Reserve ratios: further definitions

Reserve ratios for banks and finance houses, which came into effect on 16th September, were described in a supplement entitled *Reserve ratios and Special Deposits* issued with the September *Bulletin.* All banks in the United Kingdom have agreed to maintain minimum reserve ratios of 12½% and finance houses at least 10%. The discount houses, and a few other firms doing similar business are not subject to reserve ratios but have agreed to keep at least 50% of their borrowed funds in defined categories of public sector debt. This article describes more fully the categories of assets and liabilities included in these ratios, and gives details of the ratios at the third Wednesday in September and October this year.

The reserve ratios, which cannot be derived from the various series of banking statistics already published, are calculated from figures for "eligible liabilities" and "reserve assets" defined uniformly for all banks.

Banks

Eligible liabilities

The components of each bank's "eligible liabilities", are as follows:

(i) *All sterling deposits, of an original maturity of two years or under, from U.K. residents (other than banks) and from overseas residents [other than overseas offices – see (iv) below] and all funds due to customers or third parties which are temporarily held on suspense accounts [other than credits in course of transmission – see (vi) below]*

The scheme is essentially based on deposits; notes issued by the Scottish and Northern Ireland banks do not count as eligible liabilities.

A distinction has been drawn between short-term deposits and deposits at longer term having more the character of loan capital. The dividing line, which must be arbitrary, has been set at two years; deposits of a longer term, provided the depositor has no right to demand early withdrawal of his funds, are thus excluded. Suspense accounts representing the bank's own internal funds *e.g.* profit and loss accounts, reserves, provisions for tax, etc. are excluded.

(ii) *All sterling deposits – of whatever term – from banks in the United Kingdom, less any sterling claims on such banks*

(iii) *All sterling certificates of deposit issued – of whatever term – less any holdings of such certificates*

If a bank's sterling deposits from other banks in the United Kingdom fall short of the total of its sterling claims on such banks, or its issues of certificates of deposit fall short of its holdings, the differences are deducted from eligible liabilities. Thus transactions between banks cancel out when eligible liabilities of all banks are consolidated; and they do not affect the amount of reserve assets which the banking system as a whole is required to hold. By taking account of each bank's net position in the inter-bank market when calculating an individual bank's eligible liabilities, the obligation to hold reserve assets against funds obtained from outside the banking system is made to fall on the bank employing those funds outside the banking sector rather than on the bank originally acquiring the funds and passing them on. This is the only practical method of dealing with sterling certificates of deposit – which are readily negotiable – because of the difficulty of distinguishing liabilities to banks from liabilities to other holders.

Inter-bank loans and certificates of deposit of a maturity of over two years are not excluded from these calculations. Their exemption would produce a very artificial distinction in the market between certificates of deposit of identical remaining life according to whether they had been originally issued for periods of over, or under, two years. Moreover, the inter-bank market is in any event mainly short term and certificates of deposit, which in fact are held largely by banks, are highly liquid from the point of view of the holder.

(iv) *The bank's net deposit liability, if any, in sterling to its overseas offices*

Many banks with a wide network of branches in other parts of the world use their London offices as intermediaries for transfers of funds within their own organisations. To the extent that inward and outward flows match, the U.K. economy is little affected. For this reason it was agreed in the course of negotiations that a bank should be allowed to balance any sterling claims on its offices overseas against its sterling deposit liabilities to such offices, but that no deduction would be allowed from eligible liabilities if sterling claims exceeded such liabilities. It was necessary to find a uniform definition of an overseas office: while it seemed reasonable to allow banks to treat wholly-owned subsidiaries in the same way as branches, once outside capital was involved it was much more difficult to draw a dividing line between an overseas office effectively under the U.K. bank's control and one which was effectively an independent institution. The definition of an overseas office was therefore limited to a head office, parent company, or a branch overseas, or a wholly-owned overseas banking subsidiary of the U.K. bank or its parent.

U.K. offices of overseas banks have been given the opportunity to discuss individually with the Bank the extent to which deposits left with them by their overseas head offices may be regarded as capital. Agreement has been reached in certain cases for specified fixed amounts to be deducted from eligible liabilities. Otherwise deposits from overseas offices are included regardless of their term to maturity.

(v) *The bank's net liability, if any, in currencies other than sterling*

Sterling resources acquired by switching other currencies into sterling are taken into account in calculating the amount of reserve assets a bank is obliged to hold; the definition of "eligible liabilities" therefore includes all deposits and other liabilities denominated in currencies other than sterling, less any assets denominated in such currencies. But whereas 'switching' other currencies into sterling represents an addition to sterling resources, 'switching out' represents not a deduction but a particular use of these resources. Eligible sterling liabilities are not, therefore, reduced if a bank's other currency assets exceed its other currency liabilities.

As the scheme is essentially concerned with the banks' sterling resources available for use in the United Kingdom, assets and liabilities denominated in currencies of other countries in the sterling area are treated in the same way as foreign currency assets and liabilities.

less

(vi) *60% of the net value of transit items in the bank's balance sheet*

Transit items are defined as cheques etc. drawn on, and in course of collection from, other U.K. banks and all debit items in transit between the bank's own branches, less credits in course of transmission to other U.K. banks and between the bank's own branches.

An adjustment for items in course of transmission between different members of the banking system and between branches of the same bank is necessary in order to avoid over – or under – statement of the banking system's total eligible liabilities. The value of a cheque, for example, which has been credited to the payee's account at one bank but which has not yet been debited to the drawer's account at another bank will, provided both accounts are in credit, appear in both banks' reported deposits without increasing the sterling resources available to the banking system as a whole. One way of dealing with such double-counting in the total would be for the payee's bank to deduct the amount of the cheque, shown in its accounts under the heading "cheques in course of collection", from its total eligible liabilities. In the case of a credit transfer, the originating bank may debit its customer's account some time before the transferee's account is credited; again provided both accounts are in credit, it would be appropriate for the total amount of the transfer to remain in the first bank's deposits, and thus in its eligible liabilities, in order to prevent the total for the banking system as a whole being understated.

However, transit items can affect overdrawn or loan accounts as well as credit accounts, and to adjust deposits for all such items would not be correct. It is not practicable to attribute individual transit items to deposits or advances according to whether the accounts affected are in credit or overdrawn, nor has it been possible to undertake the large-scale statistical investigation that has proved to be necessary to establish a uniform formula for such an attribution, applicable to all banks. It has therefore been agreed that each bank should deduct from eligible liabilities 60% of the net value of all debit transit items less credit transit items shown in its books.[1] This broadly accords with the treatment of items in transit between branches already

[1] If a bank's debit transit items are smaller than its credit items, 60% of the difference has to be added to its eligible liabilities.

adopted by some of the main deposit banks in their balance sheets.[1]

Reserve assets (see Table B)

These comprise:

(i) *Balances at the head office or branches of the Bank of England (other than Special Deposits)*

Notes and coin held in banks' tills do not count as reserve assets, nor do Bank of England notes and coin held as cover for notes issued by the Scottish and Northern Ireland banks in excess of their authorised *i.e.* fiduciary issues.

(ii) *British government and Northern Ireland government Treasury bills*

(iii) *Company tax reserve certificates*

(iv) *Money at call with the London money market*

To qualify as a reserve asset the money must be secured and at call (or callable, if not explicitly at call) with:

(a) members of the London Discount Market Association;

(b) certain other firms carrying on an essentially similar type of business (the discount brokers[2] and the money trading departments of certain banks traditionally maintaining such business[3]); or

(c) certain firms directly concerned with the overnight finance of the gilt-edged market (the money brokers[4] and jobbers on the London stock exchange). Money at call with jobbers must be secured on British government stocks or nationalised industries' stocks guaranteed by H.M. Government.

(v) *British government stocks and nationalised industries' stocks guaranteed by H.M. Government, with one year or less to final maturity*

(vi) *Local authority bills eligible for rediscount at the Bank of England*

Bills issued by local authorities are eligible for rediscount at the Bank if they have an original term to maturity of less than six months and meet certain requirements concerning publication and notice. A complete list of such bills eligible for rediscount is displayed in the Discount Office of the Bank.

(vii) *Commercial bills eligible for rediscount at the Bank of England, up to a maximum of 2% of total eligible liabilities*

As a general guide, these must be bank bills payable in the United Kingdom, accepted by certain British and Commonwealth banks. These comprise the members of the Accepting Houses Committee, the London and Scottish clearing banks, the larger British overseas banks and those Commonwealth banks which have had branches in London for many years, together with certain other banks and some Bank of England customers of long standing. Details of the definitive list of eligible acceptors are available to banks from the Discount Office.

1 This practice has now also been adopted in the compilation of consolidated figures for the banking sector and for the money stock (see Tables 8 and 12 of the annex): 60% of the net value of transit items (instead of 100% as previously) is now deducted from gross deposits to arrive at net deposits or the money stock, while 40% is added to the banks' advances.

2 Gerald Quin, Cope and Co., Norman and Bennet Ltd. and Page and Gwyther.

3 Algemene Bank Nederland N.V., Banque Belge Ltd., Ionian Bank Ltd., Keyser Ullmann Ltd., Leopold Joseph and Sons Ltd., and Samuel Montagu and Co. Ltd.

4 Cazenove and Co., Laurie, Milbank and Co., and Sheppards and Chase.

Reserve ratios

The total of a bank's reserve assets must be at least $12\frac{1}{2}\%$ of its eligible liabilities; but there are no restrictions (other than the limitation on commercial bill holdings mentioned above) on the distribution of funds between the particular categories of assets listed above. The London clearing banks, however, have agreed to maintain (day by day) $1\frac{1}{2}\%$ of their eligible liabilities in balances at the head office of the Bank of England, partly in order to ensure that there are sufficient funds to meet the ordinary day-to-day demands of the clearing system and to facilitate the smooth working of the Bank's operations in the money markets.

The minimum reserve ratio applies to all banks in the United Kingdom, irrespective of size, other than the discount houses, the National Giro, the Banking Department of the Bank of England and, for the time being, banks in Northern Ireland (with whom discussions are still continuing). A few individual banks whose reserve ratios were well below the minimum at 15th September have been given time, appropriate to their individual circumstances, to build up their reserve asset holdings – but such transitional periods do not extend beyond the end of this year.

The total amount of eligible liabilities and reserve assets for the various groups of banks are shown below as at 15th September (the day before the new arrangements became effective) and 20th October:

Table A[a]

£ millions

		15th September	20th October
Eligible liabilities			
London clearing banks		10,561	10,752
Scottish clearing banks		984	1,021
Other deposit banks		235	257
Accepting houses		1,018	1,085
Overseas banks		2,411	2,613
Other banks		1,375	1,418
	Total	**16,584**	**17,147**
Reserve assets			
London clearing banks		1,717	1,777
Scottish clearing banks		170	149
Other deposit banks		35	34
Accepting houses		170	171
Overseas banks		372	450
Other banks		149	140
	Total	**2,612**	**2,721**
Reserve ratio (%)			
London clearing banks		*16·3*	*16·5*
Scottish clearing banks		*17·2*	*14·6*
Other deposit banks		*14·9*	*13·1*
Accepting houses		*16·7*	*15·7*
Overseas banks		*15·4*	*17·2*
Other banks		*10·8*	*9·9*
	Total	*15·8*	*15·9*

a Figures do not necessarily add to totals because of rounding.

At the same dates the distribution between the various categories of reserve assets was as follows:

Table B[a]

£ millions

	15th September	20th October
Balances with Bank of England (other than Special Deposits)	203	219
U.K. and Northern Ireland Treasury bills	277	206
Company tax reserve certificates	48	53
Money at call	1,579	1,727
British government stocks, and stocks of nationalised industries guaranteed by H.M. Government, with one year or less to final maturity	315	309
Local authority bills	52	42
Commercial bills	137	165
Total reserve assets	**2,612**	**2,721**

a Figures do not necessarily add to totals because of rounding.

Money market

Members of the London Discount Market Association have agreed to keep at least 50% of their borrowed funds in specified categories of public sector debt. The concept underlying this ratio, which is somewhat different from the banks' reserve ratio, was explained in the memorandum issued on 21st July 1971 (page 314 of the September *Bulletin*). The same ratio will be kept by the three discount brokers and by the money trading departments of the six named banks already referred to on page 485 (for the rest of their business these banks will keep the minimum reserve ratio applicable to all banks). For this purpose borrowed funds comprise:

(a) total sterling borrowing (other than capital) from all sources, less any sterling lending to other discount houses, discount brokers, money brokers, or the six banks' money trading departments, as already defined; plus

(b) the excess, if any, of liabilities denominated in currencies other than sterling over the total of assets in such currencies.

As with the banks' eligible liabilities, no deduction is allowed from the total of borrowed funds if other currency assets exceed other currency liabilities.

The categories of public sector debt included in the ratio are:

(a) U.K. and Northern Ireland Treasury bills;

(b) local authority bills eligible for rediscount at the Bank of England and negotiable bonds;

(c) public sector bills guaranteed by H.M. Government;

(d) company tax reserve certificates;

(e) British government stocks and stocks of nationalised industries guaranteed by H.M. Government, with not more than five years to final maturity; and

(f) local authority stocks with not more than five years to final maturity.

The actual public sector lending ratios in September and October were as follows:

Table C[a]

£ millions

		15th September	20th October
Borrowed funds			
Discount houses		1,898	1,987
Discount brokers		62	62
Money trading banks		68	80
	Total	**2,027**	**2,129**
Public sector debt			
Discount houses		1,136	1,168
Discount brokers		36	38
Money trading banks		63	69
	Total	**1,234**	**1,276**
Ratio (%)			
Discount houses		*59·8*	*58·8*
Discount brokers		*57·7*	*61·1*
Money trading banks		*93·2*	*86·9*
	Total	*60·9*	*59·9*

a Figures do not necessarily add to totals because of rounding.

Finance houses

As already announced, arrangements have been made with members of the Finance Houses Association (and with certain individual houses outside the Association), similar to those agreed for the banks but modified to suit the particular circumstances of the finance houses.

Some of the larger finance houses have informed the Bank that they have already applied, or intend to apply, to the Department of Trade and Industry for recognition as banks under Section 25 (2) of the Protection of Depositors' Act 1963, as amended by Section 127 of the Companies Act 1967. Houses successful in such applications may also be accorded certain other benefits, for example recognition as banks by the Inland Revenue for the purposes of the Income and Corporation Taxes' Act 1970 and authority to issue sterling certificates of deposit. In return they will be expected to comply with the arrangements for banks in regard to reserve ratios and Special Deposits.

The parallel scheme for finance houses applies in principle to all deposit-taking instalment credit finance houses which do not receive, or have not yet received, recognition as banks. Finance houses with eligible liabilities of less than £5 million are, however, exempt so long as they remain below this limit. The effect is to reduce the number of houses in the scheme at the outset to fourteen; and this total may be further reduced if some houses become recognised as banks and transfer to the main scheme. It is estimated that houses providing about 80%–85% of total instalment credit given by all finance houses will be covered by the new arrangements.

The definition of eligible liabilities for the finance houses is simpler than it is for the banks as these houses do not take deposits in currencies other than sterling, nor is there need to make special provision for issues of certificates of deposit, or for transit items or other transactions within the banking system. In addition, deposits taken by finance houses from banks are excluded from eligible liabilities. As the finance houses are outside the banking sector, a bank lending money to a finance house will be unable to set such lending against its eligible liabilities and will therefore be required to hold reserve assets in respect of the funds which finance this lending; and it would be inappropriate to require the finance houses also to hold reserve assets against these same funds. The full definition of eligible liabilities in the scheme for finance houses is therefore all deposits with an original maturity of two years or less received from U.K. residents, other than banks, or from overseas. Borrowing from a parent company which is not a bank – unless it has a fixed maturity of over two years – is treated as a deposit, but all permanent capital and long-term borrowing is excluded.

The definition of eligible reserve assets is exactly the same for finance houses as for banks. But the finance houses have not for the most part held any of these assets hitherto in the normal course of their business; and the return obtainable on reserve assets has recently been less than their cost of borrowing. The introduction of the minimum reserve ratio requirement therefore bears more heavily on the finance houses than it does on banks, and for this reason the required minimum reserve ratio has been set at 10% instead of 12½%. For the same reason, the finance houses have been allowed up to twelve months during which to build up the required proportion of reserve assets in four equal stages.

The finance houses will report their eligible liabilities, reserve assets and reserve ratio position at the same dates as the banks. On the first reporting date (20th October 1971) total eligible liabilities amounted to £756 million. Reserve assets totalled £12·6 million (or 1·7%).