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Direct Answer.

tops/reply

The Deputy Governor

Mr Blunden

Mr Boehnis

Mr George

Mr Walker

Mr Dow

Mr Forde

Mr Cooke

Mr Goodhart

Mr Quinn

Mr Robson

Mr Cobbold

APS (x3)

SECRET

GPS 29

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

31 January 1983

M Scholar Esq
10 Downing Street
London
SW1

Dear Michael

in 10920/1
As requested in your letter of 20 January I enclose a note that has been prepared here on "endowment" profits.

The note itself is somewhat technical, because the subject is in fact quite complicated, but the main point which the Prime Minister may like to have in mind is the following -

- (i) The 8.2% figure produced by the BBA as the average cost of current account balances should not be seen as some kind of floor so that banks automatically make losses on their current account business if market interest rates fall below this figure. This is because -
 - (a) current account balances tend to increase more rapidly as interest rates decline and this will in turn affect the cost figure (of 8.2%) which is expressed as a percentage of the level of current account balances;
 - (b) the banks will react to lower interest rates by charging more for the services provided to current account holders (and this will again affect the 8.2% figure);
 - (c) the banks' earnings from their investment of current account deposits are not directly proportionate to the general level of market interest rates, partly because of their fixed rate investments, and, more importantly in present circumstances, because provisions for bad debts could well be reduced as interest rates decline; and

- (d) while it nevertheless remains true that endowment profits will tend to fall with interest rates, their importance is now much less than it was because current account business now accounts for less than a quarter of total domestic sterling business.

*Yours sincerely
Tom Allen*

T E Allen
Governor's Private Secretary

"ENDOWMENT" PROFITS

1 The "endowment" element of banks' profits is generally thought of as arising when deposits are taken by banks at no interest (or at a nominal rate of interest) and then invested at prevailing market rates of interest. In practice a number of other factors affect "endowment" profits, most importantly the costs of maintaining the branch network through which current account deposits are collected and providing related services offset in part by the direct charges made for such services. It is only when the endowment element exceeds these costs that endowment profits arise.

2 The British Banking Association's report (Review of Taxation in the Banking Sector - September 1982), referred to by the Prime Minister, quotes estimates for the costs of the four major clearing banks in operating current accounts, after deducting the banks' charges, for the years 1975 to 1981. The results are expressed as a percentage of average credit balances on current accounts.

<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
6.9%	7.1%	6.8%	6.2%	6.5%	8.1%	8.2%

There is a large subjective element in the basis of cost allocation. However, the figures for 1975-77 were prepared for the Price Commission and the basis of cost allocation used was accepted by the Commission. The series has simply been updated for the recent report.

3 The total costs entering into these calculations are essentially independent of the level of interest rates. However, the volume of current account credit balances, and hence the percentages in paragraph 2 above, is affected by the level of interest rates. As interest rates rise current account balances tend to grow more slowly because of the greater incentive for funds to be switched into assets bearing a full market interest rate. As a result the costs of current account deposits to the banks expressed as a percentage of the volume of such deposits will also increase as interest rates rise. A significant part of the marked cost increase in 1980 and 1981 which the figures show is attributable to this factor, with the clearing

banks' total non-interest-bearing sight deposits rising by only 3 1/4% a year in those two years, compared with 13 1/4% a year on average in the earlier years.

4 As noted earlier, the cost figures in paragraph 2 are arrived at after deducting the banks' charges for providing current account services. These charges doubled as a percentage of average current account credit balances, from 1.7% to 3.4% in the six years to 1981 and another round of increases in bank charges has just taken place. Even after the latest increases, however, some 50% of all bank customers still pay no charges at all and there is still scope for further increases. Such increases, after taking due account of the impact of competition from interest bearing forms of account, including those of building societies, will help contain the cost, and so maintain the profitability of current accounts in a lower interest rate environment.

5 On the other side, the banks' earnings from the investment of current account deposits cannot be accurately determined because the banks do not in general match particular types of deposit with particular categories of asset. At one extreme assets in the form of cash in tills (held largely to provide cash to current account holders and equivalent to some 5% of the London clearing banks' non-interest-bearing current account deposits) earns nothing; while some types of personal lending may currently earn rates in excess of 25%. Unpublished figures on the domestic operations of three of the clearing banks* show that total interest income for 1981 expressed as a percentage of total banking assets was 14.5%; but this figure (which is arrived at before deducting the costs of managing the assets) cannot be directly set alongside the figure of 8.2% for the cost of operating current accounts in that year shown in paragraph 2 because it includes indistinguishably the banks' earnings from the investment of other, interest-bearing, deposits which are proportionately much larger and which are generally more expensive to the banks.

* Barclays, Lloyds and National Westminster. These three banks conduct the bulk of their international operations through separate subsidiaries. Midland's domestic and international operations are carried out through the same company.

6 Whatever the yield attributable to current account deposits, it will tend to vary directly with the level of interest rates, although this would not be true to the extent that the deposits were invested in fixed-rate assets, eg gilt-edged and much consumer credit business. Also it may well be the case that the banks' bad debt experience increases at higher levels of interest rates, and the associated provisions would need to be set against earnings.

7 For the reason given in paragraph 6 above it is not possible to estimate the size of the endowment element in the banks' total profits, but it is certainly much less important than it was because of the relative decline in current account business. Non-interest-bearing current account balances fell from 36% of the clearing banks' total sterling deposits in 1977 to 23% in 1981 and are still falling. It is almost certainly true that the endowment element in profits varies directly with interest rates, despite the contrary factors noted above, but the relationship is less straightforward than is sometimes supposed, and probably weaker than in the past. Because of the decline in the relative importance of the endowment element, it is much less clear that the clearing bank groups' total domestic profits[#] still vary directly with interest rates in the same way.

Bank of England

31 January 1983

[#] One recent analysis, by stockbrokers Panmure Gordon, suggests that the relationship can be inverse. They put National Westminster's profits for 1983 at £510 million if base rates fall to 8% and £520 million if base rates fall to 6%, though this result may be influenced by an expectation of lower provisions on the lower interest rate assumption.