The financial institutions: Part 2

The business of the principal financial institutions other than the banks was described in an article in the June 1965 issue of the *Bulletin*, which drew upon figures for the year 1963. Subsequent developments are being reviewed in a short series of articles, the first of which appeared in the December 1970 issue and discussed the contractual savings institutions – the insurance companies and pension funds – and property unit trusts.

The present article continues the series by looking at the development over the years 1964-69 of those institutions which invest primarily in equities, namely the investment and unit trusts,[1] and the main deposit-taking institutions – building societies, the special investment departments of the trustee savings banks, the investment account of the National Savings Bank, and the finance houses. Some of the special finance agencies are also described. This completes the list of institutions to be described, but a concluding article will assess their impact in the main security markets.

Investment trust companies

Investment trust companies, commonly termed investment trusts, acquire financial assets with money subscribed by shareholders or lent in the form of loan capital. Having no trustees, they are not trusts in the strict legal sense, but limited companies with two special characteristics: their assets consist of securities, and they are debarred by their articles of association from distributing capital gains as dividends. At the end of 1969 over 260 such companies, with total assets of about £5,000 million, were making statistical returns to the Bank of England; returns were not sought from about sixty smaller companies with assets which totalled only about £50 million at the end of 1967.

Apart from increases in the value of the securities which they hold, investment trusts can obtain new funds from capital issues, whether equity or fixed interest, and from retained income. Most of their new funds come from issues of capital, but such issues have been limited in recent years both because of the way in which the companies' shares are valued and by developments in the markets. The market price of an investment trust's shares has usually been at a discount on the net asset value of the securities in its portfolio, making it difficult for the trust to raise new equity capital. There is no obvious reason for the existence of such a discount. The marketability of some investment trust shares has in the past been rather limited and this may have given rise to a discount, which has established itself

1 The business of investment and unit trusts during the period 1961-67 was briefly surveyed in an article in the *Bulletin* for March 1969.

as a feature to be expected. Unlike unit trusts, where the price of the unit is calculated according to a predetermined formula, the true net asset value of the investment trust is not accurately known at the time of purchase or sale. The discount may, therefore, be seen partly as the market reaction to uncertainty. It may also reflect the existence of management costs and, perhaps, the reluctance of institutional investors to duplicate such costs. Again, investors seeking income rather than capital growth are deterred by the fact that the trusts cannot distribute capital gains.

The alternative for the investment trusts is to borrow on fixed interest terms. Increasing the fixed interest element of total debt means that, in times of rising income, proportionately more can be distributed to equity holders. However, the reverse also applies, so that when the income of the trust is falling, fixed interest borrowing reduces the attractions of the trusts' shares. A serious difficulty here in recent years has been the high interest cost of debenture issues; it has been impossible for a trust to invest such borrowed funds in ordinary shares without at least a temporary fall in the net income available to the holders of the equity of the trust.

Modest in amount as they have been, fixed interest issues by investment trusts have in fact exceeded new equity issues in each of the six years under review except 1966. In that year equity issues were increased by the formation of a number of split capital trusts, which gave investors the option of taking an interest either in the income of a trust or in its capital appreciation. Total new issues by investment trusts have been low over the period, with the exception of 1968 – a year of rising equity prices both in London and New York, when £95 million was raised.

During 1969 the investment trusts turned increasingly to 'back-to-back' loans to finance purchases of dollar securities. Under these reciprocal arrangements, the trust lends sterling to the U.K. subsidiary of an American company; the latter, in turn, lends dollars to the trust for investment in dollar securities. The need for this type of arrangement arose mainly because of high euro-dollar rates and United Kingdom exchange control requirements. U.K. subsidiaries of American companies also found difficulty in borrowing sterling in the United Kingdom because of credit restrictions; and there were United States restrictions on American parent companies lending sterling to their U.K. subsidiaries.

The amount of new funds which the investment trusts can secure out of income is limited. They are unwilling to retain a very large slice of their income, partly because they wish to distribute to their shareholders and partly because a retention of more than 15% attracts heavier tax on capital gains.

The following table shows how the net amount obtained for investment over the period was employed.

Table IIA

Net investment transactions by investment trust companies[a]

£ millions

	1964	1965	1966	1967	1968	1969
Net current assets	44	18	26	− 14	23	56
British government stocks	−16	24	9	− 35	− 11	44
U.K. local authority securities	− 1	3	—	− 1	− 1	− 1
U.K. company securities:						
Loan capital	2	3	− 2	− 2	− 2	18
Preference	− 1	5	29	28	5	− 7
Quoted ordinary	9	− 1	34	108	101	−29
Unquoted ordinary	2	2	—	5	− 2	2
Other U.K. investments	—	—	1	− 1	—	4
Overseas investments:						
Ordinary shares	54	−33	−31	− 26	2	−72
Other	3	− 2	2	2	15	18
Total	**97**	**19**	**69**	**64**	**130**	**34**

a Transactions over the years 1961-69 are shown quarterly, and in more detail, in the Bank's *Statistical Abstract*, 1970.

Tax and exchange control considerations have become a significant factor in the trusts' investment decisions. The restriction of U.K. taxation relief in respect of foreign company taxation, introduced in 1965, led to a lightening of the trusts' overseas portfolios between 1965 and 1967. In 1968 the trusts began to adjust to the situation differently; although they still sold existing securities they also bought new overseas stocks with the proceeds of dollar loans. In late 1969 and early 1970 they again sold dollar securities as prices on the New York stock market fell, but held much of the proceeds in liquid, high-yielding euro-dollar deposits until opportunities for reinvestment seemed better.

In 1965, also, the introduction of corporation tax brought with it new arrangements for 'franked' income, that is dividends paid on ordinary or preference shares; all other income, including that from U.K. debentures and government securities, counted as 'unfranked' income. Franked income can be distributed as dividends by an investment trust without further deduction of tax. Unfranked income cannot be so distributed (though management expenses and the cost of servicing debenture interest can be offset against the tax liability). In consequence, the investment trusts acquired few debentures in 1966 and 1967 and, instead, increased their holdings of preference shares. The movement into ordinary shares in 1967 and 1968, which the table also shows, was associated with rising markets rather than tax changes. In 1969 equity markets weakened in London and New York, and historically high yields became available on government and other fixed interest securities. Partly in consequence, and partly because the 1969 Budget exempted government stocks from long-term capital gains tax, the trusts sold equities both at home and overseas, and increased their holdings of government securities. The trusts also built up their liquid assets in 1969, probably awaiting other opportunities for investment.

The table below shows the assets of the investment trusts at market value:

Table IIB

Assets of investment trust companies[a]

£ millions

End-year	1963	1964	1965	1966	1967	1968	1969
Net current assets	12	58	75	105	89	106	170
British government stocks	38	20	43	52	53	34	77
U.K. local authority securities	2	1	4	3	2	1	1
Company securities:							
Loan capital	26	27	31	31	37	62	91
Preference	82	82	86	115	137	133	99
Quoted ordinary	1,731	1,602	1,703	1,625	2,156	3,158	2,671
Unquoted ordinary	47	53	64	59	67	74	76
Other U.K. investments	9	3	10	10	9	7	34
Overseas investments:							
Ordinary shares	856	1,024	1,087	1,009	1,430	1,937	1,593
Other	14	17	18	24	33	74	91
Total	**2,817**	**2,887**	**3,119**	**3,033**	**4,013**	**5,583**	**4,902**

a Assets at the end of the years 1960-69 are shown in more detail in the Bank's *Statistical Abstract*, 1970.

As can be seen from a comparison of Tables IIA and IIB, the market value of the assets rose by far more (£2,085 million) than the amount spent on acquiring assets (£413 million). The two years in which the market value fell, 1966 and 1969, were both years of weak equity markets.

Unit trusts

In contrast to investment trusts, unit trusts are trusts in the strict legal sense of the word and they must operate in accordance with the provisions of a trust deed. The securities in a unit trust's portfolio are held in the name of a trustee (usually a bank or an insurance company) and the portfolio is managed by a quite separate management company. Both parties must be companies incorporated in the United Kingdom with a place of business in Great Britain. Members of the public may take a beneficial interest in a trust by acquiring 'units' – shares in the trust's assets. The managers of a trust make a market in its units, selling them to new subscribers or buying them back for cash. The price directly reflects the prices of the underlying securities, in accordance with a formula laid down by the Department of Trade and Industry. The capital of a unit trust, unlike that of an investment trust, is thus variable, or open-ended as it is sometimes called. Again unlike investment trusts, unit trusts are precluded from increasing their investment by raising prior charge capital; and they distribute almost all of their income, whereas investment trusts plough some back.

Unit trusts are directed, more specifically than investment trusts, to meeting the needs of the small saver. They facilitate investment in a wide range of securities selected by professional investment managers. In particular, they give the option to invest in ordinary shares as against traditional forms of fixed interest savings media, but in a way which spreads the risks over a portfolio of securities. Unit trusts have thus filled an investment need and have become increasingly popular, mainly since the mid-1950s. At the end of 1969 there were nearly two and a half million separate unit holdings, with an average value per holding of about £590.

The net transactions of unit trusts over the six years from 1964 to 1969 can be summarised as follows:

Table IIC

Net investment transactions by unit trusts[a]

£ millions

	1964	1965	1966	1967	1968	1969
Net current assets	5	—	5	2	29	1
British government stocks	—	2	2	− 7	—	13
Other fixed interest securities	5	2	6	3	8	—
Ordinary shares:						
United Kingdom	55	58	82	83	190	132
Overseas	7	4	11	—	7	27
Total	**72**	**66**	**105**	**80**	**234**	**172**

a Transactions over the years 1961-69 are shown quarterly, and in more detail, in the Bank's *Statistical Abstract*, 1970.

Because they were not hampered by the difficulty of making new issues, the unit trusts expanded much more strongly than the investment trusts during this period, although from a much lower base. At the end of 1963 their total assets amounted to £350 million; acquisitions of assets in the following six years represented a growth of over 200%. This compares with a growth of only 15% by the investment trusts. On the other hand, the investment trusts increased the value of their assets by £2,085 million to £4,902 million after net investment of £413 million, whereas the unit trusts increased theirs by £994 million to £1,344 million after net investment of £729 million. The difference between the increase in the value of the assets and the cash spent on acquiring them occurred partly because unit trusts tend to attract most money when the market is strong, and partly because investment trusts hold a greater share of United States' equities than unit trusts.

The following table shows the assets of the unit trusts at market value:

Table IID

Assets of unit trusts[a]

£ millions

End-year	1963	1964	1965	1966	1967	1968	1969
Net current assets	6	11	11	15	17	46	47
British government stocks	2	3	5	6	5	5	18
Other fixed interest securities	15	19	22	26	36	53	49
Ordinary shares:							
United Kingdom	300	337	420	453	664	1,142	1,095
Overseas	27	36	42	53	66	103	134
Total	**350**	**406**	**500**	**553**	**788**	**1,349**	**1,344**

a Assets at the end of the years 1960-69 are shown in more detail in the Bank's *Statistical Abstract*, 1970.

Although the unit trusts increased their sales to the public so much over the period, the flow of new money varied considerably from year to year, as can be seen from the following table. The difference between the net inflow from savers during the six years (£770 million) and the net transactions shown in Table IIC (£729 million) is attributable to management charges and expenses of purchases (stamp duty, brokerage and contract stamp etc).

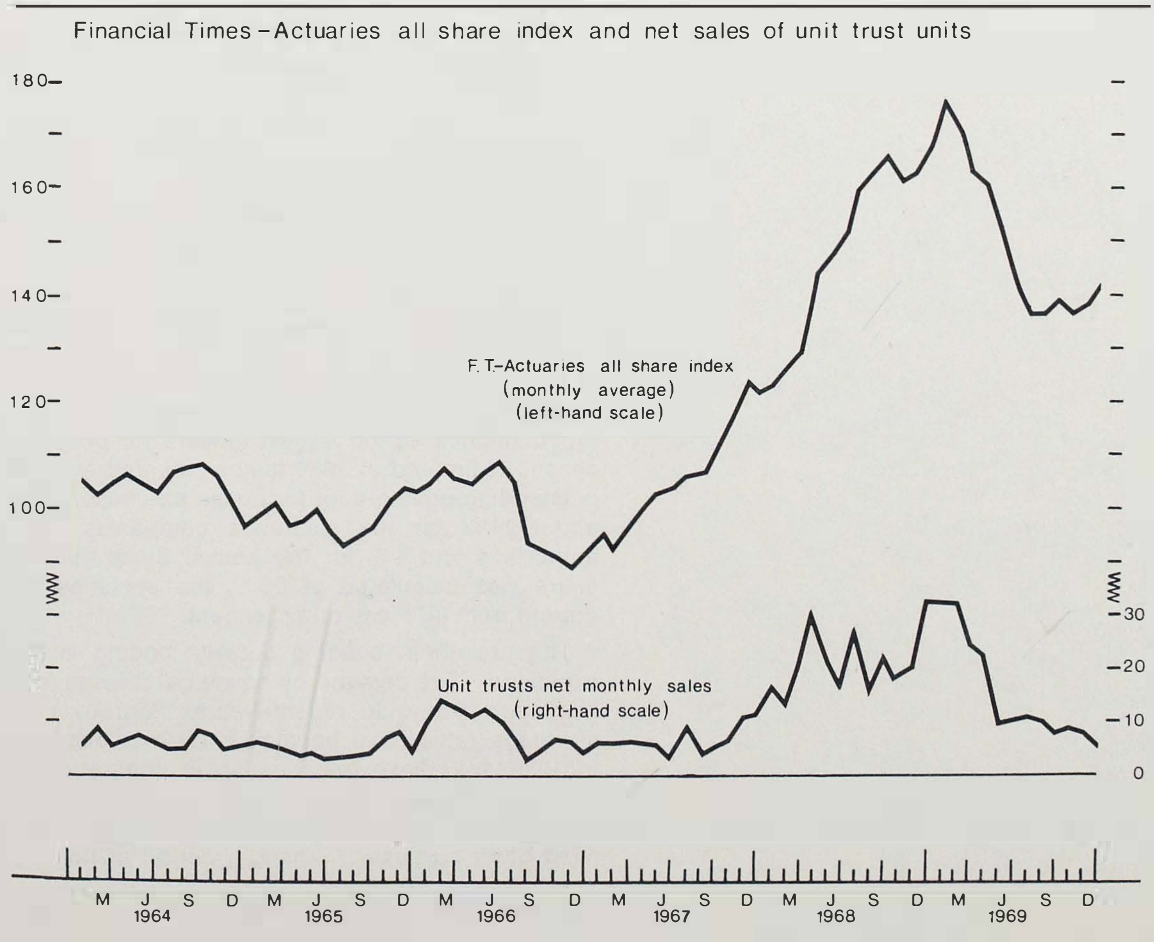
Table IIE
Unit trust sales
£ millions

	1964	1965	1966	1967	1968	1969
Sales of units	100	81	130	127	329	263
Repurchases of units	23	22	24	43	70	77
Net sales	**77**	**59**	**105**	**84**	**259**	**186**

Some, perhaps 10%, of their inflow is contractual, but, for the most part, sales of units depend upon conditions in the equity market. This is demonstrated by Chart A which

Chart A

Index numbers £ millions



shows how movements in share prices, measured by the Financial Times-Actuaries all share index, and net sales of units have run very closely together.

Building societies

Building societies channel savings into house purchase. They borrow short to lend long, and they must at all times remain able to meet commitments to their shareholders and depositors and to prospective borrowers, and to settle their interest and tax liabilities as they fall due. In practice, societies typically have a liquidity ratio of 15%–18%, the rest of their assets being almost exclusively in mortgages. Such a concentration (over 80%) in the one form of asset distinguishes the building societies from most other financial institutions.

The growth of the building societies over the six-year period from 1963 was impressive. In that period they overtook the pension funds in the size of their total assets, and now rank as the second largest of the groups of financial institutions behind the life funds of the insurance companies.[1] The following table analyses their assets at book value at the end of 1963 and 1969:

Table IIF

Holdings of assets by building societies

£ millions: *percentage of total in italics*

End-year	1963		1969	
Net current assets	186	*4*	471	*5*
British government stocks	294	*7*	573	*6*
U.K. local authority long-term debt	248	*6*	459	*5*
Mortgage loans	3,578	*82*	7,722	*83*
Other	53	*1*	111	*1*
Total	**4,359**	*100*	**9,336**	*100*

The increase in their assets strengthened the societies' predominance as the largest lenders for private house purchase. At the end of 1969 they accounted for about 75% of outstanding private debt for house purchase, compared with about 11% for the insurance companies, 9% for local authorities and 4% for the banks. Since 1963, when their share was calculated at 68%, the societies have gained ground from all these other lenders.

The growth in building society lending is fairly readily explained. The demand by house purchasers for mortgages has been strong in recent years. Moreover, even when mortgage rates have been high by previous standards, as in 1969, they have been cheap in comparison with other forms of personal borrowing – especially since the 1969 Finance Act withdrew tax relief on personal borrowing for most other purposes. Again, a period of rising prices pro-

1 See the earlier article in this series in the December 1970 issue of the *Bulletin*.

vides an incentive to borrow as much as possible – particularly on owner-occupied houses, which are exempt from capital gains tax. The continuous rise in house prices, which itself reflects both the strong demand and additions to costs, has added to the pressures on the societies, as the major lenders in the market.

In order to increase their net lending, however, the societies must first attract new funds. In contrast to their dominant position as lenders, they compete in the market with other forms of personal savings, and therefore periodically adjust their borrowing rates to current conditions. Once set, borrowing rates determine lending rates, allowing a margin for expenses, taxes and additions to reserves (which is all the profit building societies seek to make).

The societies obtain funds essentially by taking short-term investments in two forms – shares and deposits. Shares in a building society are unlike shares in a public company, in that they are not marketable. They rank after deposits on a liquidation, but there is little other practical difference between the two forms of security. In either case, small sums are repaid at once and large sums, or the whole amount, at short notice. Both carry a fixed rate of interest which is changed from time to time, shares usually paying ¼% more than deposits. So far as the payment of interest is concerned, the societies have an arrangement with the Inland Revenue to pay an average, or composite, rate of tax, currently 32·75%, which relieves the share or deposit holder from any further liability to income tax. This composite rate only applies to personal and some trustee investments of £10,000 or less; a personal or trustee investment of over this amount, or any investment by a body corporate, is subject to the standard rate of income tax. Shares comprise by far the greater part of building society liabilities; at the end of 1969 they totalled £8,376 million as against only £347 million for deposits.

Investment in a building society has several attractions for the small saver: as already noted, no tax has to be paid; the arrangements for depositing and withdrawing money are relatively simple; tax payers earn a higher effective rate of interest than on a bank deposit or on a savings bank account; and it is possible, by placing regular amounts with a building society or by investing a capital sum, to provide for the necessary down-payment on a house and to acquire a priority over other prospective borrowers. A contractual scheme also usually offers a higher interest rate. For all these reasons, the number of building society investors has been rising annually. At the end of 1969 there were over 9,000,000 share accounts and over 600,000 deposit accounts (though the number of actual shareholders and depositors was smaller, because some people have accounts with more than one society).

The growth in the number of shareholders has been accompanied by a growth in the total receipts of the societies, which has enabled them to increase their advances. The following table shows the annual additions to the liabilities and assets of the building societies from 1964 to 1969:

Table IIG
Receipts and acquisitions by building societies

£ millions

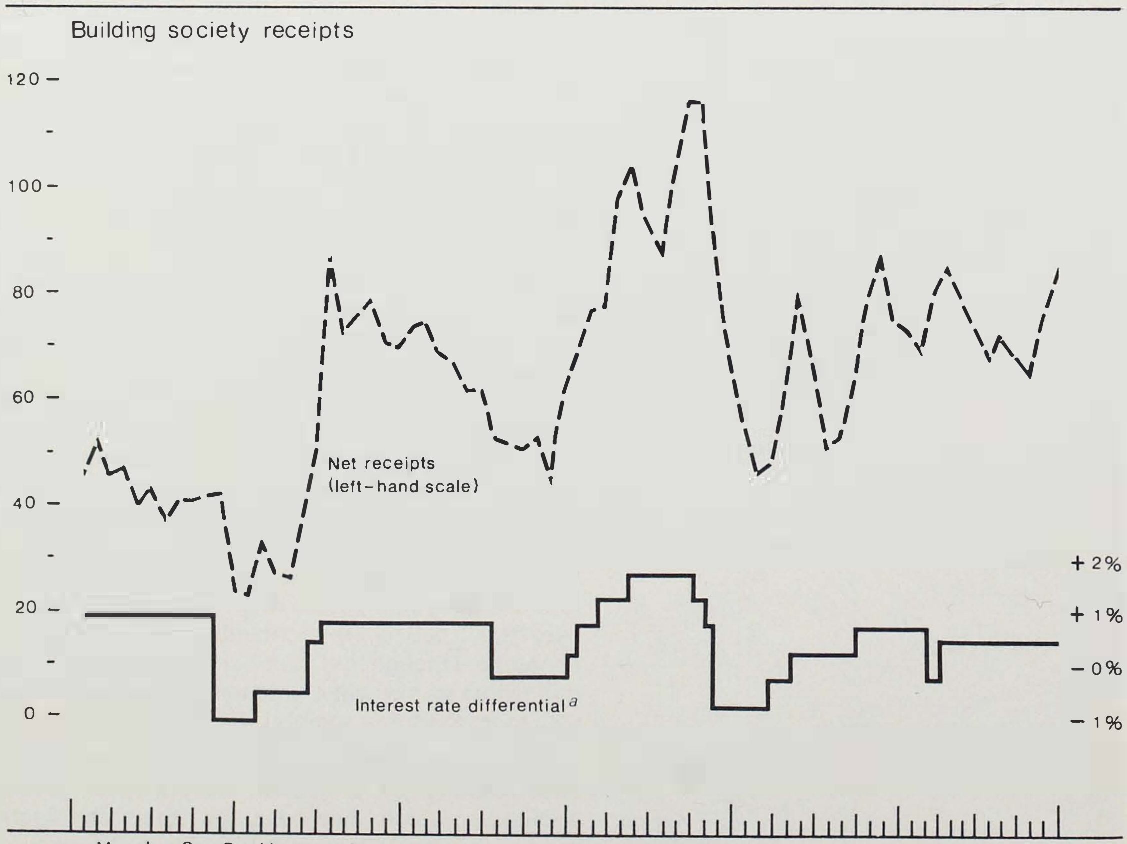
	1964	1965	1966	1967	1968	1969
Shares and deposits						
Receipts of principal	1,116	1,363	1,558	2,027	2,059	2,395
Interest credited to accounts	68	103	119	135	173	221
Gross receipts	1,184	1,466	1,677	2,162	2,232	2,616
Withdrawals	— 681	— 815	— 953	—1,063	—1,465	—1,721
Net increase in shares and deposits outstanding	**503**	**651**	**724**	**1,099**	**767**	**895**
Acquisitions of assets						
Advances on mortgage	1,052	965	1,245	1,477	1,587	1,556
less repayments of principal	— 505	— 506	— 578	— 654	— 727	— 774
Net advances	546	459	667	823	860	782
Liquid assets (investments other than mortgages)	— 26	220	91	325	— 46	183
Other assets (mainly land, buildings and equipment)	7	8	9	10	16	11
	527	**687**	**767**	**1,158**	**830**	**976**
Liquidity ratio at end-year	*14·5*	*16·7*	*16·2*	*18·1*	*15·9*	*16·1*

Although the growth over the whole period was substantial, it was also uneven. One of the main influences which affect the inflows of funds to the societies is the

Chart B

£ millions: seasonally adjusted

Per cent



a The differential between the recommended rate on building society shares, grossed up at the standard rate of income tax, and Bank rate.

margin prevailing at any one time between the share rate paid by societies and competing interest rates. Among the societies' main competitors are bank deposit accounts, some forms of national savings (including the trustee savings banks), gilt-edged securities, local authority debt, unit trust units and the equity market. As a broad indication of the competitiveness of the building societies, Chart B plots the margin by which their recommended share rate, grossed up at the standard rate of income tax, exceeds (or falls short of) Bank rate; and this is compared with monthly movements in net receipts of building societies (seasonally adjusted).

The chart suggests that changes in the interest rate differential have broadly been followed by corresponding changes in net receipts by the societies. Moreover on occasions when the timing varies, it is usually because Bank rate is an uncertain guide to interest rates in the market. For instance, in the last quarter of 1969 net receipts increased, although both Bank rate and the share rate remained unchanged; this seems to have been because falls in other interest rates, such as those on government securities and local authority deposits, reduced their advantage over the building societies' share rate.

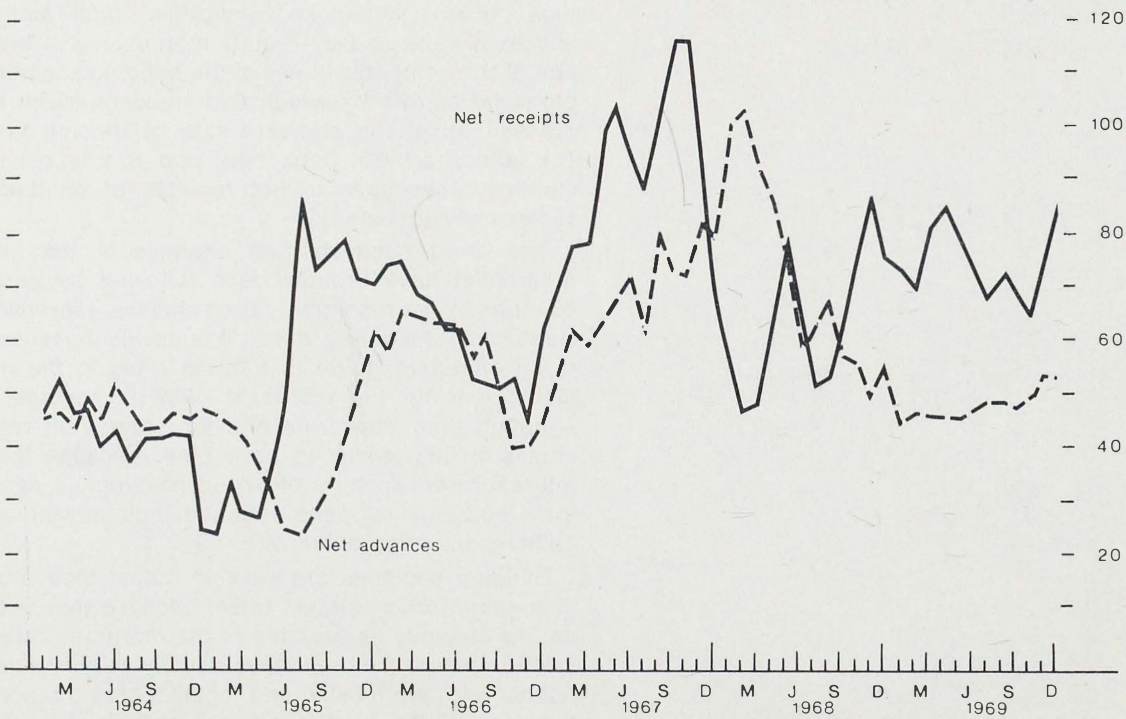
Building societies are slow to adjust their share rate to changes in other interest rates, because they wish to make as few changes as possible in the mortgage rates for existing borrowers; such changes usually require three months' notice and are costly and complicated to administer. It follows from this slowness to adjust their own rates that the societies will generally gain funds when other interest rates are falling, and lose them when they are rising.

Another important influence on the net inflow to the building societies is the level of incomes and the extent to which people are currently spending or saving their income. A comparison between monthly changes in building societies' net receipts and changes in bank deposit accounts, national savings and trustee savings banks' deposit and investment accounts, and net sales of unit trusts – the most obvious alternative outlets popular with the small saver – shows that, broadly speaking, these different forms of saving all move up and down together, though not necessarily at the same rate. Thus building society receipts may fall not because savings are being diverted elsewhere, but simply because of an overall reduction in personal savings. This probably happened, for example, in the first part of 1968. The fall in net receipts at that time seems to have owed at least as much to the pre-Budget increase in consumer spending in that year as to unfavourable interest rate comparisons.

The net inflow to the building societies is, of course, the difference between their gross receipts and withdrawals. It is noticeable that over the years 1964-69 withdrawals have, on the whole, increased fairly steadily, with smaller monthly variations than those in gross and net receipts. The steady rise in withdrawals presumably bears witness to the use of building society accounts effectively as a type of banking facility. It also suggests that changes in relative interest rates or in the level of saving have their main influence on

Chart C £ millions: seasonally adjusted

Building society receipts and advances



the opening of new accounts, or additions to existing ones, rather than on withdrawals.

As can be seen from Chart C, movements in net mortgage advances follow movements in net receipts after a time lag. The lag arises because mortgages take time to arrange, and because time is needed to see whether one month's rise or fall in receipts will continue.

Before adjusting the level of their advances to the changed flow of receipts the societies draw upon, or build up, their liquid assets. The collective end-year liquidity ratios shown in Table IIG above illustrate how they have varied their liquid assets to deal with differing situations. In 1968, for example, in spite of a large fall in net receipts, the societies were able to go on lending at the high rate reached in 1967 by running down the liquid assets they had built up in that year.

The building societies have, nevertheless, been criticised for being too cautious and inflexible in their use of liquid assets and reserves. Reserves are the excess of assets over liabilities created by the accumulation of surpluses; they are held partly as fixed assets and partly in liquid form, and currently average just over 3½% of total assets. Liquid assets, which consist of investments other than mortgages, are restricted to forms of security specified by the Chief Registrar; they range from bank deposits to British government and local authority securities. If the ratio of liquid assets to total assets is less than $7\frac{1}{2}$%, gilt-edged securities may only be taken up if they have a maturity of less than five years; in practice, the societies hold a higher proportion of short-term assets – the figure at the end of 1969 was about 10%. If the liquidity ratio is between $7\frac{1}{2}$% and 15%, the excess over $7\frac{1}{2}$% may be invested in gilt-edged securities with a maturity of up to fifteen years; and if the ratio is over 15%, the balance may be placed in gilts of up to twenty-five years' maturity. The investment of liquid funds in local authority securities is governed by similar but not identical rules. The liquidity ratio has, in fact, varied in recent years between 15% and 18%. The need to maintain ratios as high as these was questioned by the National Board for Prices and Incomes in a report in November 1966, after the Building Societies Association had recommended a rise in the mortgage rate from $6\frac{3}{4}$% to $7\frac{1}{8}$% in May of that year. The Board recommended that the Association should commission a study into the requirements for reserves and liquidity in the light of risk experience and future trends, and a committee was duly set up under the chairmanship of Mr. (now Sir) Charles Hardie. It reported in October 1967 and recommended a new scale, which was subsequently adopted by the Government, under which the minimum ratio of reserves would be inversely related to the size of society; the Committee also recommended that the $7\frac{1}{2}$% minimum liquidity ratio should be retained, but suggested that societies could in practice maintain smaller liquidity ratios than in the past, even though building society funds were becoming more volatile.

The reports of both the Hardie Committee and the Prices and Incomes Board referred to the large number of independent building societies in existence. Although there have been a number of mergers over the years, there were still 504 societies on the register of the Chief Registrar at the end of 1969, compared with about 650 in 1963. The Governor of the Bank, in a speech to the Annual Conference of the Building Societies Association on 22nd May 1969, suggested that there should be greater concentration into a smaller number of large societies. The societies which emerged would probably be able to operate on lower reserve and liquidity ratios, and would benefit from economies of scale.

Even if the societies were to establish lower liquidity ratios, this would only relieve them temporarily of the need to fix their borrowing rates according to prevailing conditions. Other suggestions have focused on possible methods of obtaining longer-term, less volatile funds. Two recent developments of this kind should be noted. The societies have participated in the Government's contractual savings scheme ("Save As You Earn"), under which individuals can contract to save regularly every month for five years. After the first year of the scheme's operation, the societies held nearly 203,000 S.A.Y.E. accounts and had outstanding balances amounting to just over £$13\frac{1}{2}$ million. Several societies have also co-operated with insurance companies in introducing schemes linking building society investment with life assurance. Both these schemes should provide useful regular additions to the societies' receipts, but they seem unlikely to reach a scale at all comparable with traditional share and deposit receipts.

Savings banks

Trustee savings banks

Trustee savings banks have existed in this country from the start of the nineteenth century, primarily serving the needs of the small saver. They are managed by boards of honorary trustees and managers with a full-time paid staff, the chief officer being designated Actuary or General Manager. The banks' activities are, however, under close government supervision.

All the banks maintain 'ordinary' or 'government' departments, which provide deposit facilities in the form of savings accounts for amounts up to £10,000; within the ordinary departments, most of the banks also provide current account facilities for depositors of six months' standing, or those who keep a stipulated minimum balance of £50. Interest is earned on savings (but not current) accounts at 3½%; the rate was raised from 2½%, where it had stood since 1888, on 21st November 1970. Up to £100 may be withdrawn on demand from a savings account at the branch where the account is held; for larger sums, notice is required. Apart from some working balances placed on deposit with clearing banks, all the funds received by the ordinary departments are passed to the National Debt Commissioners and invested wholly in government and government-guaranteed securities. In consequence, these departments are considered as being within the public sector and so outside the scope of this article.

Most of the trustee savings banks, however, also have 'special investment departments', which are required to invest their monies only partly in central government debt; they can therefore be regarded as partly independent financial institutions. There are now 72 trustee savings banks with such departments; these banks have about 1,500 branches and about 1,850,000 investment accounts. Deposits to a maximum of £10,000 are accepted, as long as the depositor has a balance of at least £50 in an ordinary account. Over two thirds of these departments now pay a higher rate of interest on six and three-month deposits than on the shortest deposits of one month; however, withdrawals may be made on demand in special circumstances. The interest rates vary from bank to bank, but many of them have now raised their top rate to 7½%. No depositor is permitted to have an account with more than one bank. As these banks pay interest without deducting tax, they are an attractive investment for those who pay less than the standard rate.

The funds of the special investment departments must be invested by the trustees in accordance with the Trustee Savings Bank Act 1969 and instructions issued by the National Debt Commissioners. Under the present instructions, at least 20% of their funds must be kept in the form of liquid assets, and at least half the liquid assets must consist of cash, Treasury bills, and gilt-edged stocks and local authority securities with less than five years to run to maturity. The remainder of the liquid assets may be in the form of local authority loans with less than one year to run. The rest of the funds may be invested in gilt-edged stocks, local authority mortgages and debentures of the Agricultural Mortgage Corporation and the Scottish Agricultural Mortgage Corporation, but no equities may be held. Holdings of gilt-edged stocks must not be less than holdings of non-government stocks, and local authority mortgages must mature, or have a break clause, within thirty years.

Table IIH shows the departments' acquisitions of assets during the years 1964-69 and their holdings at market value at the end of 1969. The pattern of investment was much the same at the end of this period as at the beginning; the departments still kept over half their assets in the form of local authority mortgages and just under a quarter in gilt-edged stocks. There was, however, a noticeable slackening in the departments' rate of growth; cash spent on acquiring assets as a proportion of assets held at the beginning of the year fell from over 20% in 1963 to only 5% in 1969. After allowance for the higher base figure in 1969, this slowing down was due mainly to the difficulty which the departments had in adjusting their borrowing rates quickly. When interest rates are rising, which they were during the period, it takes time for the yield on the departments' assets to rise enough for rates on deposits to be increased. Another reason for the slower growth may have been that, as rising incomes took depositors into the standard tax rate bracket, they found the rates paid by the departments less attractive than those offered by the building societies. A third reason was probably competition from the next institution to be discussed, the National Savings Bank investment account.

Table IIH

Assets of special investment departments of trustee savings banks

£ millions

	Additions						Holdings (market value)	
	1964	1965	1966	1967	1968	1969	1969	% of total
Cash and Treasury bills	— 3	2	— 1	2	1	4	15	*1*
U.K. local authority temporary debt	6	2	9	23	—	— 5	42	*3*
British government stocks	38	30	23	34	11	5	282	*22*
U.K. local authority long-term debt:								
Quoted	36	19	31	39	29	19	230	*18*
Unquoted	71	50	51	9	54	37	721	*56*
Overseas government securities	— 1	—	— 1	—	—	—	6	—
Total	**147**	**102**	**112**	**107**	**95**	**59**	**1,296**	***100***

National Savings Bank investment account

The National Savings Bank, which was the Post Office Savings Bank until the Post Office became a corporation in October 1969, has had ordinary accounts for many years, but first introduced investment accounts in 1966 under the Post Office Savings Bank Act of that year. Like the special investment departments of the trustee savings banks, these were accounts which depositors with £50 on their ordinary accounts could open in order to earn a higher rate of interest. At first the rate was $5\frac{1}{2}$%, but it has since risen to $7\frac{1}{2}$%, and interest is paid without deduction of tax. The maximum deposit permitted is now £10,000.

The funds from the investment account are passed to the National Debt Commissioners and, with the consent of the Treasury, invested by them in government and local authority debt. Like the special investment departments of trustee savings banks, the National Savings Bank investment account is restricted to investment in public sector debt and debentures of the Agricultural Mortgage Corporation and the Scottish Agricultural Mortgage Corporation; however, the investment account holds a much greater proportion of its assets in gilt-edged stocks – 53% compared with 22% held by the special investment departments. The main reason for this is that the transactions of the investment account, which is managed centrally, are on a much larger scale than those of the seventy-two special investment departments, and the National Debt Commissioners have difficulty in finding large enough amounts of local authority long-term debt to take up. Also, because the investment account is managed centrally, it is able to work to less stringent liquidity rules than are needed for the special investment departments. At the end of 1969 the special investment departments of the trustee savings banks held an estimated 44% of their assets in forms of debt with a maturity of less than five years, whereas the comparable proportion for the National Savings Bank investment account was 29%.

The investment account has been moderately successful in attracting deposits. Its growth between 1966 and 1969 compared favourably with that of the special investment departments of the trustee savings banks; a faster percentage rate of growth was to be expected because it was established later, but the investment account also increased its share of the combined growth each year. The National Savings Bank had two important advantages over the trustee savings banks in this period. First, many trustee savings banks had lower-yielding portfolios built up in earlier years, and were thus unable to adapt as quickly to the period of higher interest rates. Secondly, the investment account could tap, as a potential source of funds, the very large number of people who already had ordinary accounts with the National Savings Bank – about double the number of ordinary accounts held at the trustee savings banks. In fact, there was a marked increase in the ratio of new money received to money identifiably transferred from ordinary accounts. However, the amount added to the investment account since it was introduced was considerably lower than the amount withdrawn from ordinary savings accounts; the investment account seems to have moderated, but has not prevented, a decline in this part of the national savings movement.

Table IIJ

Assets of the National Savings Bank investment account

£ millions	Additions				Holdings (market value)	
	1966	1967	1968	1969	1969	% of total
U.K. local authority temporary debt	1	− 1	3	1	5	*2*
British government stocks	27	35	37	31	120	*53*
U.K. local authority long-term debt:						
Quoted	3	16	10	21	46	*20*
Unquoted	21	12	21	2	55	*24*
Total	**52**	**62**	**72**	**55**	**226**	*100*

Finance houses

Finance houses have traditionally specialised in hire purchase and other instalment credit, both for the purchase of consumer durables and for the finance of plant and machinery. Until recently, the characteristic of finance house lending has been that it was usually linked to the purchase of specified goods.

Because their assets are mainly short-term and because, also, many of their borrowers are relatively unresponsive to changes in interest costs, the finance houses can quickly adjust both their lending rates and their borrowing rates. In contrast to the building societies, they plan their lending business first and then secure the necessary finance, relying on their ability to attract deposits or drawing on their facilities with their bankers.

On the liabilities side, the houses continued to turn increasingly to deposits as opposed to bank advances as a source of funds during the six years from 1964 to 1969. The following table shows the sources of borrowed funds at the end of 1963, 1965 and 1969; it excludes issued capital and reserves and unearned finance charges,[1] which would be shown in a balance sheet total of liabilities. 1965 is included because, from that year onwards, the statistics have been rebased on the results of a Board of Trade[2] survey into finance house business in that year.

Table IIK

Borrowed funds of finance houses

£ millions: *percentage of total in italics*

End-year	1963[a]		1965		1969	
Deposits	390	*71*	654	*73*	636	*79*
Borrowing from banks	85	*15*	111	*12*	37	*5*
Other borrowing[b]	16	*3*	29	*3*	31	*4*
Bills discounted	62	*11*	107	*12*	97	*12*
Total	**553**	*100*	**901**	*100*	**801**	*100*

a Old series, not strictly comparable with later years.
b Less cash and balances with U.K. banks.

1 A provision to offset the inclusion on the assets side of the balance sheet of interest and other charges included in instalments not yet received.
2 Merged into the Department of Trade and Industry in 1970.

The growth in the proportion of deposit finance occurred partly because bank advances were subject to official restraint during most of the period. However, even when borrowing restrictions were not in force, finance houses may have preferred to rely mainly on deposits, treating their overdraft facilities, which are usually repayable on demand, as a reserve.

Turning to assets, the following table analyses the holdings of the finance houses at the end of 1963, 1965 and 1969. Again 1965 is included because of the rebasing, when the statistics were also extended to bring in leasing for the first time.

Table IIL

Assets of finance houses

£ millions

End-year	1963[a]	1965	1969
Hire purchase and other instalment credit	614	881	787
Block discounts from retailers	45	53	33
Other advances and loans	77	140	107
Other investments	60	80	88
	796	1,153	1,014
Goods the subject of leasing, hiring or rental agreements		50	127
Total		**1,203**	**1,141**

a Old series, not strictly comparable with later years.

On a consistent basis the total of these assets (excluding leased goods) increased by about 40% between end-1963 and end-1965, a period of strong demand for credit. From 1965 onwards, the possibilities of further growth were restricted by official measures intended to hold down the level of consumer credit – lending controls and hire purchase terms controls. Since May 1965, members of the Finance Houses Association and all large non-members have been asked by the Bank of England to observe quantitative ceilings on their lending similar to those applied to the banks. The severity of these ceilings has varied in accordance with policy requirements. Terms controls have been actively enforced at varying degrees of severity in most years since the early 1950s; they are operated by the Board of Trade under the Emergency Laws (Re-enactment and Repeals) Act 1964. The Board stipulates the minimum deposit which must be paid and the maximum period over which the balance must be repaid. These regulations apply only to certain specified types of goods and to certain forms of lending, in particular hire purchase and credit sale agreements. In addition, the finance houses have been asked by the Bank of England not to grant personal loans related to the purchase of goods subject to terms control on terms easier than those permitted by the Board of Trade for hire purchase contracts.

The effect which the restrictions have had on the finance houses' share of total consumer credit is hard to establish because of the difficulty of identifying all forms of such credit. The 1965 *Bulletin* article estimated that the houses accounted for a quarter of total consumer credit outstanding of just over £1,600 million at end-1963. A similar estimate for the end of 1969, based only partly on officially published figures, is shown in Table IIM:

Table IIM

Share of consumer credit: end-1969

£ millions: *percentage of total in italics*

Finance houses (excluding block discounting agreements)[a]	(485)	*28*
Banks[b]	501	*29*
Durable goods shops and department stores	276	*16*
Other instalment credit retailers	232	*13*
Other[c]	(250)	*14*
Total	**(1,740)**	*100*

a Estimate by the Department of Trade and Industry of the part of finance house instalment lending which was for consumer purposes.

b Personal loans other than for house purchase or professional purposes at mid-November 1969.

c An estimate which includes insurance companies, other financial institutions and check traders.

According to these estimates, the finance houses appear to have held their share of total consumer credit over the period. The 1969 calculation almost certainly underestimates the total amount of credit extended to consumers, because some lending (such as check traders' business, second mortgage lending, some 'budget' accounts and account credit with retailers) is covered inadequately or not at all in the official statistics. The houses may have increased their share sharply up to the beginning of 1966, but thereafter probably lost some of the ground they had gained. However, there is too much uncertainty in the statistics to draw any firm conclusions.

Although the finance houses may not have been able to increase their share of total consumer credit during the period, they made progress in developing new kinds of business. This process of diversification, which has been going forward throughout the last decade, has taken two main forms. In the field of consumer credit, finance for car purchase retains its dominant position; lending for the purchase of comparatively small goods such as radios and television sets has dwindled, but the houses have recently been turning increasing attention to lending for home improvements such as central heating and double glazing. Of greater importance for the national economy, however, has been a switch of resources by the houses into lending to businesses. They have slightly increased the proportion of their lending on hire purchase for industrial and commercial equipment, and have strongly developed their leasing business. It is difficult to measure the extent of this switch to industrial lending, because the figures available for certain categories of goods, such as "motor vehicles" and "other goods", do not distinguish between businesses and private consumers. An estimate made in the Bank suggests that, at the beginning of 1970, industrial lending of all kinds (industrial and agricultural equipment, commercial vehicles, etc.) may have amounted to as much as 50% of total finance house lending (including leasing and loans to finance motor dealers' stocks) compared with about 45% four years previously.

The finance houses have also adapted their methods of lending to changes in the law and in taxation affecting their business. The hire purchase agreement is a legal device to give the lender some security in the goods, after lending by means of a chattel mortgage was effectively ruled out by the provisions of the Bills of Sale Acts of 1878 and 1882. The Hire Purchase Act of 1965, however, reduced the advantages of the hire purchase agreement to the lender by restricting the right of repossession. Thereafter, the finance houses turned increasingly to credit sale agreements, which, until 1969, had the advantage to the borrower that they enabled tax relief to be claimed on the interest payments; when this advantage was removed by the 1969 Finance Act, however, some houses reverted to the hire purchase agreement as their main credit instrument.

Another recent development is that some finance houses have begun to extend personal loans on an increasing scale. To do so without the risk of contravening the Moneylenders Acts of 1900 and 1927, the houses have needed to obtain exemption from these provisions on the grounds that they were genuinely carrying on the business of banking; such exemption has been granted to several houses or their subsidiary companies by the Board of Trade, under Section 123 of the Companies Act 1967. To the extent that the houses have made personal loans, they have moved away from the concept of financing the sale of a specified good to the banking practice of lending on the security of general credit-worthiness. Such a development is, however, still at an early stage.

So far, the clearing banks have reacted to competition from finance houses mainly by acquiring interests in the major houses. Even when they have obtained a controlling interest, the banks have not integrated the finance houses into their own structure, but have allowed them to continue as separate, specialised institutions. Further evolution is, however, clearly possible.

The whole legal structure of consumer credit has been examined by a Committee set up in 1968 under the Chairmanship of Lord Crowther, and the report is due to be published shortly. If, as is expected, the Crowther Committee recommends a simplification of the present laws and the Government agree to legislate, then the differences between the various lenders in this field – and thereby some of the distinctive features – will be reduced.

The special finance agencies

The special finance agencies were set up to meet needs for capital which the more traditional sources could not satisfy. They lend money to borrowers who are not able to raise funds on the capital market, perhaps because they are too small or because the nature of their business involves a higher than average degree of risk. The agencies may also provide medium-term finance, where the period is too long for the banks and too short for the capital market.

There are several institutions which are classified as special finance agencies; only four of the larger ones are included in this section. They are the Agricultural Mortgage Corporation (established in 1928), the Industrial and Commercial Finance Corporation and the Finance Corporation for Industry (both established in 1945 to aid post-war development), and the Commonwealth Development Finance Company (established in 1953). The Industrial Reorganisation Corporation, which is now in the process of being wound up, is not included in this group of institutions, but is regarded as part of the public sector because it was financed with government funds.

The four agencies considered here were set up under official auspices, but their capital was subscribed by the clearing and Scottish banks and other financial institutions and, for three of these bodies, has since been supplemented by public issues of debentures. They rely on the banking sector for short-term finance. The Agricultural Mortgage Corporation (A.M.C.) was established to provide finance for farmers and the Finance Corporation for Industry (F.C.I.) to meet the needs of major industries of national importance where these are on a scale beyond the capacity of normal sources of finance. The Industrial and Commercial Finance Corporation (I.C.F.C.) is also concerned with the financing of domestic industry, but was designed to assist the expansion of smaller companies with good growth prospects; through its subsidiary, Technical Development Capital, it also helps to finance technical innovation. Finally, the Commonwealth Development Finance Company (C.D.F.C.) provides funds for development overseas, mainly in the Commonwealth.

In total, the agencies increased their assets by about 70% in the period from March 1964 to March 1970, but their individual growth rates varied considerably. The A.M.C., which almost trebled its assets in that time, accounted for two thirds of the total expansion; and the I.C.F.C. increased its fixed interest investment by about 90%, and more than doubled its equity investment. F.C.I., on the other hand, ran down its assets during the period; it has been closely involved with the steel industry, enabling the industry to maintain capital investment during the early 1960s when the prospect of re-nationalisation made market finance increasingly difficult to obtain. Since 1967 F.C.I. has progressively reduced its loans to the steel industry following nationalisation; and the Industrial Reorganisation Corporation, established in 1966, also took some potential business away. However, the F.C.I. still has some sizable commitments for future business. The C.D.F.C., the smallest of the four agencies, increased its participation in financing private development projects overseas.

Apart from the A.M.C., which does not take an equity interest, the special finance agencies may provide finance in any of several different forms – by making a straightforward loan, by making a loan with an option to convert into equity on riskier projects, or sometimes by a straight subscription to equity capital. When taking an equity interest, the I.C.F.C. and C.D.F.C. try to avoid acquiring control. In recent years the I.C.F.C. has also leased plant and equipment.

The net investments of the special finance agencies during the five years to March 1970, and their holdings at book value at that date, are given below:

Table IIN

Assets of special finance agencies

£ millions: *percentage of total in italics*

	Additions March 1964-March 1970	Holdings (book value) end-March 1970	
Short-term assets	13	21	*6*
British government stocks	7	11	*3*
Fixed interest investments in:			
U.K. agriculture	96	154	*42*
U.K. industry	6	123	*33*
Overseas enterprises	7	23	*6*
Ordinary shares	11	23	*6*
Other	15	15	*4*
	155	**368**	*100*
Of which: A.M.C.	106	168	
I.C.F.C.	77	141	
F.C.I.	— 39	31	
C.D.F.C.	9	28	

Summary of growth of financial institutions 1964-1969

The relative rates of growth of the different groups of institutions discussed in this and the preceding article[1] can now be summarised. Growth is primarily measured in terms of cash spent on acquiring assets as a proportion of asset holdings at the beginning of the period; this indicates the success of the institutions in attracting funds and is therefore the best measure of their success as a channel for savings. Another approach is to look at the increase in asset value during the period, which indicates the institutions' performance as investors; this method is complicated by the different valuations used in the available statistics.

Table IIO shows the growth of the main institutions during the period from end-1963 to end-1969.

Table IIO

Growth of the institutions

Per cent	*Valuation*	On acquisition basis	On asset value basis
Life assurance companies	*nominal and book*	54	64
Pension funds	*market*	59	59
Investment trusts	*market*	15	72
Unit trusts	*market*	208	284
Building societies	*book*	113	113
Trustee savings banks, special investment departments	*market*	82	72
Finance houses	*book*	43	43
Special finance agencies	*book*	71	71

1 See the first article in this series, in the December 1970 issue of the *Bulletin*.

On both bases, the fastest growth over the whole period was recorded by unit trusts and building societies. Their growth rates were, however, also among the most erratic. Unit trusts probably attracted funds both from investors who chose to switch from direct to indirect holdings of ordinary shares (partly perhaps because of the complexity of capital gains tax legislation) and from investors who had not previously been prepared to take the risk of equity investment. Although the movement into unit trusts from both these groups seems to have been a general feature of the period, net sales by the trusts varied considerably in the short-term in line with fluctuations in the equity market. The building societies, for their part, recorded an impressive growth of 113% during the period. But here again the longer-term growth occurred despite shorter-term variations in receipts, mainly resulting from changes in interest rates and in the level of saving.

The life assurance companies and pension funds grew by 54% and 59% respectively, though sharp fluctuations in purchases of single premium annuities for tax purposes made life fund receipts the less predictable of the two. There was probably little difference in the rate at which the market value of their assets increased.[1] The investment trusts attracted relatively small amounts of new money and grew by only 15%, though they increased the value of their assets by 72% during the period. The investment accounts of the two kinds of savings banks performed a useful role in attracting savings which might otherwise have been spent, though by the end of the period their net receipts had fallen below the peak levels reached earlier.

The finance houses met with varying experiences over the period, their assets fluctuating with changes in consumer demand and with the relaxation or tightening of official restrictions. Although lending for consumption fell at the end of the period, industrial and commercial lending, particularly through leasing, rose.

Table IIP draws together the assets held by the institutions at the end of 1969. The figures are not strictly comparable in every case, because of differences in valuation or coverage. The total assets of all the institutions covered amount to over £40,000 million, compared with over £22,000 million at the end of 1963. There may be some overlap where one institution invests in another – for example, when pension funds are used to buy the shares of an investment trust – but these aggregates do indicate the broad magnitude of the combined growth of the financial institutions over the six years. Cash spent on acquiring assets during the period was nearly £15,000 million which, taken as a proportion of assets at the beginning of the period, gives a growth of over 65%. The percentage growth of some 80% obtained by looking at the increase in the value of assets can be set against a rise of nearly 44% in the money supply over the same period and an increase of about 42% in the gross national product.

1 See the first article in this series, in the December 1970 issue of the *Bulletin*.

Table IIP

Assets held by financial institutions at end-1969

£ millions: *method of valuation shown at head of columns*

	Insurance companies: Life	Insurance companies: General	Insurance companies: Total	Pension funds[a]	Property unit trusts	Investment trust companies
	nominal and book			*market*	*market*	*market*
Current assets (partly net)	121	125	246	142	19	170
British government stocks:						
Up to 5 years	50	52	102	65[c]	—	16[c]
Over 5 years	2,902	148	3,050	840[c]	—	61[c]
U.K. local authority securities:						
Quoted	391	41	432	176	—	1
Unquoted				318[d]	—	—
Overseas government, provincial and municipal securities	88	35	123	48	—	1
Company securities:						
Debenture	2,216	74	2,290	940	—	126
Preference	232	95	327	43	—	126
Ordinary	2,837	401	3,238	3,622	—	4,340
Loans and mortgages	2,212	62	2,273	297	—	—
Land, property and ground rents	1,452	87	1,539	603[e]	100	—
Hire purchase and other instalment debt[f]	—	—	—	—	—	—
Leasing	—	—	—	—	—	—
Other	242	340	582[g]	289[h]	—	63
	12,741	**1,460**	**14,201**	**7,383**	**119**	**4,902**

a Figures for the local authority pension funds have been obtained by deducting transactions in the first quarter of 1970 from asset holdings at end-March 1970.
b At end-March 1970.
c Partly estimated.
d Of which 235 represents loans to parent authorities by local authority pension funds.
e Of which 79 invested in property unit trusts.
f Including agreements block discounted by retailers.
g Mainly working capital of the companies' agents.
h Including 112 invested in the Local Authorities Mutual Investment Trust, mainly reinvested in ordinary shares; and 157 assets of the pension funds of co-operative societies, mainly invested with parent societies.

Unit trusts	Building societies	Trustee savings banks (special investment departments)	National Savings Bank: investment account	Finance houses	Special finance agencies[b]	
market	*book*	*market*	*market*	*book*	*book*	
47	471	57	5	10	21	Current assets (partly net)
						British government stocks:
6[c]	408[c]	139[c]	31[c]	1	11	Up to 5 years
12[c]	165[c]	143[c]	89[c]			Over 5 years
						U.K. local authority securities:
—	30	230	46	—	—	Quoted
—	429	721	55	—	—	Unquoted
—	3	6	—	—	—	Overseas government, provincial and municipal securities
						Company securities:
28	—	—	—	—	87	Debenture
21	—	—	—	—	17	Preference
1,230	—	—	—	—	23	Ordinary
—	7,722	—	—	107	184	Loans and mortgages
—	100	—	—	—	—	Land, property and ground rents
—	—	—	—	819	—	Hire purchase and other instalment debt[f]
—	—	—	—	127	—	Leasing
—	8	—	—	78	15	Other
1,344	**9,336**	**1,296**	**226**	**1,141**	**358**	