 28%) based on uniformly accepted definitions of what constitutes a liquid asset. In turn, their ratios are the same because the banks concerned are all doing a broadly similar kind of business.

The situation is very different with the other banks. The difficulty of assessing the true liquid position of these banks is described in another article in this *Bulletin*,[1] where it is also explained that their liquidity needs, so far as questions of banking prudence are concerned, differ greatly according to their status and business. As their needs differ, so does their practice. And on any definition of liquid assets which might be adopted, the liquidity positions of these banks appear to vary greatly. Some appear well below the clearing banks' 28%, others greatly above it. For a liquidity control like Special Deposits to be effective, it would be necessary for groups of banks to agree to observe common ratios, or for some ratio to be applied individually bank by bank. Either way, this would interfere unjustifiably with the normal conduct of the banks' business. The effect of prescribing a common minimum ratio for a group of banks would be to compel some of them to operate with more liquid assets than their business required, which is uneconomic; while others, whose business was normally largely in assets of a liquid nature, could scarcely be required to reduce the proportion of such assets that they held, merely in order to bring them within range of the control. To apply individual ratios would involve the authorities in detailed supervision and investigation of particular banks' activities which would be as unwelcome to them as to the banks themselves.

Various alternative forms of ratio control were considered, but appeared open to equal objections. It was eventually decided to develop a scheme which could be made to impinge, if circumstances appeared to require this, on the commercial banks' earnings as well as on their liquidity. As described in the memorandum, the agreement is that, when the scheme is activated, banks will make Cash Deposits with the Bank of England, calculated as a percentage of certain of their deposit liabilities in sterling. (The scheme does not affect the banks' business in foreign currencies, except to the extent that currency deposits may have been "switched" into employment in sterling assets.) Although the percentage called will normally be the same for all banks, the Bank of England reserve a right, in exceptional circumstances, to treat banks individually. Similarly, although in the first instance the Bank undertake to pay a market (Treasury bill) rate of interest on the Cash Deposits made with them, they also reserve a right to pay a lower rate than this. Even the equivalent of the Treasury bill rate will often be less than the banks concerned would otherwise have earned.

The scheme is designed for use at times when it may be desired to influence the banks' lending policies, but when something less is called for than strict quantitative controls of the 'ceiling' type. Although quantitative controls have to be employed on occasion, they suffer from a number of well-

1 "Overseas and foreign banks in London: 1962-68."

known disadvantages, including in particular the restriction of competition between banks. The penalty aspects of the new scheme will not necessarily be invoked; but their existence should help to underline any official guidance, which it may seem desirable from time to time to offer to the banks, concerning the growth and direction of their lending.

Although the scheme is intended to influence the banks' lending policies, the Cash Deposits are related to the banks' liabilities rather than to certain specified assets, notably those which it was desired at any particular time to influence. In other words, it bears upon the source of the banks' funds rather than on their use. This feature of the scheme stems, in part, from the Bank's reluctance to become involved in detailed supervision of the banks' activities.

In more detail the advantages of a deposit-based scheme are that it would be more flexible in operation; it is more capable of development, for example, in the direction of conventional liquidity ratio controls, should this seem desirable or should some banks prefer it (after agreeing to conform to the necessary practices); it leaves open a possibility of discriminating between money from domestic and overseas sources; it minimises the injustices inevitable in any scheme of control; and is less likely to induce longer-run changes in the pattern of individual banks' business, which are not relevant to the objectives of credit policy. There are, moreover, advantages in a system which does not actively encourage banks to continue to expand their deposits, even for on-lending to the public sector, at times when private lending may be under restraint. The appetite of the public sector for funds, though no doubt large, is not unlimited; and it can carry some threat to the health of the financial markets if too great a volume of money is seeking employment in limited outlets of a kind generally regarded as appropriate for banking funds. Furthermore, the excessive accumulation of such funds, which are available to be switched very quickly to employment in the private sector as soon as restrictions are lifted, is itself something which makes for monetary instability and is liable to lead to the perpetuation of controls.

It should be stressed that the Bank of England see the new scheme essentially as an exercise in co-operation between themselves and the banks concerned. The relationship of the Bank with the commercial banks has traditionally been based upon the recognition by both parties of their mutual interest in the good order of the U.K. economy, and upon the voluntary acceptance by the banks of some restraints upon their activities. Given goodwill on both sides, co-operation of this kind can be more effective than detailed controls based upon legislative restraints, and it avoids many of the disadvantages inherent in such restraints. The Bank are grateful to the banks concerned for embarking with them upon this new, and to some extent experimental, form of co-operation.

Memorandum issued by the Bank of England on 8th February 1968

The Cash Deposits scheme

1 This memorandum sets out the main features of new arrangements designed to secure an adequate degree of

official influence over lending in sterling by banks operating in Great Britain (other than the clearing and Scottish banks which are covered by the Special Deposits system) to customers in the U.K. private sector and overseas, when it is again thought that some restraint, but not a rigid quantitative ceiling, is necessary. These new arrangements have been made by the Bank of England in consultation with H.M. Treasury, after discussion with the banks concerned.

2 At present banks are subject to the restraints set out in the Bank's "Notice on credit restriction" issued on 19th November 1967. This Notice remains fully in force and the publication of the new arrangements in this memorandum in no way implies any modification of that Notice; nor does it imply that any early modification of that Notice is being considered.

The new arrangements

3 The new arrangements apply to all institutions recognised by the Bank of England as banks for the purpose of contributing to banking statistics, other than the clearing, Scottish and Northern Irish banks. But as a practical matter, some banks whose business is very small will be relieved of the obligation to make Cash Deposits. In general, banks whose sterling deposits do not exceed £3 million will be so relieved initially.

4 Under the new arrangements, the banks covered have agreed to place with the Bank of England, when called upon to do so, Cash Deposits calculated as a percentage of the following of their deposit liabilities:

(i) Sterling deposits by U.K. residents other than banks, excluding deposits with a minimum original term of not less than one year;

(ii) Sterling deposits by overseas residents, excluding deposits with a minimum original term of not less than one year;

(iii) Foreign currency deposits (including Certificates of Deposit) to the extent that they have been switched into sterling;

(iv) Net borrowing in sterling in the inter-bank market.

For some banks there may be excluded from the above liabilities for the purpose of calculating Cash Deposits certain liabilities such as those representing the capital of London branches of overseas banks.

5 It will be a matter for decision by the Bank at the time of a call whether it is calculated by reference to all or only to some of the deposit liabilities specified in the preceding paragraph. Moreover, the Bank wish to leave open the possibility of applying different percentages to domestic and to overseas deposits.

6 During the first year after the first call for Cash Deposits is made, the Bank will not require Deposits to rise to more than 2% of relevant deposit liabilities, unless they consider that reaction to guidance given on the development of bank credit is wholly inadequate.

7 The percentage of liabilities to be deposited will normally be uniform for all banks coming within the scope of the arrangements. But the Bank reserve the right very excep-

tionally to apply different percentages either to different groups of banks or to different individual banks.

8 During the first year after the first call is made, the Bank will pay on Deposits called a rate of interest equivalent to the yield at the time on Treasury bills, so long as they consider that the response to their guidance on the development of bank credit is sufficient. But the Bank reserve the right to pay a lower rate of interest if the response is insufficient.

9 The Cash Deposits will be called for a fixed maximum period of six months, at the end of which they will be automatically released. But this does not preclude either earlier release at the Bank's discretion or the replacement of Deposits released by a fresh call, according to developments. Adequate time will be allowed between the date of a call and the date for making Deposits. The Cash Deposits will be placed on special accounts to be opened by the Bank. The amounts deposited will be adjusted monthly to take account of fluctuations in deposit liabilities and interest will be paid monthly. Further details of the technical arrangements governing the scheme are given in the Appendix.[1]

10 The arrangements outlined above will be reviewed in consultation with the banks concerned not later than one year after the first call for Cash Deposits is made.

1 The Appendix is not reproduced in this *Bulletin*; copies are available on request from the Bank's Economic Intelligence Department.