SECRET 31. 1.83

cc GPS
EAJG
WPC

THE GOVERNOR

Copies to Mr Blunden
Mr Loehnis
Mr George
Mr Walker
Mr Dow
Mr Fforde
Mr Cooke
Mr Goodhart
Mr Quinn
Mr Robson
Mr Cobbold

"ENDOWMENT" PROFITS

It seems to me that, although WPC's note on "Endowment" Profits contains the main relevant points, it is not couched in a form most persuasively to make them to the Prime Minister. I have therefore tried my hand at a redraft, which I attach. In recasting the material I may have missed some subtleties - in which case I hope amendments can be provided but I think that in something like this form the arguments may be found more cogent by the intended reader.

31 January 1983

Dictated by the Deputy Governor
and circulated unsigned

'await top'

Deputy Governor

I think it a pity not to have in a reference to the profit margin which it is "reasonable" for the Banks to seek to earn on their investment in the money transmission mechanism if they are to ~~keep it~~ ~~[illegible]~~ maintain it intact

[illegible]
31.i

"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. There are of course costs to the banks ~~of maintaining~~ (including, over time, the norm for a reasonable profit margin on the tying up of their capital) in maintenance of the branch networks which attract the non-interest bearing deposits. But if these costs and the total of the non-interest bearing deposits were independent of the level of the interest rates it would appear to follow:-

(i) that the higher the level of interest rates, the greater the level of "endowment" profits; and

(ii) that there would be some floor level of interest rates where "endowment" profits would fall to zero.

2 In practice, while it is probably broadly true that "endowment" profits tend to be higher with higher levels of interest rates, the relationship is not a straightforward one.

3 On the cost side there are three offsetting factors at work.

(a) The total of current accounts is <u>not</u> independent of the level of interest rates. The higher the level of interest rates the more people take the trouble to minimise their non-interest bearing balances. There is undoubtedly a trend at work here, partly due to the increasing financial sophistication of the community and partly due to a "ratchet" effect of periods of high interest rates: when interest rates fall again, depositors probably do not fully return to the same degree of carelessness about the level of their non-interest bearing deposits. Certainly the overall figures suggest that these trends have been at work while non-interest-bearing current account balances amounted to 36% of clearing banks' total sterling deposits in 1977, the figure was only 23% in 1981 - and it is still falling.

(b) In computing charges on current account balances the banks allow as an offset a notional interest rate. As competition has increased from the building societies, so the amount of this notional interest rate allowed has increased. This fact obviously tends to make the costs to the banks of current accounts vary to some extent with interest rates.

(c) Costs to the banks of maintaining current accounts tend to rise with costs generally, ie with the level of inflation. But the level of interest rates too is related to the level of inflation.

4 As far as the "flow" at which the banks would become unprofitable is concerned, the banks have been working to reduce this by raising charges so that they more nearly cover the costs of current accounts at any interest rate. As a percentage of average current account credit balances, these charges doubled from 1.7% to 3.4% in the six years to 1981; and there has been a further round of cost increases since.

5 On the other side, inter-bank rates are only a very rough proxy for the banks' earnings on their current account deposits, as the banks do not generally match particular types of deposit with particular categories of asset - and their investments cover a wide spectrum from cash in tills which earns nothing (and the demand for which arises primarily from current account holders) to personal loans which have relatively high yields. There is also an important, though unquantifiable, relationship between high interest rates and bad debts, which will tend to offset the advantage to profits of a regime of high interest rates.

6 Finally it should be noted that the figures in the British Banking Association's report (Review of Taxation in the Banking Sector - September 1982) referred to by the Prime Minister, do not relate to particular levels of interest rates at which the banks would become unprofitable. These figures:

1975	1976	1977	1978	1979	1980	1981
6.9%	7.1%	6.8%	6.2%	6.5%	8.1%	8.2%

are estimates of the costs of the four main clearing banks in operating current accounts, after deducting the banks' charges, and expressed as a percentage of the average credit balances on current accounts for the years in question.

Bank of England

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DG

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