Bills of exchange: current issues in a historical perspective[1]

In the centenary year of the Bills of Exchange Act, this article describes the Bank's longstanding use of bill purchases in its money market operations. Historically the Bank bought bank bills because they were among the best available assets. Their importance as a vehicle for money-market operations was reaffirmed when new arrangements for monetary control were introduced last year. Pursuit of monetary policy objectives has led the Bank to increase very substantially its portfolio of bills over the last two years, and steps have been taken to reverse this trend.

Introduction

The key elements of the Bills of Exchange Act 1882 are familiar to every student of the Institute of Bankers, although it is doubtful whether such familiarity has often bred the response of the judge who once described the Act as 'in truth, a work of art'. But, at least once the examinations have been passed, the student might well see the force of another judge's comment: that the Statute was the 'best-drafted Act of Parliament which was ever passed'. Certainly, there can be few areas of business life where a major statute has survived for a century with only minor amendments and one significant extension.

The success of the Act must owe much to the skill with which the then existing hotch-potch of law on the subject was codified. But that the law was itself so extensive already is an important reminder of just how long bills of exchange had been an integral part of business life. In 1776 Adam Smith could write that 'money is more readily advanced upon them than upon any other species of obligation'. Bills have also long been an integral part of the Bank of England's business life; and the view that commercial bills were a normal and desirable medium for its operations was carried over during the Bank's lengthy transition from private profit-making organisation to a true central bank.

From the 1920s until recently, the Bank's use of the commercial bill market was very limited. The great depression and then the Second World War greatly disrupted trade. The war also vastly increased the volume of short-term government indebtedness, so that from then until the late 1970s, the great bulk of the Bank's open-market operations could be conducted in Treasury bills. To a whole generation, this concentration of official operations on Treasury bills came to be taken so much for granted that anything else seemed somehow improper. In the last few years, however, the Government's monetary policy has greatly reduced the outstanding stock of short-term central government debt and the Bank has turned again to buying claims on the private sector as an indispensable part of its money-market operations. Once more, it has chosen prime bank bills as the instrument for those operations.

This paper explores two main questions. The first concerns the choice of bills as the medium for the Bank's management of the cash available to the banking system. The second is the reason for the size of the Bank's commercial bill holdings having risen so fast and so high. It concludes by examining the implications of the size of those holdings for the monetary control arrangements introduced last year.

[45 & 46 Vict.] *Bills of Exchange Act*, 1882. [Ch. 61.]

DIEU ET MON DROIT

CHAPTER 61.

An Act to codify the law relating to Bills of Exchange, Cheques, and Promissory Notes. [18th August 1882.] A.D. 1882.

BE it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:

PART I.

PRELIMINARY.

1. This Act may be cited as the Bills of Exchange Act, 1882. Short title.

2. In this Act, unless the context otherwise requires,— Interpretation of terms.

"Acceptance" means an acceptance completed by delivery or notification.

"Action" includes counter claim and set off.

"Banker" includes a body of persons whether incorporated or not who carry on the business of banking.

"Bankrupt" includes any person whose estate is vested in a trustee or assignee under the law for the time being in force relating to bankruptcy.

"Bearer" means the person in possession of a bill or note which is payable to bearer.

"Bill" means bill of exchange, and "note" means promissory note.

"Delivery" means transfer of possession, actual or constructive, from one person to another.

"Holder" means the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof.

"Indorsement" means an indorsement completed by delivery.

"Issue" means the first delivery of a bill or note, complete in form to a person who takes it as a holder.

[*Public.*-61.] A 1 1

(1) This paper was presented by A L Coleby, Assistant Director of the Bank of England, to a conference on the bill of exchange organised by the Institute of Bankers in London on 17 November 1982.

Why operate in bills?

The monetary arrangements adopted last year retained the historic basis of the Bank's money-market operations, which is that they are conducted in bills, and primarily with members of the London Discount Market Association, which are the only institutions in the banking sector having borrowing facilities at the Bank. Let us trace the origins of these arrangements.

Historically, the Bank bought bills because they were among the best available assets. The principal competitor, believe it or not, was consols. For considerable periods there were no public sector bills competing with bank bills and, among claims on the private sector, the attractions of prime bank bills were considerable. They gave security in depth, in that they bore at least two good 'names', and their creditworthiness had been assessed before they reached the Bank, notably by the acceptor when taking on the commitment. They were also highly marketable, in generally good supply, and available with fairly short maturities, which made them a highly flexible instrument of particular attraction to the Bank at times, such as in the early years of the nineteenth century, when the size of its balance sheet was often volatile. Further, the Bank found that regular purchases were an excellent way of monitoring developments in the bill market which was then of great relative importance.

Given the importance of bill operations to it, the Bank not surprisingly came to have close relations during the nineteenth century with the bill specialists—first, as bill brokers and later as discount houses. Relations with the commercial banks were less close. At least for the first part of the century, the Bank and the joint stock banks regarded each other as commercial rivals, while the latter considered that borrowing from the Bank of England could be construed as a sign of weakness. The Bank for its part came to understand that access to its lending facilities was a valuable privilege. Consequently, it had the problem of how to retain these facilities (and thus underpin confidence in the financial system) without giving the privileged institutions the ability to on-lend more easily or cheaply than those without access to them. The Bank's conclusion was to concentrate its lending facilities on the discount houses because they did not compete with the banks for overdraft or other lending business, or initiate new lending outside the banking sector.

There is now, of course, a much wider range of assets potentially available to the Bank for managing the cash position of the banking system, but the reasons which led us to the present position remain valid. They were strengthened by the presence, among the objectives underlying last year's monetary control arrangements, of the desire to find a market mechanism which would allow much greater scope than before for market influences to play a part in determining short-term interest rates.

The monetary authorities did not intend to abandon taking a view of the level of short-term interest rates likely to be consistent with their wider monetary objectives, expressed as targets for various monetary aggregates. But that view, and the market operations associated with it, were intended to provide no more than a sort of dragging anchor at the very short end of the market. The term structure of rates, out to the three-month point and beyond, was to be fully responsive to market influences; and the outcome of that response was itself to be an important ingredient in the continuous reassessment of the aptness of the official view on the level of very short-term interest rates.

Two conditions were identified as needing to be met for that process to work satisfactorily. The first was that the flow of funds in the money market should not be systematically and heavily out of balance. The Bank's paper in November 1980, it will be recalled, promised not to create unnecessary money-market shortages by the deliberate over-issue of Treasury bills at the weekly tender. I will come back to a discussion of our experience in that respect later on. The second condition was that the operations should be conducted at arm's length from the principal counterparties.

This was an important factor in the decision to continue doing those operations in the bill market. If the Bank operated directly in the inter-bank market, it would inevitably find its operations concentrated on the clearing banks, upon which any cash imbalance is thrown by virtue of their central function in the settlement of daily cash flows. The resolution of the cash imbalance would consequently be likely to involve a small number of, effectively, bilateral deals. It would not be an exercise that allowed any real scope for market influences to bear on the interest rates arrived at for official operations. In the bill market, by contrast, those influences are more widely diffused. It is an asset market, rather than a liability market, in which there are many participants each with potentially different circumstances and expectations.

Creating a flourishing bill market

Having concluded that the bill market was more likely than the inter-bank market to provide the desired mechanism for interest-rate determination, the Bank then had to consider how to ensure that the market was of sufficient depth for the purpose. The former reserve asset ratio requirements had had the effect—increasingly as the supply of Treasury bills declined—of compelling banks to put call money with the discount houses, and there already was a flourishing bill market. We could make no confident predictions what our prospective demands on the market might be. At times they might become substantial, and it seemed right to make arrangements so that there could be significant expansion in the supply of eligible bank bills. In those circumstances, the bill market might be expected to flourish spontaneously. But we also had to have regard for the possibility that, perhaps as a by-product of the economic cycle, there might be times when the Bank's demand for bills would be low. There would then be a risk that the bill market, no longer supported by the reserve asset arrangements, might atrophy, and not be available to meet our needs when they resumed.

From those two considerations emerged two features of the present bill market. Resources to maintain the discount houses' ability to make a market in bills were assured by the introduction of the secured deposit arrangements for eligible banks—at a level initially some two-thirds of those latterly provided through the operation of the reserve asset system. The efficacy of the new arrangements in sustaining the bill market at a time when the Bank is not a buyer has not, of course, yet been put to the test.

Eligibility

Much more tested has been the ability of the system to expand the supply of eligible bills. The principal step which the Bank took to enable that to happen was to enlarge the list of eligible names, which had remained virtually unchanged for two decades and more—a period in which the contribution of foreign banks to banking activity in London had grown apace. The criteria on which additions were to be made to the list were set out by the Bank in March 1981, and had two main elements. The first was the long-standing requirement that a successful applicant must already have built up a good bill business; the second, for foreign-owned banks, was the reciprocity principle.

The Bank's insistence on applicants demonstrating that they already have a broadly-based and substantial acceptance business has seemed odd to some commentators. To build up such a business, while still an ineligible name, in competition with energetic eligible banks, is hardly likely to be very profitable. Is there not a 'chicken and egg' problem? We readily acknowledge that there is a cost, in profits forgone, for a new name to become eligible. But that is deliberate, not accidental. We do not regard eligibility as a matter of status, to be had for the asking if a bank is sufficiently distinguished in its other activities. We see it as directly related to the function of accepting bills, a function to which a successful applicant should be committed once on the list.

The operational need to enlarge the list of eligible banks also provided the occasion to add foreign names to it. Previously, only British banks or those of British origin had appeared. It was timely to recognise the contribution of foreign banks to banking in London by removing any appearance of discrimination. The coming into effect of the Banking Act 1979 had meant that all banks which became recognised, whatever their country of origin, had to satisfy its tests of soundness and management. Nevertheless, it was concluded that eligibility should go only to those foreign banks which could show that UK banks had comparable access to equivalent facilities in their country of origin: the reciprocity principle.

Applying that principle is far from easy, because financial structures differ widely from country to country, and many of our own features are a little unusual. The two key elements that must be found are freedom for UK banks to establish and engage in domestic banking business; and freedom from discrimination, in comparison with domestic banks, in the terms of their access to official facilities for providing liquidity to the banking system. These tests do not go so far as to look for comparable commercial opportunities for UK banks in foreign markets with those available to foreign banks in the United Kingdom. That would be an impossible test to apply.

Aided by the doubling of the number of eligible banks, the supply of eligible bills has grown massively in the past two years, from around £3½ billion in October 1980 to £12¼ billion in October 1982. The growth has been needed in order to supply the Bank's voracious appetite, which has regularly absorbed up to 75 per cent of the available stock. And that leads on to this paper's second main question: why have the Bank's holdings risen so fast and so high?

Why the Bank now holds so many eligible bills

The answer begins with the relationship between monetary targets and bank lending. For much of the period since monetary targets were first published in 1976, bank lending in sterling to the UK private sector has grown considerably faster (in percentage terms) than the target set for money. The contrast was particularly marked in the fourteen months to mid-April 1982, when bank lending rose at an annual rate of 25% against a target for sterling M_3 of 6%–10%.

To help limit the impact on sterling M_3 of such rapid increases in bank lending, the central government has sold large amounts of debt to the UK non-bank private sector. On occasion, as in 1977/78 and 1981/82, this has involved what is sometimes known as 'overfunding': ie, net sales of central government and other public sector debt to the UK non-bank private sector in excess of the public sector borrowing requirement (PSBR). But those occasions were the exception. Over the last five full financial years taken together, debt sales have fallen very modestly short of the PSBR; there has been almost exactly full funding. This contrasts sharply with the previous five financial years (1972/3–1976/7) when the PSBR exceeded debt sales by nearly £14 billion.

Monetary targets and overfunding

£ billions; *seasonally adjusted*

	1972/3 to 1976/7	1977/ 1978	1978/ 1979	1979/ 1980	1980/ 1981	1981/ 1982	1977/8 to 1981/2
CGBR	23.9	4.3	8.4	9.1	13.0	7.6	42.4
Contribution of rest of public sector	10.1	1.1	1.2	1.4	0.6	1.2	5.5
PSBR	34.0	5.4	9.6	10.5	13.6	8.8	47.9
Public sector debt purchased by non-bank residents:							
Central government	15.9	7.0	8.1	8.3	11.5	11.6	46.5
Other public sector	4.4	−0.1	0.4	0.8	− 0.5	− 0.6	—
Overfunding(a)	−13.7	1.5	−1.1	−1.4	− 2.6	2.2	− 1.4
Sterling lending to private sector(b)	16.7	3.8	6.3	9.4	8.9	14.9	43.3
Target growth of sterling M_3 maximum(c)	n/a	5.3	5.6	5.8	6.6	7.1	30.4

n/a not applicable.

(a) Public sector debt purchased by non-bank residents *less* the PSBR.

(b) Including Issue Department commercial bills.

(c) Target periods often differed from financial years so these figures are no more than a guide for comparison.

Full funding of the PSBR need not lead inevitably to a large drain of cash from the money market. The outcome depends also on the composition of the PSBR and its financing. In the past five financial years, up to and including 1981/2, the PSBR has exceeded the central government's own borrowing requirement by over £5 billion. In other words, local authorities and public corporations have borrowed over £5 billion from sources other than central government. But their net sales of debt to the private sector were nil. So the funding achieved has involved the central government in over-funding its own needs by more than £4 billion.

Central government's transactions, drawing out a net £4 billion, have been the principal factor affecting the cash position of the money market over the past five years.(1) Other factors, including official transactions in the foreign exchange market, purchases of central government debt by the overseas and banking sectors (which draw cash out of the money market but do not directly affect sterling M_3) and changes in the note circulation have, on balance, aggravated the shortage of cash. This has been particularly so recently. As a result, the banking system—which maintains only a modest level of cash to meet its daily settlement obligations to the authorities—has been persistently short of cash.

Net official money-market operations

£ billions
(Flow of cash to the market, +)

	1977/78	1978/79	1979/80	1980/81	1981/82
Net official purchases of:					
Treasury bills	+0.6	+0.8	−0.1	+1.0	+0.1
Other public sector bills	+0.1	+0.1	+0.1	+0.1	+0.6
Bank bills	—	−0.1	+1.0	+2.2	+4.2
Special deposits	−0.2	+1.2	−0.1	+0.1	—
Other(a)	−0.2	+0.3	+0.5	−0.7	−0.1

(a) Comprises market advances and repurchase agreements on gilt-edged stocks.

This shortage has not been relieved by operations in bank bills alone. Initially, there were special deposits, amounting at their peak in 1976 to £1.8 billion, which could be repaid to the banks. The outstanding stock of Treasury bills was brought down, either by buying them in, or by failing to replace them fully at maturity. But it was increasingly to eligible bank bills that the Bank turned—initially to offset seasonal cash shortages and then on a continuing basis. The peak of such bill holdings in the main 1981 revenue season (March) was £3½ billion, a year or so later £8 billion and, recently, the figure has been around £9½ billion.

An inevitable consequence of such a high level of bill holdings is that the maturing of bills in the Bank's hands is itself the cause of recurring large shortages of cash in the market. The flow of maturities depends also on the average length of the bills in the Bank's portfolio. In the conditions that have prevailed for the past year, of generally optimistic expectations of falling rates, the portfolio has understandably tended to be rather short. In consequence, the Bank's purchases of bank bills (outright and for resale) over the twelve months to end-October were over £87 billion. To illustrate just how dramatic a turnaround this represents from the not so distant past, the corresponding figure for the year to end-February 1978 was £50 *million.* Meanwhile, operations in Treasury and local authority bills, then at a level of £16 billion, had fallen to £7 billion in the latest twelve months.

Implications for the monetary control arrangements

The first thing that has to be said is that the participants in the bill market, acceptors and discount houses together, have done remarkably well to cope so capably with the massive demands we have made of them. Their response speaks well for the resilience of the system we currently have.

On the other hand, it is obvious that the cash shortages just described are a long way from fulfilling the condition of a broadly-balanced market which the interest-rate mechanisms of the new arrangements ideally required. The size of the Bank's operations, day after day, has meant that the dominant influence on bill market rates, dwarfing all others, has been expectations about the rates at which the Bank would be prepared to deal, now or in the near future. We have not been able to avoid becoming a rate setter, and not just for very short bills alone. In the circumstances, it is perhaps as well that the trend of expectations about rates has been so strongly downwards, because at least we have been in no doubt about the direction of market influences.

Also unsatisfactory has been the effect which the sheer size of the Bank's operations in the bill markets has at times had of widening the gap between interest rates on bills and on other forms of private sector finance, making the former relatively cheap.

Consideration of these problems has led to the conclusion that steps should be taken to contain the growth of our bank bill portfolio and, hopefully, to reduce it somewhat. That has involved tackling the principal cause of its recent growth, namely the extent to which other parts of the public sector finance themselves from the banking system. The intention to create a new facility for local authorities at the Public Works Loans Board (PWLB), and for nationalised industries with the National Loans Fund (NLF), was announced by the Chancellor in June.(2) The PWLB facility, offering variable-rate loans which were not previously available, became operational in August, and the NLF facility more recently.

The scope for these facilities to make an impact over time is considerable. Local authorities have around £10 billion of bank borrowing outstanding and public corporation's short-term financing needs could, on occasion, reach £1½ billion. The extent of the use that is made of the new

(1) The Bank's operations in the money market are described in the article 'The role of the Bank of England in the money market' on page 86 of the March 1982 *Bulletin.*
(2) See page 353 of the September 1982 *Bulletin.*

facilities is entirely for the borrower to decide, on the basis of their competitiveness, and it may be a little while before we can judge the likely pace of take-up.

In the longer run, the reduction of our portfolio of bills could be assisted by some slowing-down in the rate of bank lending, so that it became no longer necessary to fund the PSBR fully in order to meet monetary objectives. The future course of bank lending is much too hazardous to forecast, but there have been one or two developments recently which could weaken some of the forces of expansion. Particularly welcome have been the signs of revived activity in the corporate bond market, reopening a source of financing for companies which has not been used for a decade.

Conclusions

Given the pressure to which they have been subjected, the new arrangements have worked remarkably well in the past year or so. The participants in the bill market have played an enormous part in enabling the authorities to handle an unprecedented need to inject cash into the system. But the demands we have made on them went well beyond anything we had envisaged at the outset, and this has limited the extent to which we have been able to meet our original objectives, particularly that of allowing greater market influence on the structure of interest rates. Ungrateful though it may seem, we have now turned our hand to steps intended to moderate our demands. To the extent that we succeed in doing so, by one means or another, the system as a whole will benefit.