Savings and investment: recent developments in financing arrangements

A preliminary paper, submitted by the Bank in May of this year to the Committee to Review the Functioning of Financial Institutions, chaired by Sir Harold Wilson.

Introductory

1 The financing of private industry and trade has in recent years encountered a number of unusual problems and undergone a variety of changes. Some of these problems remain and some of the changes are incomplete. This paper does not seek to describe, analyse or assess these developments exhaustively; a full discussion of them would need to take in both more of the broad economic considerations and of the state of monetary policy at the relevant times, and a more detailed examination of alternative policies. Nor have we sought to describe the structure and working of the financial system, since much of the evidence that the Committee is now receiving from other sources will bear on such matters. We have felt that the Committee's present purpose might best be served by a paper from the Bank that endeavoured briefly to describe, analyse and assess the particular developments (other than those in the field of securities regulation) with which we ourselves have been closely involved, and which have given us most concern. Since brevity has been an aim in writing the paper, we have focused mainly on the events and influences over the past ten years that have led to changes in the financial system.

2 For some fifteen or twenty years prior to the present decade, the financing of industry and commerce proceeded without difficulty within the financial system the structure of which was described in the Radcliffe Report of 1959. Industrial and commercial profitability did not appear to place a limit on the scale of new investment, and the external financing requirement of companies in the private sector was met by the banking system and capital market without problems of any severity appearing. With relatively small exceptions, existing special institutions appeared well able to take care of any 'gaps' of the kind revealed by the Macmillan Report, while an evolving demand for greater expertise in corporate financial advice, notably in the field of take-overs, was well met by the merchant banking community. There were, of course, persistent and recurring macro-economic problems and from time to time these called for fiscal and monetary policies the effect of which on industrial financing was restrictive, whether through the cost or availability of finance, or both. In addition, the seeds of a variety of unsatisfactory micro-economic developments, which were to become evident in the 1970s, were germinating and becoming established. But the private sector financial system, and specifically the arrangements for channelling of savings into productive investment, were not then held to blame or thought to need reform. Rather were the solutions regarded as a matter for management education, government intervention, or for a special governmental agency, the Industrial Reorganisation Corporation (IRC). In these conditions, the resources devoted in the Bank to 'finance and industry' were small and confined in the main to the gathering of qualitative information which supplemented statistical material used in forming judgments about the economic conjuncture and the effect of policies.

3 In only one important respect, and towards the end of the 1960s, did changes occur in the financial system, with which the Bank were closely concerned. These occurred in the banking system and the Committee may care to be reminded of what took

place, and why. Over the period 1968–71 the London clearing banks underwent four radical changes. Firstly, there were the substantial mergers which effectively reduced the number of these banks to five; secondly came the publication of annual accounts that revealed for the first time the 'true' profits of the clearing banks; thirdly came the abandonment of the agreement among these banks to apply uniform deposit and lending rates; finally, and concurrently, came the abolition in 1971 of the official ceiling controls on each bank's lending to the private sector. The Bank's purpose in these changes was to encourage a more competitive and innovatory attitude within this dominant part of our banking system and to encourage also a more efficient use of the considerable real resources used in it. All of the changes needed the agreement and encouragement of the authorities, and it became the policy of the successive Governments of that time to provide such encouragement. The Bank, too, gave wholehearted support to this policy as, in various respects, did the Monopolies Commission and the Prices and Incomes Board – not to mention informed opinion in the academic world and the press.

4 This reform of the banking system was virtually complete by 1971, though there remained one outstanding matter which was not settled until late in 1972, when the Bank issued a statement on mergers and participations.[1] The principal purpose of this document, which also had the support of the Government, was to redefine the official attitude to bank mergers and the way in which it was to be given effect, and in particular to open the way for mergers to take place between clearing banks and the principal merchant banks. Such mergers had previously been opposed by the Bank. The change was intended to facilitate the development of so-called 'universal' banks if, in the climate of greater freedom, that was the way the banking community wished to go, and to move closer to the merger rules becoming established in the European Economic Community.

5 Since 1972 the Bank have been concerned, from time to time, to encourage the development of new practices or new facilities for which a need seemed to have developed and which, in the more enterprising and competitive environment which undoubtedly prevailed, the banks might be expected to supply. The Bank did of course become much concerned with the aftermath of the property boom and the difficulties of the so-called secondary banks, but that is a different subject, for a different paper.

6 These banking reforms essentially had their roots in the relatively satisfactory era of the 1950s and 1960s, though they indeed proved relevant and useful in endeavouring to meet the problems of the 1970s. These latter can be divided into four distinct, though not wholly unrelated, classes as follows:

(i) Problems arising from the onset of inflation at a pace not hitherto experienced in this country in time of peace.

(ii) Problems arising from a decline in industrial profitability, in real terms, to levels only seen before at times of deep economic depression, for example the early 1890s and the early 1930s.

(iii) Problems arising from some apparent disinclination among banks and institutional shareholders to concern themselves with the *causes* of managerial failure in the companies in which they had financial interests, or with seeking remedies as distinct from disposing of the shares.

(iv) Problems, which at the time seemed to be particularly demoralising to management, arising from frequent unforeseen changes in government policies, in levels of taxation and tax reliefs, in regional and investment incentives, in price and wage

[1] See December 1972 *Bulletin*, page 452.

controls, and in a whole range of government actions affecting the industrial climate – though these are not the concern of this paper.

Problems arising from rapid inflation

7 It is likely that a main effect of the serious upward shift in the rate of inflation, which first occurred in 1970 and again, even more seriously, in the aftermath of the oil crisis at the end of 1973, has been to steepen the decline in real industrial profitability which was proceeding slowly during the later 1960s. The decline in profitability seems to have been world-wide; why it quickened so sharply in the United Kingdom is not entirely clear. The deficiency of final demand in this country, which prevailed for much of the time, was no doubt one reason why the rise in final prices lagged so far behind the rise in costs; but more important was the strenuous attempt to keep prices down despite increasing costs, first by voluntary restraint and later by statutory control. Historic cost accounting tended to mask the severity of the squeeze that this imposed on profit margins, to the point that companies, in many cases, did not immediately notice the approaching dangers. For a time in 1974, in real or replacement cost terms, many were trading at a loss, and most were running rapidly into difficulty in maintaining cash flow and liquidity. Low profitability has depressed industrial investment; it has lowered industry's willingness to borrow and its capacity to service new borrowing. Those problems are discussed more fully in the next section of this paper; the remainder of this section considers a number of special problems that have arisen, purely as a result of inflation, affecting the supply of private savings and its channelling into industry and commerce.

8 Rapid inflation was followed without much delay by historically high interest rates, both short and long. Proximately, these rates reflected an economic environment in which official monetary policy was increasingly directed towards a counter-inflationary restraint on the money supply and the protection of the external value of sterling. But more fundamentally they reflected the need to finance a large public sector borrowing requirement, latterly becoming very large. This need made it easier for savers to secure something nearer to a positive real rate of return, though it also added to the nominal interest burden on industry and commerce.

9 High nominal interest rates and, more generally, the squeeze on company profitability were accompanied by an increasing volatility of expectations about the future rate of inflation, to which was added at times a comparable volatility of expectations about vital governmental attitudes towards private industry and trade. It cannot be a matter for surprise that all this engendered erratic and volatile markets, with steep fluctuations in the prices both of ordinary shares and of fixed-interest securities, and that the channelling of savings into industry became volatile and was even subject to periodic interruption. As is well known, conditions in the equity market became so bad in late 1973 and 1974, with the suppliers of funds and the users both virtually paralysed, that there was no worthwhile volume of new issues. There was an abrupt recovery in 1975 when a very large total of new issues was made. This continued in the first half of 1976 but was again interrupted by the monetary and exchange disturbances in the latter part of that year. The market recovered once more in the early months in 1977 and the queue of new issues is again lengthening. It is accordingly difficult to argue that the supply of savings through the equity market has been seriously defective in the aggregate, except in so far as it has been temporarily interrupted by environmental factors exterior to the market itself. It is indeed most striking that, despite the low level of industrial

profitability and a tight degree of dividend restraint officially imposed over a lengthy period, credit-worthy companies in industry and commerce have in the main found little difficulty in raising new equity where this has been needed to preserve a desired balance-sheet structure. In the fixed-interest market, however, the opposite has been the case.

10 The high nominal interest rates and the volatility of inflationary expectations have made companies reluctant to incur fixed-interest debt of the long-term that is attractive to the life funds and pension funds. Companies have rightly seen that cash flow considerations – and uncertainties – preclude their financing new investment by borrowing long-term at very high fixed rates of interest. In this respect the possibility of the rate of inflation falling can be an added danger. New issues of debentures and loan stocks, hitherto a familiar method of industrial and commercial financing, therefore ceased altogether, and there developed in 1974 the situation where, except for companies who could raise funds abroad, equity issues and the bank overdraft were almost the only methods remaining, though the direct acquisition of commercial property by institutional investors under commitments made during the boom of 1972 and 1973 continued to provide a flow of funds into that sector. This situation was unsatisfactory and various attempts, some successful, have been made to fill the gap.

11 In the winter of 1974/75 the Bank of England and the clearing banks subscribed additional capital to Finance for Industry Limited (FFI), of which more will be said in a later section, while the life assurance and pension funds undertook to acquire loan stock to be issued by that institution. By this means, and with additional interim support from the banks and the money market, FFI was able to offer medium-term loans to industry at both fixed and variable rates of interest. But the revival of the equity market, the improvement in corporate liquidity following the tax changes of November 1974, and the conditions of deep economic recession and low profitability diminished the demand for the loans FFI could offer. None the less, in the period since 1974 that institution has obtained enough business to become established as an effective medium-term lender in the 7–15 year range with ample resources for its purpose; and the total of its business may well expand if the recovery in industrial investment foreseen for 1978 and beyond gathers pace and the external financing requirement of the corporate sector increases in consequence.

12 The other new domestic source of medium-term finance, and one that has become quantitatively much more important than FFI, has been the banking system. Historically, the British banks have been under no great pressure of demand for medium-term credit and have been reluctant to lend at medium-term, except for exports and shipbuilding with government guarantees or special arrangements for official refinancing. However, the special circumstances in the middle 1970s created a real need for medium-term finance in the 5–10 year range, and the banks were urged from many sources to increase the amount of their medium-term lending to customers. This they subsequently did, because they saw no advantage in putting such business through FFI, with which they were associated as principal shareholders, if they could do it equally well themselves. All the clearing banks are now prepared to make medium-term loans to credit-worthy customers, provided the total does not go beyond the bounds of balance-sheet prudence as seen by each bank individually. The Bank much welcomed this development. Moreover, in the spring of 1976 we entered into discussions with the clearing banks to see whether the growth of medium-term lending was likely to cause balance-sheet problems and, if so, whether facilities for the

refinancing of such loans with the Bank could suitably solve those problems. It was concluded that no early problem was likely to arise and that it would be premature to devise a refinancing scheme, particularly in view of the fact that discussions were concurrently taking place between the clearing banks and the Bank about the 'prudential' norms of the former. Should practical problems seem likely to occur, discussions about refinancing facilities would be resumed.

13 In addition to the development of medium-term lending facilities by the banks and FFI (and similar facilities offered by some of the large pension funds), attempts have been made to foster the development of a market in short and medium-term corporate bonds. To this end, the incidence of stamp duty on such bonds was lightened in 1973 and the duty abolished in 1976. So far as can be judged, a supply of funds would be available for such a market, partly (though on a small scale) from the long-term savings institutions and partly from others, such as the general insurance funds. This supply would be available on either fixed or variable rate terms. Yet so far no such market has grown up, though the recent rather special creation of floating-rate notes by the General Electric Company (GEC) may mark a beginning. A demand may well arise in 1978 and 1979, and we see no good reason why, if so, it should not now successfully be met. This would be a useful alternative channel for some of the medium-term borrowing which might otherwise overload the capacity of the banks and provoke undesirably heavy use of any refinancing facilities at the Bank.

14 From the supply side, therefore, and in particular from the banks, funds for industry and commerce have been available on a scale to match the demand from borrowers, and on terms adapted to the needs of the time. Where lending and investing institutions have been hesitant to adapt individually, they have been able to do so by acting collectively. The greater problem, arising specifically from rapid inflation, has been to find terms that the borrowers could afford and that would provide something better than a negative real return on capital for the investors. The development of medium-term lending at rates that are variable and are linked to a specific short-term rate has been a useful way of bringing borrower and lender together on mutually-agreeable terms during a period of rapid inflation and volatile expectations.

Problems arising from low profitability

15 A brief reference to the severe decline in industrial profitability, and to some of its proximate causes, has already been made at the beginning of the preceding section. Its effects upon industrial investment are by now manifest and well known although astonishingly enough its actual presence, masked as it was by conventional historic cost accounting, was not generally appreciated until the acute phase was reached in 1974. That year began with the three-day week, which left many firms with a high level of unfilled orders, taken at prices, however, that had become far out of line with costs. The severe pressures on corporate liquidity, arising from the impact of rapidly accelerating inflation and the incidence of corporation tax, which at that time was levied on stock appreciation as if it were income, compelled attention to be given to the underlying level of real profits.

16 The Bank, with their particular responsibilities towards a monetary system then experiencing considerable stress, helped bring the state of industrial profitability to the attention of Government and helped with suggestions of ameliorative changes in company taxation. Since then we have been much concerned to keep attention focused on this problem, partly because of its

paramount national importance and partly in order to prevent a problem that is primarily concerned with the users of finance coming to be mistakenly and confusingly regarded as a problem that can be solved or circumvented to any very large degree by the commercial provider of finance acting in disregard of their obligations. To be sure, the low level of profitability has accentuated and brought to the fore the various questions about the relationships between individual providers and users of finance which fall to be discussed in the next section of this paper. But a commercial financial system, under whatever ownership, with its responsibilities to depositors, to pensioners, to life and other policy-holders, and to shareholders, cannot in general compensate for low industrial profitability by providing funds on non-commercial terms that would yield no real return to the lender but would subsidise a variety of industrial capital projects that could otherwise not be undertaken. Nor can such a system be insulated from a level of interest rates dictated by the exigencies of counter-inflationary monetary policy and a heavy load of government borrowing.

17 So it has seemed to the Bank that the appropriate general response to the problem of profitability, on the part of those concerned with channelling savings and providing finance, is to make sure that that problem is, for the future, seen and understood. For solutions to it lie outside the financial system. To this end we have ourselves strongly supported the recommendations of the Sandilands Committee on inflation accounting. While recognising the considerable difficulties involved in changing to new accounting arrangements and while appreciating the particular difficulties that any one new system may present for particular classes of institution, we have been and remain anxious lest such difficulties should inhibit or unduly delay the underlying desirable change.

18 The Bank have also helped with the discussions on industrial profitability that have taken place in the Committee on Finance for Investment (the Roll Committee), set up in 1975 by the National Economic Development Council (NEDC). By preparing and supplying commentary on statistical presentations of the sources and uses of funds in manufacturing industry, both actual and hypothetical, it has been possible to demonstrate the quantitative importance of profits in the financing picture and of other economic factors governing industrial attitudes to expanding output and new investment. Copies of papers prepared by the Bank for the Roll Committee, and presented to NEDC, will have been made available to your Committee.

Problems arising from the relationship between providers and users of finance

19 During the late summer of 1970 it became apparent to the financial advisers of Rolls-Royce that their client was entering a serious financial crisis. As is well known, this crisis was due in the main to difficulties experienced in the development of the RB.211 engine. Although the Government were already involved, both directly and through the IRC, it became clear that the crisis was unlikely to be resolved simply by the provision of further official assistance. A contribution was required from the providers of finance in the private sector. The magnitude of the problems was such that the company's advisers did not feel that they could on their own co-ordinate and steer matters to a successful conclusion. Recourse was therefore had to the Bank, who found themselves drafted into an unfamiliar co-ordinating role and acting as an intermediary between the financial system and the Government. In November 1970 arrangements were made to provide Rolls-Royce with additional financial support. At the same time there

was a change of chairman. But these measures proved unavailing, and the company went into receivership early in the following year.

20 The causes of the Rolls-Royce bankruptcy were highly exceptional; but the episode did provide some support for critics who held that management failures in British industry would be more readily avoided or remedied if the providers of finance took a closer, more direct, and more continuous interest in the way in which individual companies used their money. Other examples came to mind, less exceptional than Rolls-Royce. In addition, unfavourable comparisons were made with practice in other countries, notably Western Germany, Japan, France and the United States. It was argued that the conventional relationship between finance and industry in the United Kingdom, at least as regards medium and large public companies, was too 'arm's length'. Institutional shareholders, whose importance had been growing for some years, were said to regard the sale of shares through the market as the only appropriate course when an investment looked like deteriorating. Direct action to remedy the situation in the company concerned, in concert with other large shareholders, or with major creditors, was not a familiar course. Analogously, it appeared that the operation of the established overdraft system of bank lending did not in practice enable the banks to acquire a flow of information about their customers' affairs such as might enable them to bring beneficial influence to bear upon boards and managements at a sufficiently early stage. There was some doubt indeed as to whether either the banks or the institutional shareholders had the capacity to identify the causes of impending failures, or to decide on appropriate remedies.

21 For their part, the Bank became increasingly convinced that, while the private sector financial system did in general, and within the limitations of an environment determined by forces exterior to it, efficiently channel private savings into industry and trade, its efficiency in looking after such savings, once channelled, was less marked. The very breadth of the securities markets, and the specialisation of function between one set of institutions and another, seemed partly responsible for this apparent defect. In times of prosperity and vigorous industrial growth, that defect might well be of little consequence. But those are not the times in which we live, and it has therefore seemed to the Bank that it could bring nothing but good if institutional investors could be mobilised to take, directly or indirectly, an active concern in the commercial performance of the companies whose shares they held.

22 To some, including notable examples among the institutional investors themselves, this view appears well-founded. But to others it does not. On the one hand, there are those who feel that the suggested extension of the role of private finance is misconceived or is bound to be ineffective, and that the job should instead be undertaken exclusively by the Government or a governmental agency (for example, the National Enterprise Board). On the other hand, there are those who would argue that the conventional or established market mechanisms are the right ones and that attempts to adapt them in the manner suggested would result more often than not in obstructing rather than facilitating industrial change and in weakening institutional efficiency by undermining the primary responsibility of the provider of finance to his depositors, pensioners, policy holders, etc. As the Committee will recognise, this implies that what may appear simple common sense to some raises highly-charged political or even ideological considerations for others. Accordingly, attempts in recent years to encourage a closer relationship between finance and industry have provoked considerable controversy. The Bank, while recognising

the force of some of the arguments deployed in defence of the 'arm's length' relationship, and in particular accepting that it is no easy matter for the financial sector to identify and procure the solution of industrial problems, came to the conclusion that some change was needed, and are not disappointed with the progress that has been made so far.

23 The first step, following an initiative begun by the then Governor in 1972, with a degree of support in the City, was the formation of the Institutional Shareholders' Committee (ISC) in April 1973 designed, with appropriate safeguards, to foster collective action by institutional shareholders in appropriate cases. The second step, designed to achieve a less passive role for the Finance Corporation for Industry, was the merger of that institution with the Industrial and Commercial Finance Corporation in the autumn of 1973, and the creation therefrom of Finance for Industry Limited. This merger was arranged by the Bank and the clearing banks, who became the shareholders of FFI; and care was taken to ensure that the new body, provided with substantial additional resources (see paragraph 11), would develop machinery for close monitoring of the companies to which it made loans. Then, following an initiative by the British Insurance Association, which was supported by the Bank, and after further intense debate, came the establishment of Equity Capital for Industry Limited (ECI), with most of the major institutional long-term investors as shareholders. The primary purpose of this move was to make completely sure that funds were always available for companies which might be facing an immediate need for more equity capital in excess of what could be raised in the market on the basis of current or early prospective profits, but whose long-term prospects appeared favourable. And again, the new organisation has been required to set high standards in maintaining, on behalf of its shareholders, close contact with the companies in which it invests. Moreover, many cases of financing difficulty are solved by packages containing both new medium-term lending and new equity funds; and the involvement of both FFI and ECI together in a joint financing package is expected to provide increased opportunities for ensuring that performance is adequately monitored.

24 In addition to the institutional developments outlined above, the entry of the clearing banks into large-scale medium-term lending will have required them, too, to develop systems of appraisal and monitoring different from those required for operating the traditional overdraft system and much more closely in line with those advocated by earlier critics. It is probable that the development of such new systems has presented administrative and training problems to the banks; but the impression gained by the Bank is that considerable progress is being made.

25 It is not easy to form a synoptic judgment, at the time of writing, about the extent of the changes that have occurred, or are occurring, in the relationship between finance and industry. ECI has only just started business. FFI has only recently become established as a large-scale medium-term lender. The ISC of necessity works with minimal publicity and considerable caution. The development of large-scale medium-term bank lending is only some three years old. But on the whole we feel that the work of the special institutions (including the ISC) is both constructive and catalytic; part of the role of the special institutions is indeed to convince ordinary institutions that they can do the special work perfectly well themselves. But when all that is said, the Bank still find it necessary to play an active co-ordinating role themselves, both in particular cases and in the consideration of problems affecting particular industries (currently, for example, the clothing

industry). For there continues to be a need for a central organisation, alongside rather than part of the commercial system, which is regarded as constructively neutral and which has the ability to gather together all the parties concerned and ensure that divergent interests can be combined so as to bring about an effective solution. We have been able to fulfil this function in various cases, though not without difficulty; and there seems no present option but to continue with this worthwhile task. For this purpose the Bank have, over a period of years, built up a substantially enlarged Industrial Finance Unit; and in 1975 Sir Henry Benson was appointed to a senior advisory position in the Bank, with special responsibility for this subject.

Concluding remarks

26 As was indicated at the outset, this has been a discursive and inexhaustive paper which, it is hoped, the Committee will find useful as an interim document at this early stage of its work. It has endeavoured to indicate the ways in which the arrangements for the channelling of savings into industry and trade, operating in the private sector, are responding and adapting to the special conditions of the times; and it has indicated the response of the Bank to those conditions, in the field of 'finance for industry'. It has not sought to discuss how some quite different system might have differently responded.