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SUBJECT.

Econ Pol VL13.

cc GB/E
Mr Walters

Copied to Econ Pol,
Budget Pt 4
Master set.

10 DOWNING STREET

From the Private Secretary

6 February 1981

Dear John,

I am sorry that I have not written earlier about the Prime Minister's lunch with the Committee of London Clearing Bankers last Monday. - 2/2/81.

The discussion ranged widely over a number of topics, including the short-term prospects for industry, recent monetary developments, and monetary control. The Prime Minister expressed concern at the continued growth of lending to the personal sector, including lending based on credit cards. The bankers pointed out a good deal of the lending to the personal sector was in fact to small businesses, and that credit card lending represented only a small proportion of it; they also pointed out that, since November, the banks had stopped advertising credit cards. On the question of lending to the corporate sector, they denied the criticism that in too many cases overdraft facilities had been made available to enable companies to finance uneconomic pay settlements; they argued that the clearers had played a positive role in preventing the recession from causing even more bankruptcies than had taken place. On the other hand, to the extent that in some cases overdraft facilities might have been excessive, it was pointed out that the clearers faced strong competition amongst themselves and from the American banks: if increased credit facilities to a particular borrower were held back, all too often another bank would step in.

/ They also

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They also raised the question of a possible windfall tax on bank profits. Sir Jeremy Morse said that they were strongly opposed to such a tax. They had had discussions with the Chancellor the previous autumn with a view to helping the Government reduce the PSBR by other means - namely, that they should take back some of the export credit currently being refinanced by the Government. They had not put a figure on their proposal at that time, but they were now prepared to come back to the Chancellor with a specific proposition. In response to a question from the Prime Minister, he said that he thought they would be prepared to offer to take back £1 billion.

The Prime Minister gave no indication of how the Government would move on the windfall tax proposal. She expressed interest in the proposition put forward by Sir Jeremy on refinancing, but she made it clear that the Chancellor would have to consider it carefully before taking a view.

Reply on Budget Pt 4.

Sir Jeremy has now written to the Prime Minister with a copy to the Chancellor (his letter of 2 February), and I should be grateful for advice on how the Prime Minister might respond.

I am sending a copy of this letter to the office of the Governor of the Bank of England.

Tim Lankester.

A. J. Wiggins, Esq.,
H.M. Treasury.

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

TELEPHONE: 01-623 5511

2nd February, 1981

Dear Prime Minister,

We greatly enjoyed having you to lunch today, and hope that you found it worth while.

I enclose the paper we had prepared on the question of taxing bank profits. It sets out the main reasons why we think that a special tax would be both wrong and untimely. Under the latter head I would add the damaging effect that the announcement of a tax could have on our pay negotiations, as we discussed at the table. In view of the stress you laid on credit card lending, I also enclose the figures on this. You will see that the interest-bearing part of this lending increased by 24% over the past 12 months, but is still only 11% of personal, and 3% of total sterling lending.

As I have already written to the Chancellor, we recognise the problem faced by the Government in reducing the PSBR, and we would certainly like to help with it, in a way that does not impair our basic strength to the disadvantage of our customers and our shareholders. It is in this spirit that we have suggested that we might take back a substantial part of the export credit, say, £1 billion, which is at present refinanced by the Government. This would produce a considerably greater immediate benefit to the PSBR than the other proposals made to us, and although there would be a corresponding loss of benefit in later years the discounted cash-flow advantage of such an accelerated repayment would be considerable.

I am copying this letter to the Chancellor and to the Governor.

Yrs sincerely,

Jeremy More

The Rt.Hon.Margaret Thatcher,M.P.,
Prime Minister,
10 Downing Street,
London, SW1

SECRET

LONDON CLEARING BANKS' GROUPS

CREDIT CARD DEBT

£ millions

	31.12.79	31.12.80	Change	
1. Credit Card Debt outstanding:				
(a) Total	892	1,120	+ 228	(+ 26%)
(b) Interest-Bearing	652	810	+ 158	(+ 24%)
2. Total Sterling Advances to U.K. Residents	25,491	31,080	+5,589	(+ 22%)
3. Total Sterling Advances to Personal Sector	6,214	7,594	+1,380	(+ 22%)
4. 1(b) as % of 2	3%	3%		
1(b) as % of 3	10%	11%		

C.L.C.B. Statistical Unit
2.2.81

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

1. First, it may help to consider the background against which calls have been made to subject the banks to some form of excess profits tax. There is no denying that the profits of the clearing banks have increased considerably in recent years to amounts which are not only large in absolute terms but also represent a high return on capital, by comparison both with the banks' own record and with the current achievements of other industries.

2. Moreover, a substantial element of these profits represents the margin earned on the banks' current account balances at a time of high interest rates. This 'endowment' or 'windfall' element results from economic circumstances and government policy rather than from the banks' own endeavours.

3. The counter-arguments considered in this note have been divided into three groups. First are those based directly on the banks' financial record. Second are those which relate to the nature of the banks' business. And third are those concerned with the practical implications of seeking to impose an excess profits tax.

THE FINANCIAL RECORD

4. The banks' main argument against an excess profits tax is that, allowing for inflation and cyclicality, their profits do not represent an excessive return on capital employed. This, they believe, is demonstrated by the two accompanying charts, which show how the profits of the 'big four' London clearing bank groups have developed since 1973, both before and after allowing for inflation, and which measure the rate of return that the banks have earned each year. As 1973 marked the previous peak in bank profitability, the charts cover a full profits cycle.

The Effects of Inflation

5. It can be seen from the first chart that historic cost profits in 1979 were $2\frac{1}{2}$ times higher than in 1973. However, it is now fully accepted that historic cost accounts give a misleading impression of the profitability of banks, as of other industries. For prudential reasons banks necessarily hold more monetary assets than monetary liabilities: that is to say, part of their capital has to be held in the form of monetary items. Measures of real profitability must therefore allow for the fact that inflation depletes the real value of these net monetary assets. This allowance is achieved by the monetary working capital adjustment made under current cost accounting.

6. As the chart shows, even current cost profits in 1979 were 83 per cent higher than in 1973. But this does not mean that profits rose by 83% in real terms. As is now widely recognised, current cost accounting does not provide an indication of the effect of general price inflation on a business as a whole. Rather, the banks' current cost profits may be regarded as a measure - in money terms, not real terms - of the surplus available for distribution as dividends or for use in expanding the business. The chart shows that the real value, or purchasing power, of that surplus in 1979 was only three-quarters of what it had been six years previously.

Cyclicality

7. To subject the banks to an excess profits tax on the basis of their recent profits alone would be rather like taxing a West End store solely on the basis of its Christmas sales period. Bank profits are inherently cyclical and, as the first chart shows, in real terms they declined to virtually nothing in 1975 - just two years after reaching their previous peak. The main explanation is of course the cyclical movement of interest rates themselves: when rates are high bank profits are high, and vice versa.

8. The endowment effect, however, is by no means the only consequence of high interest rates for bank profits, and some of the other results are far from beneficial. For instance, the banks' gilt-edged investments tend to fall in value, the profits of their finance house and leasing subsidiaries decline and the cost of holding interest-free balances at the Bank of England rises, to the competitive advantage of those banks which suffer no such requirement.

9. Perhaps more importantly, the harmful effect of high interest rates on the banks' business customers increases the incidence of bad debts. However, as these bad debts often do not show through until subsequent years, they can have the effect of exacerbating the profits cycle, rather than dampening it. And, of course, the inflationary processes which give rise to high interest rates also cause increases in the banks' operating costs which must continue to be borne when rates are low.

10. The effects of inflation and the cyclical nature of bank profits should each become even more evident when the banks' results for 1980 are published during the course of the coming weeks. Stockbrokers' estimates are almost unanimous in expecting profits to fall even in historic cost terms, let alone after allowing for inflation.

Return on Capital

11. Even after full allowance has been made for inflation and cyclicality, it might still be argued that bank profits were excessive. This is not an issue which can be resolved by looking at the figures on their own: after all, the banks' profits are large mainly because the banks are large businesses. What is more, over recent years an increasingly large

proportion of those profits has been earned in areas which are not greatly influenced by domestic interest rates - notably international and overseas banking, and domestic lending financed by interest-earning deposits. It is therefore important that the banks' profits be judged in relation to the capital employed in earning them.

12. The banks' profits could fairly be judged excessive if - in real terms and over time - they represented a rate of return on capital that was well in excess of that of industry at large. Chart 2 suggests that this is not the case. Although changes in accounting conventions prevent accurate comparisons from year to year, two conclusions are inescapable.

13. First, the rate of return that the banks earned in 1979 was lower, both before and after tax, than in the previous peak year of 1973. And secondly, between these two peak years the rate of return fell to very much lower levels. What is more, as the banks showed in their evidence to the Wilson Committee the rates of return they were earning in the mid-1970s were consistently well below those being earned by leading companies in other sectors of the economy. The comparative figures are reproduced as Table 1: it should be noted that no adjustment has been made for inflation. There is no evidence that the banks' average rate of return over the full profits cycle has been excessive by the standards of industry at large.

14. Even in the peak year of 1979, the banks' current cost rate of return was starting to decline, and 1980 results are almost bound to show a further fall. The banks naturally hope that their real profitability will not decline as steeply this time as it did in the mid-1970s. But for cyclical reasons alone, a further fall is probable, and the average return over the present profits cycle - as over previous ones - is likely to prove very much lower than in the peak years alone.

15. In conclusion, the clearing banks' financial record and prospects do not lend support to the belief that the banks' profits represent an excessive rate of return on capital once allowance is made for inflation and cyclical effects.

THE BUSINESS OF THE BANKS

16. The banks recognise that some of the arguments for an excess profits tax relate less to their financial record as such than to the nature of the business that they do. In particular, it is argued that the banks' profits are a fortuitous, or 'non-functional', by-product of government policy, and that the banking industry is uncompetitive.

Current Accounts and Money Transmission

17. The point has already been made that the banks have diversified heavily in recent years into international and other areas of activity. As a result, only a portion of the banks' total profits arise from the so-called 'endowment' effect. It is usually a minor portion and is sometimes negative. Not only are the majority of the banks' deposits interest-earning but current account balances themselves are very far from being cost-free.

18. The Price Commission reckoned that in 1977 the unrecovered costs of the banks' money transmission services were equivalent to an interest rate of 6.8 per cent on their current accounts. By the end of 1977, and in the early months of 1978, market rates of interest were actually lower than this, and the banks were accordingly paying more for their current account balances than they could earn on them in the market place. In other words the current account/money transmission part of their business was a drag on the profitability of the business as a whole. Despite increases in bank charges since then, the banks' unrecovered money transmission costs have continued to grow faster than their current account balances, and are now probably equivalent to an interest rate on these balances of about 9 per cent.

19. At the time of writing, Minimum Lending Rate and three-month interbank rate are each 14 per cent. Thus market rates have only to fall by about five percentage points for the banks' current account/money transmission business to become unprofitable again.

20. The banks would like to insulate their position more from the effects of short-term movements in interest rates, so as to avoid the risks of political attack when rates are high and of losses when they are low. But this would require them to pay explicit interest on current accounts, which would create tax problems for their customers, and to increase their charges for money transmission services to a level which more fully recovered the costs of providing them. This would meet strong customer resistance and could generate fresh political attacks.

Competition

21. To justify an excess profits tax, it should be shown not only that the banks are making excess profits but that market imperfections such as state monopoly powers, or licensing and franchising systems prevent these profits from being competed away. No such constraints operate in the banking market.

22. The clearing banks may be thought to constitute an oligopoly, but this does not prevent them from competing aggresively with one another in both price and service. Equally important, there is no sector of the banking market in which they do not face fierce competition from other institutions: for example, the National Girobank in money transmission, the TSBs in personal banking generally, the building societies in personal savings and mortgage lending, the merchant banks in corporate finance and over 250 foreign banks in corporate lending in both sterling

and foreign currencies. As a result, competition ensures that profits overall are kept within reasonable bounds - as the banks believe they have demonstrated by the analysis of their financial record.

The Banks and Industry

23. Nowhere is competition felt more keenly than in the area of industrial lending. Many of the banks' loans are at margins over the cost of funds which barely cover the inherent risks of the business. During the present recession in particular, the banks have provided extensive support to industry over and above that which their normal commercial instincts alone would have dictated. In the case of small and medium-sized businesses, this has been very largely at the initiative of the individual banks. In the case of certain major companies in financial difficulties, the banks have taken part in syndicated support operations arranged by the Bank of England. Throughout, the banks have observed the lending guidelines imposed by the authorities. In particular, they have greatly scaled down the promotion of their personal credit facilities, despite the provocation of major marketing and advertising campaigns by some of their competitors.

Capital Adequacy

24. There is no doubt that an excess profits tax would seriously impair the banks' ability to carry on supporting industry throughout the current recession. Perhaps the main reason is that it would make it much harder for the banks' capital to grow in line with the scale and riskiness of their lending business. As the Wilson Committee observed:

> "Banks have found it difficult in recent years to generate post-tax profits from which to set aside sufficient reserves to maintain historic capital ratios. The ratio of free capital to deposits over the period would, indeed, have fallen appreciably were it not for the banks' extensive recourse to the equity market."

Indeed, the banks' capital ratios deteriorated even in 1979, and are likely to decline further in the absence of substantial capital-raising exercises. The retained profits which have been added to the banks' capital base in recent years will, on past precedent, be needed to protect the banks against the threats to their profits which lie ahead.

25. The banks' need for capital to protect depositors against the risk of loss is crucial in view of the importance of maintaining confidence in the banking system. Confidence is essential on the part not only of domestic depositors but also of the international financial community if the banks are to continue to make their important contribution to the balance of payments. The Bank of England's responsibilities for ensuring that banks are adequately capitalised have now been given statutory backing by the Banking Act, and its paper entitled The Measurement of Capital indicates the nature of the requirements now being imposed.

26. If post-tax profits are inadequate to maintain capital ratios at the appropriate levels, then further capital issues will be necessary, thus raising the cost of equity finance for industrial and commercial companies. Two further points should be noted. First, the dividend increases of recent years were largely a catching-up process after long periods of control, when dividends failed to keep pace with inflation. And secondly, much of the absolute increase in the banks' profits in recent years has been the result of acquisitions which have required their own appropriate level of capital backing.

FURTHER IMPLICATIONS OF A TAX

27. The banks have sought to show that the case for an excess profits tax has not been made. There remain some further counter-arguments which relate to the practical problems of introducing a tax, and the adverse consequences of doing so.

Defining 'Excess' Profits

28. It might be thought that the volume of excess profits could be calculated easily by applying a market rate of interest to the banks' current account balances. But for reasons which have already been mentioned, this would be inequitable. In particular, the effective cost of the banks' current account balances is about 9 per cent, not zero, while much of the endowment element has already been offset in other areas of the banks' business, notably industrial lending. The problems of arriving at an equitable statutory definition of excess profits would be immense.

The Institutions Affected

29. A closely related problem is that of defining the range of institutions to which an excess profits tax should apply. It is not only the clearing banks which benefit from interest-free funds. Most other banks have some current account funds, and in some cases - notably the Giro, the TSBs and the Bank of England - the amounts involved are considerable. A tax measure limited to the clearing banks, even if legally feasible, would be grossly discriminatory.

The Case for Subsidies

30. If Government feels it should subject the banks to an excess profits tax at times of high interest rates, the banks would argue that at the very least they should be allowed to establish tax losses at times of low interest rates.

Retrospection and Discrimination

31. The banks' profits have already passed their cyclical peak. Indeed one bank - Midland - actually reported a post-tax loss in current cost terms for the first half of 1980. Any attempt to introduce an excess profits tax would inevitably be seen as a means of clawing back some of the allegedly excessive profits of previous years. In spirit if not in letter, it would be an exercise in retrospective legislation, and objectionable for that reason.

32. It would also set a highly undesirable political precedent for selecting a particular sector of the economy for special taxation solely on the basis of short-term profitability and fiscal expediency.

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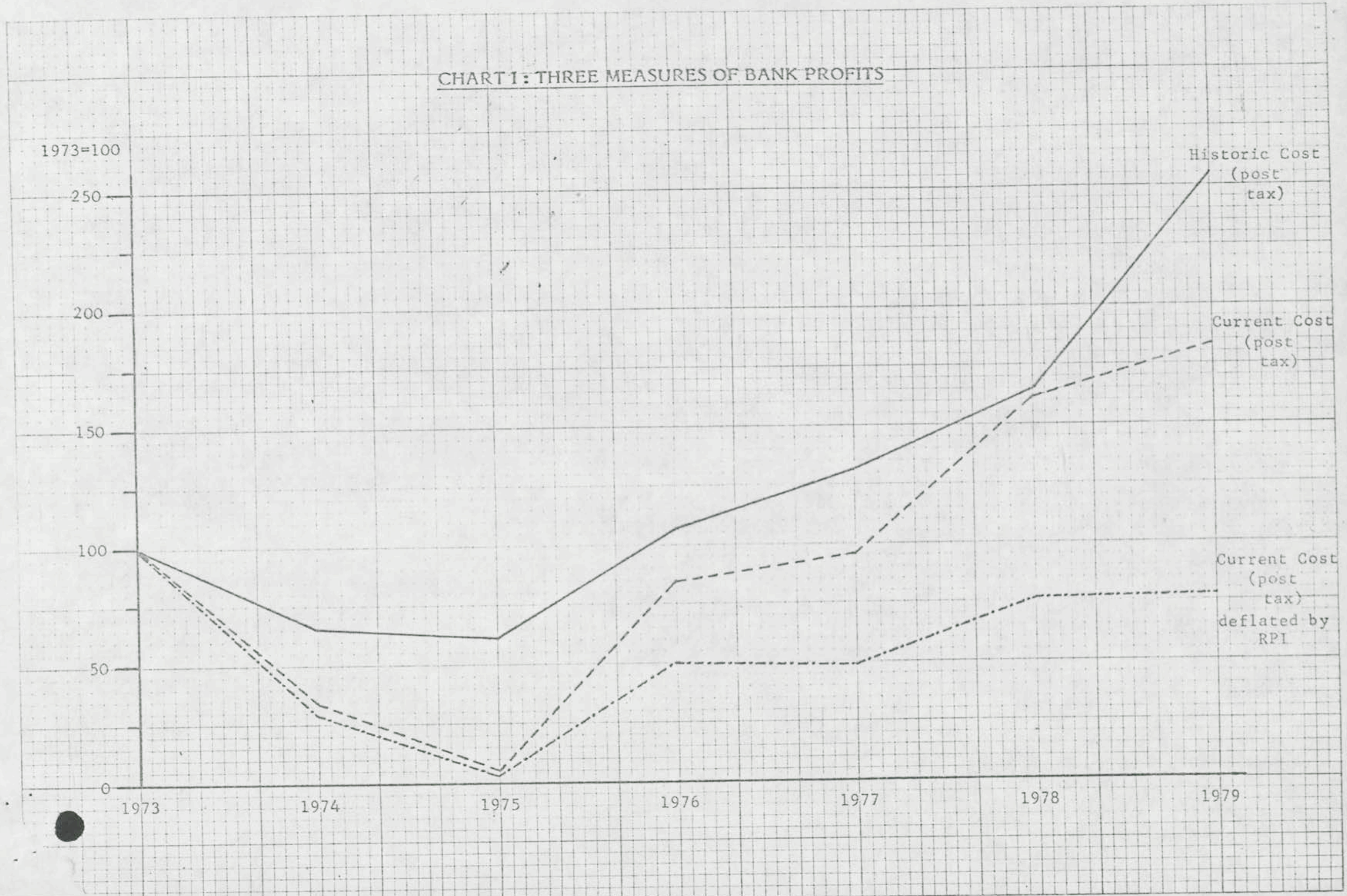

CHART 1: THREE MEASURES OF BANK PROFITS
1973=100
250
200
150
100
50
0
1973
1974
1975
1976
1977
1978
1979
Historic Cost (post tax)
Current Cost (post tax)
Current Cost (post tax) deflated by RPI

CHART 2 : THE BANKS' RATE OF RETURN

Current Cost Profits as a Percentage of Capital Employed

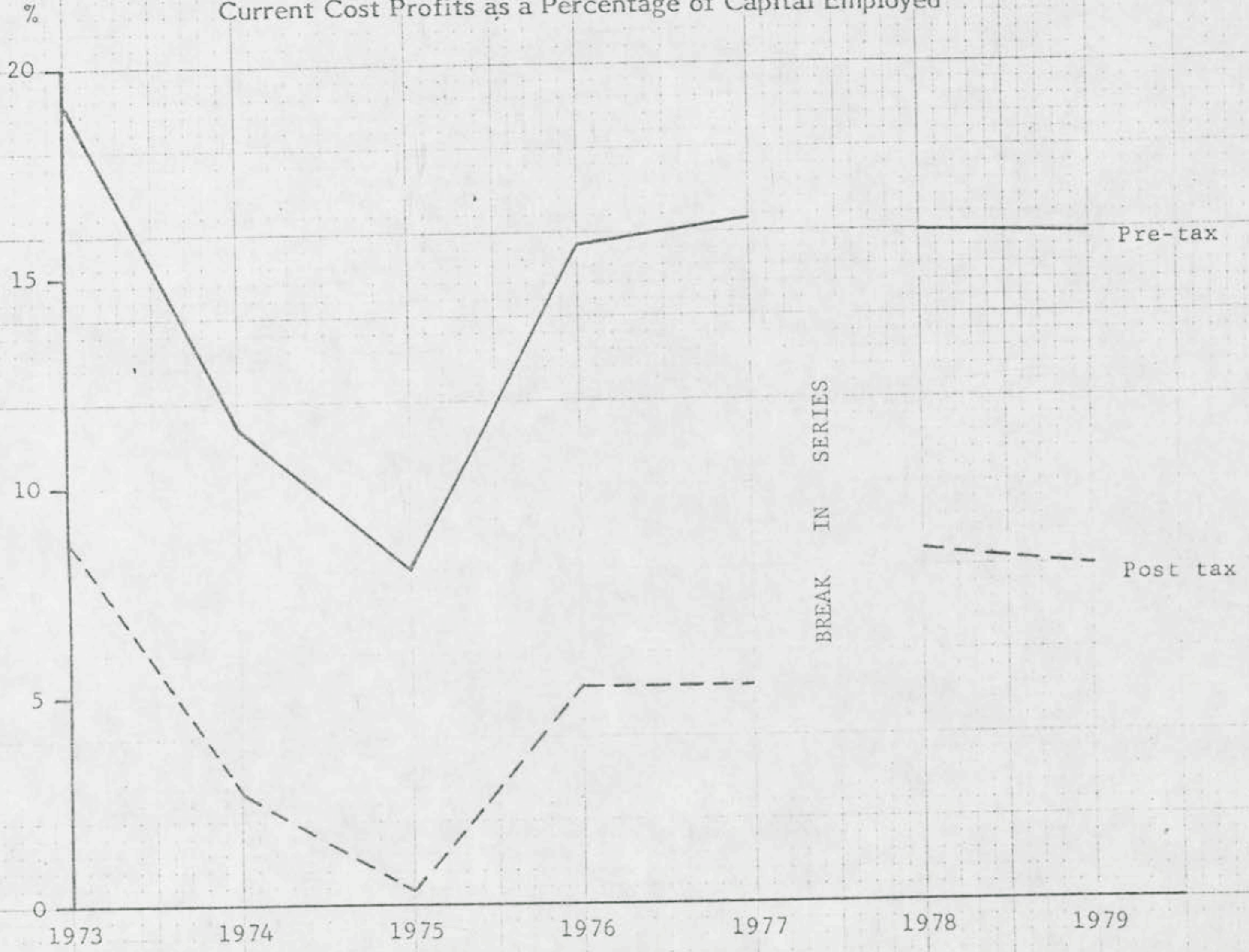

TABLE I : EXTRACT FROM LONDON CLEARING BANKS' EVIDENCE TO WILSON COMMITTEE

Profitability of other industries

Sample of four leading companies in each sector

Percentages		1969	1970	1971	1972	1973	1974	1975	1976
Profit before taxation **Percentage of end-year shareholders' funds plus minority interests**									
Average for sector sample	Breweries	16.7	19.3	23.5	26.1	21.5	17.1	18.6	21.4
	Building materials	14.1	15.6	27.6	28.9	32.7	17.0	24.2	25.7
	Chemicals	18.6	15.3	14.3	17.0	24.4	33.3	20.2	27.3
	Electricals	16.8	22.7	24.9	30.8	35.5	36.7	35.6	39.6
	Engineering	12.0	12.2	14.0	16.1	21.4	24.6	20.2	25.5
	Food manufacturing	18.5	18.2	21.2	26.2	26.4	27.7	28.1	33.5
	Other industrials	28.9	27.7	30.0	34.8	33.1	38.7	36.8	35.3
	Stores	35.5	36.1	40.2	40.9	38.4	31.0	31.5	35.3
	London clearing banks	17.2	15.6	18.2	21.1	24.1	17.2	14.9	21.3
Profit attributable to shareholders **Percentage of end-year shareholders' funds**									
Average for sector sample	Breweries	9.3	10.5	13.7	15.2	11.5	8.5	9.4	10.2
	Building materials	7.4	8.1	16.7	18.6	18.9	9.4	11.9	13.3
	Chemicals	11.1	8.9	8.6	10.1	13.4	16.8	10.5	13.9
	Electricals	10.4	13.0	14.9	18.7	20.8	18.0	17.6	19.3
	Engineering	6.0	6.6	7.9	9.6	11.1	12.4	10.1	13.7
	Food manufacturing	10.1	10.7	12.7	15.9	14.7	13.5	13.6	16.5
	Other industrials	15.8	15.0	17.0	19.9	18.7	20.4	18.9	17.8
	Stores	18.3	20.3	24.1	24.0	18.3	14.7	14.8	16.1
	London clearing banks	9.2	8.8	10.8	15.3	13.8	8.0	6.7	9.7

Companies sampled:		
	Breweries	Allied Breweries, Bass Charrington, Greenall Whitley, Arthur Guinness.
	Building materials	Associated Portland Cement Manufacturers, London Brick, Marley, Tarmac.
	Chemicals	Croda International, Fisons, Imperial Chemical Industries, Laporte Industries.
	Electricals	BICC, General Electric, Racal Electronics, Thorn Electrical Industries.
	Engineering	Babcock & Wilcox, Guest Keen & Nettlefolds, Hawker Siddeley, Tube Investments.
	Food manufacturing	Associated British Foods, Cadbury Schweppes, Ranks Hovis McDougall, United Biscuits.
	Other industrials	Beecham, Bowater, Metal Box, Reckitt & Colman.
	Stores	Boots, House of Fraser, Marks & Spencer, Mothercare.
	London clearing banks	Barclays Bank, Lloyds Bank, Midland Bank, National Westminster Bank.

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

Summary

* Allowing for inflation and cyclicality, the banks' profits do not represent an excessive return on capital. (Para 4)

* The banks' profits have not been enough to maintain their capital ratios - which is essential if confidence is to be maintained and the banks are to cope with future threats to their profitability. (Paras 24-26)

* The banks' profits must be judged in relation to the capital employed, taking account of their diversification into international and other areas of business. (Para 11)

* The banks earned a lower return on capital in 1979 than in 1973, and between those peak years the return fell to below those earned in other industries. The rate is now falling again. (Paras 13-15)

* The profits cycle is largely explained by the interest rate cycle, with bad debts and other costs continuing to be felt after rates have fallen. (Paras 7-9)

* Profits for 1980 are likely to show a decline even before allowing for inflation. (Para 10)

* Current cost profits have risen by very much less than historic cost profits since 1973, and the real value of the banks' distributable surplus has actually declined. (Paras 5-6)

* The banks' current accounts are far from being cost-free. Unrecovered money transmission costs mean that this part of the banks' business was loss-making for a time in 1977/78, and it would be loss-making again if interest rates fell to single figures. (Paras 17-20)

* The banks face fierce competition from one another, and from other institutions. (Paras 21-22)

* During the present recession the banks have provided exceptional support to industry and have forgone profitable opportunities in the personal lending market. (Para 23)

* The problems of arriving at an equitable definition of excess profits would be immense. (Para 28)

* To tax the clearing banks alone would ignore the interest-free funds enjoyed by other institutions. (Para 29)

* If banks are to be taxed when interest rates are high, they should at least be allowed to establish tax losses when they are low. (Para 30)

* Profits are already off their peak: indeed one bank made a current cost post-tax loss in the first half of 1980. So any tax would be retrospective, in spirit if not in letter, and would set an undesirable political precedent. (Paras 31-32)