S E C R E T

Prime Minister!

Mr Sen

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

18th February 1980

Dear Tim,

BANK PROFITS

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

The problem

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

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

Presentational Difficulties

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

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

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

Possible Taxation

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

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

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

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

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

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

Taxation of 1979 profits

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

Future taxation of bank profits

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

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

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

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

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

Yours

John

(A.J. WIGGINS)

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-623 5511

8 February 1980

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

BANK PROFITS

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

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

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

Brendon Sewill

BANK PROFITS

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

	Preliminary announcement	Publication of accounts
Lloyds	Feb 22	March 11
National Westminster	Feb 26	March 24
Midland	March 14	April 1
Barclays	March 20	April 15

It is hoped that this brief will put the figures in perspective. It is arranged as follows:-

SUMMARY

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

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

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

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

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

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

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

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

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

PROFITS - FACTORS BEHIND THE INCREASE

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

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

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

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

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

These benefits were partly offset by:-

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

(b) higher provisions for bad and doubtful debts;

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

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

THE BANK PROFIT CYCLE

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

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

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

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

THE RECENT TREND IN PROFITS

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

£million	Profits before tax	Profits after tax	Dividends paid
1969	210	111	43
1970	214	118	47
1971	278	161	55
1972	380	225	60
1973	580	313	47
1974	449	204	50
1975	424	190	58
1976	700	332	71
1977	854	410	84
	895	550	84
1978	1084	691	102

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

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

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

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

INFLATION AND BANK PROFITS

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

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

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

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

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

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

TAXATION AND BANK PROFITS

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

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

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

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

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

BANK PROFITS IN PERSPECTIVE

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

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

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

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

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

Total income £524m