MT

Confidential Filing

Possible Charges in the Taxation of Bank Profits.

ECONOMIC

POLICY

November 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~14.11.79~~							
~~4.2.80.~~							
~~18.2.80.~~							
~~20.2.80~~							
~~21.2.80~~							
~~25.2.80~~							
~~29.2.80~~							
12.3.80							

PREM 19/195

Dd 533270 5M 2/78 8362633 JET

Prime Minister
Econ Pol.

2

To glance. This is a Treasury note which has been sent to the Bank. Any scheme involves difficulties, but I think it ought to be possible to construct something for introduction at Report Stage of the Finance Bill.

TL
20/3

SECRET

BANK PROFITS

The Problems

1. This note considers the problems that:-

i) clearing banks are making very high profits relative to the rest of the corporate sector;

ii) these profits are in part the product of monetary policy and not of the banks' own acumen or efficiency;

iii) despite the high profits, tax paid by clearing bank groups is likely to be minimal;

iv) more revenue is needed in 1980-81;

v) pressure is building up to tax these profits soon to improve the chance of meeting other objectives.

The Present Position

2. Fully retrospective taxation of 1979 bank profits has been ruled out. An excess profits tax seems impossibly complex, and undesirable in terms of Government policies. Changes in capital allowances though needing consideration (see paragraphs 7 and 8) would have no revenue effect in 1980-81. The same is true of various ideas for widening the tax base in the financial sector which are now being studied. There remain possibilities for various sorts of levy on windfall profits in 1980-81.

Tax Schemes

3. In concept, windfall profits arise when high interest rates have significantly widened the average margin for banks with a significant proportion of non-interest or low-interest bearing deposits. To levy on these profits, it would be possible to construct either a percentage levy on sight deposits or to tax away a percentage

of the difference between the 'normal' and the current average level of interest rates, less interest paid, on the sterling deposit base. Outline schemes are at Annexes A and B. It seems likely that either scheme could yield £$\frac{1}{4}$-$\frac{1}{2}$ billion. If the money is to be paid in 1980-81 then Scheme A contains a lesser degree of retroaction than Scheme B.

Loans to the Government

4. Another possible approach to the problem of bank profits would be to call for (non or low interest bearing) deposits with the Government. Such deposits could be either:-

i) a voluntary means to ease the presentational problems of bank profits;

ii) a statutory scheme designed to produce a significant financial gain to the Exchequer.

For such schemes, the loans could be permutations of small or large, interest or non-interest bearing, liquid or illiquid. Non-interest bearing, illiquid deposits would yield the Government a benefit equivalent to Treasury Bill yield on the amount held over the time held. Such deposits would put the banks under reserve asset pressure and would raise relative rates on reserve assets and probably short rates generally. For these reasons, deposits on any substantial scale would need either to be counted as reserve assets and be available to be drawn in case of a liquidity squeeze on an individual institution, and/or bear interest. But the scheme is pointless if a market interest rate is paid and if the deposits were reserve assets then there would be a switch of funds away from the discount market perhaps with major structural consequences.

5. Further difficulties are that the present arrangements for the (voluntary) SSD scheme make it difficult to see how the banks could also be asked to place, voluntarily, further small amounts of illiquid non-interest bearing deposits with the Government. Moreover, small amounts do not correspond to any presentational points related to the

problem of bank profits. For example a credible profit equalisation reserve deposit in respect of 1979 profits would amount to some £500 million which would cost the banks of the order of £90 million if held for a year and would reduce the reserve asset ratio to around 12.25%, consequently raising the relative rate of interest on reserve assets. Pressure could be eased by phasing the uptake of the deposits but this is also true of a simple levy which would cause far less short term structural disruption.

6. One means of avoiding these difficulties would be to place interest bearing Government deposits with the banking system and take an equivalent amount from them in non-interest bearing loans to the Government. It would have to be agreed that the Government deposits did not add to sterling M3 : in this case the arrangements would not affect interest rates or the liquidity or structure of the financial system. While this scheme appears structurally foolproof it is so clearly a device to secure a flow of income to the Government that it has little advantage over a tax unless its incidence could be made more discretionary, which seems unlikely.

Withdrawing Existing Allowances

7. The argument for levy schemes turns largely on the proposition that the banks can afford to pay more tax than they do (and that the money is needed elsewhere). A simpler route into that dilemma in the longer term would be to curtail the allowances which presently shield existing bank profits from taxation. Effectively, such a route would mean action to curtail capital allowances available for assets leased to others.

8. A solution along these lines has the great merit that, whilst it can be non-discriminatory as a tax measure, it falls in practice most on those whose profits are now most in question. It is thought that something around 85% of present lease business is done by financial institutions; and perhaps of the order of 75% within the clearing bank groups. Assuming that new lease business may be some £2½ billion in 1980, then to abate the first year allowances to, say, 75% could produce

some £150 million in 1981-82 and some £300 million in the first full year, diminishing thereafter. An abatement to 50% doubles these figures. Alternatively, capital allowances might only be given against profits on leasing activities thus bringing most profits from banking activities fully into mainstream corporation tax. The yield might be £500 million in the first full year. Either change would also reduce finance leasing from the non-bank company sector, which would be an advantage. The second, in particular, would sharply reduce the attraction of lease business to new entrants to that business. The great disadvantage of this route is that while it yields no revenue until 1981-82 the increased cost of investment finance to the manufacturing sector would begin at once.

Conclusion

9. There will need to be a reference to clearing bank profits in the Budget speech. Before then, more work is needed on the feasibility and effects of the possible schemes - in particular tax changes - which have been identified. It is suggested that further study should be undertaken jointly between the Treasury, Treasury Solicitor and Parliamentary Counsel, Inland Revenue and Bank. There should be a report back in time to consider whether or not any legislative action should be taken in the Finance Bill.

H M TREASURY
12 March 1980

SECRET

ANNEX A

A Levy on Sight Deposits

The levy would be statutory. An outline scheme is as follows:-

a) the base for the levy would be UK banks sight deposits at the most recent make up day before announcement (possibly an average of 3, or even 6, make up days should be allowed - but all in the past);

b) the rate of call should not be greater than the difference between an assumed 'normal' interest rate and current market rates;

c) subject to that (unreal) constraint the call could be set to produce the yield which the Government wanted - 2% for example could well look reasonable;

d) banks might have to be allowed some offset for interest paid on those sight deposits which do attract interest (one fifth of the interest rate offered on sight deposits on that date might be reasonable in relation to a 2% call);

e) payment of the levy could be staged so as to allow the banks to pay from cash flow, minimising upward pressure on interest rates.

The primary purpose of the scheme is a reduction in the PSBR but its monetary effects should also be favourable. In the worst case, if bank lending was unaffected, the banks would finance the levy by extra deposits but the PSBR would be lower so that £M3 would be unchanged and DCE falls. If the banks reduced their lending because of lower reserves following the levy then £M3 also falls.

ANNEX B

A Levy on Total Deposits

An outline scheme for the calculation might be

Total deposits, private sector, excluding overseas on 19 March 1980 (or 16 January)		100
Average MLR in previous 12 months	16%	
Notional allowances for expenses profits etc	8%	
Net available fund	8%	= 8
Actual average interest paid on deposits in question		5
Notional excess available		3
Tax at 20%		0.6

As MLR falls and/or actual interest paid rises, the tax automatically liquidates itself.

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

Chancellor of the Duchy of Lancaster

29 February 1980

MBPM

Dear Mike

... I enclose a copy of a letter the Chancellor of the Duchy has received from Keith Brown of W Greenwell & Co about bank profits. The Chancellor thought the Prime Minister might be interested to have a copy of this for information.

Yours sincerely

Petra

PETRA LAIDLAW
Private Secretary

M Pattison Esq
Private Secretary
10 Downing Street
SW1

3 - MAR 1980

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25th February, 1980

Rt. Hon. Norman St. John Stevas, M.P.,
House of Commons,
London SW1A OAA.

Dear Norman

Further to our conversation on Friday I promised to let you have some background information on the current round of bank profits.

i) Lloyds Bank have already announced their profits for 1979, National Westminster are due to report tomorrow (Tuesday 26th February) and Midland and Barclays will announce their results in the middle of March.

ii) Lloyds' profits were up by 49% to £277m. Of this total around £170m. was attributable to domestic banking operations, which were almost doubled. International profits i.e. their subsidiaries operating in South America, the United States, Europe, South East Asia and other financial centres as well as international business transacted in London amounted to around £80m. This was a similar figure to 1978 due to the strength of sterling and difficult operating conditions. Other operations accounted for the remaining £27m.

iii) Total banking profits in 1979 of the big four London Clearing Banks will amount to around £1.5bn. Of this total around £950m. will be attributable to domestic banking, around £350m. to international banking and overseas subsidiaries and the remainder, £200m., to other operations including leasing, hire purchase, insurance broking, travel, merchant banking etc. Of the total profits of £1.5bn., approximately £600m. will be absorbed by tax and only £130m., or 14% of net profits will be paid out in dividends. The remainder will be retained to finance the growth in the business.

Contd/.......

iv) The dividend increases this year will appear to be excessive, Lloyds were up by 40%. It should be remembered that up until recently dividends had been controlled since 1972. Consequently dividends have lagged both wages and prices and the increases being seen this year will redress some of the balance, although they will still lag the growth in the R.P.I. since 1972.

v) Tax should absorb some £600m. of the total profits. This can be a misleading figure. Banks are to all intents and purposes are subject to a 52% tax charge but because of various tax concessions against capital allowances and leasing the actual tax charges are around 30%-35%. For political purposes it would be best to use the figure of £600m. I have quoted, otherwise you will get embroiled in all sorts of technical arguments.

vi) Because banks have a large taxable bases they are able to take advantage of existing legislation which enables them to undertake substantial leasing business. Leasing is a method whereby companies effectively rent plant or machinery instead of buying, because they are unable to obtain tax allowances themselves, largely because they do not earn enough profit. Leasing covers anything from oil rigs to photo-copying machines. Total new leased assets last year amounted to around £1.7bn of which the banks are responsible for almost the entire amount. If bank profits were lower then the amount of assistance they would be able to give industry would be reduced.

vii) It is necessary for banks to retain a large proportion of their profits in order to finance the expansion of the business. Also the working capital of a bank is money, and this corresponds to around 3% of deposits. With inflation moving up during the year this sum of money needs to be supplemented. It is interesting to note in the case of Lloyds, that despite their good profits the retentions are only sufficient to maintain the working capital. In the past banks have had to call on shareholders to increase their capital because the working capital had become inadequate. The Bank of England rigorously supervise the banking system in this respect. After the secondary banking crisis of 1974 when many small banks ran into trouble because of inadequate capital, this aspect is most important. At that time it should be remembered that it was the big Clearing Banks who launched the "lifeboat" which saved the deposits of the customers of these secondary banks.

viii) It is important to give emphasise to inflation adjusted profits. It is now recommended, although not mandatory, that all companies produce inflation adjusted profits on a formula laid down by the Institute of Chartered Accountants. In the case of Lloyds Bank inflation adjusted pre-tax profits rose by 28% but net profits were only 3% higher.

Contd/.....

ix) On the assumption that the Government get their economic policy right and inflation and interest rates fall, then bank profits will suffer. Our own estimates see little or no rise in profits in 1980 and it could be bleak for them thereafter. It is important to appreciate this point because if the Government were considering an excess profits tax it would be a tacit admission that they expect high interest rates to continue for some time.

I think these are all the salient points. I have tried not to be too technical but I hope it will give you and your colleagues the political ammunition you need. I should be happy to supply further briefings if you so wish.

My Best Wishes.

Yours

Keith

KEITH BROWN

TELEPHONE
01 - 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

25th February 1980.

Dear Tim,

Bank Profits

In case it might be helpful in connection with the Prime Minister's appearance on Panorama, I enclose a note produced here which seeks to put bank profits into a current cost accounting context.

The backing figures are being checked with the clearing banks and if any corrections are necessary they will be telephoned to you.

Since this sort of material is not easily put across in debate, I also enclose a very short speaking note which is designed to shift a questioner from the gross figures on which he might be expected to base himself to the adjusted figures.

I am sending a copy to John Wiggins at the Treasury.

Yours sincerely,

Jasper Hollom

T.P.Lankester, Esq.

BANK PROFITS

Main Points

1. Bank profits are of a cyclical character but the peaks and troughs do not coincide with industrial and commercial activity as a whole. When interest rates are high, business activity tends to be depressed; at that time bank profits are at their peak, which is presently the case.

2. Profits expressed in terms of historical cost are misleading for comparative purposes. They must be expressed in current cost terms and adjusted for inflation. On that basis the present level of profits is no more than adequate for the banks' needs.

3. The banks are particularly vulnerable in times of economic uncertainty. They need to earn good profits to support depositors' money; to maintain the confidence of the public at home and abroad; and to expand their business and their services to the public. They earn substantial sums of invisible exports.

Supporting figures

4. On the basis stated in paragraph 2, the profits remaining in the hands of the banks, after tax and the payment of modest dividends, were as follows:

	£ million	
1973	~~194~~	199
1974	~~13~~	21
1975	~~(52)~~	(39)
1976	~~45~~	57
1977	134	
1978	171	
1979 (estimated only)	107	

The cyclical nature of the retained profits will be noticed. There was a deficit in 1975 and, in real terms, the retentions even in 1978, and the estimated figures in 1979, have not reached the 1973 level. (Note: The above figures are shown in graph form on the attached schedule

5. For prudential reasons the banks are required to maintain a margin of "free" capital on a basis laid down by the Bank of England. This free capital is designed as additional cover against any possible loss falling on depositors. The following shows the figures for the last six years:

	Deposits at year-end £ million (1)	"Free" Capital £ million (2)	Percentage of column (2) to column (1) (3)
1973	~~36,676~~ 36,717	~~1,135~~ 1,094	~~3.1~~ 3.0
1974	~~43,001~~ 43,061	~~1,084~~ 1,024	~~2.5~~ 2.4
1975	~~47,212~~ 47,279	~~1,198~~ 1,131	~~2.5~~ 2.4
1976	~~55,129~~ 55259	~~1,675~~ 1,545	~~3.0~~ 2.8
1977	62,885	2,267	3.6
1978	70,151	3,051	4.3

Having regard to the very large deposits held by the banks, the "free" capital is no more than is needed for prudential purposes.

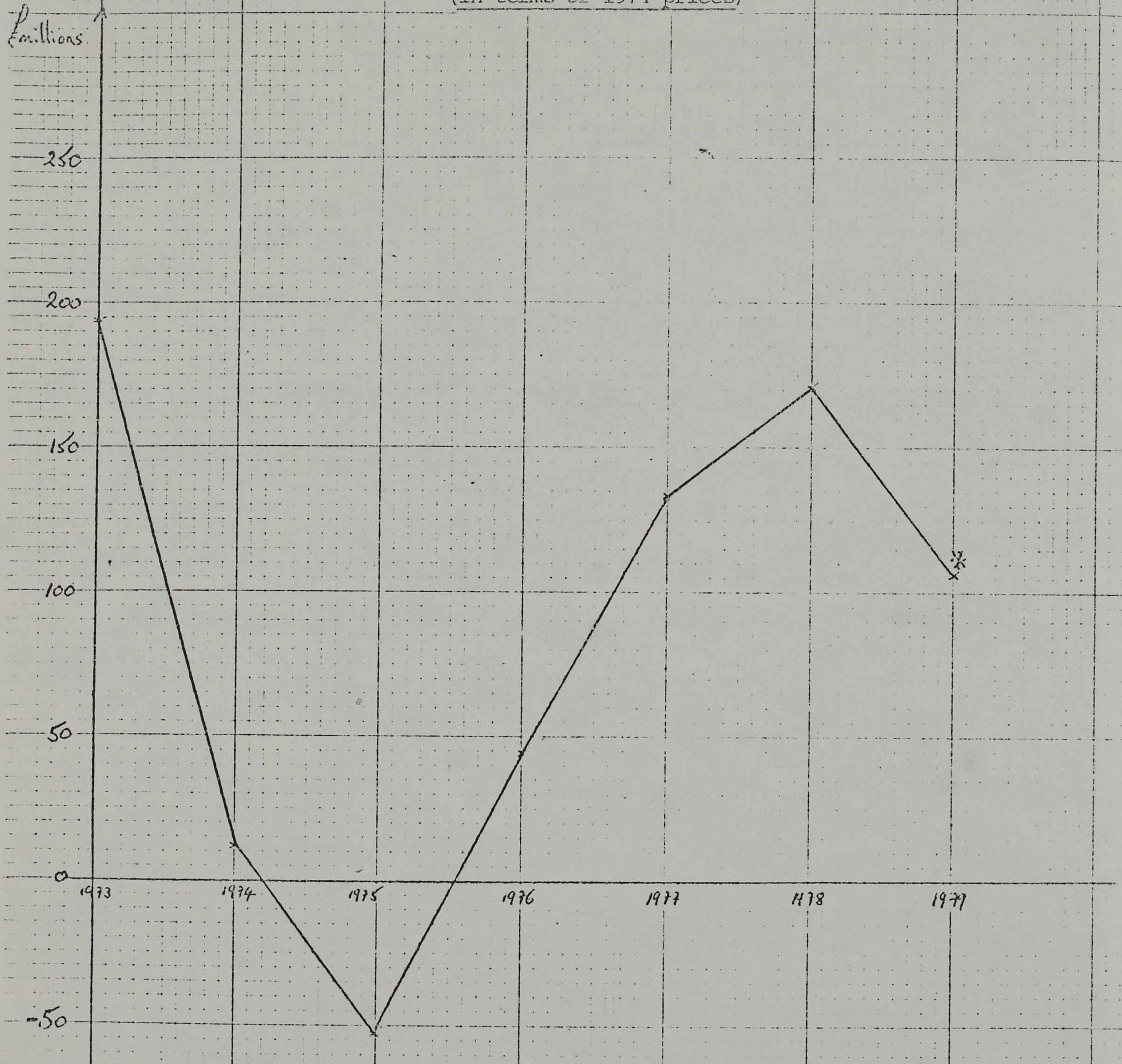
6. In case it is needed for reference, a summarised statement for the past seven years is attached.

(Note: Arrangements are being made to verify these figures which have been prepared at short notice. It should be appreciated that the 1979 figures at this point of time are guesswork because the annual accounts for that year have not yet been published.)

Bank of England,
22nd February 1980.

Retained Inflation Adjusted Profits of Four Largest Clearers

(In terms of 1974 prices)



⁎ : Estimated

Profits of the four largest clearers adjusted for CCA and expressed in terms of 1974 prices

£ millions

Year	Pre-tax Profits in historical cost terms	Column 1 adjusted to 1974 prices	Column 2 adjusted for Taxation	Column 3 after CCA adjustments	Dividends in 1974 prices	Column 4 less Column 5
		Pre-tax Profit	Post-tax Profits	Post-tax Profits after CCA adjustments	Dividends	Retentions
	1	2	3	4	5	6
1973	580	620	349	246	52	194
1974	449	414	188	58	45	13
1975	424	315	137	(9)	43	(52)
1976	700	446	197	90	45	45
1977	896	492	291	180	46	134
1978	1,083	549	331	223	52	171
1979*	1,500	644	365	159	52	107

*Estimated

SPEAKING NOTE

Bank Profits

You must remember that when looking at these figures you are using a measuring rod - money - which changes over time, because of inflation. So straight readings are misleading.

Remember too that money is the banks' working capital; and that with inflation the value of that working capital is continually evaporating away. That loss of real value must be made good before you can sensibly talk about profits.

If allowance is made for these points, it can be seen that both the banks' dividends and their retained profits have been modest. A run of figures for the four big clearing banks on a CCA basis and adjusted for inflation in terms of 1974 prices is as follows:

£ millions

Year	Dividends	Retentions
1973	52	194
1974	45	13
1975	43	(52)
1976	45	45
1977	46	134
1978	52	171
1979*	52	107

*Estimated

cc Mr Ingham

CONFIDENTIAL

Prime Minister

2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

22nd February 1980

Dear Richard,

BANK PROFITS

At Cabinet yesterday morning, the Chancellor agreed that we would provide a briefing note about bank profits for use by Ministers in the coming weeks when the four clearing banks will be declaring their 1979 results. In doing so we have drawn on the points in Tim Lankester's letter to me of 20 February but with two important qualifications. First, point 2, about taxation cannot be made in this form since tax accrued may well not be tax paid so that the general taxpayer can only be said to benefit in the very long term. Second, we have not included the bit in point 4 about fringe banks since the yield on the business they were doing in 1973 was good: the problems were liquidity and bad debts.

As you will see, the subject is a difficult one and the Chancellor has asked me to say that he hopes the Paymaster General will make quite clear, in circulating the notes, that anything Ministers say should simply be designed to put the question of bank profits into perspective by describing the facts with which the banks have to deal - e.g. the impact of inflation on the real value of their business and the increased level of risk in domestic and international lending. He would not wish colleagues to go further and say anything which implied a value judgement (for or against) the present level of profits in the banking sector. To a considerable extent these profits are, indeed, a by-product of the level of interest rates brought about by inflation and by the Government's efforts to defeat inflation. They are not in the main a result of efficiency or merit on the part of the banks. In this sense, the banks cannot be complimented in the same way as would be appropriate for profitability on this scale in, say, manufacturing industry.

I am copying this letter to Tim Lankester and to John Beverly in the Governor's Office, Bank of England.

Also to John Chilcot (Home Office)
& David Wright (Cabinet Office).

Yours sincerely

John Wiggins

A.J. WIGGINS
(Private Secretary

R. Prescott Esq.

CONFIDENTIAL

BRIEF FOR MINISTERS

BANK PROFITS

General

The London clearing banks will be declaring their 1979 results in the next few weeks, starting with Lloyds Bank on 22nd February. The figures will show a very significant increase in historic cost profits over previous years. These results may be criticised as a by-product of government counter-inflation policy which has led to the present, relatively high level of interest rates.

Apparent and real profits

2. It is expected that aggregate profits for the London clearing banks, on an historic cost basis, will be about £1,500 million compared with just over £1,000 million in 1978. This overstates the true result in the sense that current cost accounting profits, which would adjust for inflation in the way described in the Accounting Standards Committees Exposure Draft 24, are likely to be no more than about £900 million. This is a level of real profitability, as opposed to money profitability, which is broadly similar to that achieved in 1973 but not since then.

Cyclical characteristic of bank profits

3. Bank profits vary with interest rates. Inflation has pushed interest rates to very high levels in the past two years and the Government's counter-inflation policy means that rates can only be allowed to come down again as the inflation is driven back. During the present period banks will inevitably make good profits. This is the phase of the cycle at which the banks are building up their capital and reserves in readiness for future periods when reduced inflation and lower interest rates should mean lower profits.

Finance for industry

4. The great bulk of bank profits are retained where they serve to build up the reserves on which future lending can be based. Industry and commerce are heavily dependent on bank finance for their operations; the future growth of the British economy, for which the foundations are being laid by Government policy, will increase the demand for loan and overdraft facilities. It is entirely desirable that these reserves should be being built up now, in readiness.

Confidence in the banking system

5. Britain has long enjoyed the advantage of a soundly managed banking system. At a time of turbulent economic conditions, both at home and abroad, the stability of the domestic banking system should not be lightly taken for granted. The profits which the banks are currently making, and using to strengthen their reserves, are helping to ensure that confidence in British banking will be maintained.

Assistance to exports (for use in response to specific questions on export credit finance)

6. The suggestion has been made that the banks should devote some of their profits to relieving the Government of the burden of interest subsidies on fixed rate export credit. There is no particular logic about this or any other suggestion that the banks should give away some proportion of their profits; and they do not get more than normal commercial returns on the export finance they provide. However the point can be made that the clearing banks have helped the Government a great deal towards reducing public expenditure by taking an increasing proportion of export credit finance onto their own books instead of its being refinanced by the Government. The cumulative public expenditure saving since 1976 is about £700 million; and the Government will be providing no refinancing facilities whatever on any export credit business taken after the beginning of April this year.

Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES.

Reference: CC (80) 7th Conclusions, Minute 6

Date: 21 February 1980

Signed AWayland Date 23 March 2010

PREM Records Team

10 DOWNING STREET

NICK SANDERS

Brendon Sewill wrote to me and you might be interested to have these papers.

JOHN HOSKYNS
21 February 1980

CF done

Pls. send copy of
my letter of yesterday
on bank profits
to J Hoskyns
(if you haven't
done already).
T.

CONFIDENTIAL

cc Master Set

PO JPH

bc Wolfson
Ingham
Hoskyns

10 DOWNING STREET

From the Private Secretary

20 February 1980

Dear John.

The Prime Minister held a meeting this evening with the Home Secretary, the Chancellor and the Governor to discuss how the large bank profits which are due out shortly might best be presented. The Chancellor and the Governor made various suggestions. The Prime Minister said that these would not be understood by the public at large if they were too technical and arcane.

In the light of the discussion, and after the Chancellor had left the meeting, the Prime Minister suggested that Ministers might draw on the following points:

(1) When interest rates are high as they unfortunately are at present, bank profits are inevitably high. The Government are determined to get interest rates down for the sake of industry and so that mortgage rates can fall. When interest rates do fall bank profits will be lower. Bank profits always fluctuate with interest rates.

(2) The taxpayer will benefit because approximately one-third of the profits will be taken by the Government in Corporation Tax.

(3) At a time of difficulty for industry, the banks need good profits so that they can provide industry with adequate borrowing facilities. Without good profits, they would not have the confidence to lend.

(4) In times of difficulty, the public need to be thankful that they can be confident that their money is safe. With good bank profits, they can be sure of this. This was not the case with the fringe banks in 1974; nor has it been in some countries overseas.

(5) If you adjust the banks' profits and their assets for inflation, the profit increase is not as great as it looks. The banks' assets are very largely in the form of money, whereas manufacturing industry's are in the form of physical capital whose value goes up with inflation. The banks therefore need bigger profits to keep step with inflation.

/(6) As

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M. B.

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(6) As with any industry, profits are needed for maintenance and expansion of the business. It is no: coincidence that the banking sector has been one of the more successful - in terms of efficiency, increased employment and invisible earnings.

(7) If bank profits are high, the sooner we get the inflation rate down the sooner they will fall.

As the Prime Minister told the Chancellor, she will wish to raise this in Cabinet tomorrow.

I am sending a copy of this letter to John Chilcot (Home Office), John Beverly (Bank of England), Richard Prescott (Paymaster General's Office) and David Wright (Cabinet Office).

John Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

SECRET

Prime Minister!

Mr Sen

TL 20/2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

18th February 1980

Dear Tim,

BANK PROFITS

You wrote to Tony Battishill on 14th November expressing the Prime Minister's concern about the current high level of bank profits and requesting a note on the possibilities for changing the taxation of bank profits. I apologise for the delay in replying - since November considerable work has been put into examining the options by Bank of England, Inland Revenue and Treasury officials.

The problem

As has been widely reported in the financial press, the big four clearing banks are expected shortly to announce record pre-tax profits for 1979 of around £1,500 million - a rise of 40 per cent on the 1978 level. While it is difficult to estimate the element of these profits that is due to high interest rates, high interest rates caused by monetary policy were undoubtedly the main reason for the high profits as they enabled banks to employ their current account balances more remuneratively. Our latest information on the timing of the announcement of the profits of the four London clearers is as follows:-

	Announcement	Publication of Annual Report
Lloyds	22 Feb	11 March
Nat West	26 Feb	24 March
Midland	14 March	1 April
Barclays	20 March	15 April

Presentational Difficulties

Treasury Ministers are keenly aware of the political difficulties to which these record profits by the four clearers might give rise. The Chancellor has agreed that the Governor of the Bank of England should urge the banks to take various steps to reduce the adverse impact of these high profits figures. These steps include the banks drawing

/attention

T. Lankester, Esq.,
No.10, Downing Street

attention to their inflation-adjusted accounts (under which pre-tax profits would be some £600 million lower at £900 million), considering some form of profit equalization reserve on the face of their accounts (to offset fluctuations in bank profits caused by monetary policy) and examining the possibilities of giving greater help to small firms. The banks would also be urged to avoid high dividends, high pay increases or increases in transmission charges. The Chancellor is particularly concerned that the banks should recognise clearly the force of the criticism to which they may all be subjected, and that they should take careful and concerted steps to reply effectively to their critics, as they had done in the campaign against possible nationalisation. There is already evidence that the clearers have taken this message to ..... heart in the attached brief prepared by the Committee of London Clearing Bankers.

Possible Taxation

Officials have identified three possible means of taxing banks' profits:-

(a) An 'excess' profits tax (on the precedent of PRT or DLT);

(b) a levy related to banks' 'current account' business;

(c) a call for non-interest bearing special deposits.

Officials see considerable technical disadvantages in an 'excess' profits tax - it would be difficult to define an 'acceptable' rate of increase in profits; the shifting of profits within a group of companies would cause considerable problems; there would need to be a ring fence between profits from traditional banking business and non-traditional business such as leasing. Difficulties for a levy on current accounts include a definition of current accounts that would be proof against manipulation, and the choice of a trigger to impose the tax charge when interest rates rise above a certain level, and withdraw it when interest rates fall. (If interest rates fell far enough there would even be a case for some offsetting allowance to be set against future payments of the levy.) Officials see no advantages in a call for non-interest bearing special deposits in comparison to such a levy - both schemes would have to be statutory to have any significant impact on bank profits - and the non-interest bearing special deposits would have the major disadvantage of having a dramatic impact on the liquidity of the financial system. Of the schemes outlined above, a levy on current accounts would appear to present the least difficulty; but at first sight a long term scheme - as opposed to a once off levy - looks both difficult

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and unattractive. All the schemes above would require considerable further work before officials could be certain any of them would be viable.

Taxation of 1979 profits

The Chancellor has considered carefully whether further taxation of banks' 1979 profits is justified. He is firmly opposed to any additional taxation of 1979 profits. Such taxation would be new and wholly retrospective and would be difficult to reconcile with wider Government policies to encourage profitable industries. The Chancellor considers that the banks need to use their 1979 profits to strengthen their capital base to face future risks - such as business failures and the increased risks of international business - particularly those involved in recycling the enormous prospective OPEC surplus.

Future taxation of bank profits

The Chancellor has also considered against the background of monetary policy whether officials should investigate further the possibilities of additional future taxation of bank profits. Such a move would be justified by the fact that the banks were making windfall gains from monetary policy due to the effect of high interest rates on non-interest bearing current accounts. It could also be argued - following the 1979 results - that there was no longer the same need for future high profits to strengthen the banks' capital bases, and that such additional taxation might help on pay restraint. On the other hand, additional taxation could well reduce banks' willingness to co-operate with Government in other areas - such as financing small firms, and providing funds for export credit and - depending on the form of additional taxation - could encourage the banks to meet higher pay claims (as the Exchequer would in effect pick up the bill).

In view of the difficulties of principle and administrative costs, and also of its doubtful efficacy, the Chancellor is opposed to the development of any continuing scheme for the continuous special taxation of bank profits. He is also profoundly uneasy at the prospects of a once-off or occasional special levy on banks' current accounts, but would not absolutely rule this out in all circumstances. However, he doubts whether detailed contingency work by officials at this stage on such a levy would be justified.

On a longer timescale, the Chancellor, while concerned about the potential complexity of greater taxation in the

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financial area, has authorised officials to explore the possibility of widening the tax base in the financial sector. Possibilities include taxes on money transmission, on miscellaneous banking activities or on consumer credit. Any such taxation would, however, be very unlikely to have a sharp impact on bank profits in any one year.

I am sending a copy of this letter with the enclosure to David Wright ~~Martin Vile~~ (Cabinet Office).

Yours

John

(A.J. WIGGINS)

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

8 February 1980

Rt. Hon. Sir Geoffrey Howe, QC., MP.,
Chancellor of the Exchequer,
Treasury Chambers,
Parliament Street,
SW1P 3AG

BANK PROFITS

You will remember, as I do, the political trouble that was caused in 1974 when the banks announced a substantial increase in their profits. And you will be aware that a similar increase is expected this spring.

We hope, however, that this time there will be no adverse political repercussions. Public attitudes have changed: people are now more inclined to be glad to find any British industry making a profit. The profit increases have been well signalled in advance, and should come as no surprise. Moreover the banks have learned a good deal from experience and are now much more sophisticated in their presentation. The profit announcements will be accompanied by full briefing for press, for television and for Members of Parliament.

As part of this process I am sending, in advance of the profit announcements, a brief to a number of Conservative Members to enable them to produce an immediate robust reply to any criticism from the Opposition. I attach a copy of this brief for you, and am also sending copies to the other Treasury Ministers.

Brendon Sewill

BANK PROFITS

The big four clearing banks will be declaring their 1979 results during February and March, beginning on Friday, February 22.

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National Westminster	Feb 26	March 24
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It is hoped that this brief will put the figures in perspective. It is arranged as follows:-

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* The big four banks' 1979 profits are expected to show a healthy increase over 1978.

* This is mainly because of the higher level of interest rates.

* Bank profits tend to move in cycles. They are currently near their peak and profits for 1980 may well be lower than those for 1979.

* Since the previous peak, profits have barely kept pace with inflation.

* As with other businesses, historical-cost accounting conventions give a misleading picture of profitability. Current-cost profits after tax for 1979 are likely to be less than half historical-cost profits.

* The tax system does not give the banks any relief for the effect of inflation on profits, whereas industrial companies benefit from stock relief.

* The fact that the banks receive no capital allowances on premises is also inequitable.

* The banks' ability to engage in leasing transactions does not provide satisfactory compensation for taxing them on their distorted historical-cost profits.

* The banks' profits need to be large in absolute terms because the banks are large businesses, and it is of paramount importance that they maintain public confidence.

PROFITS - FACTORS BEHIND THE INCREASE

Most observers are expecting pre-tax profits, measured on the traditional historical-cost basis, to increase by about 40 per cent, from a total of £1,084 million in 1978 to something over £1,500 million in 1979.

The chief reason for this expected improvement is the much higher level of interest rates prevailing. The banks' base rates averaged about 13.7% in 1979 compared to 9.1% in 1978. Higher interest rates are beneficial to the banks because they enable balances on current account to be more remuneratively employed.

Two other factors working in the bank's favour were:-

(a) The banks' branch retail deposits (current accounts and seven-day notice deposits) grew faster than their total assets, enabling them to reduce their reliance on expensive money-market deposits.

(b) There was an increase in revenue from bank charges, mainly derived from corporate customers, as a result of the banks' efforts to get their money transmission activities on to a sounder economic basis. (Most personal customers still pay nothing in charges, largely because the banks have increased the rates at which notional interest is allowed as an offset against charges, as was recommended by the Price Commission.)

These benefits were partly offset by:-

(a) a contraction in the margin between the banks' seven-day retail deposit rate and other interest rates;

(b) higher provisions for bad and doubtful debts;

(c) increased costs, which outpaced the growth in the volume of business (which was constrained by the 'corset' controls). The need for a large branch network to provide an efficient service to the public means that costs absorb a large proportion of the banks' income. Increases in costs therefore have a disproportionate impact on profits.

Almost all the expected growth in profits is due to the banks' domestic clearing bank operations. Profits from international banking have been held back by the strength of sterling and by the narrow margins currently prevailing in the eurocurrency market. The banks' instalment credit subsidiaries have suffered from higher interest rates, and all their activities have been affected by rising costs.

THE BANK PROFIT CYCLE

The strong effect of changes in the level of interest rates on the short-term trend in bank profits means that profits inevitably show a cyclical pattern. Interest rates are probably now at their cyclical peak, and the present time probably represents the peak for the bank profits cycles also. Bank profits may very well show a fall in 1980, though the banks hope that any fall will not be as abrupt as that between 1973 and 1974, when the secondary banking crisis was superimposed on other adverse factors.

The banks' 1979 profits are likely to have exceeded those of the previous peak year (1973) by some 160%. During that time the retail price index has risen by some 150%. That bank profits have barely kept pace with inflation must be judged disappointing in view of the substantial new capital injected during the period.

The banks have in fact had to raise fresh capital just in order to stay in the same place, which is never a satisfactory state of affairs for any business. However, new capital has also been applied to expansion and diversification (especially overseas) and to continued investment in computer and other equipment.

The banks have always remained in the forefront of technological progress and this - together with their excellent industrial relations - is one of the main reasons that they have avoided the serious difficulties that have afflicted some parts of British industry.

THE RECENT TREND IN PROFITS

The combined historical-cost profits record for the big four banks and their subsidiaries since true profits were first disclosed is shown below. There is a break in the series in 1977 as a result of changes in accounting practice (notably the treatment of deferred taxation). Dividends are shown gross until 1973, when the imputation system was introduced.

£million	Profits before tax	Profits after tax	Dividends paid
1969	210	111	43
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1972	380	225	60
1973	580	313	47
1974	449	204	50
1975	424	190	58
1976	700	332	71
1977	854	410	84
	895	550	84
1978	1084	691	102

Expressed in terms of return on capital employed (shareholders' funds and minorities for profits; shareholders' funds for dividends), the figures are as follows:-

Percentages	Profits before tax	Profits after tax	Dividends paid
1969	17.2	9.1	3.7
1970	15.6	8.6	3.6
1971	18.2	10.5	3.7
1972	21.1	12.5	3.5
1973	24.1	13.0	2.0
1974	17.2	7.8	2.0
1975	14.9	6.7	2.1
1976	21.3	10.1	2.2
1977	23.5	11.3	2.4
	22.2	13.6	2.1
1978	22.7	14.5	2.2

Deflated by the retail price index and expressed in index number form, the profits and dividends are as follows:-

1969=100	Profits before tax	Profits after tax	Dividends paid
1969	100	100	100
1970	96	100	103
1971	114	125	110
1972	145	162	112
1973	203	207	80
1974	135	116	74
1975	103	87	69
1976	146	131	72
1977	160	139	74
	168	187	74
1978	188	217	83

INFLATION AND BANK PROFITS

As with industrial and commercial companies, so with the banks the historical-cost accounting convention gives a misleading picture of true profitability.

Banks need an adequate capital base to protect depositors against the risk of loss. Although some part of the banks' capital is effectively invested in physical assets such as premises and equipment, prudence dictates that substantial amounts of "free" capital must be held in monetary assets.

This margin of free capital is continually eroded by inflation. If profits are measured in historical-cost terms, the banks must earn and retain enough profit to maintain free capital in real terms, simply in order to maintain their business in real terms. This amount must be deducted from profits when measuring the real profit which remunerates the capital employed in the business

The banks will be publishing current-cost accounting figures for the first time in respect of 1979. The amount required to maintain free capital intact in real terms is likely to be of the order of £600 million. To this must be added additional depreciation to reflect the current replacement cost of the banks' fixed assets, while the total adjustment must then be scaled down by a gearing factor to reflect the fact that some of the banks' capital resources take the form of loan capital.

The outcome is likely to be a current-cost profit before tax of the order of £1,000 million - less than two-thirds of the historical-cost figure. Current-cost profits after tax are likely to amount to less than half the historical-cost figure.

The banks' real rate of return in 1979 was adequate, but bearing in mind the cyclicality of bank profits there are anxieties that it may return to an unsatisfactory level as the cycle turns down. The banks would have shown little or no profit in current-cost terms in 1974 and 1975. They will need to do better than that over the coming years if they are to be properly placed to meet industry's financial needs when economic growth is eventually resumed.

TAXATION AND BANK PROFITS

The need for more realistic accounting conventions is now generally accepted, but - as far as the banks are concerned - no attempt has yet been made to adapt the tax system to the realities of bank profitability.

The banks maintain strongly that their profits for tax purposes should be adjusted to reflect the effect of inflation on free capital. The amounts involved are the analogy for banks of stock appreciation in industrial companies. The problems of industrial companies have been recognised by granting stock relief, but the banks have been given no corresponding relief.

Industrial companies also benefit from the availability of capital allowances on almost all their fixed assets - including industrial buildings. The banks, on the other hand, receive no tax relief at all on their principal form of fixed investment, their premises. There seems to be no justification at all for this discrimination. Discussions with the Inland Revenue have elicited no reason for it beyond sheer expediency.

Because of the growth in their leasing business, the banks do not actually pay to the Revenue the full rate of 52 per cent corporation tax: part of the tax is deferred by capital allowances on leased assets. However, the true burden of the tax is not commensurately reduced, since the benefits of these capital allowances are not enjoyed by the banks but are for the most part passed on to lessee customers by folding them into the rates that are charged.

Thus the banks' ability to engage in leasing activities is no compensation for the fact that they are taxed on their distorted historical-cost profits rather than their true profits.

BANK PROFITS IN PERSPECTIVE

Even if profits are not excessive they still seem an enormous amount of money to ordinary people. But the banks are very large businesses.

At the end of 1978 total deposits (worldwide) in the Big Four banks were nearly £70,000m. The Big Four have nearly 12,000 outlets in Britain alone and employ a quarter of a million people. Shareholders' capital employed was nearly £5,000m. In Britain, their total sterling deposits were nearly £40,000m and their sterling lending (80% of it to industry and commerce) some £23,000m; they maintain 31 million accounts for customers. The banks' total lending to British industry and commerce, both sterling and foreign currencies, including export credit under the ECGD scheme, was about £21,000m.

If they are to continue to play their key role in the economy the banks must maintain public confidence. To do this they must be adequately capitalised and earn adequate profits. Their financial strength stood them in good stead in 1974 when they were called upon to commit substantial sums to the 'lifeboat' operation.

Taking one year with another, bank profits in Britain are not high compared with other countries, particularly if allowance is made for the need to maintain free capital against a worse than average rate of inflation.

A typical example of how the income of a bank is distributed is shown in the following analysis which is based on that published by the Royal Bank of Scotland Group (which includes Williams & Glyn's as well as the Royal Bank of Scotland). The Group's total assets of about £5,000m produced a gross income in the year to end September 1979 of £524m.

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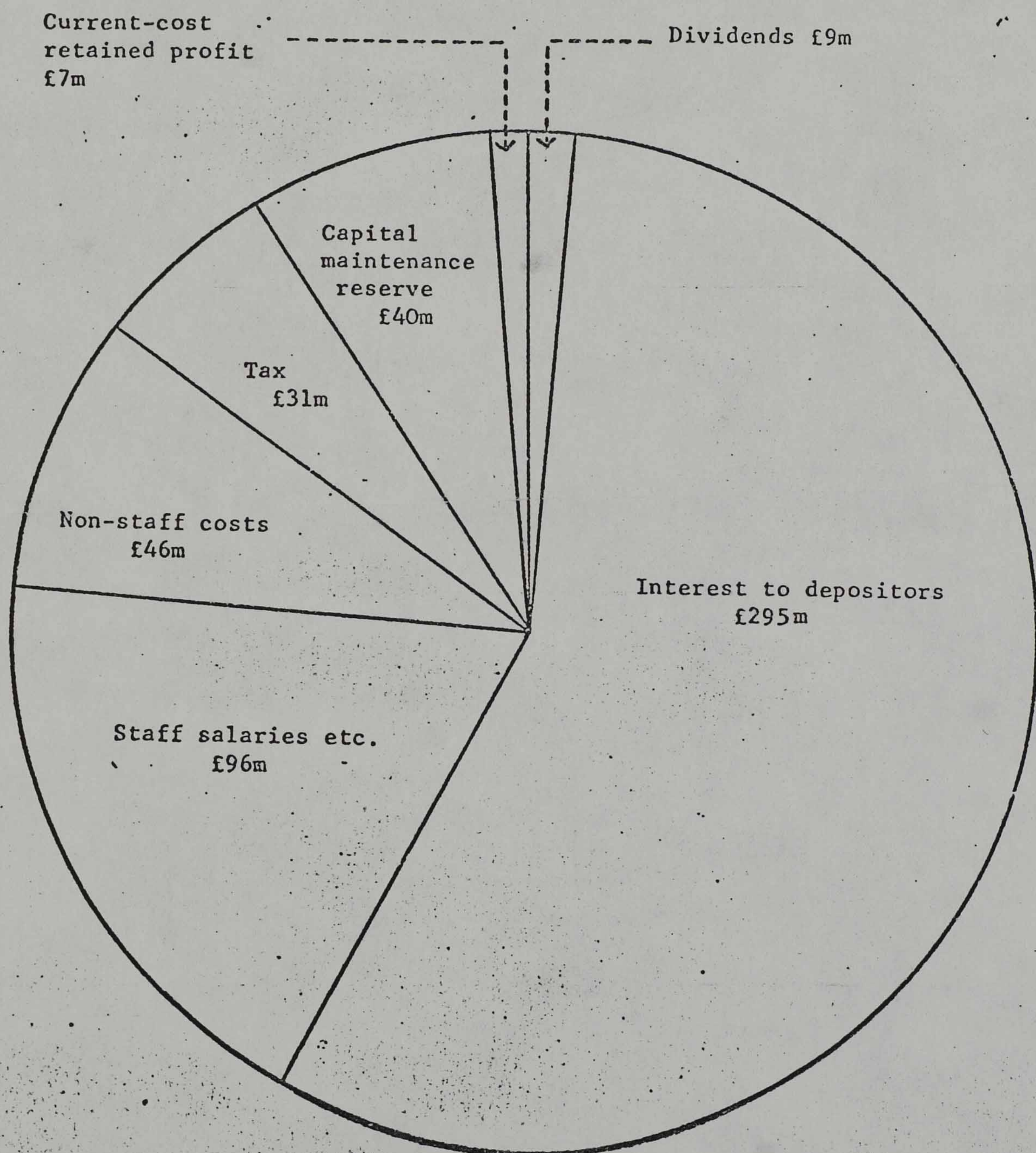

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

February 15, 1980

John Hoskyns Esq.,
10, Downing Street,
SW1

Dear Mr Hoskyns

I attach a copy of a brief on bank profits which I have sent to Treasury Ministers, and to a number of Conservative backbenchers. I thought you might also like to have a copy as the subject may come up during the Prime Minister's question time.

Yours sincerely

Brendon Sewill

Brendon Sewill

I used to be Director of the Conservative Research Department. It would be pleasant to meet you, although I realise how busy you must be. Do let me know if you are ever free for lunch.

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10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

February 18, 1980

During the coming month the banks will be announcing their 1979 profits, and it is widely expected that these will show a substantial increase.

Although these days the public are more inclined to recognise that it is better for an industry to make a profit than a loss, and although we are taking care to provide extensive press briefing, there is still the possibility that the announcements may give rise to criticism from the Opposition.

I hope we can rely on your help in rebutting any such criticism, and that the attached brief may be of use to you.

Please let me know if there is any further information you would like.

Brendon Sewill

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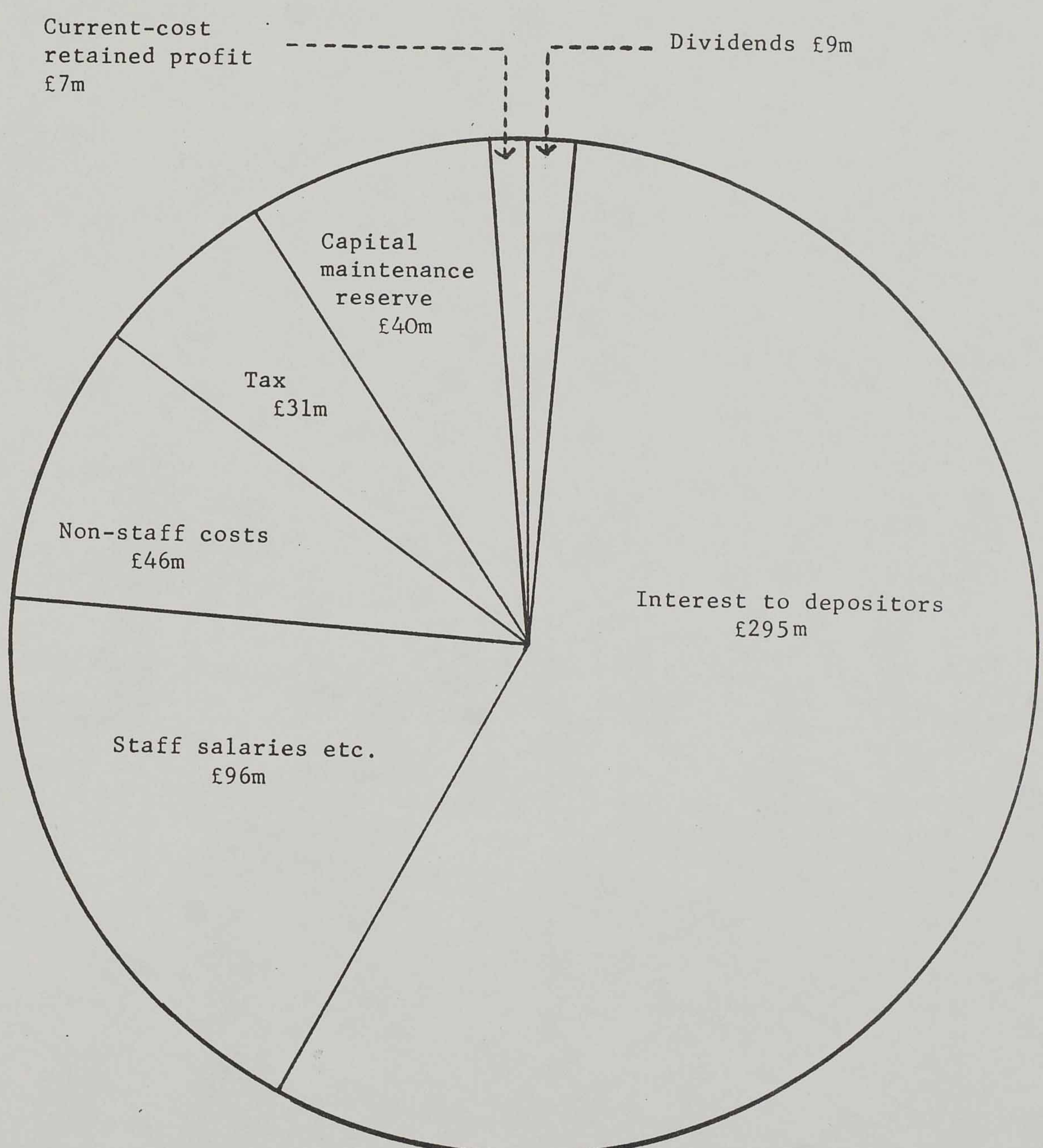
Total income £524m



CABINET OFFICE

CF - put on this file ns.

With the compliments of
The Private Secretary to the
Secretary of the Cabinet

T.P. Lankester, Esq

CF [illegible]

there is a return to taxing such profits on maturity this can [illegible]

70 Whitehall, London SW1A 2AS
Telephone 01-233 3000

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CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB, CVO

Ref: A01318

4th February 1980

NBPM

TL

4/2

Sir Arnold Weinstock spoke to Sir Robert Armstrong on the afternoon of 2nd February, to inject into official thinking a proposal which he thought worth consideration for the Chancellor's Budget. He said that he had been trying without success to get hold of the Chancellor, and was approaching Sir Robert Armstrong because he had been unable to make contact with the Chancellor and thought it important to get the proposal into the system without further delay.

The proposal related to the very considerable "windfall" profits accruing to the banks as a result of the high level of interest rates. Sir Arnold Weinstock said that, while their assets were all earning interest at today's high rates, on 30 per cent of their liabilities they were paying no interest at all. He acknowledged the difficulties on taxing the windfall profits. His proposal was that, as an alternative to taxing them, the banks should be "exhorted" to use their windfall profits in order to provide extremely favourable terms for export finance. Sir Robert Armstrong referred to the favourable rates already available as between suppliers and their customers on contracts guaranteed by ECGD, but Sir Arnold Weinstock made it clear that he was thinking a good deal more widely than that.

Sir Robert Armstrong promised to convey Sir Arnold Weinstock's proposal to the Chancellor. Hence this letter.

I am sending a copy of this letter to Tim Lankester.

D. J. WRIGHT

(D. J. Wright)

A. J. Wiggins, Esq

CONFIDENTIAL cc Master Set

NOTE FOR THE RECORD

The Chancellor called on the Prime Minister at 0900 hours this morning. The main points of their discussion are recorded in my letter and Clive Whitmore's of today's date to Tony Battishill. The Chancellor also mentioned that Treasury officials had completed a review of the possibilities of a special tax on bank profits. They had concluded that this would be extremely difficult. He agreed with this assessment; but the high level of bank profits was going to cause problems. He intended to discuss this further with the Governor shortly. He would also take up the question of re-introducing some kind of controls on bank lending. While this might not have any major effect, it might still have some symbolic use.

TL

10 January 1980

CONFIDENTIAL

CONFIDENTIAL cc CO
bc MR WOLFSON

BF ~~20~~ 22 ~~15~~/11/79

10 DOWNING STREET Econ Pol.

From the Private Secretary

14 November 1979

The Prime Minister is concerned about the current high level of bank profits which will no doubt rise still further with the rise in interest rates. She feels that these profits are, in a sense, a windfall resulting from the high level of interest rates, and her impression is that they will make the banks more likely to concede excessive pay increases for their staff this year. She also feels that there is a good case for the Government taking a larger share of these profits.

In view of the Prime Minister's comments, I would be grateful for an urgent note on what are the possibilities for changing the taxation of bank profits.

I am sending a copy of this letter to Martin Vile (Cabinet Office).

T. P. LANKESTER

KRB

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