

Competition and credit control

Text of a consultative document issued on 14th May 1971 as a basis for discussion with banks and finance houses

1 The Chancellor of the Exchequer announced in his Budget speech that the authorities wished to explore with the banks and finance houses the possible development of new techniques of monetary policy, with the objective of combining an effective measure of control over credit conditions with greater scope for competition and innovation. He said: "I believe it should be possible to achieve more flexible but still effective arrangements basically by operating on the banks' resources rather than by directly guiding their lending."

2 This paper sets out some proposals to this end as a basis for discussion.

3 In recent years the authorities have paid particular attention to certain categories of lending in sterling by banks and finance houses who have been asked and have agreed to observe quantitative limits on that lending. In practice these limits have been applied individually to most of the banks and finance houses affected and consequently have impeded competition and innovation so that the efficient have been prevented from growing and the less efficient have been helped to maintain the level of their business. Competition in the banking system is at present also limited by the agreements between the Bank of England and the London and Scottish clearing banks which require these groups, but not other banks, to hold certain specified classes of assets to an amount not less than a fixed percentage of their deposit liabilities (the cash and liquidity ratios). In addition, the London and Scottish clearing banks adhere to collective agreements fixing the rates which they pay on deposits and setting minimum rates charged on advances.

4 The authorities, for their part, propose that the impediments to competition arising from the existing liquidity and quantitative lending controls should be replaced by other means of influencing bank and finance house lending in sterling, including the application of a reserve ratio across the whole banking system. It would be part of these proposals that when the changes are introduced, the London and Scottish clearing banks should abandon their collective agreements on interest rates (subject to the proviso in paragraph 15 below about the terms offered on savings deposits).

5 The techniques of monetary policy now proposed would involve less reliance on particular methods of influencing bank and finance house lending and more reliance on changes in interest rates, supported by calls for Special Deposits on the basis of a reserve ratio across the whole of the banking system. There would be similar arrangements for deposit-taking finance houses.

6 For the banking system it is proposed to modify the Special and Cash Deposits schemes so as to put banks on a common basis so far as the operation of these schemes is concerned. The Special Deposits scheme provides for calls for deposits by the Bank of England to whatever extent the authorities deem necessary for the purposes of credit control and for payment of interest on such deposits close to the Treasury bill rate. Its effectiveness rests in part on the agreement by the London and Scottish clearing banks, mentioned above, to hold certain specified assets to an amount not less than a fixed percentage of their deposit liabilities. The Cash Deposits scheme places a narrow limit on the extent to which the Bank of England may call for deposits but allows the Bank in certain circumstances to pay a low or even nil rate of interest on outstanding deposits. No agreement exists with the banks participating in the Cash Deposits scheme regarding any minimum ratio of specified assets. The effectiveness of the Cash Deposits scheme rests predominantly on guidance being given by the authorities, which in practice may differ little from requests for quantitative restriction.

7 It is now proposed that all banks should:

- (i) hold not less than a fixed percentage of their sterling deposit liabilities in certain specified reserve assets;
- (ii) place such amount of Special Deposits with the Bank of England as the Bank may call for from time to time.

The proposal that all banks should observe a minimum reserve assets ratio is intended to provide the authorities with a known firm base for the operation of monetary policy.

8 It is proposed that the reserve assets should comprise cash at the Bank of England and certain assets which the Bank will normally be prepared to convert into cash. The principal assets which would qualify for inclusion are balances with the Bank of England (other than Special Deposits), British government and Northern Ireland government Treasury bills, money at call with the London Money Market,¹ British government securities with a year or less to run to maturity, local authority bills eligible for rediscount at the Bank of England and, up to a proportion of deposits to be specified, commercial bills eligible for rediscount at the Bank of England. The Bank will wish to discuss with the London clearing banks the understanding which for the future should govern the level of their balances with the Bank within the reserve ratio. It is not proposed that notes in tills should be included in the ratio because they are held mainly as a stock-in-trade to meet the needs of the banks' customers.

9 The amount of reserve assets to be held by banks would be calculated by reference to their sterling deposits obtained outside the banking system, including sterling resources acquired by switching foreign currencies into sterling.

¹ The exact definition of this item is to be agreed in the light of discussions. It is not proposed to include money placed in the inter-bank or local authority temporary money markets.

10 The objective of putting banks on a common basis leads to a strong presumption that the reserve ratio in 7 (i) above should be uniform for all banks. It is recognised that there is a wide diversity of business between banks in the United Kingdom but in that part of their business which involves the taking of sterling deposits and their employment in sterling assets – which is all that the present proposals seek to control – the similarities of function are more important than the dissimilarities. Moreover, according different treatment to different parts of the banking system would be difficult to reconcile with the objectives of the proposals in this paper, and would impede the authorities in making uniform calls for Special Deposits.

11 A preliminary examination suggests that a uniform reserve ratio as defined above could be set close to the average practice of the banking system in recent years without causing inequity or undue disturbance arising from banks needing to rearrange their portfolios. Such an average would suggest a ratio of $12\frac{1}{2}\%$ of relevant deposit liabilities. In addition, it would be for consideration from time to time what level of Special Deposits was required. The need for a call for Special Deposits would be determined by the authorities, in the light of monetary conditions generally, including the behaviour of total sterling lending by all banks, and of the intention of the authorities to maintain adequate control. The amount of Special Deposits to be placed with the Bank of England might be calculated by reference to all or only some of the banks' liabilities to which the reserve ratio would be applied. In particular, a call could be related to domestic or to overseas deposits, or the rate of call might be different for domestic and overseas deposits. The rate or rates of call would be the same for all banks; and all deposits called would bear interest at a rate equivalent to the Treasury bill rate.

12 Problems would be likely to arise in moving from the existing methods of control to the arrangements just described. Where reserve assets were appreciably below the prescribed ratio, there would be problems of adjustment for the banks concerned. Where reserve assets were appreciably above the prescribed ratio, there would be problems for the authorities in ensuring maintenance of adequate control over monetary conditions. Special provisions to meet each set of problems would need to be devised and agreed.

13 In the context of the above proposals it has been decided to restrict the extent of the Bank of England's operations in the gilt-edged market. With immediate effect, these will be conducted on the following general basis:

- (i) the Bank will no longer be prepared to respond to requests to buy stock outright, except in the case of stocks with one year or less to run to maturity;
- (ii) they reserve the right to make outright purchases of stock with more than a year to run solely at their discretion and initiative;

- (iii) they will be prepared to undertake, at prices of their own choosing, exchanges of stock with the market except those which unduly shorten the life of the debt;
- (iv) and will be prepared to respond to bids for the sale by them of 'tap' stocks and of such other stocks held by them as they may wish to sell.

This modification by the Bank of their mode of operation in the gilt-edged market represents a return towards the position in the market which they occupied up to some ten years ago. In the present context, it will help to limit, further than can be achieved solely by alterations in the Bank's dealing prices, fluctuations in the resources of the banking system arising from official operations in the gilt-edged market. It is being put into effect now so that it can be taken into account in discussions of the proposals on credit control outlined in this paper. More generally, it is considered appropriate to accompany changes in credit control intended to allow greater freedom of competition in the banking system with lesser intervention by the authorities in the gilt-edged market so as to leave more freedom for prices to be affected by market conditions and for others to operate if they so wish.

14 Notwithstanding the abandonment of quantitative ceilings, and the adoption of the above proposals, the authorities would continue to provide the banks with such qualitative guidance as may be appropriate. For example, so long as hire purchase terms control remains in force, banks will be asked that personal loans related to the purchase of goods subject to terms control should be made on terms no easier than those permitted by the Department of Trade and Industry for hire purchase contracts.

15 The greater freedom afforded to banks by the above proposals might lead them to compete for individuals' savings at present invested in public sector debt or in the finance of housing. The impact of such competition on savings banks and building societies would need careful consideration and the Bank of England would wish to discuss this matter with the banks. It might be that a need would be recognised, for example, to observe some limits on the terms offered for savings deposits. The need for such limits would be open to reconsideration in the light of changed circumstances.

16 The members of the London Discount Market Association are not parties to either the Special Deposits or the Cash Deposits schemes; separate proposals are therefore being made to the Association to ensure that their operations do not undermine the authorities' arrangements with the banks.

17 The Bank of England would wish to discuss with the Finance Houses Association arrangements for their members parallel with those for banks proposed above. The Bank

would wish to discuss this question also with those finance houses not members of the Association who have been receiving the Bank's requests for credit restriction.

18 Some amendments to and amplification of existing statistical information provided by banks and finance houses would be required to put the arrangements proposed above into practice. It would be essential for the authorities to receive this modified information, accurately compiled, promptly each month.