Recent changes in the monetary and regulatory framework

In the course of an address to the Finance Houses Association,[1] the Governor discusses three topics:

- *The response of the finance houses to* ***developments in the industrial and consumer credit market.***
- ***The stance of monetary policy,*** *which now '. . . has regard to a number of indicators, including the exchange rate, rather than to any single monetary aggregate. . . . There is confidence that a more pragmatic approach has not meant a weak one.'*
- ***Supervision of deposit-taking institutions.*** *'. . . we have sought to retain our personal and informal style of relationship with management. Our concern has been to keep to a minimum interference in the great majority of companies that are soundly managed, but to supervise more actively the minority who most need it.'*

Developments in industrial and consumer credit

In January 1977, when I last spoke at the annual dinner of the Finance Houses Association (FHA), I noted that the previous five years had been eventful for your industry. This time I can but say the same. Indeed, the forces of change and the responses they have met are my main themes tonight.

There have been great changes in the monetary and regulatory framework within which you work. In 1979, the Banking Act became law; and we have seen since then a methodical introduction of new supervisory arrangements. Last summer, after many months of thought, debate, and detailed negotiation, new arrangements for the execution of monetary policy were put into effect. You hardly need reminding that active competition in the provision of credit to the corporate and personal sectors has persisted throughout and been a constant spur to efficiency and innovation.

Competition and innovation have altered the composition of your business. Industrial credit extended by your members has risen from about 60% of the total in 1977 to almost 70%, while the share of consumer credit has fallen from 40% to 30%. The main explanation for this pronounced shift is the rapid growth of leasing. Without trespassing on ground belonging to the Equipment Leasing Association, I recall that it was largely the finance houses who developed leasing techniques in this country. In so doing, you have helped British industry and commerce to sustain its capital investment in otherwise difficult conditions.

Because of the growth of leasing, the fall in the share of consumer credit in your total business can be misunderstood. In terms of the manpower devoted to it, consumer credit remains your main activity. Here, external and internal competition is intensifying. You have met strengthening competition both from the clearing banks and from other banks, whose interest in consumer credit has been growing along with their numbers. Within your own ranks, the differing origins and connections of your members have given an added spur to competition between you; between bank-affiliated and independent houses; and between British-owned and overseas-owned houses.

In the event, while banks have increased their share of the consumer credit market over the last four years, FHA members have maintained their share of about one fifth. The banks' gain in share has been mainly won from retailers. Because they find it more efficient to do so, large department stores have increasingly sought arrangements whereby a bank or a finance house handles their credit sales.

At one time, finance houses concentrated on providing credit to the purchaser at the point of retail sale, while banks made loans to personal customers through their branch network. Competition and innovation are now blurring this. Banks have developed their credit cards, and have introduced accounts which combine a regular savings plan with a revolving credit facility. Finance houses, on the other hand, have reduced their dependence on point-of-sale credit in various new ways—by introducing revolving credit facilities, by contacting potential borrowers through direct mailing, and by arranging with manufacturers to finance the holding of their stocks by retailers. The introduction of money shops, albeit on a relatively small scale, can also be seen as challenging the banks on their own ground.

These innovative developments have occurred under unfavourable economic and financial conditions. Recession has been combined with high and volatile interest rates. Not surprisingly, bad debts and arrears have risen throughout your business. It is for individual houses to judge the scale

(1) Given on 28 January.

of provision required to cover them; but, so far as can be seen now, they do not appear cause for serious concern, or to reflect a significant lowering of credit standards. Finance houses can, moreover, share in the praise won by the banking community for the sensitive and patient manner in which they have responded to the difficulties of some of their borrowers, particularly in manufacturing industry.

The volatility of interest rates has aggravated the cyclical fluctuations in your profits. But houses have responded by reducing their dependence on assets earning fixed rates of interest. Much leasing business is done at variable rates and this has provided a new form of protection. I note, too, the recent development of consumer loans where the repayment period is recalculated at six-monthly intervals to allow for changes in interest rates.

A feature of the last year, despite the recession, has been the relative buoyancy of personal borrowing. Real incomes have fallen, but persons have sought to maintain their expenditure by reducing saving and increasing borrowing. Admittedly this trend may be less apparent to you than it is to me, because it is lending by banks rather than by finance houses that has grown most rapidly. Moreover, much of that growth has been in lending for house purchase, in which finance houses are engaged on only a very small, though growing, scale. This expansion of mortgage lending has eliminated the long-established borrowing queue, but it may also have tended to release additional funds which the borrowers can employ for other purposes, including consumption.

In this context you will have seen the request which the Bank issued last week to all banks and licensed deposit-takers and which the Treasury has issued to building societies. Its purpose is to help ensure that lending on mortgage for house purchase is in fact applied to that purpose. Competition between banks and building societies is welcome because it leads to a more efficient service in the provision of housing finance. But there is a danger that as a by-product of this competition the funds provided on favourable mortgage terms could increasingly be used to finance an expansion of cheap consumer credit. This would have undesirable consequences for monetary growth and for the general level of interest rates. It is this that we are seeking to avert.

Monetary policy

Last week saw a further modest but welcome reduction in interest rates from the exceptionally high level reached last autumn. Market opinion, responding to the coalminers' ballot, to a relatively robust performance of sterling in the exchange markets, and to a less gloomy view of domestic monetary trends, became more favourable. The Bank, in its daily operations in the money market, was able to take a similar attitude and acted to encourage a modest fall.

This episode marks a further brief chapter in the story of the new monetary arrangements introduced last August; and I think provides further evidence of their virtues. We are a relatively small country with a relatively very large financial centre exposed to international monetary forces acting in a turbulent world. At the same time, our domestic monetary policy remains crucial to success in the steady, unremitting fight against inflation. Recent experience serves, I believe, to confirm the judgment that arrangements that allow maximum flexibility of response, that leave as much room as possible for the free play of market forces, and that enable us to operate with a somewhat lower profile than before, are best suited to our times and enable us to pursue as steady a course as is practicable.

This very flexibility has become associated with the now well-known fact that policy has regard to a number of indicators, including the exchange rate, rather than to any single monetary aggregate. This might give an impression that policy lacks coherence. But I would suggest that the consistency and steadiness of our behaviour in pursuit of the ultimate objectives of policy is more important than the apparent intellectual coherence and presentational simplicity of concentration on a single monetary aggregate. Of course it would be best if we could successfully combine both; but hard experience has taught us that that is not our world.

I think it would be accepted that the general stance of policy, fiscal as well as monetary, remains firm. There is confidence that a more pragmatic approach has not meant a weak one. It is essential that this confidence should be preserved. We are in no position to throw overboard the constraints of financial discipline.

Developments in monetary supervision

From confidence in our monetary policy, I now turn to confidence of another sort. Since I last spoke to you, we have seen the passage of the Banking Act. Five years ago a crisis of confidence in many deposit-taking institutions was an uncomfortably recent memory—to me and to many of you here tonight. That crisis was due in part to an unusual combination of financial and economic instability. But it was precipitated by the uncovering of imprudent, and in some instances improper, practices. A statutory procedure for the licensing of deposit-taking companies, a requirement also of the First EEC Banking Directive, was introduced as the answer.

In discharging our responsibilities under the new Act, we have sought to retain our personal and informal style of relationship with management. Our concern has been to keep to a minimum interference in the great majority of companies that are soundly managed, but to supervise more actively the minority who most need it. The lesson of past crises is that contagion can undermine the strong as well as the weak. So it is in the interests of all that proper standards for the management and control of risk should be observed by all companies which seek to attract deposits from the public. No system of supervision, however rigorous, can guarantee that there will never be failures among deposit-taking companies. Even if it were possible, it would in my view be undesirable. Prudent management alert to the risk of failure is the surest protection for the depositor.

As you well know, the Banking Act provides for a two-tier system that distinguishes between recognised banks and licensed deposit-takers. This replaced a confusing many-runged ladder of recognitions granted by different bodies for different purposes. The new distinction between recognised banks and licensed deposit-takers is in large part a distinction of function. With some success we have attempted to get this message across in order to prevent unjustified discrimination purely on the basis of the label a company bears. The financial system is continuously changing and in our administration of the Banking Act we shall take note of such structural change, as well as of developments in the business of individual institutions. Some licensed companies may choose to develop their range of services and apply for recognition as banks. Others, perfectly naturally, will choose to remain specialists.

As a further refinement of our supervisory techniques, we hope before long to issue the definitive paper setting out the principles which the Bank will follow in measuring the liquidity of deposit-taking companies. Its contents have been considered within your Association, and I will not burden you with its details. I observe only that, in giving full recognition to the importance of a strong cash flow in addition to the more traditional yardstick of a stock of easily realisable assets, the paper follows the common convention which you as finance houses already employ in the management of your liquidity.

Like its predecessor, on the measurement of capital, this latest paper imposes no requirement or prescriptive ratio that all deposit-taking companies would be expected to observe. We remain firmly opposed to rigid formulae which take no account of the differing characteristics of supervised institutions. Some will require more capital and more liquidity than others, reflecting their different exposures to credit and funding risks. In due course, after bilateral discussion, we would expect to agree appropriate guidelines for the control and management of liquidity with each institution in much the same way as for capital.

Finally, I would refer to the new statistical requirements which follow the changes in monetary control and prudential supervision. I very much hope they will be seen as benefiting those who supply as well as those who request the statistics. For example, we are hoping to achieve a clearer statistical distinction between the different forms of personal borrowing, with separate figures for overdraft, credit card, house purchase loans and other credit extended to persons. This should give you, too, a better perception of trends in your own market. For we are all continually seeking better and more up-to-date information on which to base our decisions. But we are all also seeking, with a sharp eye on costs, to improve the ways in which we handle, process and transmit all forms of information. I believe, therefore, that it is particularly opportune that the Prime Minister has chosen to designate 1982 as Information Technology Year.

In your own houses, you are, I know, using modern equipment to handle information in its various forms and will be seeking to take advantage of the opportunities that the advancing technology is presenting. Financial organisations, by publicising what they are already doing and thinking about, will help the exploitation of the new technology by UK companies, whether it be in the use or provision of services or in manufacturing equipment. How effective we are in this country in that exploitation will be of the utmost importance to our economic prosperity in the years ahead. I am confident, Mr Chairman, that your Association will contribute to the support given by financial institutions to Information Technology Year.

So there it all is: competition, innovation, information, monetary control, and supervision. It is a continuing story of change combined with an underlying steadiness of purpose. Much has been done. Much, as always, remains to be done. None can be taken for granted, least of all the wide measure of self-regulation and voluntary agreement which underpins the vigour of our financial system. The customary authority of the Bank, exercised steadily and in rational discussion—not, I might say, by mysterious ocular contortions on my part—is vital to this underpinning. That is why I have done my best to uphold it.

Mr Chairman, it follows that we put a high value on the good working relationship we have long enjoyed with your Association. With your help, it will continue.