SECRET

27.6.79

MR. FFORDE

Copies to: Mr.Dow
The Chief Cashier
Mr.Walker
Mr.Goodhart
Mr.George
Mr.Wiles
Mr.Elston

The Building Societies' Mortgage Rate

1. The Governor is to attend a meeting called by the Prime Minister next Wednesday, 4th July, to consider what to do about mortgage rates, ahead of the JAC meeting on 5th July, and the BSA Council meeting on 13th July at which decisions on the recommended share and mortgage rates will be taken.

2. At present the share rate is 8% net of tax which, grossed up at the new standard income tax rate of 30%, gives an effective rate of 11.43%. On the usual comparison with the three-month local authority rate, this leaves an unfavourable competitive differential of about 2½%. The present mortgage rate is 11¾%.

3. In the absence of a rise in their share rates, or a fall in competing rates, societies' net inflows must be expected to fall to £200 million* a month or less compared with an average of about £300 million in the first five months of the year. This would in two or three months drive the average liquidity ratio, now 17½% seasonally adjusted, down to 17% - a ratio which most societies would regard as a practical minimum, though some larger societies might be prepared to go lower. So societies would have to cut back their lending - perhaps to under £600 million a month compared to over £700 million a month so far this year.

4. If the BSA Council are left to their own devices, and see no signs of a fall in competing rates, they seem likely - though given their capacity for procrastination, not certain - to wish to increase their recommended rates at their July meeting, rather than postpone a decision until their next scheduled meeting, which is not till September. Their choice would seem to be between a partial restoration of their competitive position before the increase in MLR to 14% - taking the gross share rate and the mortgage rate to, say, 13% each - or a full restoration - taking them each to 14%.

*This estimate (which is of net receipts before adding interest credited of about £170 million a month) may indeed be over-optimistic. Weekly figures for the last two weeks show net withdrawals of funds, and only part of this seems attributable to a last surge of spending before the increase in VAT.

5. The Government may wish to consider a variety of devices by which societies could be enabled to maintain their lending without increasing mortgage rates. The attached annex to a DoE paper lists and discusses such possible devices. The three most likely candidates appear to be:-

(i) An interest rate subsidy of say 2%, allowing societies to increase their share rate but not their mortgage rate - this might cost about £50 million a month. (In April 1973 such a grant, of £15 million, was paid to societies to allow them to hold mortgage rates to 9½% rather than 10% for three months.)

(ii) A short-term loan to maintain inflows without increasing either the share or mortgage rates. The last Government lent £500 million for this purpose in tranches of £100 million a month for five months beginning in April 1974. Similar loans now would probably need to total more than £500 million.

(iii) Borrowing by societies from the money markets.

Of these the first two would be open to the obvious objection that they would increase the PSBR. Borrowing from the money markets would be very difficult to organise quickly, would be unwelcome to societies (because it would mean paying higher rates than those paid to their ordinary investors), and would put extra pressure on short-term interest rates.

6. In addition to these objections to the alternatives, there are strong arguments in favour of allowing the BSA to increase their rates.

(a) High interest rates generally are necessary to keep the growth of sterling M3 on course. A rise in building society rates would also be helpful to that objective because societies would be likely to use part of their increased inflows to acquire public sector debt rather than, as now, running down their holdings. Subsidies or loans increasing the PSBR would be particularly unhelpful to monetary policy objectives.

(b) A rise in mortgage rates would have a desirable dampening effect on inflation in house prices - which has been continuing at a recent rate of 1½-2% a month.

(c) Admittedly that dampening effect would be reduced - as would the increased real burden on borrowers - by the tax relief on mortgage interest. But this underlines the futility of fuelling mortgage demand by tax reliefs - to a cost to the Exchequer in 1978/79 of £1.1 billion.

7. The Governor may wish to be reminded of Mrs.Thatchers' pledge when opposition spokesman for the Environment in the election campaign of October 1974 that the mortgage rate (then 11%) would be reduced to 9½% by Christmas. No such commitment, however, was made in the last election.

Economic Intelligence Department,
27th June 1979.

M.E.Hewitt (4391)

MEH

ANNEX G

ALTERNATIVES TO MORTGAGE RATE INCREASES

1. This note reviews the ways in which it might be open for the Government to persuade societies not to put up mortgage rates.

The Possible Types of Measure

2. There are two groups of measures. There are first those which are primarily directed to enabling societies to maintain sufficient competitiveness in the market to avoid the net outflow situation without raising the mortgage rate. The second group are ways of providing societies with additional funds, whether from the Government or from other types of investor - they would deal with inadequacies of funds for lending but would not really remove the risk of net outflow of conventional funds undermining confidence.

Rise in share rates, not mortgage rates

Interest Rate Subsidy

3. An interest rate subsidy of say 2% would be the simplest and most direct method of enabling societies to vary their share rates as they would now wish, but to avoid an increase in mortgage rates. There is a precedent for such a subsidy. In April 1973, following a period of rising interest rates, the BSA increased its investment rate from 6.3% to 6.75%. The BSA also increased the mortgage rate from 8.5% to 9.5%, but were persuaded not to go to 10% by a government "bridging grant", which lasted for 3 months. This grant - which cost £15 million - was an essentially short-term measure. It also proved to be ineffective because competing rates of interest rose during the summer, and the mortgage rate rose to 11% in September.

4 A direct subsidy of 2% for 6 months would cost about £280M given over £29,000 million of mortgage debt. The expenditure would have to be found from the Contingencies Fund in the first instance, and would need, in due course, to be authorised by a Supplemntary Estimate and Consolidated Fund Bill.

Societies' Operating at a Loss

5. The last Administration's Housing Green Paper floated the idea of societies adopting a more flexible relationship between the rate paid by mortgagors and the rate paid by investors, by varying the latter more frequently, or to a greater extent, or both. It accepted that this would involve societies making higher surpluses than normal at some periods, and losses in others.

6. All but one of the largest 18 societies has reserves more than 1% higher than the minimum required for trustee status (the average is 3.5% compared with 1.6%). It could therefore be argued that they could well

...ord a ½% per annum loss for, say, 4 or 6 months. But societies ... in practice never run deliberately at a loss in this way before, ... would certainly argue that these are untried waters as far as ...eties are concerned and they would strongly insist that the first ...lication of this approach should not be on this scale. They would ...tainly be apprehensive of loss of confidence if they started to show ...tial losses in their annual reports, and before that if the Press ...icted that they would do so, even if backed by Government guarantee, ...ch of course would need legislation.

B Alternative sources of finance

a. Short-term money markets

7. The last Administration's Green Paper included a proposal, which had already been aired with societies, that when funds from normal sources were lost through general rises in interest rates the societies should be prepared to raise short term loans on the money markets. The purpose of the loans would be to meet short term deficiencies. The Green Paper argued that in certain circumstances this would be cheaper than raising interest rates across the board to all investors in the normal way.

8. The money would be borrowed, probably, for 3 months, at the ruling money market rates. If societies' competitive position had not improved in 3 months time, it would have to be rolled forward at the rates then ruling. At present the societies might need to pay /9½/ for wholesale money for 3 months. Societies' margins are currently such that they would be able to afford to secure a modest proportion of their funds in this way.

9. There has been some preliminary discussions of this idea with societies. Most societies seem reluctant, partly because they see paying a higher rate to a particular class of large investor as cutting across the traditional mutual principles of societies with all investors being offered the same terms for money for comparable periods. If this reluctance could be overcome, this approach would provide a useful supplementary source of finance. But the scale would be limited, by the number of societies who would have the technical competence to do this, by the limited proportion of its total funds which a society could prudently take from such a volatile source, and by the capacity of the money markets to provide such funds without forcing up rates significantly.

10. This scheme therefore appears to be one which is worth pursuing again with societies as a way of giving a modest alleviation of any shortage of funds which may develop later this year rather than as an answer to their fear that they may run their liquidity down too quickly if they do not raise their interest rates somewhat. But there is such pressure on the wholesale money market at the present time that it is not a runner; and in any event it would be impossible to float a scheme quickly in which all societies would participate.

b. A short term Government loan

11. The Government could make available short term block loans which the societies could use while inflow remains inadequate to sustain present liquidity, and the planned lending levels.

12. The last Administration's loan of £500 million began in May 1974. At that time the mortgage rate was already 11%. The average interest rates differential was minus 5%. Liquidity had dropped to 14.5%. There was a mortgage famine - commitments were running at 27,000 a month. The Government offer was made in response to a threat by the BSA to raise rates to 13%. It consisted of 5 monthly tranches of £100 million on which the BSA paid interest at their share rate: the difference between that and the Government borrowing rates was concealed by the Government. The Bank provided the first £100 million until the necessary legislation - a Supplementary Estimate and Consolidated Fund Bill - could be passed. Repayment was geared to inflow over the subsequent months.

13. A comparable operation would certainly involve short-term loans nearer £1,000M than £500M. There could be no guarantee that competing rates would drop sufficiently to ensure that the loans were paid back in the current financial year, so there would be a public expenditure bill as well as additions to the PSBR. And the societies would be very reluctant to become embroiled once again in a Government scheme of this character since they believe it limits their independence.

c. Persuading societies to make greater use of their liquidity

14. It is certainly arguable that societies tend to be too cautious about the extent to which they run down their liquidity, and that they could weather a low level of inflows (but not necessarily outflows because of the confidence factor) for longer than they concede: until a few years ago, societies intended to regard 14-16% as their norm for liquidity, rather than 17%. Societies justify this upward shift by

pointing to the greater variability in markets: they accept that on occasion their liquidity will fall significantly below 17% because of unforeseen events but they think it wrong to budget for it to do so.

15. A Government guarantee might be offered, convertible into a cash loan from Government if societies got into difficulties as a result of running down liquidity further than they would otherwise have done. But (i) this would involve legislation, (ii) it would involve societies in selling gilts etc and aggravating the Government's task in funding the PSBR, and (iii) it would be difficult if not impossible to persuade the societies to accept such an arrangement.

Other Matters

16. One other possibility is temporarily to widen the priority categories of borrower for local authority lending to include all first-time buyers of new houses. [Such a move was made in 1975] But local authority lending is severely constrained to about £180M in 1979/80. Much will already be committed. So even a small programme of special lending - say on 5,000 new houses - would involve an increase in public expenditure of at least £50M.

4F

RELATIONSHIP BETWEEN RATE STRUCTURES, INFLOW AND LIQUIDITY FOR LENDING AT £720m A MONTH (INCLUDING PERIPHERALS)

	'Net' Share Rate %	Grossed-up Share Rate %	Differential Interest Rate[1] %	Average Corresponding Net Inflow £m/month	Mortgage Rate %	Forecast Liquidity Ratio (End Period) % Seasonally Adjusted[2]	
						Q3	Q4
Present Position	8	11.43	- 2.57	205	11.75	16.8	16.6
Pre Budget Position	8	11.94	NIL	330	11.75	17.7	18.1
Assumed[2] Increase in Rate Structure	9.1	13.0	- 1.0	280	13.0%	17.3	17.5
Assumed Increase in Rate Structure	9.8	14.0	NIL	330	14%	17.7	18;1

(1) Grossed up building society rate less local authority 3 month deposit rate 14%

(2) Assume composite tax at 19.5%. A rate of 20.5% would add about 0.2% to Mortgage Rates.

29.6.79.

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THE GOVERNORS' PRIVATE SECRETARY

Copies to: Mr.Fforde
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Mr.Goodhart
Mr.George
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Mr.Elston

Mortgage Rates

1. The Governor will have seen my note of 27th June on this subject. C.A.E.G. tells me, however, that he may wish to have the following further information.

2. House prices have risen in the 12 months to April by 30%. There is no sign yet of a deceleration.

3. Private housing starts rose in 1978 to 157,000 from 135,000 in 1977; but are currently expected to fall back again this year, perhaps within a range of 135,000-150,000. Builders claim that they are constrained by shortgage of land as much as, if not more than, by shortgage of finance; nevertheless, a reduction in building society lending would probably undo any beneficial effects on supply which came from the Government's intended policy of relaxing restrictions on development.

4. In the first five months of the year, with little or no differential either in their favour or against them, building societies were obtaining new inflows at about £300 million a month. This, together with their other less variable sources of funds (interest credited to accounts and mortgage repayments) and some gradual running down of liquidity, enabled them to make lending commitments of about £730 million a month.

5. As a result mainly of the 2% rise in MLR, but also of the reduction in the standard rate of income tax, the differential is about 2½% against them. Inflows in June are expected to reach only about £120 million, and there have been net withdrawals in the last two weeks. Some of this fall in receipts is probably due to the surge of Budget-induced spending in the first half of the month. But it seems unlikely that receipts will rise much above £200 million in July and they would be as low as £100 million. £150 million might be a reasonable forecast.

6. To maintain lending commitments at their recent size, with the short-term interest rates that go with a 14% MLR, societies would probably need to raise their share rate to 9¾% (giving a gross effective rate of just under 14%). Since they have some room to compress their margins, this would probably entail a mortgage rate of 13¾% or, perhaps, 13½% rather than 14%.

7. If market rates fell by 1% (with an MLR of 13%), societies could maintain their recent rate of lending commitments, at the expense even then of some further erosion of their liquidity ratios, by raising their share rate to 9% (giving a gross rate of almost 13%). The rise in the mortgage rate might then be contained to 1%, giving a probable rate of 12¾% (though it could be ¼% higher or lower).

Economic Intelligence Department,
Other Financial Institutions Group,
29th June 1979.

M.E.Hewitt (4391)/M.J.Pratt (4443)
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3.7.79

THE GOVERNOR

Copies to: Mr.Goodhart
Mr.Dicks-Mireaux
Mr.Wiles/Mr.Hewitt
Mr.Threadgold
Group 7/4
Group 8/5

THE BUILDING SOCIETIES AND ALL THAT

I attach below comprehensive briefing organised by ART on this general area: I have annotated your copy with some of the main points. Picking out a few of the major figures that you will wish to have in mind:

(a) As a result of the Budget measures, specifically the 2% rise in MLR but also the reduction in the standard rate of income tax, the gross share rate, roughly on a par with the 3-months' local authority deposit rate before the Budget, is now some 2½% below it; and whereas the gross share rate was nearly 2½% ahead of the 7-day deposit rate of the clearers before the Budget, it is now fractionally below it.

(b) A rise in the share rate of 1 percentage point would add something like 0.2% to the RPI.

(c) The potential Exchequer saving from total withdrawal of the present mortgage interest relief would be some £1.6 billion this year: this compares with subsidies on public sector housing running at just under £2 billion, ie total housing "subsidies" of £3.5 billion.

(d) These housing subsidies contrast with public sector support to private industry (if the financing of NEB and employment subsidies are excluded) of about £1 billion - a disproportion indeed.

D.A.Walker

3rd July 1979.

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THE GOVERNOR

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MORTGAGE RATES AND HOUSE PRICES

In talking with the Prime Minister, I wonder whether something cannot be made of the political implications of the rise of house prices. In my view, this ought to be a cause of some concern.

The relevance of this point to the Prime Minister might be:

(a) Anything of the nature of a loan to the Building Societies would appear to be feeding the demand for houses and the rise in house prices.

(b) A rise of mortgage rates on the other hand could be presented as a way of moderating demand for mortgage finance.

(It has to be admitted that this argument is not water tight - since a freeze of building society rates would probably do more than anything else to reduce the flow of mortgage finance and thus also the rise in prices. But it could still be a political argument.)

The political arguments might be expanded as follows:

(a) Even 14% mortgage rate is not high, given the present rate of rise in house prices (30% p.a.).

(b) We need to moderate the rise in house prices, and hence need to let market forces work on the mortgage rate.

It is true that a small rise in mortgage rates is unlikely to do much to slow the rise in house prices. Even so higher interest rates are the classic response to rising property prices, and it would be perverse to inhibit this response. First time borrowers would not of course be helped by higher mortgage rates. But they have even more to lose by rapidly rising house prices. If the price of the house they want rises 5% in the two months they spend negotiating, they will have to raise another £1,000 or £2,000 - quite likely to put them out of the market. Higher interest charges on incomes likely to rise by 15% is probably less painful.

JCRD

3rd July 1979.

J.C.R.Dow.

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