EXPLANATORY MEMORANDUM TO

THE CASH RATIO DEPOSITS (VALUE BANDS AND RATIOS) ORDER 2018

2018 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Cash Ratio Deposits (Value Bands and Ratios) Order 2018 amends the ratio used for calculating the percentage of eligible liabilities that eligible financial institutions are required to deposit in a non-interest bearing account at the Bank of England ("**the Bank**") under the cash ratio deposit ("**CRD**") scheme. The CRD scheme funds the Bank's monetary policy and financial stability functions.

2.2 Currently, a fixed ratio of 0.18% is applied when determining the amount to be deposited at the Bank by such institutions. This Order amends the scheme to provide that the ratio for institutions whose eligible liabilities are more than £600 million will be calculated every six months by applying the formula contained in the Order.

2.3 No amendments are made to:

(a) the ratio to be applied in respect of those eligible institutions who have eligible liabilities between £0 and £600 million. For this value band, the ratio remains at 0%; and

(b) the threshold value band, which determines the minimum value of deposits that an institution must hold to be eligible for the scheme. The threshold is any eligible liabilities above £600 million.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and Northern Ireland.

4. Legislative Context

4.1 Schedule 2 to the Bank of England Act 1998 (c. 11) ("**the Act**") makes provision concerning the maintenance by certain institutions of cash ratio deposits with the Bank.

4.2 The institutions covered by these arrangements are those defined as "deposit-takers" by section 17(7) of, and paragraph 1(1A) to (1C) of Schedule 2 to, the Act.

4.3 The Bank is empowered, by paragraph 3 of Schedule 2, to give such an institution a call notice, specifying an amount the institution is expected to have on deposit with the Bank during a specified period.

4.4 Under paragraph 4 of Schedule 2, this depositable amount is to be calculated by multiplying so much of an institution's average liability base as falls into each of the different value bands by the ratio applicable to that band, and adding up these amounts.

4.5 Under paragraph 5 of Schedule 2, the Treasury may, by order, specify the value bands and the ratios applicable to those value bands. This Order is made under that provision and, pursuant to section 40(2) of the Act, is subject to the draft affirmative procedure.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 The Chief Secretary to the Treasury has made the following statement regarding Human Rights:

"In my view the provisions of the Cash Ratio Deposits (Value Bands and Ratios) Order 2018 are compatible with the Convention rights."

7. Policy background

What is being done and why

Background to the CRD scheme

7.1 The following financial institutions are potentially liable to make deposits under the 1998 Act. These are, broadly:

(a) UK deposit-taking institutions (banks and building societies) authorised under the Financial Services and Markets Act 2000; and

(b) European institutions not authorised by the Prudential Regulation Authority but having permission according to the Capital Requirements Directive 2013/36/EU to operate a branch in the UK for the purposes of accepting deposits or other repayable funds from the public.

7.2 The size of an eligible institution's cash ratio deposit is calculated by applying two factors:

(a) the size of its eligible liabilities[1] above a minimum threshold; and

(b) a cash ratio, applied above this threshold.

7.3 Under the current scheme, the ratio for calculating the percentage of eligible liabilities that eligible financial institutions whose eligible liabilities are above £600 million are required to deposit in a non-interest bearing account at the Bank is fixed at 0.18%.[2]

---

[1] Paragraph 2 of Schedule 2 to the Act provides that the liability base of an eligible institution at any time is the aggregate of those sterling and foreign currency liabilities of the institution which are eligible liabilities.

[2] This ratio was calculated in 2013, having regard to (i) the Bank's forecast income for the period 2013-18, and (ii) market expectations of gilt yields and the projected levels of eligible liabilities over the same period. The ratio was specified in the Cash Ratio Deposits (Value Bands and Ratios) Order 2013 (S.I. 2013/1189).

The 2018 review

7.4 The 2018 review found that the CRD scheme resulted in a shortfall of funding for the Bank's policy functions over the five-year period 2013-18.

7.5 The total cost of the Bank's monetary policy and financial stability functions over this period was higher than expected, totalling £744 million (of which £172 million is expected to be incurred during the current financial year 2017/18).

7.6 The CRD scheme is expected to yield a total income of £587 million, which is lower than the £657 million forecast. The shortfall in CRD income has resulted in a deficit on the scheme, which reduces the dividend transferred from the Bank to the Treasury and the Bank's reserves.

7.7 Lower-than-expected CRD income has arisen largely because the average investment yield that was expected to be achieved by the Bank on CRD deposits over the period 2013-18 was lower than expected. This is due to the lower prevailing yields on new gilt investments and the prolonged period of a low Bank Rate.

7.8 Looking to the future, the 2018 review examined (i) the Bank's forecast costs for the next five-year period (2018-23), (ii) the expected investment yield over the forthcoming five years, and (iii) the anticipated eligible liabilities over the same period. The review then went on to consider what the implications of these forecast figures would be for the parameters of the scheme. The review found that:

(a) The projected total costs of the Bank's monetary policy and financial stability functions over the five-year period 2018-23 will be in the order of £845 million. The increase reflects the additional responsibilities given to the Bank since the last review, as well as enhancements made to the way in which it achieves its monetary policy and financial stability objectives, and includes, amongst other things, the resource needed to meet (i) the Bank's increased responsibilities under the Bank Resolution and Recovery Directive 2014, and (ii) enhancements to the Financial Stability Strategy and Risk division in order to support the Financial Policy Committee and Monetary Policy Committee.

(b) The investment yield achieved on the deposits is affected mainly by gilt yields and is forecast to average 2.0% per annum, assuming that investment and accounting policies remain unchanged. This estimate is from current market expectations.[3]

(c) Annual growth in eligible liabilities is expected to average 2.9%. This is based on the Bank's forecasts for growth in broad money over the period 2018-23.

(d) The Bank has put in place a cost containment and re-prioritisation programme and, absent any significant change to its remit, will fund any future costs in excess of the budget through efficiency savings.

7.9 Given the assumptions above, and on the basis of the current parameters of a fixed ratio of 0.18%, a minimum threshold of £600 million and the existing definition of eligible liabilities, the CRD scheme would generate income of £501 million, significantly short of the projected £845 million costs of the Bank's policy functions for the period 2018-23.

7.10 In the light of this projected shortfall, the 2018 review went on to consider what amendments should be made to the CRD scheme to ensure the Bank can recover, in

[3] Forward rates as implied by the gilt yield curve averaged over the ten working days to 26 January 2018.

full, its monetary policy and financial stability costs over the period 2018-23. The review considered, amongst other things, the possibility of:

(a) amending the current parameters of the scheme, in particular, the liability base, the threshold over which eligible institutions must place deposits with the Bank and/or the ratio applicable to deposits over that threshold value band; and/or

(b) moving to an indexation-based approach, by which the ratio applicable to the threshold value band would be indexed to gilt yields and calculated (and adjusted) once every six months, in line with the timetable for call notices.[4]

7.11 The review found that, if average annual growth in eligible liabilities of 2.9% over the period was assumed, increasing the ratio to 0.35% would result in forecast income from the CRD scheme that was expected to be close to the forecast costs of the Bank's policy functions over the next five years.

7.12 The review concluded, however, that, in order to achieve a more accurate cost-recovery basis under the CRD scheme, a move to an indexation model would be preferable. This model would see the ratio calculated every six months, which would allow it to be more closely aligned to prevailing gilt yields. The ratio would increase when yields fall and decrease when yields rise.

7.13 The review found that a ratio that was indexed to prevailing gilt yields would more likely result in a smoother income profile over the five-year period and, therefore, lead to the Bank better recovering its costs under the scheme.

The indexation model

7.14 Under the indexation approach, the ratio will be calculated (and adjusted) every six months (immediately before call notices are sent to eligible institutions).[5] The operation of an indexation model will fit within the existing timetable for call notices, with the ratio to be calculated on the fourteenth working day of May and November.

7.15 The market data used to calculate the ratio will be:

(a) based on gilt yield data (of a weekly frequency),[6] relating to a reference gilt with approximately eight years to maturity;[7]

(b) collated using yields from the close of business on the last working day of each week, up to and including the thirteenth working day of the month prior to the commencement of each call notice period;

(c) collected by a third-party provider; and

(d) published on the Bank's website, together with the ratio as calculated every six months.

[4] The call notice specifies the amount an institution is expected to have on deposit with the Bank during a specified period.

[5] The ratio will be calculated on the fourteenth working day of the month before the commencement of each call notice period.

[6] The yield refers to the yield to maturity.

[7] The practice of referencing a benchmark security is standard across data vendors.

7.16 The ratio will be calculated using the following formula:

$$\text{\textit{CRD ratio}} = \frac{\text{\textit{Income} [fixed]}}{\text{\textit{Aggregate eligible liabilities} [fixed] x \textit{Portfolio yield} [variable]}}$$

7.17 For the purposes of this formula:

(a) "**Income**" means the income required by the Bank to cover its monetary policy and financial stability costs over the period 2018-23. This is calculated based on the Bank's total five-year budget, divided by five. The annualised figure is fixed for each year and is equal to £169 million.

(b) "**Aggregate eligible liabilities**" means the sum of all eligible liabilities above the threshold value band, across all eligible institutions. This is a fixed input to the formula, based on the average of forecast eligible liabilities over the period 2018-23 and is equal to £2,837,817.5 million.

(c) "**Portfolio yield**" is an approximation of the Bank's portfolio yield on the investments made by the Bank under the cash ratio deposit scheme. It will be calculated every six months, using market-based data, and has three components weighted to reflect the respective yield composition of the portfolio:

$$(0.55 \text{ x } a) + (0.42 \text{ x } b) + (0.03 \text{ x } c)$$[8]

where:

(i) "*a*" is the Bank's long-term gilt holdings, and is represented by a historical average of yields over a look-back period of 13 years (which represents the Bank's current gilt portfolio). It is calculated using the arithmetic mean of the yield on 8-year gilts over the period of 13 years ending with the thirteenth working day[9] of the month immediately prior to the commencement of each call notice period.

The average yield over the look-back period will be updated every six months at the point at which the portfolio yield is calculated.

(ii) "*b*" represents the fact that, due to the initial increase in the ratio in the middle of 2018 (which is necessary to ensure the Bank's costs over the period 2018-23 are met by the CRD scheme), increased cash ratio deposits will be placed at the Bank. This will mean that the Bank will need to invest a significant part of the portfolio in or around mid-2018, and will therefore be exposed to prevailing market yields in this period. This term will be calculated as follows:

- For the first call notice period following the coming into force of the Order, the term will be calculated using the arithmetic mean of the yield on 8-year gilts over the period of six months ending with

[8] An eight-year benchmark has been chosen to reflect the average duration of the Bank's portfolio (which is a portfolio that generally holds purchases to maturity).
[9] Working day is defined in paragraph 12 of Schedule 2 to the Act.

thirteenth working day of the month prior to the commencement of that period.

- For each subsequent call notice period, the arithmetic mean of the yield on 8-year gilts over the period of six months ending with the thirteenth working day of the month prior to the commencement of the second call notice period following the coming into force of this Order. The term will then become a constant in the portfolio yield calculation.

(iii) "*c*" reflects the expected re-investments from the Bank's maturing gilt holdings in each six-month call notice period. As the yield on the forthcoming investments will not be known with certainty when call notices are sent out, this term will be calculated using the arithmetic mean of the yield on 8-year gilts over the period of six months ending with the thirteenth working day of the month immediately prior to the commencement of each call notice period.

8. Consultation outcome

8.1 The Government issued a consultation paper entitled "Review of the cash ratio deposit scheme: consultation on proposed changes" on 8 February 2018. The consultation period closed on 9 March 2018 and three responses were received.[10] The Treasury has published a response to the consultation at the following location: https://www.gov.uk/government/consultations/review-of-the-cash-ratio-deposit-scheme-consultation-on-proposed-changes.

9. Guidance

9.1 The Treasury does not propose to issue guidance on the content of this Order. The Bank will issue operational guidance.

10. Impact

10.1 The impact on business is limited to eligible institutions as defined in paragraph 7.1. There is no impact on charities or voluntary bodies.

10.2 The scheme funds the Bank's monetary policy and financial stability functions. The Bank falls within the public sector accounting boundary. Therefore, there is an impact on the public sector.

10.3 An Impact Assessment is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation applies to all firms set out in paragraph 7.1. The ratio on eligible liabilities of £600 million or less is 0% as set out in paragraph 2.2, therefore, the Treasury expects the impact on small and micro-businesses to be negligible, as set out in the impact assessment.

12. Monitoring & review

12.1 The Order contains a review clause, which provides that the Treasury must keep the Order under review and publish a report setting out the conclusions of the review. The first report must be published before the end of the period of five years beginning

[10] An earlier informal consultation was also run, to which 19 responses were received.

with 1 June 2018. Subsequent reports must be published at intervals not exceeding five years.

13. Contact

13.1 Derek Dunne at HM Treasury (020 7270 4358 or derek.dunne@hmtreasury.gsi.gov.uk) can answer any queries regarding the instrument.