MT

269

Confidential Filing

Prime Minister's lunches with Clearing Bankers

ECONOMIC POLICY

S
808

OCTOBER 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~17.10.79~~							
~~6.2.81~~							
2.2.83							

PREM 19/1002

Dd 533270 5M 2/73 8362633 JET

See also:

Econ Pol, Budget, Pt 4
for papers from Sir Jeremy Morse
covering 1981 Budget

SUBJECT

cc E

FILE B/c: A. Walker
B. Ingham

Econ Pol.

10 DOWNING STREET

From the Private Secretary

2 February 1983

Dear Jill,

Prime Minister's lunch with the Committee of London Clearing Bankers

The Prime Minister had lunch today with the clearing bank Chairmen. I attach a list of those present.

The Prime Minister said that domestic interest rates were too high. They were higher in real terms than they had been since 1973, notwithstanding the correct financial policies which the Government was following. She had been mortified on her return from the Falkland Islands at the rise in base rates from 10% to 11%. Nothing had been achieved by the latest rise: the exchange rate was precisely where it would have been if this rise had not occurred. It was regrettable that the clearing banks had been moved by the sentiment in the markets to raise their base rates. If they had held on for a day or so longer the pressure would have abated. The Chairmen said that the pressure was a market pressure which went much wider than the clearing banks. Mr. Bevan, replying to the Prime Minister's comment that Barclays had led the last two rises in base rates, said that they had led the last four, two up and two down; they were now depending, given the fall in current account balances, on money from the markets to a much greater degree than previously. Thus, they were market takers and not market makers. Mr. Leigh-Pemberton said that Nat West had been losing £1 billion a week through keeping their base rate out of line with money market rates. The Prime Minister said that she believed that one of the factors here was the lines of credit, or overdrafts , which British banks made available to customers. Banks in other countries did not follow this course, and it was regrettable that British banks entered into open-ended commitments of this sort. There followed a discussion about the utility to UK industry of the overdraft system, and the desirability of returning to a position where debenture finance was more readily available.

All the Chairmen said that they shared the Prime Minister's view that interest rates were too high. The higher the rates, the more they suffered from bad debts. The Prime Minister said that she had been told by several overseas bankers that there

/ would

would be resistance from British banks to a lower interest rate regime, because British banking costs had risen rapidly and because the endowment factor operated only when interest rates were above a certain level. The Chairmen demurred. They did not believe that their costs had risen disproportionately, and it was not true to say that they needed interest rates above 8% or 9% at the present time to cover their costs. The Prime Minister said that she had seen evidence from the banks themselves that their costs in running current accounts as a proportion of average current account balances had risen from 6.9% in 1975 to 8.2% now. This figure was still rising. Furthermore bank charges, similarly measured in an inflation-adjusted way, had risen sharply over the same period. Sir Jeremy Morse suggested that these figures did not take account of the reduction in total current account balances in recent years. The Prime Minister said that she was very concerned about the pay situation in the clearing banks. Pay in insurance companies, merchant banks and in the clearing banks was very high in relation to the Civil Service. and she was alarmed to hear that the Chairmen were thinking in terms of a settlement around 5%. She hoped that they would remember that the nurses had settled at 4½% in the current year, and that that had been a special case. There was every reason for a settlement well below the going rate of inflation.

On Argentina, the Chairmen thanked the Prime Minister for the position which the Government had taken. They recognised the political difficulties, but argued,on the lines of the Times Leader on Saturday, that this course was very much in the national interest. Mr. Bevan said that they had welcomed the Inland Revenue's recent letter to the banks about specific provision for bad debts. When it was suggested that this letter simply confirmed the Revenue's existing practice, which had been obscured by misleading press reports, Sir Jeremy Morse commented that the Revenue's claim to this effect was correct in letter but not in spirit. There followed a discussion about Barclays' Saturday opening initiative. The other Chairmen argued that the alternative approach, a 24 hour mechanised cash distribution/plastic card system, gave equal service to their customers. The Prime Minister commended Barclays' initiative, and said that she expected it would lead to new accounts.

I am copying this letter to Tim Allen in the Governor of the Bank of England's Office.

Yours sincerely,

Michael Scholar

Miss Jill Rutter,
H.M. Treasury.

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-283 8866

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1983

1.00 for 1.15 P.M.

The Rt.Hon.Margaret Thatcher, M.P., Prime Minister

Mr.M.C.Scholar, Private Secretary to the Prime Minister

Sir Robert Fairbairn, J.P., Chairman, Clydesdale Bank PLC

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank PLC (Chairman, Committee of London Clearing Bankers)

Mr.T.H.Bevan, Chairman, Barclays Bank PLC (Deputy Chairman, Committee of London Clearing Bankers)

Sir Jeremy Morse, K.C.M.G., Chairman, Lloyds Bank Plc

Sir Donald Barron, Chairman, Midland Bank plc

Sir George Kenyon, J.P., D.L., LL.D., Chairman, Williams & Glyn's Bank plc

Mr.J.G.Quinton, Director and Senior General Manager, Barclays Bank PLC (Chairman, Chief Executive Officers' Committee)

Mr.K.S.Lucas, Secretary-General, Committee of London Clearing Bankers

---ooOoo---

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-283 8866

A

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1983

1.00 for 1.15 P.M.

The Rt.Hon.Margaret Thatcher,M.P., Prime Minister

Mr.M.C.Scholar, Private Secretary to the Prime Minister

Sir Robert Fairbairn,J.P., Chairman, Clydesdale Bank PLC

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank PLC (Chairman, Committee of London Clearing Bankers)

Mr.T.H.Bevan, Chairman, Barclays Bank PLC (Deputy Chairman, Committee of London Clearing Bankers)

Sir Jeremy Morse,K.C.M.G., Chairman, Lloyds Bank Plc

Sir Donald Barron, Chairman, Midland Bank plc

Sir George Kenyon,J.P.,D.L.,LL.D.,Chairman,Williams & Glyn's Bank plc

Mr.J.G.Quinton,Director and Senior General Manager, Barclays Bank PLC (Chairman, Chief Executive Officers' Committee)

Mr.K.S.Lucas, Secretary-General, Committee of London Clearing Bankers

---oo0oo---

King Wm St

10 DOWNING STREET

PRIME MINISTER

I attach:

1. List of guests (Flag A)

2. Treasury brief (Flag B)

cc: Mr. Scholar

1 February 1983

B

Prime Minister

The pay brief is important. I have had the tax brief condensed (flag C)

MCS 1/2

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

Michael Scholar, Esq
No 10 Downing Street
LONDON SW1

1 February 1983

Dear Michael,

... I enclose some briefing notes for the Prime Minister's lunch with the clearing bank chairmen tomorrow - they cover the following subjects:

a. the clearers' pay negotiations (negotiations start on 3 February);

b. provisions for bad debts

i. figures for general provisions for bad debts, which appear in the accounts and include the (smaller) specific provisions relevant to tax;

ii. the Inland Revenue's recent letter to the banks about specific provision for bad debts;

c. the Chancellor's decision not to impose additional taxation on the banks in the 1983 Budget.

... I also attach background notes by the Bank of England on the clearers' activities in support of recession-hit companies, and on some international points.

Yours sincerely,

Jim Rutter

pp J O KERR

ANNEX A

CLEARERS PAY

Background

The claims by the two unions in the clearing banks are for increases of 8% in the case of the CBU and in the case of BIFU £9 a week or 10%, whichever is greater, with a minimum wage of £90 for everyone over 20. The next negotiating meeting between the clearing banks and the unions is on Friday 4 February.

2. Before Christmas the Chancellor urged the case for settlements in the financial sector close to the 3½% public expenditure provision for pay increases in 1983. The employers line will be decided on 3 February.

3. In the insurance sector offers in the range of 4 to 5% have been made by the different companies and have been rejected by the unions. One company is,however, understood to be about to implement a 4½% offer which has been accepted by one union.

4. Recent exchanges between the Chancellor, the Governor and the Chairmen of the clearers have shown that the Chairmen

a. regard an opening offer of 3½% as provocatively low; but

b. want the settlement to be 4½% or a little higher and certainly not above 5%.

Points to Make

5. a. It is essential for the economy as a whole that pay increases and settlements should fall again in this round. The fall in the exchange rate makes that even more necessary - not only fur further progress on inflation but for competitiveness and jobs.

b. Compared with a year ago the RPI increase is now down to 5.4%. This puts in perspective settlements below 5%.

c. The clearers' settlement is likely to influence pay negotiations throughout the financial sector in the rest of the year: Scottish clearers, TSBs, Finance Houses and many others. The settlement for the key clerical grades will also have an impact on the non-industrial Civil Service negotiations.

d. There are particular arguments for a settlement well below the RPI increase in the case of the clearers.

e. In recent years the banks and other institutions have made settlements which led to earnings growth in the financial sector 2-3% faster than in the economy as a whole.

f. The clearers have no recruitment or retention problems in the key clerical grades.

g. A low pay settlement would help profitability which has been depressed by lower interest rates /though this is in part being recouped through sharp increases in bank charges/ and by international debt problems. High retentions are particularly needed this year to help improve or at least maintain capital ratios.

h. wrong to undermine 4½% increase being implemented by one insurance company.

i. The clearers' settlement should be well below 5%.

Defensive

6. True that general level of settlements in the private sector seems to be about 5-6%. But clearers' settlement needs to be below that, see sub-paragraph 5e. above.

7. The NHS settlement was equivalent to 4½% from 1 April. The local authority manuals are expected to accept an offer of 4½% on 11 February. The engineering settlement was 4.8%.

ANNEX B(i)

CLEARING BANKS' BAD DEBT PROVISIONS FOR 1982

In the first half of 1982, the/general provisions* of the four main clearing banks almost doubled to £330 million from £167 million in the first half of 1981. Since then the Royal Bank of Scotland Group have published their full year's results for the year ending 30 September 1982 showing provisions of £31 million against £13 million in 1981 while Lloyds Bank International's results recorded an increase in provisions to £115 million from £44 million. Those banks whose financial year ends at the end of December 1982 will now be in the process of finalising their provisions. Confidential indications given to the Bank suggest that the charge for provisions in the second half of 1982 is likely to be higher than in the first half of the year.

Figures and August press comment attached.

* The general provisions appear in the accounts and include the (smaller) specific provisions which are relevant to tax.

BAD DEBT PROVISIONS

London Clearing Banks 1979 to 1982

	1979	1980	1981 First Half	1981 Second Half	1982 First Half[2,3] (Interim)
	£m	£m	£m	£m	£m
BARCLAYS	55	130	60	80	115
LLOYDS	11	68	24	62	62
MIDLAND	12	83	38	75	75
NATIONAL WESTMINSTER	40	120	45	(3)[1]	78
TOTAL	Whole Year 118	Whole Year 401	Half Year 167	Half Year 214	Half Year 330

NOTE 1: reflects bunched recovery of provisions from earlier years.

NOTE 2: details of provisions for second half 1982 are not yet known but are expected to be worse:

Barclays report on 7 March 1983;
Lloyds report on 18 February 1983;
Midland report on 9 March 1983
National Westminster report on 15 March 1983.

NOTE 3: Barclays, Midland and Lloyds commented that provisions had been particularly increased on foreign business (private as well as public sector); Lloyds mentioned South America especially, Midland and Barclays North America.

Banker August 1982

JK BANKS

ntensive care

High interest rates and the world ecession are blamed by all four JK clearers in reporting excep- ionally high provisions for bad and loubtful debts which have cut into rofits for the latest half-year to 30 une 1982. Barclays has suffered he worst in this respect with rovisions totalling £115·4 million, lashing profits by 15% over the ame period last year to £236·5 nillion. Midland's profits fell to 95·1 million, down by 9% on ven last year's disappointing first- alf results, after deducting a nassive £75 million charge for rovisions, over 80% of the pre-tax rofit figure.

Both Lloyds and NatWest, lthough reporting increased total rovisions, managed to raise profits rom last year, Lloyds by 10% to 193·1 million, and NatWest by ·6% to £214 million. But, lthough it was Lloyds which egistered the best profit growth, it lso showed the biggest increase in ad debt provisions at £62·1 nillion, more than double last ear's first-half figure. NatWest harged the highest provisions fter Barclays at £78 million, hough significantly only £68 nillion of this total was applied to pecific provisions compared with 138 million for Barclays (reduced o £115 million overall by ecoveries and a credit to general rovisions).

Barclays puts the blame for this startlingly high figure on its US operation where a £25 million profit in the last half of 1981 has been turned into a £23·5 million oss this half, largely through bad and doubtful debt provisions in espect of three specific (but nnamed) customers. Earnings for the international operation overall were down from £129·0 million in the second half of last year to £63·7 million in this half, due mainly to the US problems.

Midland has also been hit in the United Sates, by the poor performance of its newly acquired subsidiary Crocker National. Crocker's extensive portfolio of non-performing real-estate loans and its loss-making fixed interest rate advances have been the culprit there.

Lloyds does not break down its figures between international and domestic profits but declares that on the international side earnings were down over the previous half-year. It also suffered a £14·2 million exchange deficit on translation of foreign currency working capital largely due to the devaluation of the Argentine peso. No mention is made of any other damage suffered by the bank to its Argentine interests, though chairman Sir Jeremy Morse noted that international conditions were affecting 'both sovereign and corporate borrowers around the world'. At NatWest the international banking division held its own, increasing its contribution to overall profits from 32% to 34% compared with the same period last year.

Both Lloyds and NatWest are pleased with their domestic performance although suffering somewhat from the decline in the level of non-interest-bearing current accounts as a proportion of overall deposits. Sterling advances are up 24% at Lloyds and 14% at NatWest in the last six months while net interest income has risen by only 2·7% and 4·8% respectively over the previous half-year. The lower increase in net interest income for Lloyds, despite its big jump in advances, is indicative of the lower margin business it appears to be attracting from its competitors. Average base rates fell from 13·7% in the previous half-year to 13·4% in this, compounding the squeeze on all the bank's margins.

Midland has been hit hardest by the UK recession, particularly by poor results from its domestic subsidiaries. Hefty provisions for bad debts have been necessary at its Northern Bank group, while both Clydesdale Bank and Thomas Cook have turned in reduced profits. Sterling advances for the whole group rose only 10% in the period. At Barclays, advances rose by just under 14% and the bank showed modest growth in domestic profits from £184·7 million in the last half-year to £203·3 million this time. It too has been affected by falling interest rates, narrowing margins and increased bad debt provisions. Barclaycard has made a significantly greater contribution to group profits but Mercantile Credit has had a poor first half.

All four banks have emphasised that they are helping customers caught in the recession—'to the limits of prudence' says Barclays—and the domestic figures should be seen in this context. Barclays has over 500 medium to large customers in 'intensive care' while the Midland quotes a figure of 70 major companies. With little prospect of immediate relief to this gloomy picture, full-year results are unlikely to match last year's extraordinary growth for any of the clearers.

UK BANKS INTERIM RESULTS

Jan-June 1982, £ million	Lloyds		NatWest		Midland		Barclays	
Net interest income (% change*)	590·5	(+29·4)	704	(+18·1)	668·9	(+12·9)	915·7	(+13·5)
Pre-tax profits (% change)	193·1	(+10·5)	214	(+8·6)	95·1	(−9·0)	236·5	(−15·6)
Taxation	48·0		32		34·0		67·2	
Earnings per share (% change)	75·2p	(+0·7)	75·8p	(+3·1)	28·9p	(−31·0)	44·9p	(−23·2)
Bad debt provision (% change)	62·1	(+155·6)	78	(+73·3)	75·3	(+96·6)	115·4	(+93·3)
Current cost pre-tax profit (% change)	129·5	(+22·5)	139	(+9·4)	46·0	(+39·4)	136·5	(−14·0)

*Over the half-year to 30 June 1981

TAX TREATMENT OF COUNTRY-RISK DEBTS

The tax treatment of country-risk debts is an important consideration for the banks at this particular time of the year, as they draw up their accounts for 1982. Some concern had been expressed about the extent to which they could claim a tax deduction for"specific provisions" in respect of doubtful international debts - particularly those where the overseas governments have rescheduled the debt or interest payments and are therefore not technically in default. (This was not helped by some un-informed press comment.)

The country-risk debt issue is not a new one - countries have been in trouble both pre-war and post-war. But the scale of the problem - the number of countries in difficulty, the spread of banks concerned and the size of the amounts involved - is new.

Talks have taken place between the British Bankers' Association and the Revenue, as a result of which the Revenue sent the Association a letter on 17 January, at the Association's request, setting out the general tax principles in respect of bad or doubtful debts, and focusing on how in practice these principles apply in the special case of country-risk debts.

These principles are not new. The letter codifies the Revenue's view of the law in relation to the tax treatment of debts generally. One of the points made is that the rescheduling of a debt does not in itself necessarily preclude some writing down for tax purposes. The need for rescheduling usually indicates that the debtor is in some difficulty.

The Association has sent the letter to its members, and, in response to a Parliamentary Question from Mr Tim Smith, MP, the Revenue published it as a Statement of Practice on 25 January (copy attached). The Statement has been widely welcomed.

INLAND REVENUE
Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01–438 6692 OR 6706

25 January 1983

[3x]

COUNTRY-RISK DEBTS

In answer to a Parliamentary Question yesterday, the Minister of State at the Treasury, Mr John Wakeham MP, said that, with the agreement of the British Bankers' Association, the Inland Revenue would be publishing the text of a letter sent to the Association on 17 January 1983, indicating the principles which the Board of Inland Revenue consider appropriate in applying the tax law to the consideration of country-risk debts.

The text of the letter is included in the attached Statement of Practice (SP1/83).

Note of Editors

The letter of 17 January was written at the request of the British Bankers' Association, for the guidance of their members. It sets out the general principles which the Inland Revenue have always regarded as applying in law to the tax treatment of debts generally.

Statement of Practice

SP 1 / 83

Date 25 January 1983

INLAND REVENUE, SOMERSET HOUSE, LONDON

FURTHER COPIES OF THIS STATEMENT MAY BE OBTAINED BY CALLING AT OR WRITING TO THE PUBLIC ENQUIRY ROOM, NEW WING, SOMERSET HOUSE; STRAND, LONDON WC2R 1LB.

COUNTRY-RISK DEBTS

The following statement of the Board of Inland Revenue's practice in relation to the tax treatment of country-risk debts is contained in a letter sent to the British Bankers' Association on 17 January 1983:

"The Board confirm that, in their view, the following general principles are applicable in determining the extent to which specific provisions for country-risk debts - as for debts generally - can properly be allowed for tax purposes.

a. It is for each individual bank to decide on the amount of any specific provisions which it regards as appropriate and to justify such provisions for tax purposes.

b. Whether a specific provision can properly be allowed for any debt can be determined only in accordance with the relevant tax law and in the light of the particular circumstances of that debt, including, as regards a sovereign debt, the present and prospective ability of the debtor country to service its debts. (By a "sovereign debt" is meant a debt incurred by a government or government agency or guaranteed by a government or government agency.)

c. Subject to all other circumstances the re-scheduling of a debt, or of the interest thereon, does not of itself necessarily preclude the allowance of a specific provision in respect of that debt.

d. Where interest is overdue on a debt and the bank is taxable on an accruals basis, a provision may be allowable against that interest until such time as it is paid.

e. Any specific provision allowed for tax is subject to annual review, even if, during the year, there has been no recovery of the debt. This review will have regard, amongst other things, to any changes in the economy of the debtor country which might have a bearing on the prospects of recovering the debt.

/ f.

ANNEX C

TAX AND BANKS

Background

In the 1982 Budget the Chancellor announced several measures designed to reduce the amount of tax shelter available to the banks. He said that while these measures would help he would be giving further thought

> "to the problem of how best to ensure a sufficient contribution to tax revenues from the banking sector".

2. A report has been prepared and the Chancellor has decided that, given lower interest rates and mounting bad debts (see Annex B (ii) on loans to countries and companies in difficulties, current circumstances were inappropriate for the imposition of additional taxation on the banking sector in the 1983 Budget. The banks have not been told about this decision, though they may guess it.

Defensive Brief

"No doubt the Chancellor will make his decision known at the appropriate time."

INTERNATIONAL DEBTS

Issue

To what extent can banks claim tax relief for international loans which go sour?

Line to Take

Relief is available under the normal rules relating to the tax treatment of bad or doubtful debtors. In the case of international loans, this will normally be when a debtor country gets into actual difficulty - either defaulting completely or rescheduling its loan repayments.

Discussions have taken place between the British Bankers Association and the Inland Revenue. The Revenue have issued guidance on above lines. The banks are now understood to be happy.

worried that law & practice
where reschedule short default
always have IR - now clarified
(ill-informed Press comment)

Domestic Side

In addition to the important role the banks are playing in the international banking arena, they are being equally supportive on the domestic front in supporting UK companies in difficulties.

In recent years British industry has come to rely more and more on the banks for their outside finance, as the pressures of inflation and the high interest rates had closed off until last year the alternative of raising long-term fixed rate finance through the corporate bond market. Last year 80% of companies' external financing was provided by the banks; fifteen years ago that proportion was less than one-third. Although overdraft financing remains the predominant form of bank lending, the banks have made very positive and encouraging efforts to increase the level of their term lending to replace overdraft financing wherever practicable.

The length and depth of the current recession has confronted the banking system with problems which have required the banks to adapt many of their traditional ideas of prudential lending. And while, for instance, the aggregate average level of capital gearing remains at a tolerable level of around 30-40% for listed companies, the banks are continuing to support a significant number of companies with debt/equity ratios well in excess of these levels. The need for increased support in difficult cases is, of course, one of the reasons why the banks have substantially increased in recent months their provisions for possible bad debts.

Apart from making additional facilities available to companies which have a real prospect of recovery once demand picks-up, given the right financial support during the interim period, the banks have shown themselves able to respond with an encouraging degree of flexibility and innovativeness to the variety of problems they face. They are willing to participate constructively in discussions with other interested parties, s uch as institutional shareholders, in capital reconstructions of company balance sheets and in the right circumstances to convert part of existing debt into share capital which is of immediate benefit to companies' capital and income gearing and cash flow. The banks have also been increasingly willing to discuss and implement, in conjunction with institutional shareholders, changes where necessary to strengthen management; this development is an important part of the improvement in the banks' monitoring of their corporate customers which should play an increasingly important role in identifying problems at an early stage enabling action to be taken well in advance of a possible crisis.

A particularly good example of the banks working in close harmony with other financial institutions, and government, was in the recent formation of Sheffield Forgemasters, which brought together the forging interest of Johnson & Firth Brown and BSC. As part of this package the banks converted £5 mn of debt into convertible unsecured loan stock with a matching subscription from financial institutions and BSC, as well as converting some overdraft facilities into term loans. Another important case is Massey Ferguson where the participation of the UK banks led by Barclays alongside ECGD is a crucial part of the scheme for the reconstruction of this important international group with major UK interests.

BANK OF ENGLAND

AIDE-MEMOIRE ON INTERNATIONAL POINTS

The IMF has encouraged the international banks to play their part in finding a solution to the debt difficulties of Mexico, Brazil, Yugoslavia (and Argentina). The Bank of England and the Fed have given their support, and recognised that an increase in exposure may in certain circumstances improve the quality of existing loans - in particular where it is part of an internationally coordinated package of support and an IMF adjustment programme has been put in place.

2. The clearing banks have assumed the responsibilities between them for coordination and leadership of the London banking community under the negotiations now in progress with Mexico, Brazil, Argentina and Yugoslavia. This involves a good deal of administration. They have co operated both with the Bank of England and among themselves to share the load as follows:

Mexico: Membership of the international Advisory Group of Banks: Lloyds Bank International

Brazil: Liaison group for international overall coordination: Midland and Lloyds Bank International.

Project I new money Midland.
Project II rescheduling of 1983 maturities: Lloyds Bank International.
Project III trade-related credits: National Westminster.
Project IV interbank liabilities: Barclays.

Argentina: Member of international working group Lloyds Bank International (who, with Barclays, run domestic banks there).

Yugoslavia: Member of the Advisory Committee: Barclays Bank International

Poland: Member of the Steering Group: Barclays Bank and Lloyds Bank International

Member of the Advisory Committee: Midland

Romania: Member of the Steering Committee: Barclays Bank International and Lloyds Bank International

3. For some time the clearers have had a Sovereign Risk Committee, set up with the encouragement of the Bank of England, which meets to discuss the problem countries. While playing their part the clearers have stressed that they are willing to do so only on the principle of burden sharing. This means both a contribution from the whole banking community, the official side and international financial institutions.

4. And the burden has been shared. There are the resources provided by the IMF (and our support for an enlargement in the size of the Fund, and the enlarged GAB). Closer home, there were the HMT guarantees for the Bank of England contribution to BIS loans to Mexico ($140 million ex $925 million), Brazil ($110 million ex $1.2 billion). ECGD $150 million for Mexico. [Some bankers have sought assurances that the governments contribution to Mexico will be on all fours with theirs, with a maximum maturity of six years on new money, eight years on rescheduled loans. No commitment has been made on the terms of the ECGD facilities, and nor would it be helpful in general to do so. However the contracts which benefit will be subject to the usual terms appropriate for the individual projects, each of which will be negotiated independently. Final maturities are expected to be at least five years and could be as long as eight. Thus the terms, which are for new money, compare favourably with those of the commercial bank contribution.]

5. The Inland Revenue has written to the banks to clarify the position on tax relief, on specific provisions in respect of sovereign loans which have been rescheduled - and the banks are thought to be happy with the position.

6. The banks have now agreed to set up Ditchley II ("Institute of International Finance") and hope it will be operating from March (optimistic). Its precise role and functions remain unclear - eg how far will it operate as a clearing house for information about country risk and exposure?

7. Mexico has so far raised over $4.7 billion towards their target from international banks of $5.0 billion and Brazil nearly $4.0 billion towards $4.4 billion.

CONFIDENTIAL

Econ Pol. VL13.

SUBJECT.

cc GB/E
Mr Walters

Copied to Econ Pol, Budget Pt 4
EC Master set.

10 DOWNING STREET

From the Private Secretary

6 February 1981

Dear John,

I am sorry that I have not written earlier about the Prime Minister's lunch with the Committee of London Clearing Bankers last Monday. - 2/2/81.

The discussion ranged widely over a number of topics, including the short-term prospects for industry, recent monetary developments, and monetary control. The Prime Minister expressed concern at the continued growth of lending to the personal sector, including lending based on credit cards. The bankers pointed out a good deal of the lending to the personal sector was in fact to small businesses, and that credit card lending represented only a small proportion of it; they also pointed out that, since November, the banks had stopped advertising credit cards. On the question of lending to the corporate sector, they denied the criticism that in too many cases overdraft facilities had been made available to enable companies to finance uneconomic pay settlements; they argued that the clearers had played a positive role in preventing the recession from causing even more bankruptcies than had taken place. On the other hand, to the extent that in some cases overdraft facilities might have been excessive, it was pointed out that the clearers faced strong competition amongst themselves and from the American banks: if increased credit facilities to a particular borrower were held back, all too often another bank would step in.

/ They also

CONFIDENTIAL

They also raised the question of a possible windfall tax on bank profits. Sir Jeremy Morse said that they were strongly opposed to such a tax. They had had discussions with the Chancellor the previous autumn with a view to helping the Government reduce the PSBR by other means - namely, that they should take back some of the export credit currently being refinanced by the Government. They had not put a figure on their proposal at that time, but they were now prepared to come back to the Chancellor with a specific proposition. In response to a question from the Prime Minister, he said that he thought they would be prepared to offer to take back £1 billion.

The Prime Minister gave no indication of how the Government would move on the windfall tax proposal. She expressed interest in the proposition put forward by Sir Jeremy on refinancing, but she made it clear that the Chancellor would have to consider it carefully before taking a view.

Reply on Budget Pt 4.

Sir Jeremy has now written to the Prime Minister with a copy to the Chancellor (his letter of 2 February), and I should be grateful for advice on how the Prime Minister might respond.

I am sending a copy of this letter to the office of the Governor of the Bank of England.

Tim Lankester

A. J. Wiggins, Esq.,
H.M. Treasury.

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

TELEPHONE: 01-623 5511

2nd February, 1981

Dear Prime Minister,

We greatly enjoyed having you to lunch today, and hope that you found it worth while.

I enclose the paper we had prepared on the question of taxing bank profits. It sets out the main reasons why we think that a special tax would be both wrong and untimely. Under the latter head I would add the damaging effect that the announcement of a tax could have on our pay negotiations, as we discussed at the table. In view of the stress you laid on credit card lending, I also enclose the figures on this. You will see that the interest-bearing part of this lending increased by 24% over the past 12 months, but is still only 11% of personal, and 3% of total sterling lending.

As I have already written to the Chancellor, we recognise the problem faced by the Government in reducing the PSBR, and we would certainly like to help with it, in a way that does not impair our basic strength to the disadvantage of our customers and our shareholders. It is in this spirit that we have suggested that we might take back a substantial part of the export credit, say, £1 billion, which is at present refinanced by the Government. This would produce a considerably greater immediate benefit to the PSBR than the other proposals made to us, and although there would be a corresponding loss of benefit in later years the discounted cash-flow advantage of such an accelerated repayment would be considerable.

I am copying this letter to the Chancellor and to the Governor.

Yours sincerely,

Jeremy Morse

The Rt.Hon.Margaret Thatcher,M.P.,
Prime Minister,
10 Downing Street,
London, SW1

SECRET

LONDON CLEARING BANKS' GROUPS

CREDIT CARD DEBT

£ millions

		31.12.79	31.12.80	Change	
1.	Credit Card Debt outstanding:				
	(a) Total	892	1,120	+ 228	(+ 26%)
	(b) Interest-Bearing	652	810	+ 158	(+ 24%)
2.	Total Sterling Advances to U.K. Residents	25,491	31,080	+5,589	(+ 22%)
3.	Total Sterling Advances to Personal Sector	6,214	7,594	+1,380	(+ 22%)
4.	1(b) as % of 2	3%	3%		
	1(b) as % of 3	10%	11%		

C.L.C.B. Statistical Unit
2.2.81

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

1. First, it may help to consider the background against which calls have been made to subject the banks to some form of excess profits tax. There is no denying that the profits of the clearing banks have increased considerably in recent years to amounts which are not only large in absolute terms but also represent a high return on capital, by comparison both with the banks' own record and with the current achievements of other industries.

2. Moreover, a substantial element of these profits represents the margin earned on the banks' current account balances at a time of high interest rates. This 'endowment' or 'windfall' element results from economic circumstances and government policy rather than from the banks' own endeavours.

3. The counter-arguments considered in this note have been divided into three groups. First are those based directly on the banks' financial record. Second are those which relate to the nature of the banks' business. And third are those concerned with the practical implications of seeking to impose an excess profits tax.

THE FINANCIAL RECORD

4. The banks' main argument against an excess profits tax is that, allowing for inflation and cyclicality, their profits do not represent an excessive return on capital employed. This, they believe, is demonstrated by the two accompanying charts, which show how the profits of the 'big four' London clearing bank groups have developed since 1973, both before and after allowing for inflation, and which measure the rate of return that the banks have earned each year. As 1973 marked the previous peak in bank profitability, the charts cover a full profits cycle.

The Effects of Inflation

5. It can be seen from the first chart that historic cost profits in 1979 were $2\frac{1}{2}$ times higher than in 1973. However, it is now fully accepted that historic cost accounts give a misleading impression of the profitability of banks, as of other industries. For prudential reasons banks necessarily hold more monetary assets than monetary liabilities: that is to say, part of their capital has to be held in the form of monetary items. Measures of real profitability must therefore allow for the fact that inflation depletes the real value of these net monetary assets. This allowance is achieved by the monetary working capital adjustment made under current cost accounting.

6. As the chart shows, even current cost profits in 1979 were 83 per cent higher than in 1973. But this does not mean that profits rose by 83% in real terms. As is now widely recognised, current cost accounting does not provide an indication of the effect of general price inflation on a business as a whole. Rather, the banks' current cost profits may be regarded as a measure - in money terms, not real terms - of the surplus available for distribution as dividends or for use in expanding the business. The chart shows that the real value, or purchasing power, of that surplus in 1979 was only three-quarters of what it had been six years previously.

Cyclicality

7. To subject the banks to an excess profits tax on the basis of their recent profits alone would be rather like taxing a West End store solely on the basis of its Christmas sales period. Bank profits are inherently cyclical and, as the first chart shows, in real terms they declined to virtually nothing in 1975 - just two years after reaching their previous peak. The main explanation is of course the cyclical movement of interest rates themselves: when rates are high bank profits are high, and vice versa.

8. The endowment effect, however, is by no means the only consequence of high interest rates for bank profits, and some of the other results are far from beneficial. For instance, the banks' gilt-edged investments tend to fall in value, the profits of their finance house and leasing subsidiaries decline and the cost of holding interest-free balances at the Bank of England rises, to the competitive advantage of those banks which suffer no such requirement.

9. Perhaps more importantly, the harmful effect of high interest rates on the banks' business customers increases the incidence of bad debts. However, as these bad debts often do not show through until subsequent years, they can have the effect of exacerbating the profits cycle, rather than dampening it. And, of course, the inflationary processes which give rise to high interest rates also cause increases in the banks' operating costs which must continue to be borne when rates are low.

10. The effects of inflation and the cyclical nature of bank profits should each become even more evident when the banks' results for 1980 are published during the course of the coming weeks. Stockbrokers' estimates are almost unanimous in expecting profits to fall even in historic cost terms, let alone after allowing for inflation.

Return on Capital

11. Even after full allowance has been made for inflation and cyclicality, it might still be argued that bank profits were excessive. This is not an issue which can be resolved by looking at the figures on their own: after all, the banks' profits are large mainly because the banks are large businesses. What is more, over recent years an increasingly large

proportion of those profits has been earned in areas which are not greatly influenced by domestic interest rates - notably international and overseas banking, and domestic lending financed by interest-earning deposits. It is therefore important that the banks' profits be judged in relation to the capital employed in earning them.

12. The banks' profits could fairly be judged excessive if - in real terms and over time - they represented a rate of return on capital that was well in excess of that of industry at large. Chart 2 suggests that this is not the case. Although changes in accounting conventions prevent accurate comparisons from year to year, two conclusions are inescapable.

13. First, the rate of return that the banks earned in 1979 was lower, both before and after tax, than in the previous peak year of 1973. And secondly, between these two peak years the rate of return fell to very much lower levels. What is more, as the banks showed in their evidence to the Wilson Committee the rates of return they were earning in the mid-1970s were consistently well below those being earned by leading companies in other sectors of the economy. The comparative figures are reproduced as Table 1: it should be noted that no adjustment has been made for inflation. There is no evidence that the banks' average rate of return over the full profits cycle has been excessive by the standards of industry at large.

14. Even in the peak year of 1979, the banks' current cost rate of return was starting to decline, and 1980 results are almost bound to show a further fall. The banks naturally hope that their real profitability will not decline as steeply this time as it did in the mid-1970s. But for cyclical reasons alone, a further fall is probable, and the average return over the present profits cycle - as over previous ones - is likely to prove very much lower than in the peak years alone.

15. In conclusion, the clearing banks' financial record and prospects do not lend support to the belief that the banks' profits represent an excessive rate of return on capital once allowance is made for inflation and cyclical effects.

THE BUSINESS OF THE BANKS

16. The banks recognise that some of the arguments for an excess profits tax relate less to their financial record as such than to the nature of the business that they do. In particular, it is argued that the banks' profits are a fortuitous, or 'non-functional', by-product of government policy, and that the banking industry is uncompetitive.

Current Accounts and Money Transmission

17. The point has already been made that the banks have diversified heavily in recent years into international and other areas of activity. As a result, only a portion of the banks' total profits arise from the so-called 'endowment' effect. It is usually a minor portion and is sometimes negative. Not only are the majority of the banks' deposits interest-earning but current account balances themselves are very far from being cost-free.

18. The Price Commission reckoned that in 1977 the unrecovered costs of the banks' money transmission services were equivalent to an interest rate of 6.8 per cent on their current accounts. By the end of 1977, and in the early months of 1978, market rates of interest were actually lower than this, and the banks were accordingly paying more for their current account balances than they could earn on them in the market place. In other words the current account/money transmission part of their business was a drag on the profitability of the business as a whole. Despite increases in bank charges since then, the banks' unrecovered money transmission costs have continued to grow faster than their current account balances, and are now probably equivalent to an interest rate on these balances of about 9 per cent.

19. At the time of writing, Minimum Lending Rate and three-month interbank rate are each 14 per cent. Thus market rates have only to fall by about five percentage points for the banks' current account/money transmission business to become unprofitable again.

20. The banks would like to insulate their position more from the effects of short-term movements in interest rates, so as to avoid the risks of political attack when rates are high and of losses when they are low. But this would require them to pay explicit interest on current accounts, which would create tax problems for their customers, and to increase their charges for money transmission services to a level which more fully recovered the costs of providing them. This would meet strong customer resistance and could generate fresh political attacks.

Competition

21. To justify an excess profits tax, it should be shown not only that the banks are making excess profits but that market imperfections such as state monopoly powers, or licensing and franchising systems prevent these profits from being competed away. No such constraints operate in the banking market.

22. The clearing banks may be thought to constitute an oligopoly, but this does not prevent them from competing aggresively with one another in both price and service. Equally important, there is no sector of the banking market in which they do not face fierce competition from other institutions: for example, the National Girobank in money transmission, the TSBs in personal banking generally, the building societies in personal savings and mortgage lending, the merchant banks in corporate finance and over 250 foreign banks in corporate lending in both sterling

and foreign currencies. As a result, competition ensures that profits overall are kept within reasonable bounds - as the banks believe they have demonstrated by the analysis of their financial record.

The Banks and Industry

23. Nowhere is competition felt more keenly than in the area of industrial lending. Many of the banks' loans are at margins over the cost of funds which barely cover the inherent risks of the business. During the present recession in particular, the banks have provided extensive support to industry over and above that which their normal commercial instincts alone would have dictated. In the case of small and medium-sized businesses, this has been very largely at the initiative of the individual banks. In the case of certain major companies in financial difficulties, the banks have taken part in syndicated support operations arranged by the Bank of England. Throughout, the banks have observed the lending guidelines imposed by the authorities. In particular, they have greatly scaled down the promotion of their personal credit facilities, despite the provocation of major marketing and advertising campaigns by some of their competitors.

Capital Adequacy

24. There is no doubt that an excess profits tax would seriously impair the banks' ability to carry on supporting industry throughout the current recession. Perhaps the main reason is that it would make it much harder for the banks' capital to grow in line with the scale and riskiness of their lending business. As the Wilson Committee observed:

> "Banks have found it difficult in recent years to generate post-tax profits from which to set aside sufficient reserves to maintain historic capital ratios. The ratio of free capital to deposits over the period would, indeed, have fallen appreciably were it not for the banks' extensive recourse to the equity market."

Indeed, the banks' capital ratios deteriorated even in 1979, and are likely to decline further in the absence of substantial capital-raising exercises. The retained profits which have been added to the banks' capital base in recent years will, on past precedent, be needed to protect the banks against the threats to their profits which lie ahead.

25. The banks' need for capital to protect depositors against the risk of loss is crucial in view of the importance of maintaining confidence in the banking system. Confidence is essential on the part not only of domestic depositors but also of the international financial community if the banks are to continue to make their important contribution to the balance of payments. The Bank of England's responsibilities for ensuring that banks are adequately capitalised have now been given statutory backing by the Banking Act, and its paper entitled The Measurement of Capital indicates the nature of the requirements now being imposed.

26. If post-tax profits are inadequate to maintain capital ratios at the appropriate levels, then further capital issues will be necessary, thus raising the cost of equity finance for industrial and commercial companies. Two further points should be noted. First, the dividend increases of recent years were largely a catching-up process after long periods of control, when dividends failed to keep pace with inflation. And secondly, much of the absolute increase in the banks' profits in recent years has been the result of acquisitions which have required their own appropriate level of capital backing.

FURTHER IMPLICATIONS OF A TAX

27. The banks have sought to show that the case for an excess profits tax has not been made. There remain some further counter-arguments which relate to the practical problems of introducing a tax, and the adverse consequences of doing so.

Defining 'Excess' Profits

28. It might be thought that the volume of excess profits could be calculated easily by applying a market rate of interest to the banks' current account balances. But for reasons which have already been mentioned, this would be inequitable. In particular, the effective cost of the banks' current account balances is about 9 per cent, not zero, while much of the endowment element has already been offset in other areas of the banks' business, notably industrial lending. The problems of arriving at an equitable statutory definition of excess profits would be immense.

The Institutions Affected

29. A closely related problem is that of defining the range of institutions to which an excess profits tax should apply. It is not only the clearing banks which benefit from interest-free funds. Most other banks have some current account funds, and in some cases - notably the Giro, the TSBs and the Bank of England - the amounts involved are considerable. A tax measure limited to the clearing banks, even if legally feasible, would be grossly discriminatory.

The Case for Subsidies

30. If Government feels it should subject the banks to an excess profits tax at times of high interest rates, the banks would argue that at the very least they should be allowed to establish tax losses at times of low interest rates.

Retrospection and Discrimination

31. The banks' profits have already passed their cyclical peak. Indeed one bank - Midland - actually reported a post-tax loss in current cost terms for the first half of 1980. Any attempt to introduce an excess profits tax would inevitably be seen as a means of clawing back some of the allegedly excessive profits of previous years. In spirit if not in letter, it would be an exercise in retrospective legislation, and objectionable for that reason.

32. It would also set a highly undesirable political precedent for selecting a particular sector of the economy for special taxation solely on the basis of short-term profitability and fiscal expediency.

---oooOooo---

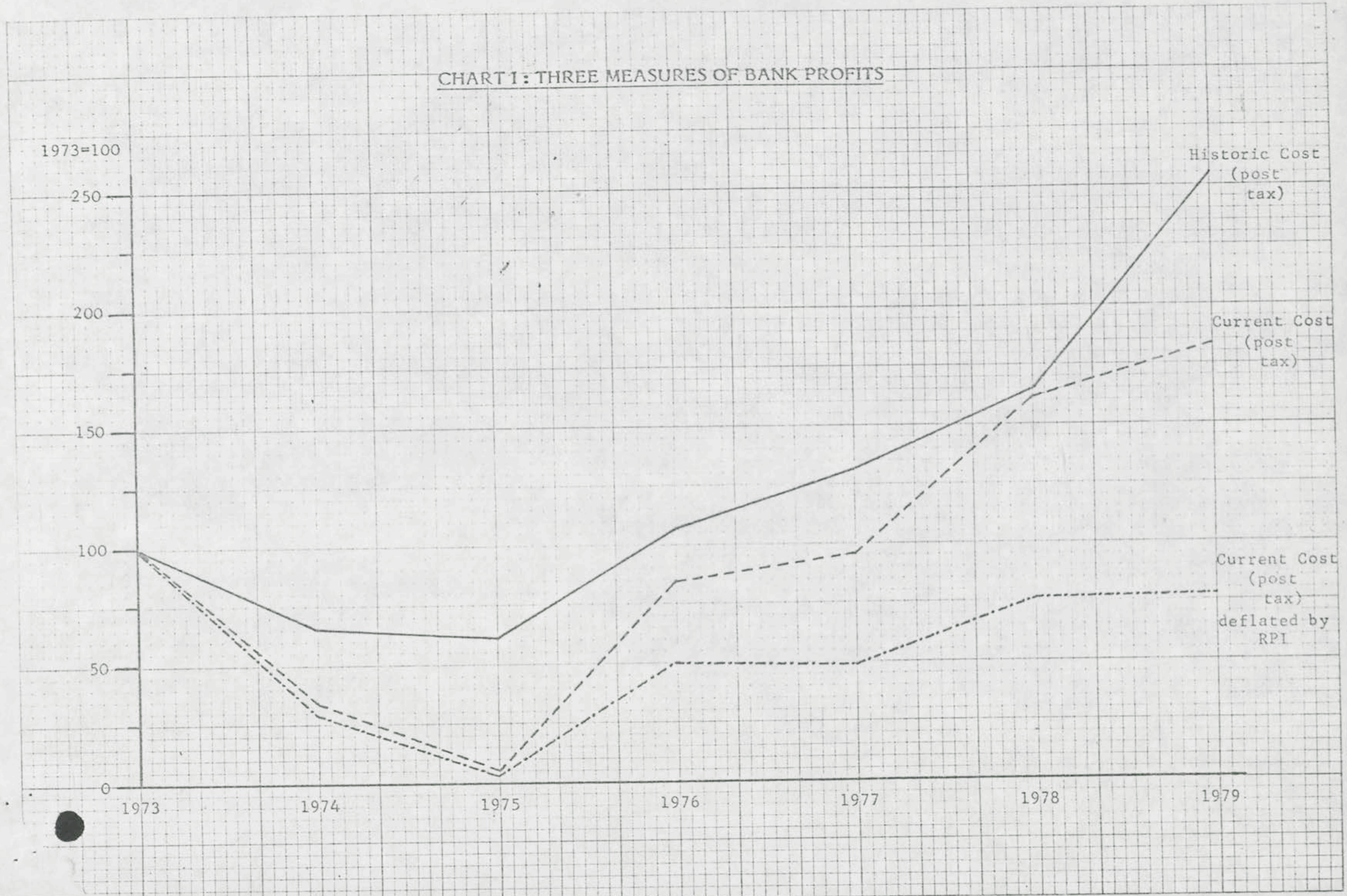


CHART 1: THREE MEASURES OF BANK PROFITS
1973=100
250
200
150
100
50
0
1973
1974
1975
1976
1977
1978
1979
Historic Cost (post tax)
Current Cost (post tax)
Current Cost (post tax) deflated by RPI

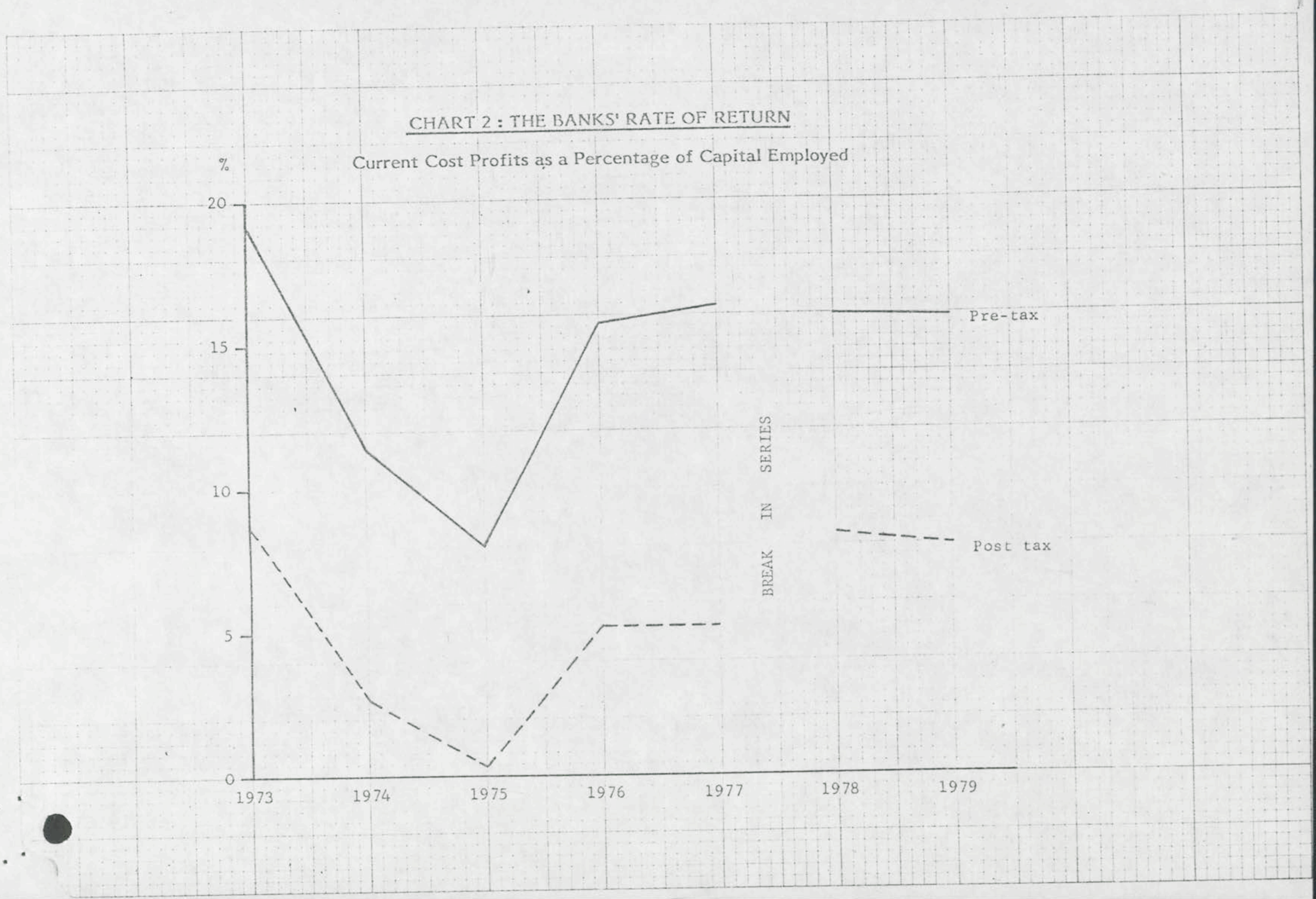


CHART 2 : THE BANKS' RATE OF RETURN
Current Cost Profits as a Percentage of Capital Employed
%
20
15
10
5
0
1973
1974
1975
1976
1977
1978
1979
BREAK IN SERIES
Pre-tax
Post tax

TABLE I : EXTRACT FROM LONDON CLEARING BANKS' EVIDENCE TO WILSON COMMITTEE

Profitability of other industries

Sample of four leading companies in each sector

Percentages		1969	1970	1971	1972	1973	1974	1975	1976
Profit before taxation **Percentage of end-year shareholders' funds plus minority interests**									
Average for sector sample	Breweries	16.7	19.3	23.5	26.1	21.5	17.1	18.6	21.4
	Building materials	14.1	15.6	27.6	28.9	32.7	17.0	24.2	25.7
	Chemicals	18.6	15.3	14.3	17.0	24.4	33.3	20.2	27.3
	Electricals	16.8	22.7	24.9	30.8	35.5	36.7	35.6	39.6
	Engineering	12.0	12.2	14.0	16.1	21.4	24.6	20.2	25.5
	Food manufacturing	18.5	18.2	21.2	26.2	26.4	27.7	28.1	33.5
	Other industrials	28.9	27.7	30.0	34.8	33.1	38.7	36.8	35.3
	Stores	35.5	36.1	40.2	40.9	38.4	31.0	31.5	35.3
	London clearing banks	17.2	15.6	18.2	21.1	24.1	17.2	14.9	21.3
Profit attributable to shareholders **Percentage of end-year shareholders' funds**									
Average for sector sample	Breweries	9.3	10.5	13.7	15.2	11.5	8.5	9.4	10.2
	Building materials	7.4	8.1	16.7	18.6	18.9	9.4	11.9	13.3
	Chemicals	11.1	8.9	8.6	10.1	13.4	16.8	10.5	13.9
	Electricals	10.4	13.0	14.9	18.7	20.8	18.0	17.6	19.3
	Engineering	6.0	6.6	7.9	9.6	11.1	12.4	10.1	13.7
	Food manufacturing	10.1	10.7	12.7	15.9	14.7	13.5	13.6	16.5
	Other industrials	15.8	15.0	17.0	19.9	18.7	20.4	18.9	17.8
	Stores	18.3	20.3	24.1	24.0	18.3	14.7	14.8	16.1
	London clearing banks	9.2	8.8	10.8	15.3	13.8	8.0	6.7	9.7

Companies sampled:		
	Breweries	Allied Breweries, Bass Charrington, Greenall Whitley, Arthur Guinness.
	Building materials	Associated Portland Cement Manufacturers, London Brick, Marley, Tarmac.
	Chemicals	Croda International, Fisons, Imperial Chemical Industries, Laporte Industries.
	Electricals	BICC, General Electric, Racal Electronics, Thorn Electrical Industries.
	Engineering	Babcock & Wilcox, Guest Keen & Nettlefolds, Hawker Siddeley, Tube Investments.
	Food manufacturing	Associated British Foods, Cadbury Schweppes, Ranks Hovis McDougall, United Biscuits.
	Other industrials	Beecham, Bowater, Metal Box, Reckitt & Colman.
	Stores	Boots, House of Fraser, Marks & Spencer, Mothercare.
	London clearing banks	Barclays Bank, Lloyds Bank, Midland Bank, National Westminster Bank.

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

Summary

* Allowing for inflation and cyclicality, the banks' profits do not represent an excessive return on capital. (Para 4)

* The banks' profits have not been enough to maintain their capital ratios - which is essential if confidence is to be maintained and the banks are to cope with future threats to their profitability. (Paras 24-26)

* The banks' profits must be judged in relation to the capital employed, taking account of their diversification into international and other areas of business. (Para 11)

* The banks earned a lower return on capital in 1979 than in 1973, and between those peak years the return fell to below those earned in other industries. The rate is now falling again. (Paras 13-15)

* The profits cycle is largely explained by the interest rate cycle, with bad debts and other costs continuing to be felt after rates have fallen. (Paras 7-9)

* Profits for 1980 are likely to show a decline even before allowing for inflation. (Para 10)

* Current cost profits have risen by very much less than historic cost profits since 1973, and the real value of the banks' distributable surplus has actually declined. (Paras 5-6)

* The banks' current accounts are far from being cost-free. Unrecovered money transmission costs mean that this part of the banks' business was loss-making for a time in 1977/78, and it would be loss-making again if interest rates fell to single figures. (Paras 17-20)

* The banks face fierce competition from one another, and from other institutions. (Paras 21-22)

* During the present recession the banks have provided exceptional support to industry and have forgone profitable opportunities in the personal lending market. (Para 23)

* The problems of arriving at an equitable definition of excess profits would be immense. (Para 28)

* To tax the clearing banks alone would ignore the interest-free funds enjoyed by other institutions. (Para 29)

* If banks are to be taxed when interest rates are high, they should at least be allowed to establish tax losses when they are low. (Para 30)

* Profits are already off their peak: indeed one bank made a current cost post-tax loss in the first half of 1980. So any tax would be retrospective, in spirit if not in letter, and would set an undesirable political precedent. (Paras 31-32)

3

SECRET

CAW

(1)

Prime Minister

Relevant to your clearing bank lunch.

The table in para 2 shows that banks' costs have, indeed, grown as a % of average credit balances; and para 4 shows the sharp increase in charges over the same period. Note that both tables - because they show percentages of credit balances - are inflation-adjusted.

MCS 1/2

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

31 January 1983

M Scholar Esq
10 Downing Street
London
SW1

Dear Michael

As requested in your letter of 20 January I enclose a note that has been prepared here on "endowment" profits.

The note itself is somewhat technical, because the subject is in fact quite complicated, but the main point which the Prime Minister may like to have in mind is the following -

(i) The 8.2% figure produced by the BBA as the average cost of current account balances should not be seen as some kind of floor so that banks automatically make losses on their current account business if market interest rates fall below this figure. This is because -

(a) current account balances tend to increase more rapidly as interest rates decline and this will in turn affect the cost figure (of 8.2%) which is expressed as a percentage of the level of current account balances;

(b) the banks will react to lower interest rates by charging more for the services provided to current account holders (and this will again affect the 8.2% figure);

(c) the banks' earnings from their investment of current account deposits are not directly proportionate to the general level of market interest rates, partly because of their fixed rate investments, and, more importantly in present circumstances, because provisions for bad debts could well be reduced as interest rates decline; and

(d) while it nevertheless remains true that endowment profits will tend to fall with interest rates, their importance is now much less than it was because current account business now accounts for less than a quarter of total domestic sterling business.

Yours sincerely
Tom Allen

T E Allen
Governor's Private Secretary

"ENDOWMENT" PROFITS

1 The "endowment" element of banks' profits is generally thought of as arising when deposits are taken by banks at no interest (or at a nominal rate of interest) and then invested at prevailing market rates of interest. In practice a number of other factors affect "endowment" profits, most importantly the costs of maintaining the branch network through which current account deposits are collected and providing related services offset in part by the direct charges made for such services. It is only when the endowment element exceeds these costs that endowment profits arise.

2 The British Banking Association's report (Review of Taxation in the Banking Sector - September 1982), referred to by the Prime Minister, quotes estimates for the costs of the four major clearing banks in operating current accounts, after deducting the banks' charges, for the years 1975 to 1981. The results are expressed as a percentage of average credit balances on current accounts.

1975	1976	1977	1978	1979	1980	1981
6.9%	7.1%	6.8%	6.2%	6.5%	8.1%	8.2%

There is a large subjective element in the basis of cost allocation. However, the figures for 1975-77 were prepared for the Price Commission and the basis of cost allocation used was accepted by the Commission. The series has simply been updated for the recent report.

3 The total costs entering into these calculations are essentially independent of the level of interest rates. However, the volume of current account credit balances, and hence the percentages in paragraph 2 above, is affected by the level of interest rates. As interest rates rise current account balances tend to grow more slowly because of the greater incentive for funds to be switched into assets bearing a full market interest rate. As a result the costs of current account deposits to the banks expressed as a percentage of the volume of such deposits will also increase as interest rates rise. A significant part of the marked cost increase in 1980 and 1981 which the figures show is attributable to this factor, with the clearing

banks' total non-interest-bearing sight deposits rising by only 3 1/4% a year in those two years, compared with 13 1/4% a year on average in the earlier years.

4 As noted earlier, the cost figures in paragraph 2 are arrived at after deducting the banks' charges for providing current account services. These charges doubled as a percentage of average current account credit balances, from 1.7% to 3.4% in the six years to 1981 and another round of increases in bank charges has just taken place. Even after the latest increases, however, some 50% of all bank customers still pay no charges at all and there is still scope for further increases. Such increases, after taking due account of the impact of competition from interest bearing forms of account, including those of building societies, will help contain the cost, and so maintain the profitability of current accounts in a lower interest rate environment.

5 On the other side, the banks' earnings from the investment of current account deposits cannot be accurately determined because the banks do not in general match particular types of deposit with particular categories of asset. At one extreme assets in the form of cash in tills (held largely to provide cash to current account holders and equivalent to some 5% of the London clearing banks' non-interest-bearing current account deposits) earns nothing; while some types of personal lending may currently earn rates in excess of 25%. Unpublished figures on the domestic operations of three of the clearing banks* show that toal interest income for 1981 expressed as a percentage of total banking assets was 14.5%; but this figure (which is arrived at before deducting the costs of managing the assets) cannot be directly set alongside the figure of 8.2% for the cost of operating current accounts in that year shown in paragraph 2 because it includes indistinguishably the banks' earnings from the investment of other, interest-bearing, deposits which are proportionately much larger and which are generally more expensive to the banks.

---

* Barclays, Lloyds and National Westminster. These three banks conduct the bulk of their international operations through separate subsidiaries. Midland's domestic and international operations are carried out through the same company.

6 Whatever the yield attributable to current account deposits, it will tend to vary directly with the level of interest rates, although this would not be true to the extent that the deposits were invested in fixed-rate assets, eg gilt-edged and much consumer credit business. Also it may well be the case that the banks' bad debt experience increases at higher levels of interest rates, and the associated provisions would need to be set against earnings.

7 For the reason given in paragraph 6 above it is not possible to estimate the size of the endowment element in the banks' total profits, but it is certainly much less important than it was because of the relative decline in current account business. Non-interest-bearing current account balances fell from 36% of the clearing banks' total sterling deposits in 1977 to 23% in 1981 and are still falling. It is almost certainly true that the endowment element in profits varies directly with interest rates, despite the contrary factors noted above, but the relationship is less straightforward than is sometimes supposed, and probably weaker than in the past. Because of the decline in the relative importance of the endowment element, it is much less clear that the clearing bank groups' total domestic profits# still vary directly with interest rates in the same way.

Bank of England
31 January 1983

One recent analysis, by stockbrokers Panmure Gordon, suggests that the relationship can be inverse. They put National Westminster's profits for 1983 at £510 million if base rates fall to 8% and £520 million if base rates fall to 6%, though this result may be influenced by an expectation of lower provisions on the lower interest rate assumption.

COVERING S E C R E T

2

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

29 January 1981

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

P.

Dear Tim,

PRIME MINISTER'S LUNCH WITH THE LONDON CLEARING BANKERS

In accordance with your letter of 19 January
... I attach briefing material prepared in different parts of the Treasury.

Yours

John

A.J. WIGGINS

BANK PROFITS AND ADDITIONAL REVENUE FROM THE BANKS

1. The big four clearing banks in 1979 announced profits of around £1½bn. Their results for the first half of 1980 disappointed analysts - with their nominal profits below the second half of 1979. Figures for 1980 will be announced in February and March and are unlikely to be better than the 1979 figures - some analysts are predicting a fall of up to 10% - which means a significant worsening in current cost accounting terms.

2. Since these profits remain high in comparison with those of industry generally, Treasury Ministers have been exploring with the clearers various schemes for securing additional revenue from the banking system. One possibility was that the clearers might agree to finance a large part of the interest rate subsidy involved in fixed rate export credit lending. The clearers have now rejected this approach.* In discussions Ministers made it clear to the clearers that the likely result - if they refused to cooperate on fixed rate lending - was some form of tax on their "windfall" profits.

*In view of their decision not to pursue the possibility of a voluntary agreement with the Govt, a meeting arranged with the Chancellor for 29 January was cancelled.

3. Work is proceeding on a one-off levy on the banks so that this is an option for the Budget. It would be based on non-interest-bearing deposits, from which the banks derive their opportunity to make "windfall" profits. Final decisions on whether to proceed with such a levy, and on its precise form, remain to be taken. The clearers' results for 1980 (which three of them will be announcing before the Budget) will be among the factors to be taken into account.

It would not be desirable to reveal to the banks at this stage that we are thinking of a one-off levy rather than a continuing tax.

4. The CLCB are likely to argue that the clearers need their large profits because of their support for industry through its present difficulties and that this constructive role is demonstrated by the large rise of both their general and specific provisions for bad debts. If this argument is used the Prime Minister is recommended to emphasize that:-

i) The clearers' profit figures - for example the £1½ bn for 1979 - are net of these provisions for general and specific bad debts;

ii) But, whatever the precise profits figures, the clearers are undoubtedly doing extremely well in relation to the rest of industry, particularly the manufacturing sector;

iii) In part the clearers' high profits are a windfall resulting from high interest rates;

iv) Inevitably, against this background, it should be no surprise to the CLCB that a special tax on banks' profits was being actively considered as an option for the Budget. The CLCB however would not expect the Prime Minister to reveal the contents of the Budget in advance.

CLEARING BANK PAY

1. The Unions representing bank employees are claiming increases of 15 to over 20 per cent. Press reports suggest that the banks are not willing to contemplate settlements of this order. Sir J Morse - Chairman of the CLCB - has told the Chancellor that the clearers are determined to get a settlement in single figures, and would be prepared to stand together against attack from their unions.

2. The Trustee Savings Banks - the first group of banks in the present payround - announced an 8% offer to the unions on 27 January - which was firmly rejected by the Banking, Insurance and Finance Union. [The clearing banks are due to respond on 29 January to the unions' claim probably with a figure in a similar range : the brief will be updated in the light of their offer]*. The risk however remains that the clearing banks will again pay more than the average, because they are exceptionally vulnerable to industrial action as relatively small numbers of computer operators can effectively paralyse many of their activities.

3. The Prime Minister will recall that in her Guildhall speech on 10 November 1980 she said "I would hope that those who gain from high interest rates... will take care to avoid leaving those who work in industry with the feeling that those who work in the financial institutions are benefiting from their misfortune". The Prime Minister, while seeking the CLCB's views on the progress of negotiations, will wish to remind the CLCB of the crucial importance of moderation in the clearers' pay settlements in leading the way for settlements in the rest of the financial sector.

* Later: the English clearers offered 8½ per cent for the year beginning 1 April 1981, and made it clear they were looking for a single figure settlement.

BANK LENDING : RECENT EVIDENCE

An analysis of bank advances and acceptances by individual category of borrowers was published by the Bank on 5 January for the period up to mid-November 1980. Broadly speaking, the figures indicated that there had been a fairly rapid deceleration in borrowing by businesses after the spring of 1980 and a less marked deceleration in borrowing by households. Nevertheless, over a period of a year, the growth rate of lending to households had not been much different from that of total lending. Lending for consumption represented about 12% of total lending (or just under 18% including house purchase).

2. Over the year to mid-November, lending to both households and in total grew by roughly 20%. This however covered a period in which an apparently faster acceleration of business borrowing compared with borrowing by consumers through 1979 was followed by a faster deceleration through 1980. This difference in behaviour has looked particularly marked since the summer of 1980 but because of data problems and seasonal factors it is not possible to be certain about its magnitude. For lending as a whole, bank counterpart data suggest that the rate of growth roughly halved between the spring and winter of 1980.

3. The apparently discrepant behaviour of company as opposed to persons' borrowing is not, in retrospect, a surprising phenomenon given the very different financial conditions which have prevailed in the two sectors. Whilst the high exchange rate and buoyant earnings kept real personal disposable incomes and hence borrowing high in 1980, they imposed a very tight squeeze on the company sector : a squeeze which was initially financed by higher borrowing (partially in foreign currencies) but eventually had to be met by heavy destocking and a labour shake-out instead. This relativity can be expected to be reversed as the deceleration in earnings and fall in employment lead to lower growth in consumer borrowing and business borrowing bottoms out with the stock cycle.

4. The latest figures we have are provisional data, for the clearers only, to mid-December. These show (unadjusted) only a small rise in lending to households and some fall to businesses in the month. The next quarterly figures, which are seasonally adjusted and provide a better sectoral split between persons as a whole and companies, will be available in a few weeks.

LOAN GUARANTEE SCHEME

Consultations with the clearing banks on the possibility of a loan guarantee scheme are now under way. No decision however has been taken on the principle of introducing a scheme. It is thus too early to say whether a scheme can be formulated or to go into much detail.

2. The current position is that officials are examining the possibility of a limited trial scheme, designed to discover whether there is a need for term loans at market rates of interest that is at present unsatisfied for reasons other than the inherent risk in projects. For instance, it is claimed that worthwhile projects have failed to secure finance because the would-be borrower was unwilling to give personal guarantees or had no track record. The intention is to plug any financing gap which may exist by stimulating some additional lending on the back of Government guarantee. It is intended that any pilot scheme should be self-financing.

3. If this subject is raised, you will wish to say the Government is considering a loan guarantee scheme as one of a number of possible measures to assist the flow of funds to small businesses. Consultations with the CLCB on such a scheme began on 29 January and you can assure the CLCB that their views on any scheme will be fully taken into account.

COMPANIES IN DIFFICULTIES - ROLE OF BANK OF ENGLAND

1. There have been a number of newspaper references to the Bank of England's role in relation to companies facing financial difficulties. The Governor in his speech to the Institute of Banks in Scotland on 19 January emphasized various points about the Bank's role:-

a) The Bank are not involved as lenders;

b) The judgement on viability remains a matter for the banks themselves. The Bank can play a useful coordinating role, for example, when several banks are involved;

c) The scale of lending in such cases is scarcely significant in relation to total bank lending or the size of monetary aggregates;

d) The Bank have not been keeping basically unviable companies alive; in this situation where some parts of the business are still good their aim has been simply to provide time to rescue these parts.

2. The CLCB are unlikely to share any illusions on the Bank's role in the case of companies in difficulties. If the matter is raised, you could draw on the above points as appropriate. You could also express appreciation for the constructive role the banks have been playing in seeing industry through its difficulties,

whilst emphasising the need for the banks to exercise restraint in bank lending.

MONETARY CONTROL

The Prime Minister will recall that changes in monetary control were announced on 24 November : I attach the relevant extract from the Chancellor's statement, and also a copy of the Bank's background note. The Prime Minister had a report on progress since then in Mr Tolkien's letter to Mr Lankester of 12 January (copy attached).

Extract from Hansard
24 November 1980
'Chancellors speech
on Economic Policy'

The Treasury and Bank of England have completed the consultations arising from the Green Paper on methods of monetary control published last March. As a result, between now and the Budget a number of improvements will be set in hand.

First, detailed consideration of new prudential arrangements for the banks will be brought to a conclusion so that the reserve asset ratio, which has complicated monetary control, can be phased out.

Secondly, the Bank of England will develop changes in its open market operations and last resort lending in ways that will allow the market a greater role in the determination of the structure of short-term interest rates.

Thirdly, we are considering the future of the clearing banks' cash ratio and also collecting and publishing an additional series for banking retail deposits. These steps are desirable in their own right. They would be consistent with a gradual evolution towards a monetary base system, and will help us to judge how far such a system would contribute towards our medium-term monetary objectives.

. Extract from

Methods of monetary control

This background note was issued by the Bank on 24 November.

1 Since publication of the Green Paper on Monetary Control[1] the Treasury and the Bank have carried out extensive consultations and discussions on proposals for a change to a system of monetary base control and also on possible improvements to operational techniques within the existing framework.

2 From the consultations on monetary base control, two main types of proposal emerged, with an important distinction drawn between:

(i) non-mandatory systems in which banks are free to choose the amount of cash balances which they hold at the Bank of England; and

(ii) mandatory systems in which banks are required to hold a specified proportion of their liabilities as cash balances at the Bank of England.

3 Present arrangements do not allow firm judgments to be made about the desirability of moving to either kind of base control. In the case of a non-mandatory arrangement, it is not known whether the cash which the banks would choose to hold would be stably related to the money supply or to nominal income over an appropriate period. A mandatory system, on the other hand, particularly if related to a broad monetary aggregate, could prove vulnerable to the diversion of monetary flows outside the controlled area. In addition, and before fully moving to either system, time would be needed for adequate information and experience to be gained about the banks' demand for cash.

4 In this context, the Chancellor has announced in the House of Commons this afternoon that a number of improvements to the present system will be set in hand. These are desirable in their own right but they would also enable more to be learnt about the properties of a monetary base system and would be consistent with further evolution in either of the directions set out in paragraph 2 above.

5 The improvements to be set in hand within the existing framework are as follows:

(i) Once consultations with the banking system regarding adequate holdings of liquid assets have been completed, and appropriate norms agreed, the reserve asset ratio will be abolished. This was foreshadowed in the Green Paper.

(ii) Further consideration will be given to the future of the $1\frac{1}{2}\%$ cash ratio currently applying only to the London clearing banks, with a view to establishing arrangements that would be equitable within the banking system, and that could enable the authorities to monitor the development of the functional demand for cash balances at the Bank of England which could ultimately be associated with a non-mandatory system of monetary base control.

(iii) Discussions will take place with the banks regarding the collection of additional statistics on retail deposits, which would provide further information on monetary conditions and could, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.

(iv) Changes will be developed in the Bank of England's methods of intervention in the money market:

(a) It is envisaged that the Bank's intervention will place a greater emphasis on open market operations and less on discount window (lender of last resort) lending. It has been decided that these operations should continue to be conducted in the bill markets rather than through the inter-bank market, and in large part through the existing intermediaries, members of the London Discount Market Association, to whom discount window facilities would remain confined.

(b) Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives. The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band. At an appropriate stage the Bank might cease to announce a minimum lending rate. These arrangements would allow market factors a greater role in determining the structure of short-term interest rates. It is accepted that this could lead to more flexible, market related, pricing of overdraft facilities.

(c) The Bank's operations would be broadly intended to offset daily cash flows between the Bank and the money markets. The present technique of creating initial shortages in the money markets which the Bank then acts to relieve would be abandoned. There would accordingly no longer be a deliberate over-issue of Treasury bills at the weekly tender.

(1) *Monetary Control* (HM Stationery Office, Cmnd. 7858).

6 The Bank will discuss the operational details of these changes with those institutions that will be affected as soon as practicable. It is intended that they will be put into effect next spring.

7 The Bank will also be putting forward proposals for changes in the institutional coverage of credit control and statistical reporting in the light of the Banking Act 1979.

8 Finally, in the light of the above changes, the Bank will examine further the possibilities of broadening the market for short-term central government debt as a means of providing greater flexibility to the government funding programme.

cc: Sir Douglas Wass
Mr. Burns
Mr. Ryrie
Mr. Middleton
Mr. Unwin
Mr. Britton
Mrs. Lomax
Mr. Monck
Mr. Turnbull
Mr. Ridley
Mr. Fforde - B/E

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

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

12 January 1981

T P Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Tim,

MONETARY CONTROL

In your letter of 22 December you asked for a progress report on developments in the system of monetary control.

... I now attach such a report. It has been agreed with the Bank of England.

Yours ever,

Richard Tolkien

R I TOLKIEN
Private Secretary

MONETARY CONTROL

1. Following the seminar on 18 November the Chancellor set out the next stages on monetary control in his statement of 24 November. This was accompanied by a background note from the Bank. Copies of the relevant parts of the Chancellor's statement and the note by the Bank are attached. These make clear that although no decision has yet been taken on monetary base control, the changes would be consistent with further moves in that direction. The notes below record the state of play on the main items.

Phasing Out the Reserve Asset Ratio

2. The RAR was reduced to 10% from 5 January. The change was well taken by the markets as being in line with Government policy. There have been no suggestions that it could result in a loss of monetary or prudential control.

3. Final abolition of the RAR depends on making sufficient progress with new arrangements for ensuring adequate liquidity for the banks so that confidence in the banking system is fully maintained. These new arrangements also have to be tied in with the proposed changes in the Bank of England's operating procedures (paragraph 7 below). The Bank are carrying their discussions on this and related technical questions further and are discussing it with the Treasury.

4. We are aiming to carry negotiations with the banking system far enough by the Budget for the RAR to be abolished without raising prudential risks.

The Cash Ratio

5. In order to clear the way for a possible move in the direction of monetary base control, the 1½% cash ratio (which applies only to the London clearing banks) also needs to be removed. This could be done without loss of monetary control but it would deprive the Bank of an important source of income. Discussions are taking place with the Bank about possible supplementary sources of income to replace what would be lost if the

banks held less of their cash reserves with the Bank.

6. It is expected that we shall be able to make recommendations before the Budget.

Money Market Management and Lender of Last Resort

7. The Bank has already started to make its operating techniques in the money markets more flexible. Discsussions are taking place between the Treasury and the Bank in order to specify more precisely the further changes described in the Bank paper for the Prime Minister's seminar. This includes the introduction of a band in which interest rates might be allowed to fluctuate. It will be important to conduct these operations so that we do gain as much experience as we can about the banks' own requirements for base money.

8. A report will be brought to Ministers so that the new arrangements, along with those already described, could be implemented at Budget time.

A New Series for Retail Deposits (M2)

9. The above changes would be enough to move, when sufficient experience has been gained, to a system of monetary base control where the base itself was targeted, and the banks were left to determine their own requirements for cash (a non-mandatory system).

10. In order to ensure that the alternative of moving to a system of monetary base control in which the authorities set the requirement for the base, is also kept open, and because it would be a useful indicator in its own right, work is in hand. The next stage is to consult the banks; this is about to take place. There are a number of complications, including the treatment of building society deposits, but it is hoped that the work will be sufficiently advanced to allow progress to be reported at Budget time, with the series introduced later in the year.

Funding

11. There are 3 issues:

a. Funding Techniques for conventional stocks. This is being discussed in a Treasury/Bank group chaired by Sir Douglas Wass. It is taking a very wide look at funding methods.

b. Widening the Market by selling more short term Government debt. Selling more short term debt is a possibility once the RAR is out of the way. The Bank are forming a small advisory group from the market to assess the practical possibilities. This will also be considered in Sir Douglas Wass' group.

c. Indexed Gilts for Pension Funds. The Financial Secretary will shortly be letting the Prime Minister have a paper for further Ministerial discussion. It will take account of the points made in the Scott Report.

General

12. A good deal of progress is being made on the issues raised at the Prime Minister's seminar. The early March Budget date means that time is extremely short, but it should be possible to report to Ministers in good time before the Budget.

IN PLACE OF CASH / MONTHLY PAYMENT OF WAGES

1. The CLCB announced, on 21 January, the formation of a Payment of Wages Working Group by the 12 major high street banks to promote the acceptance of non-cash methods of pay. The banks recognise that the task of changing the nation's pay will inevitably take a long time and that the change must remain a voluntary decision for each person. The banks are not therefore advocating any amendment to the Truck Acts which give manual workers the right to be paid in cash. At present 54% of all employees (and 78% of manual workers) are paid in cash.

2. There are undoubtedly advantages for the economy as a whole in switching to more efficient methods of payment where these are available. Cash is generally inefficient for the payment of relatively large sums, such as wages, on a regular basis and there is little doubt that a widespread switch from weekly payments in cash to monthly payments via the banks would involve substantial resource gains for the economy as a whole. The CPRS report on this question which, subject to Ministerial approval, is due to be published in the next couple of months concludes that there would be general advantage if the movement to cashless pay, and to monthly rather than weekly pay, could be made more rapid in both the private and public sector.

3. If this subject is raised, the Prime Minister could express appreciation for the work the CLCB have carried out and express the hope that the discussion document that the CPRS are intending to publish soon will stimulate further progress in this area.

ARRANGEMENTS FOR MORTGAGE INTEREST RELIEF

The Prime Minister will recall that the Financial Secretary announced during the debate on the Wilson Report on 23 January a review of the administrative arrangements governing mortgage interest relief. The Inland Revenue have written to the CLCB - as one of the bodies representing major lenders for house purchase - drawing their attention to this announcement.

If the CLCB raise this issue, the Prime Minister will wish to emphasise that the study will be concerned only with the mechanism for giving tax relief and not with the amount of the relief. Any new arrangements could only give basic rate relief at source and higher rate tax would be given separately. The CLCB can be assured that no decisions have yet been reached and their views will be fully taken into account before decisions are taken.

STUDENT LOANS

The DES are considering the replacement of all or part of the present structure of student awards with loans. In the course of this, the CLCB's comments on the possibility of their making such loans were requested on the basis of a DES/Treasury paper. (The CLCB themselves had expressed interest in such a possibility in a letter to the Education Select Committee). The CLCB provided comments at short notice so that DES Ministers could take account of them when they considered an internal report which had been prepared on the options.

2. The CLCB did not rule out the possibility of their running a student loan scheme, although naturally they laid down a number of conditions, including Government guarantees against default and compensation for any subsidised rate of interest.

3. DES Ministers have not yet come to any conclusions. When they do, the Treasury will want to be sure that the monetary policy, as well as the public expenditure, implications of their proposals are acceptable before supporting them.

4. If the matter is raised you could thank the CLCB for their quick response to the DES paper and say that DES Ministers are now looking at the options. The CLCB can be assured that if the banks' involvement is favoured, they will be consulted further.

File

10 DOWNING STREET

From the Private Secretary

19 January 1981

has arrived.

The Prime Minister is lunching with the Committee of London Clearing Bankers on 2 February. I should be grateful for a brief - to reach me by 30 January please.

I am sending a copy of this letter to Tim Allen in the Governor's Office.

T. P. LANKESTER

A. J. Wiggins, Esq.,
H.M. Treasury.

10 DOWNING STREET

MR. LANKESTER

OK - commitment

I attach a guest list for the Prime Minister's lunch with the Committee of London Clearing Bankers on 2 February.

I assume that you will be doing a meetings folder, but I am pretty certain that the Prime Minister knows all the people mentioned. But what about briefing?

Please file

15 January 1981

20/1

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1981

12.45 for 1.00 P.M.

The Rt.Hon.Margaret Thatcher,M.P., Prime Minister

Mr.T.P.Lankester, Private Secretary to the Prime Minister (Home Affairs)

Sir Michael Herries,O.B.E.,M.C.,LL.D., Chairman, The Royal Bank of Scotland Limited

Sir Jeremy Morse,K.C.M.G., Chairman, Lloyds Bank Limited (Chairman, Committee of London Clearing Bankers)

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank Limited (Deputy Chairman, Committee of London Clearing Bankers)

Sir Anthony Tuke, Chairman, Barclays Bank Limited

Sir David Barran, Chairman, Midland Bank Limited

Sir George Kenyon,D.L.,J.P., Chairman, Williams & Glyn's Bank Limited

Mr.L.W.Priestley, T.D., Secretary-General, Committee of London Clearing Bankers

--ooOoo--

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

13th January, 1981

Dear Miss Stephens,

COMMITTEE OF LONDON CLEARING BANKERS' LUNCHEON
12.45 FOR 1.00 P.M. - 2ND FEBRUARY, 1981

I refer to my Secretary's telephone conversation with you today and now have pleasure in enclosing two copies of a list of those who will be attending the above luncheon. I also enclose a small map indicating the location of these premises.

As my Secretary mentioned to you, we shall, of course, be very pleased to provide lunch for the Prime Minister's Detective and Chauffeur.

We all very much look forward to the Prime Minister's visit.

Yours sincerely,

Leslie Priestley

Miss C.Stephens,
Personal Assistant to the Prime Minister,
10 Downing Street,
London, SW1

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1981

12.45 for 1.00 P.M.

The Rt.Hon.Margaret Thatcher,M.P., Prime Minister

Mr.T.P.Lankester, Private Secretary to the Prime Minister (Home Affairs)

Sir Michael Herries,O.B.E.,M.C.,LL.D., Chairman, The Royal Bank of Scotland Limited

Sir Jeremy Morse,K.C.M.G., Chairman, Lloyds Bank Limited (Chairman, Committee of London Clearing Bankers)

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank Limited (Deputy Chairman, Committee of London Clearing Bankers)

Sir Anthony Tuke, Chairman, Barclays Bank Limited

Sir David Barran, Chairman, Midland Bank Limited

Sir George Kenyon,D.L.,J.P., Chairman, Williams & Glyn's Bank Limited

Mr.L.W.Priestley, T.D., Secretary-General, Committee of London Clearing Bankers

--ooOoo--

File SK

30 October 1980

The Prime Minister has asked me to thank you for your letter of 29 October. She was so pleased that a date has been found for her to lunch with the Committee of London Clearing Bankers.

She would like to be accompanied by one of her Private Secretaries, probably Mr. Tim Lankester but I will be confirming this at a later date. Sir Jeremy Morse's secretary very kindly said that parking and lunch could be made available for the Prime Minister's detective and driver.

C STEPHENS

Leslie Priestley, Esq.

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

29th October, 1980

Dear Prime Minister,

x 30/10

In the absence of my Chairman, Sir Jeremy Morse, who is presently visiting China, I am writing to confirm the invitation extended to you over the telephone for you to join him and the other Clearing Bank Chairmen at a Luncheon to be held here on Monday, 2nd February, 1981. I understand that you are able to accept and we all very much look forward to welcoming you on that day.

Should you wish to be accompanied, this invitation is extended to anyone of your choice.

The timing for the Luncheon will be 12.45 for 1.00 p.m.

Yours sincerely,

Leslie Priestley.

The Rt.Hon.Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
London, SW1

BF 29.10

NOTE FOR THE FILE

The Prime Minister has agreed to lunch with the Clearing Banks and they will be coming back to me shortly about a date in early 1981.

27 October 1980

10 DOWNING STREET

PRIME MINISTER

Sir Jeremy Morse would like to give a lunch for you together with all the Chairmen of the other clearing banks. I have discussed this with Tim who thinks this would be an excellent idea. They mentioned a date in November 1981.

Agree that I should see whether this can be brought forward?

Yes MT

Miss Roberts
623 5511

23 October 1980

cc Mr. Whitmore
Mr. Lankester

29/10

PRIME MINISTER

In my absence you indicated to Mike Pattison that you wished to reinstate your contacts with the City and that you would be happy to do this, as in the past, via Michael Richardson of Cazenove's.

Would you like me to contact Michael Richardson and ask for some suggestions or would you rather that it was done through the Treasury? I must point out, however, that nothing can be arranged until the beginning x/ of next year.

Wait a few weeks and I will make other enquiries M

C.P.

29 September 1980

x/ as far as Lunches are concerned.

~~COVERING SECRET~~

Prime Minister

17.10.79

Economic Policy

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

17th October, 1979

Dear Tim,

LUNCH WITH THE CLEARING BANKERS

I attach for the Prime Minister a Treasury brief for tomorrow's lunch which she is giving to the Chairman and Vice-Chairman of the CLGB.

The brief is in two parts. The first suggests some topics for discussion, and the second provides the factual background. The latter includes the money supply figures for banking September, which the Prime Minister and the Chancellor may wish to draw on. We understand that the Clearing Bank Chairmen will not be leaving before 2.30 p.m. when the figures will be published.

Yours ever,

Tony Battishill

(A.M.W. BATTISHILL)

T. Lankester, Esq.,

COVERING SECRET

COVERING SECRET

LUNCH WITH THE CHAIRMAN AND VICE CHAIRMAN OF THE CLCB
THURSDAY 18 OCTOBER 1979

Possible Topics for Discussion

A factual brief is attached on recent monetary trends, the position of the clearing banks and some other points of background information. This note suggests some points for discussion.

The General Economic Strategy

2. Ministers will presumably wish to start by underlining their commitment to control inflation by controlling the growth of the money supply, and having a series of progressively lower targets for that purpose. In particular, given that the general attitude in the City appears to be one of good will towards the overall policy, but some scepticism about whether it will be carried through, they will presumably wish to impress upon the Clearing Bank Chairman that they have the resolve to carry this through, and that, unlike some of their predecessors, they accept that this will require taking a politically unpopular decisions in particular cases, and forgoing some of the other objectives until the counter-inflation objective is achieved. (The general line of argument is that developed in the Chancellor's Mansion House Speech for that evening.)

The Need to Affect Expectations

3. Ministers will then presumably deal with the critical need to break the pernicious expectation that a high rate of inflation will be a continuing feature of the scene, and to bring it home that the Government are determined to break the circle of inflation feeding upon inflation. The banks could contribute significantly to this by bringing it home to their customers that the Government's monetary objectives mean that it will not be possible to increase bank facilities to match whatever level of wage settlements is granted. If the employers do not restrain wage increases which they grant, they will not find the finance necessary - if the banks start to give them that finance, interest rates will just have to rise to keep the money supply under control.

4. Ministers may like to ask the Clearing Bank Chairman how they think that they could best get this message across to their customers. Ideally, one would like the clearing banks to discriminate, granting increased facilities to those employers who had resisted wage claims, riding out a strike if necessary, but not granting facilities to those who have granted them. However, this is probably impracticable. However the message does need to be got across that money will not be available without limit, and that if the demand for it goes up beyond what can be accommodated within the monetary target, interest rates will have to rise to choke it off.

The Clearers' Lending Policies

5. There is some circumstantial evidence that the clearers are not taking monetary restraint very seriously. It may be that most of the increase in personal lending recently has been increased utilization of existing facilities, but one suspects not. The clearing banks still seem to be marketing personal lending, and at least one of the bank credit card companies has increased the credit limits for virtually all its customers. Ministers may like to ask the Clearing Bank Chairmen how they reconcile this with the directional guidance that personal lending should be constrained in order to allow room for lending to priority categories, such as manufacturing. Similarly, ~~it would~~ appear that the clearing banks have been using acceptances as a way round the SSD scheme, in particular as a way of providing finance to their finance house and leasing subsidiaries. Ministers might like to make the point that monetary control ought not to be considered as a game betweem the authorities and the banks, with the latter considering how they can get round the rules. In assessing monetary conditions, and the appropriate interest rates, the authorities have to look at both the published £M3 statistic, and the amount of evasion. Therefore, to the extent that the clearing banks failed to take what measures they could to restrain lending, but instead resorted to evasion, the higher interest rates needed to be. It is hardly helping the clearing banks' customers to force the Government to either raise interest rates, or to maintain interest rates at their present level longer than would otherwise have been necessary.

Bank Profits

6. As the factual brief brings out, the clearing banks have declared high profits for the first half of this year, and it is likely that they will be high again in the second half, because of the "endowment income" which the clearing banks earn on current account when interest rates are high. There is a risk that if the banks declare high profits for the second half of the year, this will bring criticism on the Government for adopting high interest rates which favour the banks. Ministers might express the hope that the clearing banks would show some sensitivity when the time comes to declare profits next February.

7. Lloyds increase in charges for current accounts, which was announced at the beginning of this week, singularly failed to show such sensitivity. It is rumoured that the other banks are also about to increase their charges. The apparent reason for the increase in charges is that the clearing banks are guarding themselves against the position in which interest rates generally are lower and they therefore get less "endowment income" on their current accounts. While it is entirely reasonable for the clearing banks to look forward to the situation of lower interest rates, and how they will finance the operation of their branch network when that happens, it seems unnecessary to increase their charges now, ahead of the fall in interest rates, ~~than~~ and when they are making substantial profits.

SECRET

(until 2.30pm Thursday 18 October)

FACTUAL BRIEF

Contents:

SECRET

GENERAL MONETARY SITUATION

1. Recent Monetary Growth

£bn seasonally adjusted

Banking Months

	Average April to June	July	August	September
CGBR	+ 1.2	+0.8	+0.3	+ 1.6
Purchases of central government debt by non-bank private sector (increase:-)	- 1.1	-0.8	-0.2	- 1.0
Other public sector	-	+0.1	+0.2	+ 0.1
Sterling bank lending				
to private sector	+ 0.8	+0.4	+0.7	+ 0.2
to overseas	-	-	+0.1	-
DCE	+ 0.9	+0.4	+1.1	+ 0.9
External and foreign currency finance adjustment	- 0.1	-	-0.4	- 0.5
Net non-deposit liabilities, etc	- 0.1	-	-0.1	- 0.1
Change in £M3	+ 0.7	+0.4	+0.5	+ 0.3
(Percentage)	(+ 1.4)	(+0.8)	(+1.0)	(+ 0.6)
(% at an annual rate in target period mid-June 1979 to mid-April 1980)			(+11.6)	(+10.3)

Memo item

	Average April to June	July	August	September
Change in acceptances held by non-banks	+ 0.1	+0.1	+0.3	+ 0.2

2. Banking September

   i. £M3 growth (at annual rate) back within the target range.

   ii. High CGBR as expected; only two thirds financed by sales of debt to non-banks. External factors were contractionary.

   iii. Much smaller increase in bank lending, but published figure understates underlying trend. Underlying figure about £600-£700 million, compared with about £1 billion in recent months.

3. Monetary Target

   i. Current target: 7-11% (annual rate) for 10 months mid-June 1979 to mid-April 1980: equivalent to 10% in year to mid-April 1980.

   ii. Target to be rolled forward to cover 12 months to mid-October 1980: an announcement might best be made in mid-November.

   iii. Decision on whether to roll forward SSD scheme, and if so with what guideline, might be announced at the same time.

4. Interest Rates

Short term rates have changes very little since the Budget. Main rates currently are:

MLR - 14%
Clearing Banks' Base Rate - 14% (ie 15% for prime borrowers)
3 month inter-bank - $13\frac{7}{8}$%

SECRET

THE CLEARERS' POSITION

1. Bank Lending

Clearing bank advances have been accounting for about half the increase in bank lending.

£ billion

	Banking Months			
	Average April to June	July	August	September
Not seasonally adjusted:				
Clearers' advances	+0.4	+0.8	+0.1	-0.3
Other bank lending*	+0.4	+0.3	-	+0.4
TOTAL	+0.8	+1.1	+0.1	+0.1
Seasonally adjusted:				
TOTAL	+0.8	+0.4	+0.7	+0.2

(* includes lending by clearers other than by advances.)

In banking September, relative structure of interest rates on make-up day encouraged borrowers to reduce their overdrafts with the clearers and to increase their market borrowing.

2. Sectoral Split

The sectoral breakdown of the clearers' advances has been:

£m unadjusted

	Banking Months				
	Average April to June	July	August	September	Percentage increase over last 12 months
Advances					
manufacturing	+ 88	+246	+ 74	-328	+22
personal	+152	+130	+ 62	+120	+28
other	+177	+428	+ 13	-108	+21
TOTAL	+417	+804	+149	-316	+23

Advances to the personal sector (which include credit card lending) continued to grow strongly, though more slowly than earlier in the year. Advances to manufacturing fell sharply in banking September; the engineering strike may have reduced borrowing from banks as stocks were run down.

3. Directional Guidance

The banks, including the clearers, have for the last 5 years been requested to give priority to finance required by manufacturing industry, for exports and for the saving of imports, and "in order to ensure their future ability to meet those [priority] requirements"to exercise restraint on other lending, particularly lending and the granting of facilities to persons, to property companies and for purely financial transactions.

4. The SSD Scheme

SSD scheme pressure was less severe in banking September than recently and the London clearing banks were all within the penalty free limit. Some of the clearers did incur penalties in the previous two months. The clearers have taken advantage recently of the acceptance leak to avoid the corset: they do not normally accept many bills, but they have more than tripled the amount in the last year. Anecdote suggests that much of this has been to replace direct lending to their finance house and leasing subsidiaries.

The clearers have been dissatisfied with the SSD scheme. A committee of their economists under Professor Harold Rose (Barclays) has prepared a report on the scheme and possible successors. Their report is still being considered within the CLCB, before being put to the Bank.

SECRET

OTHER ISSUES

1. Bank Profits

The main clearers announced interim results at the end of July.

Group pre-tax profits

	1976	1977	1978	First half 1979
Lloyds	148*	166	182	123
Nat West	188*	238	297	221
Barclays	198	295	373	244
Midland	167	197	231	138

* Not strictly comparable with other figures in the table.

These figures are not adjusted for inflation, and in recent years greater part of profits taken to reserves to maintain capital adequacy. Bank profits are extremely dependent on interest rates (because no interest is paid on current accounts); this means that large second half profits are expected.

2. Banking Act

i. Most parts of Banking Act came into operation on 1 October 1979.

ii. Existing organizations have to apply to be recognised as banks or licensed deposit takers by 1 April 1980.

iii. A deposit protection fund will come into existence in 6 months (no definite date).

iv. Late amendments to the Bill met most of clearers' points, but they may mention:

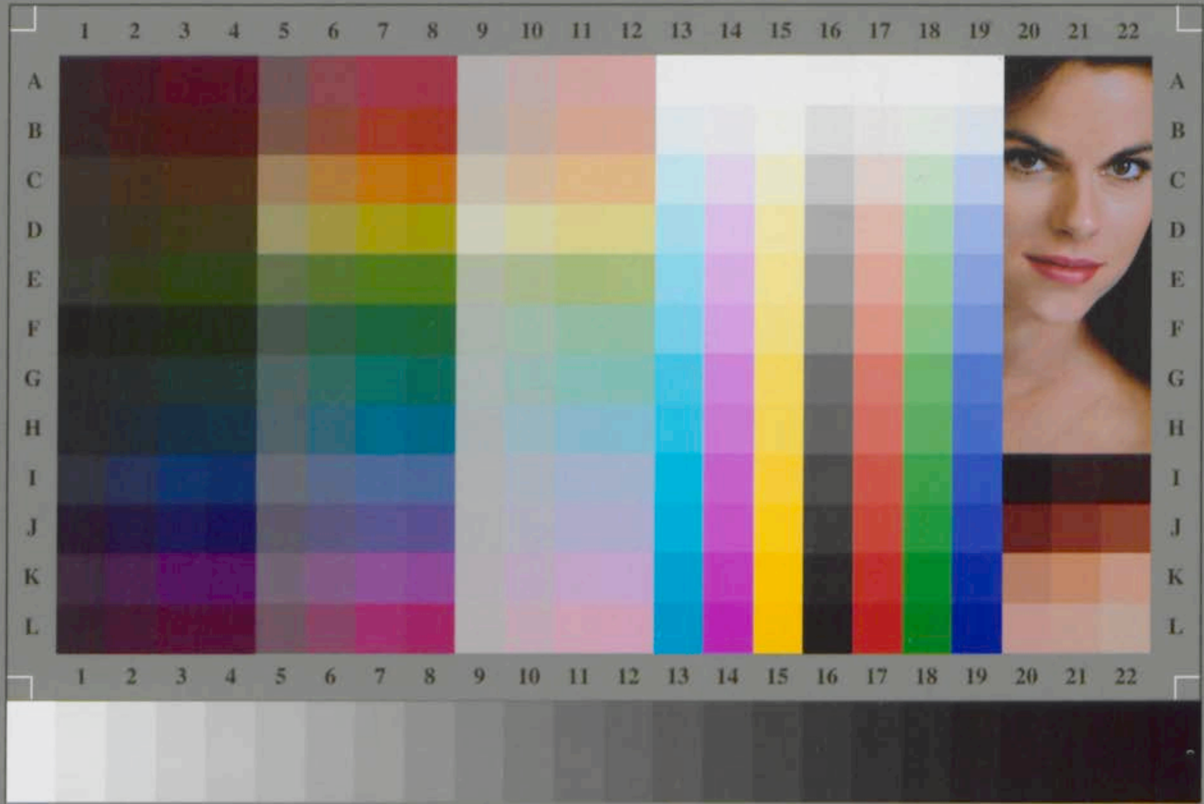
a. the Deposit Protection Scheme, which they feel it is unfair for them to have to subsidize;

b. their finance house subsidiaries, which are looking for recognition as banks. This is entirely a matter for the Bank of England.

3. <u>Export Credit</u>

The Government is proposing some changes in fixed rate sterling financing scheme to reduce public expenditure. Banks are not aware of detailed proposals, although a meeting of officials has been arranged with their representatives. At this stage Ministers need only express hope that banks will respond helpfully to proposals that would reduce public expenditure.

KODAK Q-60 Color Input Target



IT8.7/2-1993
2007:03

FTP://FTP.KODAK.COM/GASTDS/Q60DATA

Q-60R2 Target for
KODAK
Professional Papers