

cc Mr Ingham

CONFIDENTIAL

Prime Minister

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

22nd February 1980

Dear Richard,

BANK PROFITS

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

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

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

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

yours sincerely
John Wiggins

A.J. WIGGINS
(Private Secretary)

R. Prescott Esq.

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BRIEF FOR MINISTERS

BANK PROFITS

General

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

Apparent and real profits

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

Cyclical characteristic of bank profits

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

Finance for industry

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

Confidence in the banking system

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

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

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

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