Credit control: a supplementary scheme

On 17th December 1973 the Bank announced arrangements for improving their control over the money supply and bank lending, under which the banks and finance houses have agreed individually to place non-interest-bearing supplementary deposits with the Bank if the interest-bearing eligible liabilities of the institutions concerned grow faster than a specified rate. The rate specified for the first six months is 8%, and that for the subsequent period is to be announced no later than the end of April. No deposit is required to be lodged until the scheme has run for six months. Thereafter, while the arrangements remain activated, the amount to be lodged will be calculated by reference to a three months' moving average of the growth of interest-bearing eligible liabilities above their average at the make-up dates of October, November and December 1973. The scale of supplementary deposits to be made will rise with the excess of the three months' average over the allowable rate of growth: for an excess of 1% or less the rate will be 5% of the excess, for more than 1% up to 3% it will be 25%, and thereafter 50% (the maximum under the scheme).[1] The arrangements apply to interest-bearing eligible liabilities only, and so exclude such non-interest-bearing liabilities as most current accounts. The arrangements can be suspended by the Bank when that seems appropriate, but are intended to be permanently at hand.

The rate of growth of interest-bearing liabilities depends in part upon the rates of interest offered by the banks. Strong bidding for funds by the banks while the scheme is activated could result in their eligible liabilities rising faster than the allowable rate, and thus incurring a progressively larger penalty in the form of non-interest-bearing supplementary deposits. The arrangements should therefore restrain the pace of monetary expansion, including the pace at which banks extend new facilities for bank lending, without requiring rises in short-term interest rates and bank lending rates to unacceptable heights.

As a consequence of restraint on bidding for funds, patterns of interest rates where money market rates are high in comparison with the clearing banks' lending rates, and with rates in other markets, should be avoided. Such patterns have fostered the demand for bank loans and encouraged arbitrage, and have thus served at times to inflate the money stock.[2] Alongside the new scheme, the clearing banks themselves announced that for certain classes of customer they would begin to link overdraft rates direct to market rates instead of to base rates. Thus, whether or not the supplementary scheme is in active use, a better structure of short-term interest rates will be obtained to the extent that the banks find themselves able to vary their lending rates more flexibly with money market rates.

Again, whether or not the supplementary scheme is being used, the authorities will continue to use their previously established monetary instruments to influence the general level of money market rates, notably by daily market operations, supported as necessary by general calls or repayments of special deposits.

As far as possible, the supplementary scheme is intended to maintain the main structural benefits to the banking system of the reforms introduced in 1971. As the new technique applies an incremental penalty to a three months' moving average of the increase in interest-bearing eligible liabilities above an allowable rate of growth, it should cause fewer distortions to the normal pattern of banking business than would rigid ceiling controls on particular areas of bank lending, or the general imposition of maximum interest rates on deposits (akin to the Regulation Q of the Federal Reserve Board), or indeed than most other schemes for reinforcing credit control which have been canvassed. Nevertheless, the arrangements will tend to constrain each bank within roughly the same rate of overall growth and will therefore impose a limit on competition for business. The relative freedom of bankers to run their own businesses within that overall rate of growth, and the inherent flexibility of the scheme itself, should

[1] Full details of the scheme are set out in the notice to banks, which is reprinted as an appendix to this note.
[2] June 1973 *Bulletin*, pages 139 and 197; December 1973 *Bulletin*, page 414.

however limit the additional constraints on competition to the minimum possible under the circumstances.

The scheme is similar in some respects to one in operation in France. There a penalty is applied to the extension, above some allowable rate, of bank lending to the private sector. Basing the scheme on interest-bearing eligible liabilities, however, leaves more freedom to banks to arrange their portfolios of assets; introduces less discrimination between the treatment of public and private sector debt; and should provide greater control over the money stock itself. At the same time, the direction of bank lending to the private sector remains subject to such qualitative guidance as may from time to time be given.

It is hoped that the transition between periods when the scheme is actively in operation and those when it is in abeyance will, when the time comes, be able to be made smoothly. In the past, when controls were applied to bank lending, the authorities have hesitated to remove them for fear of releasing pent-up demand, the full extent of which could not be known. When ceilings, or limitations on bank lending, were in abeyance but were seen as a possibility, fear of their reimposition may have caused banks to expand credit, and in particular to expand commitments, faster than otherwise. The likelihood of this occurring under the present scheme – at least, on any large scale – should be less. It is a main object of the present scheme to encourage banks to relate their lending commitments to a prudent view of the likely availability of funds; and, at times when the scheme is in abeyance, the possibility of its activation should impose some check upon the extension of facilities.

It is also hoped that the scheme will prove an adequately flexible instrument in operation. It incorporates several elements which are susceptible of ready adjustment in the light of experience. The first of these is the length of the period to which a given allowable rate of growth of liabilities is applied. The choice of six months as the initial period represented a compromise, given on the one hand the major uncertainties affecting the economy, which argued for a short period, and the wish on the other hand to give banks enough time to adjust. It will also be possible to change the allowable rate of increase of interest-bearing eligible liabilities (8% in the first six months). As well, it might be necessary to reconsider the method of estimating a bank's position relative to the allowable rate of increase (at present a three months' moving average); or the tranches above this allowable rate to which the progressive penalty will apply (now three tranches, 0% – 1%, 1% – 3%, and over 3%); or, lastly, the rates at which the supplementary deposit will be levied on these tranches (now 5%, 25%, and 50%).

The introduction of the scheme has, in the event, coincided with a period of unusual uncertainty for business, and the financial effects of the three-day working week could lead to a temporary exceptional demand for credit. There is no intention of preventing the banks from accommodating industry's needs of this kind, and some special deposits were released on 4th February. Within the total of bank lending, qualitative guidance on priorities had previously been given, and a fall in advances in one of the areas of low priority – personal lending – has already occurred. The need to limit lending to such classes of borrower has become all the greater, in order to make room for more loans to industry. Beyond this, the Bank are receiving much help from the commercial banks in assessing the pressures upon industry, and the authorities will continue to respond flexibly to these temporary circumstances. In the longer term, the need to contain the growth of the money supply and bank lending within reasonable limits, and to operate monetary policy to this end, will again become dominant.

Appendix

Notice to banks and deposit-taking finance houses issued by the Bank of England on 17 December 1973

1 Supplementary scheme

The Bank ask that banks and deposit-taking finance houses should be prepared to place with the Bank non-interest-bearing special deposits in relation to the growth in each institution's interest-bearing resources on the following basis:

(i) interest-bearing resources to be defined as the interest-bearing element of each institution's eligible liabilities;

(ii) the growth in each institution's interest-bearing resources as defined in (i) above to be measured from the average of the amounts outstanding on the three make-up days preceding each activation of this scheme;

(iii) up to 50% of the growth in each institution's interest-bearing resources, on a three months' moving average basis, over and above a rate to be specified, to be placed on non-interest-bearing deposit with the Bank, subject to:

(iv) no deposit being required to be lodged within the first six months of the initial activation of this scheme;

(v) non-interest-bearing special deposits made to be repayable in full should the growth in an institution's interest-bearing resources fall back to the rate specified or in part if the amount of the excess should decline;

(vi) the requirement to lodge non-interest-bearing special deposits to be capable of variation or suspension at the Bank's discretion.

The initial activation of the scheme will take place immediately and will apply to all banks (except the Northern Ireland banks) and to deposit-taking finance houses. The base level will therefore be the average of interest-bearing resources at the make-up days for October, November and December 1973. The rate of growth specified is 8% for the first six months; the rate to be specified thereafter will be notified in due course, but not later than the end of April 1974. The rate of deposit required will be progressive with the excess rate of growth of each institution's interest-bearing resources: in respect of an excess of 1% or less, the rate will be 5%; in respect of an excess of over 1% but not more than 3%, the rate will be 25%; thereafter the rate will be 50%.

The effect of these arrangements is that, if the average of an institution's interest-bearing resources on the make-up days for April, May and June 1974 were to exceed the average amount outstanding on the make-up days in October, November and December 1973 by more than 8%, a non-interest-bearing special deposit on the scale specified above would be required to be lodged during July 1974. Thereafter the requirement to lodge non-interest-bearing special deposits will be assessed monthly in relation to the rate of growth in interest-bearing resources to be specified.

Banks and deposit-taking finance houses are not expected to respond to the introduction of these arrangements with a general rise in their lending rates.

2 Other matters

Banks and finance houses are asked to reinforce strongly their restraint on lending to persons generally, to property companies and for purely financial transactions.

In view of the introduction of the new arrangements and taking account also of the immediate prospects for the reserve asset position of banks and deposit-taking finance houses, the Bank have decided, with the approval of the Chancellor of the Exchequer, to revoke the calls for special deposits, each of ½% of eligible liabilities, which were due to have been made on 27th December 1973 and 2nd January 1974.

Note

Since this notice was issued, the Bank have considered the problems which the supplementary scheme posed for banks (such as those newly established) with a very small base of interest-bearing resources. As a result, it has now been decided that banks should be exempt from the requirements of the scheme until their interest-bearing eligible liabilities average £3 million or more for a period of three months. Thereafter, in the current period of operation, the rate of growth of interest-bearing eligible liabilities permitted before non-interest-bearing special deposits become payable will be related to a base of £3 million. Banks to which this provision applies will continue to be subject without modification to the obligation to maintain the reserve asset ratio, and to respond to general calls for special deposits. The exemption will not apply to finance houses, which are not subject to the arrangements for control of credit until their eligible liabilities reach £5 million.