[CONFIDENTIAL] SECRET

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Copies to The Deputy Governors
Mr [illegible]
Mr Dow
Mr Blunden
Mr Page
Mr Loehnis
Sir Jasper Hollom
GPS

Sir Douglas Wass GCB

Permanent Secretary

The Governor
Bank of England
Threadneedle Street
LONDON
EC2R 8AH

GR 4/3

26 February 1981

27/2

rec'd 27 FEB 1981 2.00pm.

My dear Gordon,

THE SOURCE OF THE BANK'S INCOME

When you called on the Chancellor on Monday you raised two points arising from your consideration of an extension from the clearing Banks to all commercial Banks of the requirement to place a fixed proportion of their eligible liabilities as an interest free deposit with the Bank of England. We have been thinking over the implications of what you suggested and, after discussing the matter with the Chancellor, I am now able to let you have our reactions.

The first of your suggestions was that we should agree to accept in future only the "minimum statutory dividend" for an indefinite period. You thought that the banks would take unkindly to the idea of for-going income in favour of the Bank only to find that a proportion of it found its way into the Treasury. I well understand the point you are making, but I find your suggestion very difficult to accept. It seems to me to be dubious in principle, as well as hard to justify to Parliament, that the sole shareholder in the Bank should lose his equity status and should receive only a nominal fixed sum irrespective of the size of the operating profit. I would have thought that if the operating profit is sufficiently large to enable you to pay us a dividend of the order of magnitude that you have paid in recent years, the banks would be no better pleased to see this sum being put to reserve by the Bank than they would to see it passed to the Treasury. It is not as though the dividend represents a significant proportion of the income which will be passing from the banks to the Bank. On past form it has represented only a modest percentage of such income. In any case not all the Bank's operating profit comes from the interest free deposits of the banking system.

I do however see that if the banks raise the question of the dividend in spite of its relatively small share of the income they would be supplying you with, you would want to have a suitable reply. What I think you could say is that if experience showed that the formula provided you with a significantly greater income than you needed you would be prepared to review the formula. This seems to me to be a proposition which would be far more attractive to the banks than one which simply assured them that, whatever the level of the Bank's income, only a tiny proportion of it would ever find its way to the Treasury.

Your second suggestion was that the Government might say publicly that we would, if necessary, enact legislation to compel all banks to make the deposit you are seeking with the Bank. Having thought about the matter, the Chancellor feels disinclined to make such a commitment publicly - or indeed privately in a form that could be quoted to the banks. If you have difficulty in negotiating your proposals voluntarily he would want to reconsider all the various alternatives, not excluding the possibility of simply continuing the status quo. The Chancellor would be less adverse to a less binding form of the idea you put to him, viz that you would say to the banks that if you were to have difficulty in negotiating your proposals voluntarily you would have to recommend legislation to the Government.

I am sorry that we are not able to give you the assurances you wanted on both these points. As you will see they do present considerable difficulties for us, but I hope that my counter suggestions will not be unhelpful to you in what I recognise will not be easy negotiations.

Yours ever,

Douglas.

DOUGLAS WASS

SECRET 20.2.81

S4/1
await
Gov's set of PPS

THE GOVERNOR

YOUR MEETINGS WITH THE CHANCELLOR (23 FEBRUARY) mtg took place.

Papers are enclosed on the following subjects which you specifically requested to be included:

1 The Bank's Income - BKg Dept / See Wass /S on 26.2.81.
2 The Direction - JNS safe T/s.
3 The article on the Crown Agents in the "Financial Times"
4 The draft Select Committee Report (in separate folder)
5 The Medium Term Financial Strategy docs. ED
6 Possible help for the Bundesbank / JLS with SPC 19/2
7 Lloyds Bank's profits

I also enclose recent papers on the following subjects:

8 Monetary Control - strategy and tactics in the next few weeks (including JBP's paper on Prudential Liquidity)
9 Monetary Targets docs
10 Indexed Gilts - Moody to be consulted
11 Sundry monetary papers, including post-Budget forecast and others you have not read pps to CRO NC RA
12 Relocation - we have not yet informed the Chancellor officially of the Court's decision, but the Deputy Governor will be writing very shortly (a draft letter was with GB for the weekend)
13 The new £50 note - you may wish to show it to the Chancellor
14 Financial Futures - you may wish to mention (no papers enclosed) pps - 0/s.

Governor's Office HO-P
20 February 1981

S P Collins (4122)

SPC

SECRET 20. 2.81

Thank you very much.
GR 24/2

THE GOVERNOR, PERSONALLY

THE BANK'S INCOME: POSSIBLE SPEAKING NOTE FOR YOUR MEETING WITH THE CHANCELLOR

This is obviously a question of the utmost importance to the Bank. It is also delicate and complex, therefore I must be absolutely sure of my ground before agreeing to any changes or making any initiatives. The question is not only of securing an adequate prospective income for the foreseeable future but of ensuring as far as humanly possible the certainty of that income and avoiding any impairment to the Bank's status and independence as an institution.

Over the last ten years there has been a steady deterioration in real terms in the Bank's free capital and reserves. While I would not claim to know what the appropriate level of capital and reserves is for the Bank, it cannot be right to project indefinitely a deterioration. In my own view it is right to aim from now on to stabilise the position.

— by reason of an agreement reached in connexion with CCC

In recent years our income has derived from the employment of 1½% non-interest bearing deposits which the Clearers have held with us. Faced with a reduction in these balances we have to look elsewhere for an adequate and certain income.

Most central banks in the world derive their income from the note issue; but most central banks do not have the British division between Banking Department and Issue Department, so that the note issue is normally the central bank's own, rather than in our case, the Government's, issued by the Bank. These facts have long been held to imply that the profits of issue belong to the Treasury and are handed over with the minimum delay.

Nevertheless in the new circumstances we have considered the possibility of seeking Treasury's agreement to a longer delay, in passing over profits of issue. On plausible assumptions about the balances the Clearers would voluntarily hold with us this would probably mean payments at six-monthly intervals yielding us an average balance of some £250 mn. We have received intimations from Treasury officials that such an approach would be unwelcome and we ourselves are not concerned to pursue it. It would be a self-evidently arbitrary basis onwhich to rest and it would invite a continuing degree of detailed Treasury interest /and it would invite a continuing Treasury involvement with Bank affairs which would be undesirable itself and contrary to the Bank of England Act7.

We believe therefore that we should rely for our income on the banking system. Specifically we could have reasonable assurance of meeting our needs from balances of ¾% - or perhaps a little less - of the eligible liabilities of all recognised banks (i.e. not including LDTs). It is, I think, appropriate that the banking system should provide for its own central bank; and we could perhaps give broad justification for these balances in prudential terms - agreeing to their release to an institution in severe liquidity difficulties. We are, however, still exploring what would be the most appropriate justification for our holding the balances /in any event it will be something of a figleaf; it is likely to be fairly widely recognised that the balances are needed primarily at least to maintain the Bank's income.7

In persuading the banking system to place non-interest bearing balances with us we shall encounter certain difficulties; and we shall need to take great care if we are to overcome these because we lack statutory authority.

First, if we were to continue to pass on substantial sums to the Treasury in the form of a dividend there would be bound to be resistance in the banks on the grounds that to this extent the balances were simply a tax and not for the maintenance of the Bank's income. The clearing banks have raised this point with some force in the past. It seems to me, therefore, essential that we should at least for some years and until we can make sure that our position is firmly based, revert to the position where we pay over only the statutory dividend of £873,180 each half year. /The legal position is in any case that we pay the statutory dividend or such higher/ or lower dividend as the Treasury and the Bank agree./

Our second difficulty relates to the lack of statutory authority. While I am sure that most banks would pay regularly if a bit reluctantly, there must be a possibility that some - perhaps particularly foreign banks - will refuse unless we can show authority. In the post-Banking Act conditions, we can no longer say to such banks that they must go away. It would therefore be /essential/ appropriate/helpful/ to have assurance that if necessary legislation could be introduced to enforce the placing of balances with us.

It would be useful if you could reflect rather urgently on this second question. /Meanwhile we shall be carrying forward some confidential negotiations with the banks, beginning with the Clearers./

Cwth

20 February 1981

SECRET 2. 3.81

THE DEPUTY GOVERNOR Copy to Mr Blunden

THE BANK'S INCOME

Govr

Sir Douglas Wass' letter of 26 February to the Governor.

Wass makes two points on and related to the dividend -

(a) that the dividend does not represent a significant proportion of the income (on Bankers' Balances), and that in the past it has represented only a modest percentage of such income;

(b) that in any case not all the Bank's operating profit comes from the interest-free deposits of the banking system.

I attach a summary of the Banking Department's profit and loss accounts from 1971 to 1980. From this summary the following table can be drawn -

	1 Income from Bankers' Balances	2 Profit before provisions	3 Dividend paid	4 Dividend as a % of column 1
1971	12.0	6.3	1.8	15.0
1972	9.6	18.7	5.5	57.3
1973	12.1	19.9	7.0	57.8
1974	24.8	25.5	6.0	24.2
1975	31.3	34.9	6.0	19.2
1976	29.5	30.2	6.0	20.3
1977	36.4	29.2	3.0	8.2
1978	23.6	30.8	5.5	23.3
1979	36.5	36.1	7.5	20.5
1980	60.4	51.0	6.5	10.8
	276·2	282·6		

From this table two relevant comments may be made:- 256·6

(a) the amount of the dividend has not been such a modest percentage of the income derived from Bankers' Balances as Wass suggests;

Avge propn is 1/4 Sometimes as much as 3/5

Over the past 10 years income from bankers balances has almost exactly equalled our operating profit

DG 2/3 24

(b) the income from Bankers' Balances has, on the basis upon which we have always looked at our profit and loss account, formed a very substantial proportion of our operating profit - in fact in 1977, 1979 and 1980 this income was in excess of the operating profit.

JR

Corporate Services Department BB-1
2 March 1981

J S Rumins (4375)

APPENDIX

BANKING DEPARTMENT - PROFIT AND LOSS ACCOUNT 1971-1980

£ millions

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	TOTAL
FIXED INCOME	12.7	13.8	15.4	16.1	18.6	22.9	24.4	25.1	25.5	31.6	206.1
VARIABLE INCOME	9.1	9.1	12.0	23.4	30.5	24.8	26.9	21.6	31.8	52.6	241.8
Profit/(Loss) on sale of securities etc	(0.4)	2.5	(0.1)	(4.8)	(6.3)	(6.4)	(7.2)	2.2	(4.8)	(7.5)	(32.8)
Total Income	21.4	25.4	27.3	34.7	42.8	41.3	44.1	48.9	52.5	76.7	415.1
Expenditure not recovered from HMG	15.1	6.7	7.4	9.2	7.9	11.1	14.9	18.1	16.4	25.7	132.5
OPERATING PROFIT (BEFORE EXCEPTIONAL ITEMS)	6.3	18.7	19.9	25.5	34.9	30.2	29.2	30.8	36.1	51.0	282.6
Additional Provision for retirement benefits (incl VSS)	-	8.2	8.0	11.9	12.1	-	-	-	-	14.0	54.2
Provision for losses	-	-	-	23.1	9.8	14.3	16.2	10.2	8.0	11.4	93.0
PROFIT BEFORE TAXATION	6.3	10.5	11.9	(9.5)	13.0	15.9	13.0	20.6	28.1	25.6	135.4
Taxation	1.9	1.8	1.7	(8.1)	3.6	6.7	3.7	5.4	4.7	7.9	29.3
Dividend	1.8	5.5	7.0	6.0	6.0	6.0	3.0	5.5	7.5	6.5	54.8
	3.7	7.3	8.7	(2.1)	9.6	12.7	6.7	10.9	12.2	14.4	84.1
PROFIT RETAINED	2.6	3.2	3.2	(7.4)	3.4	3.2	6.3	9.7	15.9	11.2	51.3
Average: Bankers' Balances	174.0	184.0	198.0	250.0	282.0	292.0	309.0	331.0	393.0	441.0	
Treasury Bill Rate %	6.9	5.2	6.1	9.9	11.1	10.1	11.8	7.1	9.3	13.7	
Bankers' Balances x TBR	12.0	9.6	12.1	24.8	31.3	29.5	36.4	23.6	36.5	60.4	276.2

3 points on Wass's letter

On (a) For 20 years we simply paid the statutory dividend which covers the servicing of the only cost which the Tsy have ever incurred. They have never put in any equity

On (b) Over the past 10 years on average the dividend has represented 1/4 of operating profit. (Sometimes as low as 10%, sometimes nearly up to 60%)

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