PO-CH/NL/0428
PART A

Part. A.

Begins: 10/4/89.
Ends: 14/4/89.

THIS FOLDER HAS BEEN
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PO CH/NL/0428
PART. A.

Chancellor's (Lawson) Papers:
Local Authority Investment In Gilts.

PO CH/NL/0428
PART. A

DD's: 25 Years

24/1/96.

UNCLASSIFIED

MAMC: N3

FROM: J W GRICE (MG2)
DATE: 10 April 1989
x5509

SIR T BURNS

How much scope for the banks & BS's for LAs to be sellers for further of gilts?

cc PPS
Sir P Middleton
Mr Scholar
Mr Peretz
Mr Odling-Smee
Miss O'Mara
Mr Pirie
Mr Potter (LG1) o/r
Mr Devereux (FIM1)
Mr Laite (LG1)

LOCAL AUTHORITY INVESTMENT IN GILTS

(behind)

I understand that you asked Mr Peretz for any views about the article in the Times this morning which suggests that local authorities may buy gilts in some scale in the near future.

2. Mr Devereux's minute, attached, suggests that the new capital finance regime for local authorities will not, of itself, cause the local authorities to move into gilts, though they certainly have the scope to buy gilts should they decide on general grounds to rearrange their portfolios of short term assets.

3. So far as the funding programme is concerned, the effects of local authorities buying gilts would depend upon from whom they were purchased. If the gilts were bought from the banks and building societies, then there would be no effect. But to the extent that the gilts were purchased from other sectors, then the local authorities would effectively be carrying out part of our own buying-in programme. Central government buying-in of gilts would then need to be lower to the same extent in order to maintain the full fund. Since the local authorities are likely to be interested in very short gilts, a substantial but unquantifiable portion is likely to be supplied by banks and buildings societies whose holdings are concentrated in this maturity area. These institutions have, moreover, been net sellers of gilts in recent years.

JWG

J W GRICE

FROM: R J DEVEREUX (FIM1)
DATE: 10 April 1989
x4648

MR GRICE

cc Miss O'Mara
Mr Pirie
Mr Potter (LG1) o/r
Mr Laite (LG1)

LOCAL AUTHORITY INVESTMENT IN GILTS

You asked for a brief comment on the article in today's Times (attached), which suggests that as a consequence of the Local Government and Housing Bill local authorities are likely to become significant investors in short gilts.

2. Local authorities certainly have substantial investments at present: Financial Statistics records £10 billion of investments, of which £9¼ billion is short term (£6½ billion with banks and £2 billion with building societies) and only £¾ billion long term (less than £0.2 billion in gilts).

3. Under the new capital finance regime a significant proportion of LA capital receipts (including the £7 billion or so which already exist and which form the dominant part of the investments above) will have to be set aside for debt redemption. In principle, this should reduce LA investments, as the funds are used to reduce liabilities. But, subject to some overall constraints ~~contrasts~~ yet to be agreed, LAs may hold funds set aside for debt redemption in 'Approved Investments' - see below - pending their use for actual debt repayment. LAs will also want to keep any other surplus funds (revenue balances etc.) in Approved Investments to avoid the penalties that will be incurred by investing elsewhere (eg. on equities).

4. Approved investment regulations have not yet been drafted, but the intention is to include deposits with banks and building societies, loans to other LAs, gilt-edged securities,

sterling loans to other governments and eligible bills. So there is no requirement for LAs to change their present investment strategies and move into gilts, although they may if they wish. But the Times article does not explain why such a change in investment strategy is likely.

5. In the circumstances, the best line to take on the Times article is that the new capital finance regime will not, of itself, make a move into short gilts likely as other investment opportunities will also be available, including deposits with banks and building societies which are popular with LAs at present.

R J DEVEREUX

Monday, April 1?, 19?

THE TIMES

GILT-EDGED

24"

Council house sell-offs will lift short end

A new factor is about to influence the balance between supply and demand in the gilt-edged market.

Local authority finances are in the process of being radically altered in a way which could potentially be as important an influence on the market as the Bank of England's buying-in programme.

We estimate that in a year's time the demand for short gilts by local authorities could be as much as £10 billion.

This is the likely result of regulations to be made under the Local Government Finance and Housing Bill, which is passing through the committee stage in Parliament.

The most important part of the Bill, from the point of view of the gilt market, concerns the local authorities' receipts from the sale of assets and the restrictions on the way in which those funds are used.

The increasing build-up of capital cash in the accounts of local authorities, particularly housing authorities, is a product of a change in the present government's policy towards local authorities.

Prior to the "right to buy" legislation, which gave council tenants the right to purchase their homes at huge discounts, the income of local authorities from the sale of their assets was minimal.

Subsequent legislation encouraged local authorities to dispose of whole housing estates, or even their entire housing portfolio.

The first of these deals are already in train and there will be many more in the near future.

Reliable statistics suggest that the receipts from the sale of capital assets (chiefly the sale of council houses) amounted to about £2.5 billion in each of 1985-86 and 1986-87, £4 billion in 1987-88 and an estimated £6 billion in 1988-89.

The pace may be slowed temporarily in line with the recent downturn in the housing markets but the expectation is that there will be an acceleration over the next few years.

Although the local authorities have been encouraged to dispose of their housing and other capital assets and to build up these capital receipts, the Government has placed restrictions on their ability to spend these funds, most importantly in the following three ways.

First, they are not allowed to spend all their capital receipts in the year in which they are received but do have the facility to do so over a number of years. By law they are obliged to invest unused capital receipts.

Second, under the new Bill the first call on capital receipts will be the repayment of existing debt to a certain extent.

Third, the new regulations will govern the investment of the remaining cash.

To date most authorities have simply placed the money on short-term deposit, but after the regulations are published later this year, they will probably wish to acquire longer assets.

However, in the consultative paper *Capital Expenditure and Finance* the Government expressed concern that some local authorities had acted speculatively and proposed to tighten up the restrictions on the use of funds.

The paper recommends that one of the main types of investment should be gilt-edged stock.

Gilts are particularly appropriate in that they can be used to match future liabilities — the subsequent spending of the capital receipt.

A number of institutions have complained that the list of possible investments is too restrictive and have proposed extending it to include equities, futures and options and even overseas bonds.

We expect these attempts to fail, especially after recent experience in the swap-option market and previously with equities in the October crash.

The new regulations come into effect on April 1, 1990, but local authorities will probably want to act as soon as the details of the bill are finalized.

We estimate that the cumulative total of the authorities' capital receipts may now be as high as £20 billion and growing. Some of this maybe used to repay outstanding debt but clearly a considerable sum is available for investment.

Market participants faced with a stock shortage and a government buying-in programme on the one hand may be amazed to find them encouraging the demand for gilts on the other.

But the effect on the market of a gilt purchase by a local authority depends on who sells the stock.

To the extent that stock is purchased from a bank or building society there is an increase in overall market demand and a depressing effect on yields. That is, there is no effect on the Government's requirement to buy stock.

However, if stock is purchased from the private sector (excluding banks or building societies) or the overseas sector, then, given the "unfunding rule," this is effectively buying in stock on behalf of central government.

The Government's purchases can be reduced and the effect on the total demand for gilts will be broadly neutral.

However, there would still be a marked effect on the shape of yield curve with Bank of England purchases, largely in longer and medium-dated stock, being replaced by local authority buying at the short end of the market.

This could be taking place at the same time that a fall in short-term rates is also pointing to a flatter yield curve.

David Wileman and Dan Regan
ANZ McCaughan

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7.

FROM: D I SPARKES
DATE: 11 April 1989

MR GRICE (MG2)

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Odling-Smee
Miss O'Mara
Mr Pirie
Mr Potter
Mr Devereux
Mr Laite

BF 18/4

LOCAL AUTHORITY INVESTMENT IN GILTS

The Chancellor has seen a copy of your minute of 10 April to Sir T Burns commenting on the article in yesterday's Times which suggested that local authorities may buy gilts on a greater scale in the near future.

2. The Chancellor noted your comments that local authorities are likely to be interested in very short gilts and that a substantial but unquantifiable portion is likely to be supplied by banks and building societies whose holdings are concentrated in this maturity area. The Chancellor would be grateful for your advice as to the scope that these institutions have for further net sales of gilts.

D.C.S.

DUNCAN SPARKES

MAMC: N3

FROM: J W GRICE (MG2)
DATE: 13 April 1989
x5509

CHANCELLOR OF THE EXCHEQUER

[illegible]

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Odling-Smee
Miss O'Mara
Mr Pirie
Mr Potter (LG1) o/r
Mr Devereux (FIM1)
Mr Laite (LG1)
Mr Brooks (MG2)
Mr Ritchie (FIM2)

LOCAL AUTHORITY INVESTMENT IN GILTS

You asked for advice as to the scope that banks and building societies might have for further net sales of gilts (Mr Sparkes minute to me of 11 April). The TCSC have now also asked us to comment on a proposal by Professor Brian Tew to which this issue is germane.

2. Although they have made net disposals in recent years, both sets of institutions still have sizeable holdings of gilts: at the end of February the banks' holdings were worth £5 billion and building societies an estimated £7 billion. So together, they hold getting on for a tenth of the total gilts in issue.

3. The attached table shows the transactions that they have made in recent years. Banks made sizeable purchases in 1986 but were substantial sellers in 1987 and, more particularly, in 1988. But their transactions have been erratic and in individual quarters they have been net purchasers. Building societies' behaviour has been affected by regulatory changes announced in 1986 which encouraged them to hold liquidity in bank deposits rather than in gilts. Consequently, they were sellers in both 1986 and 1987. However, last year they made net purchases and we began to wonder whether the adjustment process had been completed. In the first two months of 1989, though, their sales resumed, amounting to nearly a £1 billion in the two months together.

4. For the future, there is no clear case to be made for banks being either systematic sellers or buyers. Their attitude in recent years seems to have been largely opportunistic; they have bought gilts when they thought them a good investment and sold them when they believed the opposite to be the case. But if the local authorities were to bid aggressively for short gilts, the banks might well be willing sellers at sufficiently attractive prices. As to the building societies, the advice we have had from the Building Society Commission is that there is still some adjustment to be made to a new steady state following the 1985 regulatory changes. In our funding arithmetic projections, we have allowed for £½ billion a year net sales on this account. Otherwise, like the banks, the building societies' behaviour is liable to be opportunistic. Taken together, the quarterly transactions of the two institutions are likely to continue to be erratic, though, for the building societies, at least, the chances of sales are probably greater than of purchases.

C Rees

for J W GRICE

Bank and Building Society Transactions in Gilts

£ billion

	Banks	Building Societies
1984	0.3	0.8
1985	0.4	0.1
1986	1.4	- 1.5
1987	- 0.9	- 1.2
1988	- 2.3	0.6
1988 Q1	0.6	- 0.2
Q2	- 1.3	0.4
Q3	- 0.5	0.4
Q4	- 1.1	-
1989 Jan	-	- 0.6
Feb	- 0.4	- 0.3

chex.ul/ds/4.14.4

UNCLASSIFIED

FROM: D I SPARKES
DATE: 14 APRIL 1989

MR GRICE

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Odling-Smee
Miss O'Mara
Mr Pirie
Mr Potter (LG1)
Mr Devereux (FIM1)
Mr Laite (LG1)
Mr Brooks (MG2)
mr Ritchie (FIM2)

PMP

LOCAL AUTHORITY INVESTMENT IN GILTS

The Chancellor has seen and was grateful for your minute of 13 April advising on the scope that banks and building societies might have for further net sales of gilts.

D.S.

D SPARKES