CONFIDENTIAL

Mr Walters
Mr Wolfson
Mr Duguid
Mr Ingham

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

Prime Minister

PRIME MINISTER

PM sem

In your minute of 4 June you suggested a stock-taking seminar on monetary control before the Recess, and I understand a meeting is being arranged for the end of July. I think the seminar will be very useful. We shall need to settle how we shall be operating the new arrangements - the basis for short term interest rates and the Bank's intervention in the money markets - once they have come into effect. This discussion will cover the role of the narrow monetary aggregates, including the monetary base, in these decisions and in any later developments of the system.

2. The Bank have made considerable progress in negotiating the detailed provisions for implementing the new arrangements foreshadowed in my statement last November. Their document setting out these provisions has been circulated this week to the clearing banks on a confidential basis and will be circulated for final comments to the rest of the financial system on Monday. The Bank hope to have the definitive version ready by mid-July and have told the clearers that the provisional date they have in mind for implementation is 20 August, the first day of banking September. A copy of the document is attached. If you would like any further explanation, in advance of the papers which will be prepared for the seminar I should be happy to arrange it.

3. I am sending a copy of this minute to the Governor.

(G.H.)
19 June 1981

CONFIDENTIAL

MONETARY CONTROL - DRAFT PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs) in "Monetary control: next steps". The present paper sets out the provisions resulting from discussions that have taken place since with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to recognised banks and LDTs (and National Girobank) having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

---

[1] A deposit due in, say, March would relate to the monthly average of ELs from September to February inclusive.

For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector[(1)] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stock, Treasury bills, local authority bills and bills of exchange.

6 ELs will be calculated in uniform fashion for all reporting institutions[(2)] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector;

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[(3)]

7 It would be contrary to the objective of these agreed arrangements for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

---

(1) See paragraph 16 below.

(2) The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

(3) The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more[1]. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits[2] will lapse once the provisions in the 1981 Finance Bill relating to additional exchange control powers become law.

Eligibility

9 As set out in its March paper the Bank has judged applications, by recognised banks wishing their acceptances to become eligible for discount at the Bank, according to the following criteria:

(i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;

(ii) whether its acceptances command the finest rates in the market for ineligible bills;

(iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.*

10 A bank may apply for eligibility at any time. An eligible bank which wishes to renounce its eligibility is free to do so on giving notice to the Bank.

---

(1) Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

(2) The scheme was devised and agreed with banks in 1972 but never used. It would have permitted the authorities to call, as Special Deposits, different proportions of any increase from a specified base in (i) domestic residents' and (ii) overseas residents' sterling deposits. Details can be found in the Bank's Quarterly Bulletin for March 1973.

* It will be attached to the final version of this document.

Undertakings by eligible banks

11 From a date to be announced, each eligible bank undertakes to maintain secured money with members of the LDMA and secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average [ ]* of that bank's ELs;

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below [ ] of ELs on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods at its discretion, the ratio on any particular day being calculated as a proportion of ELs at the latest make-up day.

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevant monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

---

(1) The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett Ltd, Laurie Milbank & Co, Rowe & Pitman Moneybroking and Sheppards & Chase (Moneybroking). Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

* The figure in this sub-paragraph will be calculated to produce an aggregate amount of around £3 billion and is expected to be around 5% of ELs as presently defined, or perhaps 6% on the new definition. The figure in sub-paragraph (ii) will be approximately two-thirds of that in (i).

Prudential considerations

14 The Bank has received the assurances mentioned in the Chancellor's Budget Speech, and in its paper of 12 March "The liquidity of banks", that those institutions to whom the reserve asset ratio has applied will discuss with the Bank in advance, in the course of the normal process of prudential supervision by the Bank, changes in their policies for the management of their liquidity and its composition. Discussions on developments in supervision are continuing and a separate paper on liquidity will be issued by the Bank when appropriate.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, currently contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who are evolving towards banking status and who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt from the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) banks in the Channel Islands and the Isle of Man, so long as they are subject to broadly parallel arrangements for a cash ratio.

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

---

[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Recognised banks and LDTs having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other recognised banks and LDTs will be asked to report only at end-calendar quarters.

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 The Bank will shortly specify an operative date when:

(i) the Reserve Asset Ratio will be abolished;

(ii) banks whose acceptances are eligible for discount at the Bank will begin to observe the requirements set out in paragraph 11 above;

(iii) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(iv) the Bank will receive the first deposits under the cash ratio requirement.

21 On this operative date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs over the latest six-month period available, ELs being calculated as at present, except that offsets will be allowed in respect of all lending to the discount market and all secured money at call placed with money-brokers and gilt-edged jobbers and money-trading banks.(1) These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below).

---

(1) The Bank can calculate these offsets from statistics already provided.

Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks will commence on the operative date, on the same definition of ELs and in respect of their latest available ELs figures.

22 As soon as possible thereafter, currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the proposed cut-off points for full statistical reporting will join the reporting network (and will be asked to place cash deposits with the Bank shortly thereafter).

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed.