8 The Discount Market

All banking systems need a highly developed money market so that banks may adjust their liquidity positions day by day and occasionally during the same day. Until September 1971 it was true to say that there were two money markets corresponding to the two banking systems—the discount market serving deposit banks and the parallel sterling money market serving secondary banks. For some time there had not been a rigid separation between them; secondary banks operated in a small way in the discount market, and discount houses had begun to assume an important role in the parallel market. The new arrangements for the control of banks will bring these two money markets much closer together. The basic difference between them will remain, however, that the discount market is predominantly a market on which lending is secured, while on the parallel market all lending is unsecured. On the discount market the Bank of England acts as lender of last resort to the discount houses, whereas the parallel market lacks a lender of last resort.

In this chapter we shall deal with the discount market, using that term to refer to the market on which the discount houses and certain other bodies operate instead of restricting its use, as the Bank of England does, to the discount houses themselves. The parallel sterling money market is described in Chapter 10, after we have analysed the working of secondary banks.

1. Discount Houses

A. Functions

The discount houses can trace their history back about 150 years, but during this time their main line of business has changed several times.
To begin with their staple trade was in inland bills of exchange, which formed the normal method of bank lending in the early nineteenth century: the function of the bill brokers, as they were then called, was to enable the small local 'country banks' to adjust their liquidity by the purchase and sale of these bills. Later the bill of exchange became more important in foreign trade, and the 'bill on London' developed as an international currency; the discount houses were an indispensable part of the mechanism, acquiring a specialised knowledge of the 'names' on these bills. The bill on London declined with the First World War, but at the same time the treasury bill assumed importance as a means of government financing, and the discount houses organised the secondary market for treasury bills. During the late 1930s they also began to act as jobbers in the short end of the gilt-edged market (stocks with less than five years to maturity). Finally, in the past few years bill finance has once again become important in both internal and international trade, and discount houses have resumed some of their old functions. They have also begun to operate on the parallel money market in several ways. They act as dealers in both dollar and sterling negotiable certificates of deposit (CDs) and in local authority negotiable ('yearling') bonds; they have begun to act through subsidiaries as brokers in the parallel money markets and in the foreign exchange market.

Through this somewhat chequered career several threads can be traced. (1) Since the early days of the nineteenth century the discount houses have operated, not as brokers, but as principals, buying and selling for their own account. (2) One important aspect of their functions has always been the service provided to banks of all kinds of enabling them to adjust their liquidity as conveniently as possible; the discount houses accepted deposits on call or at short notice, and employed the funds in the financing of a 'book' of bills and short bonds, which they were prepared to sell to the banks when required. (3) All but a tiny part of their borrowing has always been secured. Discount houses thus borrow money to finance the purchase of assets, which they then use as security for their borrowings. (4) The services which the discount houses provide have always been regarded as so useful that both the banks and the Bank of England have found new types of business for the discount houses to do when their old lines of business were in decline.