Competition and credit control: modified arrangements for the discount market

Under the arrangements agreed for the money market in 1971 in the context of the new approach to competition and credit control in the banking system, members of the London Discount Market Association undertook to hold at least 50% of their borrowed funds in defined categories of public sector debt. Subsequent experience has shown that this requirement tended to complicate the Bank's task of securing adequate influence over credit extended by the discount market, and produced distortions in short-term money markets.

The requirement that a house should hold 50% of its funds in certain forms of public sector debt placed a premium on these public sector assets, particularly those such as Treasury and local authority bills which are bought by the Bank when providing assistance to the market. Since a house operating near the limit set by the ratio could acquire other assets only if it acquired an almost equal amount of these public sector assets, rates for the latter were sometimes bid very low relative to the rates on other assets. And, at times of pressure, when the Bank purchased large amounts of Treasury or local authority bills in their assistance to the market, the houses were forced by the need to maintain the ratio either to sell equivalent amounts of private sector assets, pushing yields for these even higher in relation to yields on public sector assets, or to bid aggressively to replace the public sector assets they had sold, thereby depressing the rate for these still further at times when other rates were rising.

Experience with the public sector lending ratio brought to light other practical disadvantages. All the banks' money at call with the discount market qualifies as reserve assets; and some constraint is therefore needed on the market's freedom to invest in private sector assets. The public sector lending ratio, however, was more constrictive than was necessary: a house near to its 50% ratio and selling its Treasury bills to meet the Bank's market purchases might be forced either to sell bank bills, which are eligible as collateral at the Bank, or to buy other public sector assets in the categories not eligible at the Bank. In either case the sale of liquid public sector assets such as Treasury bills would drive the house, because of the 50% ratio, into action that would tighten its liquidity still further. This secondary effect became an undesirable consequence of the system in that it caused a disproportionate reduction in the market's liquidity whenever the Government's need of finance was falling; neither the houses nor the Bank wished this to continue. On occasion the Bank have been unable to give assistance to the market by buying Treasury and local authority bills because of this secondary consequence, and could complete their market operations only by purchasing eligible bank bills. Such purchases had the effect of refinancing the market's credit to the private sector and so increasing the volume of acceptance credits which could be absorbed by the banking system; this was not always consistent with other aims of policy at the time.

When it was not immediately constrained by the 50% ratio to avoid further purchases of private sector assets the market was positively encouraged to acquire such assets by the exaggerated differential in yield. This, too, could have become an undesirable by-product of the ratio.

With the object of alleviating these difficulties, the public sector lending ratio was replaced, with effect from 19th July, by a control which limits aggregate holdings of certain assets by each house to a maximum of twenty times its capital and reserves. These are all assets other than those defined as public sector assets for the purpose of the discarded 50% ratio.[1] Allied to this limit there is the continuing requirement that the size of each house's total business should bear an appropriate relationship to its capital and reserves. This overall limit reinforces the twenty times multiplier in restricting the creation of reserve assets through the discount market. The Bank attach considerable importance to this limit and monitor it closely.

A comparable modification has been made at the same time to the arrangements agreed with the discount brokers outside the London Discount Market Association and with the money trading departments of certain banks. Other details of the arrangements for the money market, which were described in two previous articles in the *Bulletin*,[2] remain in force.

Although the twenty times multiplier gives the houses considerably greater flexibility in managing their books, it does not weaken the authorities' influence over credit extended by the discount market, nor represent an easing of credit control. For although the multiplier is large enough to accommodate occasional temporary movements by individual houses, it is in no sense to be regarded as a norm.

Although the obligation to hold a proportion of their assets in certain forms of public sector debt has formally been lifted, market practices will continue to require houses to include in their portfolios a substantial proportion of such assets, particularly those that provide liquidity. Assistance from the Bank can be obtained only against approved securities, and, except for eligible bank bills, these consist of the public sector assets which counted towards the 50% ratio. The Bank continue to require that collateral for lending to the market should include a minimum proportion of Treasury bills, and there are other lenders to the market who will undoubtedly still require that collateral pledged with them against borrowed funds should include a proportion of public sector debt which could be used by the houses to obtain funds from the Bank if the lenders were obliged to call their loans. Further, some of the large banks, rather than tendering for Treasury bills, habitually look to the houses to supply their requirements. Hence, the houses will still need to maintain considerable portfolios of public sector assets, usually to the extent that there will not be room within their overall limits for them to hold other assets amounting to twenty times their resources. The figure of resources on which the multiplier is currently based is approximately £100 million. The figure will be calculated as a three-year moving average of end-December figures relating to the net worth of each house. Undefined assets on 18th July totalled about £1,400 million.

1 "Defined assets" are:
- Balances at the Bank of England
- U.K. and Northern Ireland Treasury bills
- British government stocks and stocks of nationalised industries guaranteed by H.M. Government } With not more than five years to final maturity
- Local authority stocks } With not more than five years to final maturity
- Local authority and other public boards' bills eligible at the Bank
- Local authority negotiable bonds
- Bank bills drawn by nationalised industries under specific government guarantee.

2 "Reserve ratios and Special Deposits", September 1971, and "Reserve ratios: further definitions", December 1971.