Sterling certificates of deposit

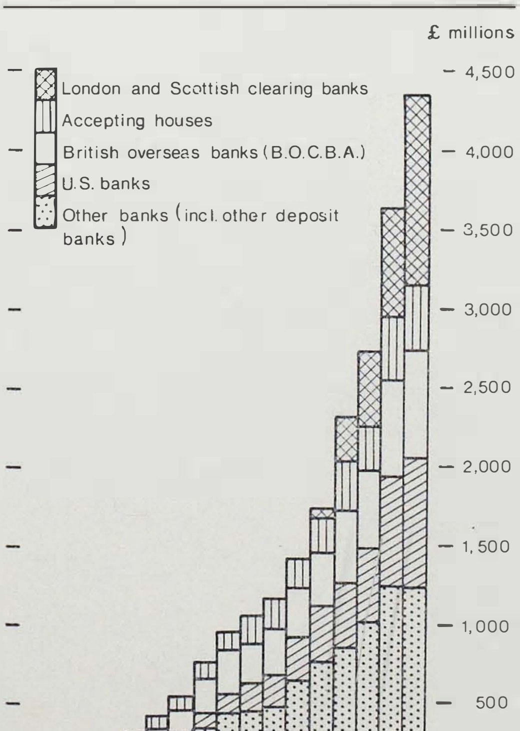
Introduction

Sterling certificates of deposit were first issued in October 1968.[1] Following the successful development of a market in dollar certificates of deposit, which were introduced into the United States on a large scale early in 1961, and into the United Kingdom in May 1966,[2] a number of banks suggested that a similar market might be made in sterling certificates of deposit and that this would be a useful addition to the range of services provided by the U.K. banking system.

This article first gives a brief description of the certificate and of the primary and secondary markets, and then looks at developments in these markets in the four years since sterling certificates were first issued.

Chart A

Sterling certificates of deposit: outstanding issues by banks



The instrument

A sterling certificate of deposit is a document, issued by a U.K. office of a British or foreign bank, certifying that a sterling deposit has been made with that bank which is repayable to the bearer upon the surrender of the certificate at maturity. It also states the rate of interest and the date of repayment, and is negotiable by simple delivery. A sterling certificate of deposit may be issued in multiples of £10,000. with a minimum of £50,000 and (normally) a maximum of £500,000, and with a term to maturity of not less than three months and not longer than five years. The rate of interest is fixed by the issuing bank, but is usually closely related to the current market rate on sterling inter-bank deposits of the corresponding maturity. For certificates of a year or less, interest is paid at maturity; on longer-dated certificates it is normally payable annually to the bearer of the certificate at the time, and at maturity. Certificates are usually issued at par. But the secondary market price takes account of accrued interest and current market rates. The form of certificate recommended by the London Discount Market Association is reproduced on the next page.

Sterling certificates of deposit would not have fallen within the scope of the earlier exchange control powers. The Exchange Control Act 1947 was therefore amended (by Section 55 of the Finance Act 1968) and the definition of securities for the purpose of the Exchange Control Act was broadened in order to include such certificates (and some other instruments). As a result, sterling certificates may not be issued without exchange control permission (and this permission is normally given only to banks which are authorised dealers); they must be deposited with an authorised depositary; and specific consent must be obtained from the Bank of England before they may be exported.

Certain market and other conventions also apply to the certificates. They are not eligible as security for advances

1 See the December 1968 *Bulletin*, page 347.

2 See the article "Overseas and foreign banks in London: 1962–68" in the June 1968 *Bulletin*, pages 156–65.

FRONT

NEGOTIABLE STERLING CERTIFICATE OF DEPOSIT

....BANK LIMITED

....ADDRESS

Serial Number (Figs)

.... £....................

Maturity Date....................Fixed

(issue date)

LONDON....................19......

(Issuing Bank)

....................LIMITED CERTIFIES THAT

(Words)

the sum of....................
POUNDS STERLING has been deposited upon terms that it is payable to bearer on surrender of this certificate, through an Authorised Bank,

(Address)

at ....

(Maturity date)

on the....................

(Words)

fixed, with interest at the rate of....................
per cent., per annum, calculated on a 365 day year basis, from the date hereof to the date of maturity only, payable at maturity if one year or less from the date hereof, and otherwise annually on the anniversary of the date hereof and at maturity.

For and on behalf of
X Bank Ltd.

....
Authorised Signature

For and on behalf of
X Bank Ltd.

....
Authorised Signature

BACK

Interest Payments

	Date	Amount	Payment made on	Initials
1st year				
2nd year				
3rd year				
4th year				
Maturity				

(First two columns to be completed at time of issue)

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Chart B

Composition of banks' sterling deposit liabilities (i)

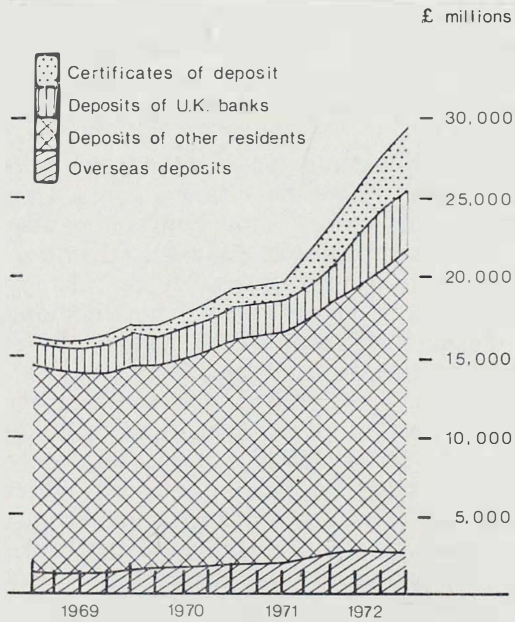
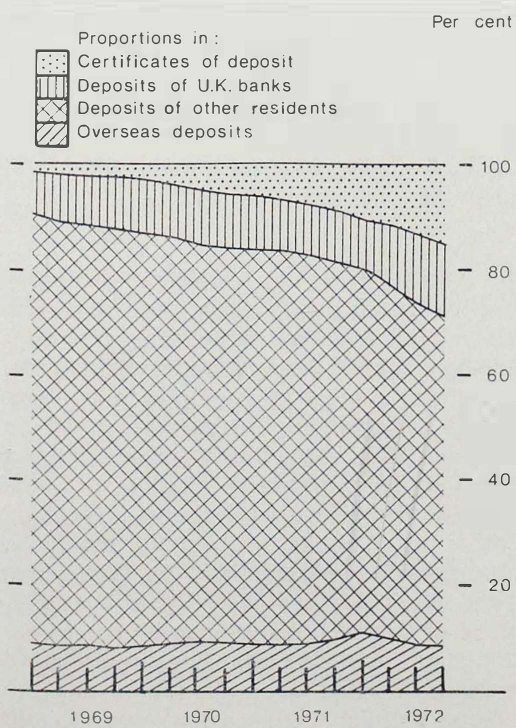


Chart C

Composition of banks' sterling deposit liabilities (ii)



by the Bank of England to the discount market, nor are the Bank prepared to discount them; other banks may take certificates as security for call money, but they are not normally expected to purchase, or take as collateral, certificates issued by themselves or by their own subsidiaries.

Sterling certificates of deposit were not regarded as liquid assets under the former 28% liquidity ratio convention applying to the London clearing banks. Under the new arrangements for credit control introduced in September 1971, holdings of certificates do not qualify as reserve assets, but—like balances with other banks—they may be subtracted from a bank's total deposit liabilities (including liabilities on account of certificates outstanding) in the calculation of eligible liabilities.[1]

The markets

In the primary market for sterling certificates of deposit, the issuing banks either issue certificates to the ultimate holders—principally other U.K. banks, other financial institutions, and industrial and commercial companies; or they place them with a dealer in the secondary market, which is made by the twelve members of the London Discount Market Association and a few banks. These institutions buy certificates from issuing banks or from other holders, and either on sell them or hold them until maturity. For any of these types of transactions brokers may be employed as intermediaries.

Certificates of deposit have proved attractive both to issuing banks and to holders. Issuing banks have found them a useful way of raising large sums, at a fixed rate of interest, and for a fixed period. Compared with ordinary term deposits they have the advantage from the bank's point of view that the funds cannot be withdrawn before maturity: by contrast, even with a term deposit, it can be difficult to refuse premature repayment if a bank's customer unexpectedly and urgently needs the funds. The issue of certificates also allows the banks to tap funds from a wider range of sources. Conversely, their chief attractions to holders are that they earn as good a rate of interest as a fixed term deposit, they lend themselves to more flexible techniques (such as the forward transactions described later) and, if the need arises to regain liquidity before they mature, they can be negotiated in the secondary market at the ruling market rates. Furthermore, the anonymity of the transaction, as between the ultimate lender and borrower, may in some cases be seen as an advantage.

Developments in the primary market

1 *Issues*

Chart A shows that the value of sterling certificates of deposit outstanding has grown very rapidly since they were first issued in October 1968. The amounts outstanding more than doubled in each of the three years 1969 to 1971; and a substantial acceleration in the twelve months to

1 See the article "Reserve ratios: further definitions" in the December 1971 *Bulletin*, pages 482–9.

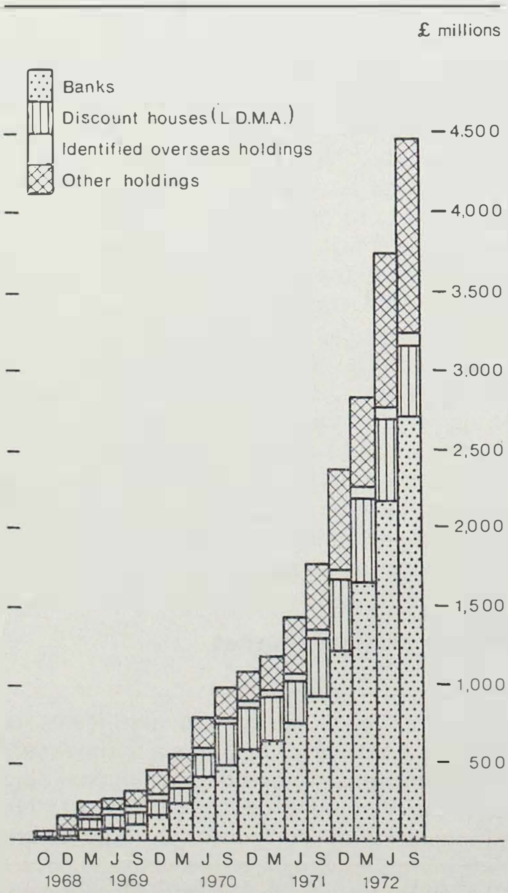
September 1972 brought the total to £4,460 million compared with £1,780 million a year earlier.

The number of banks issuing certificates increased from 79 in December 1968 to 144 in September 1972. At first the issuing banks came mostly from among the accepting houses, the British overseas and Commonwealth banks, the American banks, and the 'bidding' subsidiaries of the London and Scottish clearing banks. These subsidiaries made up the greater part of the "other banks" group shown in the chart.

Before the new arrangements for credit control were introduced in September 1971, the clearing banks were precluded – by the interest rate and other conventions then in force – from issuing certificates of deposit in their own names. Since then, however, they have made considerable use of such certificates as a means of attracting additional resources. They did so particularly in the middle of this year when they found themselves short of reserve assets as a result of the flow of funds abroad. Between May and August the London clearing banks issued as much as £630 million of sterling certificates of deposit; and by the end of September their issues (excluding the issues of their subsidiaries) accounted for 24% of the total outstanding.

Chart B shows the growth and make-up of all banks' sterling deposit liabilities since December 1968. Until September 1971, credit restrictions limited the development of the banks' sterling business and the total grew relatively slowly, from £16,000 million at the beginning of the period to something over £21,000 million; but there was then a considerable acceleration, to some £30,000 million in September 1972. Throughout the four years, however, certificates of deposit have grown, proportionately, considerably faster than total deposits. Chart C shows that, from a negligible proportion in December 1968, soon after issues began, certificates accounted for 15% of the total by September 1972. Over the same period the proportion contributed by inter-bank deposits rose from 8% to 14%, but deposits of other U.K. residents fell from 82% of the total to 63%. Deposits from overseas were about 9% of the total at both dates.

Chart D
Holdings of sterling certificates of deposit



2 *Holdings*

From the start, the banks themselves have held an appreciable proportion of the certificates in issue; and the market in certificates has developed to a large extent as an extension of the ordinary inter-bank market in unsecured sterling funds. It has thus served a similar purpose in helping to redistribute funds within the banking system. For the past year, since the credit restrictions were lifted, the banks have used the instrument more actively as a means of bidding for funds from outside the banking system, and the amount held by private holders other than banks has grown markedly. Even so, the proportion of the total held by banks has increased further, and was just over 60% in September 1972.

The predominance of banks' holdings can be seen from Chart D. The holdings of the discount houses are discussed later. Apart from the banks and discount houses and the relatively small amounts which banks are known to hold

Chart E
Composition of banks' sterling assets (i)

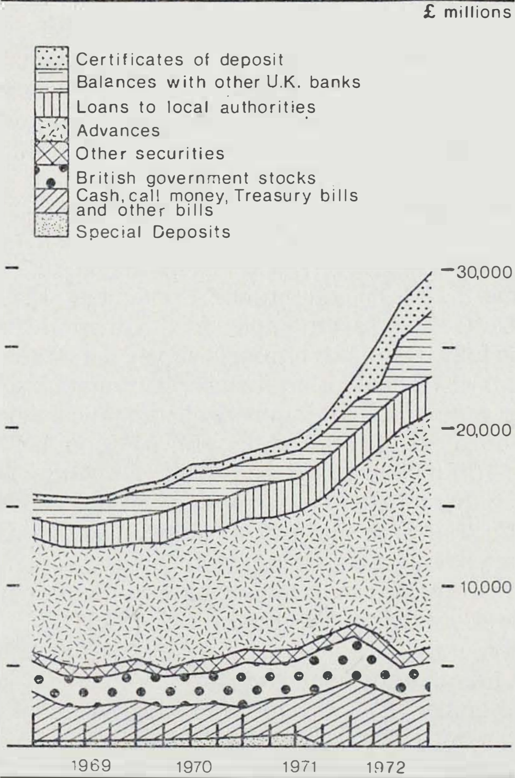
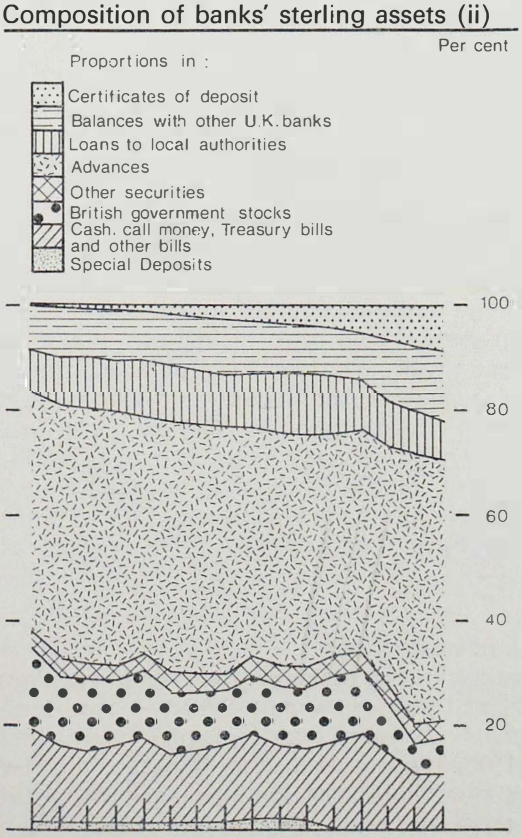


Chart F
Composition of banks' sterling assets (ii)



on behalf of overseas customers, the holders cannot be identified at all precisely. Such information as is available, however, suggests that they are mainly industrial and commercial companies and financial institutions.

(a) *By banks* Charts E and F illustrate the growth and changing composition of all banks' assets between December 1968 and September 1972. As with deposits, the growth in assets was comparatively slow until September 1971, when the credit restrictions were eased, but it then accelerated. Throughout the period banks' holdings of certificates of deposit grew both absolutely and as a proportion of total assets; and in September 1972 they amounted to £2,700 million, or 9% of the total. At the same date balances with other U.K. banks amounted to £3,980 million, or 13% of all assets, so that the two items together were over 20% of the whole. The comparable figure at the end of 1968 was 8%.

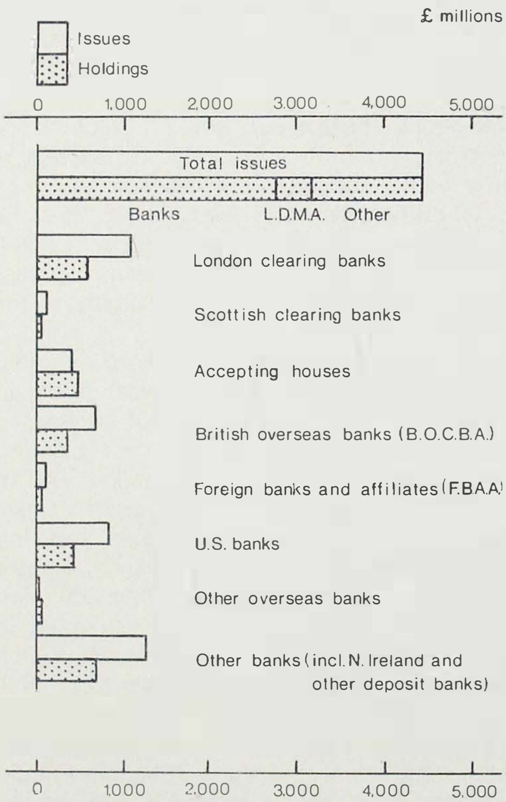
The growth in the sterling inter-bank market, including banks' holdings of certificates of deposit, was given an added impetus by the changes in credit control introduced in September 1971. The London and Scottish clearing banks then began to deal in the inter-bank market, and to issue and hold certificates of deposit in their own names. At the same time, under the new arrangements applying to all banks, inter-bank balances and holdings of certificates of deposit were allowed to count as offsets in the calculation of eligible liabilities. This made them more attractive in relation to some other short-term investments which qualified neither as reserve assets nor as offsets to eligible liabilities. Furthermore, as balances with other banks and certificates of deposit earn a higher rate of interest than most reserve assets, there is an advantage in keeping liquid resources in this form rather than in reserve assets, to the extent that the minimum reserve ratio allows.

Elsewhere in the balance sheet, the charts show the substantial expansion of advances since September 1971; this item is now nearly 50% of total assets compared with 46% in December 1968. In the same period – and again, mainly since September 1971 – the proportion represented by British government stocks was run down from 14% of the whole to 7%, and that by cash, call money, Treasury bills and other bills (the clearing banks' traditional liquid assets under the former conventions) from 19% to 11%.

The extent to which the various groups of banks are involved in the market for certificates of deposit, both as issuers and holders, is shown in Chart G. The function of the market as an extension of the inter-bank market has already been mentioned. Apart from this, there are a number of reasons why a bank may wish both to issue and to hold certificates. It may, for example, wish to match future receipts and payments by issuing certificates which mature in a period of expected cash surplus and holding certificates which mature in a period of expected cash shortage. A bank may, moreover, issue and hold certificates of the same maturity if, for example, it has bought certificates to make provision for the redemption of certificates which it has previously issued. In running their books, banks will also have in mind the difference in yield – actual or expected – between

Chart G

Issues and holdings of sterling certificates of deposit (as at end-September 1972)



different certificates *e.g.* between shorter and longer-dated certificates.

(b) *By others* Holdings of certificates by the private sector *i.e.* all holdings other than those of banks, discount houses and – so far as they can be identified – of overseas residents, have grown particularly rapidly in the last two years: from less than £200 million in December 1970 they rose to £560 million in March 1972, and then to as much as £1,200 million in September 1972 (Chart D). Some of the increase was due to other financial institutions (building societies, the Crown Agents, investment trusts and unit trusts) which held some £280 million at end-September 1972 compared with £140 million six months earlier. Other private holders cannot be fully identified: a sample survey conducted by the Department of Trade and Industry showed that about 200 of the largest industrial and commercial companies held some £250 million of certificates at the end of June 1972 compared with £100 million at the end of March. And it is generally assumed that most of the remaining certificates are also held by industrial and commercial companies. These increases in private holdings of sterling certificates of deposit made a significant contribution to the increase in the money stock (M_3) in the second and third quarters of 1972.

One explanation of the recent very rapid growth of private holdings may be found in the keener climate of competition introduced in September 1971, as a result of which the banks began bidding for money more aggressively and have become more competitive as intermediaries between other sectors of the economy. Certainly it would seem that some companies and financial institutions have been investing in interest-bearing deposits with banks (including certificates of deposit) in preference to other short-term assets such as deposits with local authorities and hire purchase finance houses. There has also been some transfer from current accounts with banks, which generally pay no interest, to deposit accounts.

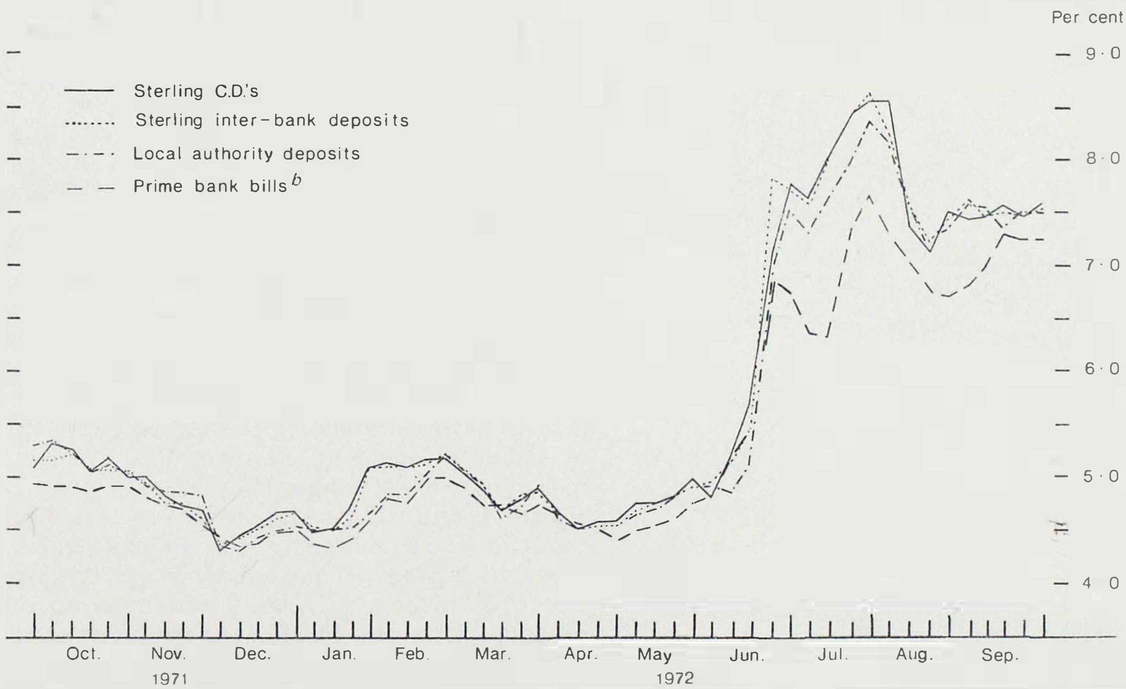
Apart from these general considerations, there were special circumstances in the middle of 1972 which no doubt contributed to the rapid growth in private holdings of certificates. The very large outflow of funds abroad led to sharp increases in short-term market rates of interest, and some bank customers may well have found it profitable to draw on their advances facilities and redeposit the money in sterling certificates. There were also at this time some fears that monetary policy might become more restrictive, including the reimposition of credit ceilings, and this may have led to some precautionary borrowing from the banks. These funds, again, may have been invested in certificates of deposit.

Interest rates and maturities

Chart H illustrates the relative yields on three-month sterling certificates of deposit and on some alternative short-term sterling investments between end-September 1971 and end-September 1972. It suggests that, for banks, certificates of deposit are a close substitute for inter-bank deposits: during the year there was rarely a difference of more than

Chart H

Selected three-month money rates[a]



a The chart illustrates the average rates on the last working day of each week.
b The discount market's buying rate.

$\frac{1}{8}$% between the two rates, and neither was consistently higher than the other. There was also a close relationship between the rates on certificates of deposit and on local authority deposits, although the certificate rate was usually higher, on occasions by more than $\frac{1}{8}$%: this may perhaps indicate that the certificate rate has led the local authority rate upwards in response to the banks' need for funds. The relationship between the rates on certificates of deposit and on prime bank bills has not been quite so close, with a normal differential of up to $\frac{3}{8}$% in favour of certificates. The differential increased considerably between end-June and early September, after the sterling outflow (on one occasion reaching $1\frac{3}{4}$%). This reflected partly the influence on the certificate rate of the demand by banks for funds and partly the status of the eligible bank bill as a reserve asset and an ultimate source of liquidity.

As can be seen from Chart J, which analyses issues outstanding at end-September 1972 by maturity groups, sterling certificates of deposit are primarily a short-term investment. Although they may be issued originally with a term to maturity of between three months and five years, little more than 10% of those outstanding at end-September 1972 were due to mature in more than one year. Over 60% were due to mature within six months and more than a third within three months. These figures are not, however, necessarily a good guide to the amount of new business done at short term. They relate to remaining, not original, maturity; and the shorter categories are therefore swollen by the inclusion of longer-

Chart J
Maturities at end-September 1972[a]

a The height of each block shows the average monthly amount maturing in each period. The area of the blocks indicates the total value of maturities in each period.

term certificates coming nearer to maturity. Furthermore the practice, described later, of issuing 'forward' certificates leads to some inflation of the figures of maturities under one year by what is really longer-term business.

Developments in the secondary market

Chart K illustrates the growth of turnover in the secondary market (as measured by monthly totals of purchases plus sales) between the fourth quarter of 1968 and the third quarter of 1972. Turnover has grown broadly in line with the growth in issues, and in any one month has generally represented about 40% of all issues outstanding. Normally between 30% and 40% of certificates purchased by the secondary market are acquired direct from issuing banks.

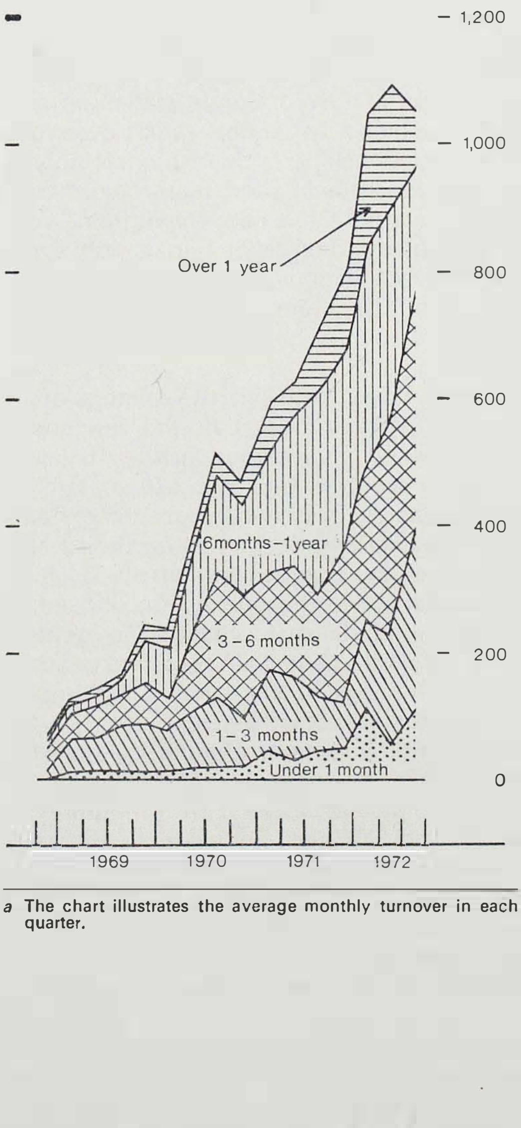
Holdings by members of the London Discount Market Association, which form the greater part of the secondary market, have generally represented between 15% and 25% of issues outstanding, although their holdings of £465 million at end-September 1972 were, in fact, down to 10% (Charts D and G). Sterling certificates of deposit were also the third largest item, after local authority bonds and commercial bills, among the discount houses' assets, representing about 19% of the total. This is a substantial proportion, which no doubt reflects the fact that – apart from the need to maintain a dealing portfolio in order to fulfil their secondary market function – the discount houses have also found sterling certificates an attractive investment in their own right. Such holdings are not, however, without risk – as has been underlined by the sharp rise in short-term interest rates since June this year.

Mention also needs to be made of two forms of forward dealing which have developed in the market. The first is a device adopted by issuing banks to attract longer-term deposits while avoiding the disadvantage to purchasers of holding longer-dated certificates, which are not so easily marketable. The procedure is for the issuing bank to issue, say, a one-year certificate, on the understanding that at the end of the year it will be 'rolled over' for a further year or years. The rate is generally that applicable to the full term. It is fixed at the outset and applies to each roll-over period regardless of market rates prevailing at the time of the roll-over.

The second form comes nearer to the ordinary meaning of a forward market, and enables banks, discount houses, and others to enter into contracts to buy or sell certificates at some future date when they foresee a surplus or lack of funds. Such transactions are often linked initially to roll-over transactions of the kind described in the previous paragraph, and will often offer opportunities of obtaining a slightly higher yield on term assets than a simple purchase of a longer-term certificate. Because the rate is fixed at the time of the contract, they may also provide a hedge against the risk of changes in interest rates. An example of an arrangement of this kind would be the sale of a one-year certificate for delivery in two years' time. Alternatively a transaction might cover (say) five years, with equal amounts of one-year certificates being delivered at the end of each year. Such transactions may, of course, involve risks for the

Chart K

Monthly turnover in the secondary market, by maturities[a]



a The chart illustrates the average monthly turnover in each quarter.

operators; and there has in fact been an appreciable contraction in the market during recent months following the sharp rise in short-term rates.

Conclusion

After a slightly slow start in its first months, the market in sterling certificates of deposit expanded rapidly. In the early years it evolved largely as an extension of the sterling inter-bank market, which had itself developed during the 1950s and 1960s alongside the 'parallel' sterling markets in local authority and finance house deposits. At the same time, this older inter-bank market has also continued to develop rapidly. Both have probably expanded beyond the expectations of a few years ago. The sterling certificate of deposit must have broadened and increased the flexibility of the inter-bank market; but it is, of course, difficult to say to what extent the new instrument has enlarged the total of inter-bank dealing as distinct from altering the form of a growth which would have taken place in any event.

It is possible that in the earlier years the existence of restrictions on bank lending to the private sector, which limited individual banks' scope for the employment of sterling resources, did something to foster the development of the inter-bank market. Banks expanded their lending in the local authority short-term market, which – as public sector lending – was exempt from the credit restrictions; and the inter-bank market, which is to some extent an ancillary of the local authority market, naturally reflected this expansion. The market also provided a means for transferring funds from banks with surplus resources which had reached their credit ceilings to others which still had scope within the restrictions for private lending.

The more competitive conditions in the banking system introduced in September 1971 have given a further strong stimulus to the development of the inter-bank market in both its forms. The market adds to the efficiency of the banking system; and well-developed markets in inter-bank funds and certificates of deposit must strengthen the system as a whole by improving its ability to mobilise funds quickly in response to unforeseen calls.

The very rapid increases in total issues of certificates and in holdings by the banks themselves are evidence that funds are, in effect, passed from bank to bank, each bank in turn regarding the market as providing an attractive employment for its second line of reserves. It will therefore be important for the banks to keep in mind the extent to which their issues of certificates are likely to be held within the system by other banks, since in other circumstances the process of multiple expansion could be reversed, and their ability to gather resources quickly in this market by further issues of certificates would depend on how readily they could attract funds from outside the banking system. In the context of the new arrangements for credit control, the market plays a valuable part in allowing changes in the banking system's need for resources, and ability to attract them, to be reflected in and regulated by a market rate of interest.