EXPLANATORY MEMORANDUM TO

THE CASH RATIO DEPOSITS (VALUE BANDS AND RATIOS) ORDER 2013

2013 No. 1189

AND

THE BANK OF ENGLAND (CALL NOTICE) (BENCHMARK RATE OF INTEREST) ORDER 2013

2013 No. 721

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

This memorandum contains information for the Joint Committee on Statutory Instruments and explains two related Statutory Instruments.

One memorandum has been prepared in relation to both instruments as they are closely linked.

2. Purpose of the instruments

2.1 The Cash Ratio Deposits (Value Bands and Ratios) Order 2013 changes the percentage of eligible liabilities that eligible financial institutions are required to deposit in a non interest bearing account at the Bank of England under the cash ratio deposit (CRD) scheme. The CRD scheme funds the Bank of England's monetary policy and financial stability functions. This instrument changes:

- The CRD rate, which is the percentage of eligible liabilities that are required to be deposited at the Bank of England. The instrument changes the rate from 0.11% to 0.18%.
- The CRD threshold, which determines the minimum value of deposits that an institution must hold to be eligible for the scheme. The instrument changes the CRD threshold from £500m to £600m.

2.2 The Bank of England (Call Notice) (Benchmark Rate of Interest) Order 2013 changes the benchmark rate of interest that eligible institutions are required to pay if they do not deposit the appropriate amount as specified by the bank of England in a call notice.

Currently the benchmark rate is very complicated. It is calculated by taking the average of the rates at which 3 month deposits in sterling are bid at 11.00 am on the day by the 5 eligible institutions having in the opinion of the Bank the largest eligible liabilities at the end of the reference period for the relevant call notice.

This instrument changes the benchmark rate of interest from 3 June onwards to the Bank Rate, the official rate of interest set by the Bank of England's Monetary Policy Committee.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 The Cash Ratio Deposits (Value Bands and Ratios) Order 2013

Schedule 2 to the Bank of England Act 1998 (c. 11) ("the 1998 Act") makes provision concerning the maintenance by certain institutions of cash ratio deposits with the Bank of England ("the Bank"). The institutions covered by these arrangements are those defined as "deposit-takers" by section 17(7) of, and sub-paragraphs (1A) to (1C) of paragraph 1 in Schedule 2 to, the 1998 Act. The Bank is empowered by paragraph 3 of that Schedule to give such an institution a call notice specifying an amount it is expected to have on deposit with the Bank during a specified period. Under paragraph 4 of that Schedule, 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. This Order is subject to the draft affirmative procedure.

4.2 The Bank of England (Call Notice) (Benchmark Rate of Interest) Order 2013

Under paragraph 6(3) of Schedule 2 to the 1998 Act the amount the Bank may require an institution to pay when eligible institutions are late in making deposits is an amount equal to interest for the period covered by the notice, at 4% over the benchmark rate.

This Order replaces paragraph 7 of Schedule 2 which currently specifies the benchmark rate for this purpose. This Order specifies that the Bank rate (as defined in new paragraph 7(2)) is the benchmark rate. The Order is subject to the negative procedure.

5. Territorial Extent and Application

5.1 These instruments apply to all of the United Kingdom.

6. European Convention on Human Rights

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 2013 and the Bank of England (Call Notice) (Benchmark Rate of Interest) Order 2013 are compatible with the Convention rights.

7. Policy background

Background to the CRD scheme

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

- UK deposit-taking institutions (banks and building societies) authorised under the Financial Services and Markets Act 2000.
- European institutions not authorised by the Financial Services Authority (FSA) but having permission under the Banking Consolidation Directive 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:

- The size of its eligible liabilities above a minimum threshold ; and
- A cash ratio, applied above this threshold.

7.3 The 2013 review found that the CRD scheme resulted in a shortfall of funding for the Bank of England's policy functions over the five-year period 2008-13.

The total cost of the Bank of England's monetary policy and financial stability functions over the 2008-2013 period is expected to be £603m (of which £132m is expected to be incurred during the current financial year 2012/13). This is above the £563m projected in the 2008 review. The difference in costs is attributable to the Bank of England taking on new responsibilities and introducing new facilities to support the financial system during that time. In real terms, the costs charged to the CRD scheme are no higher in 2012/13 than in 2003/04, despite the increase in responsibilities. The Bank's additional responsibilities include

7.4 The CRD scheme is expected to yield a total income of £523m, lower than the £575m forecast. The shortfall in CRD income has resulted in a deficit on the scheme, which the Bank has had to recoup from its capital and reserves, reducing the dividend transferred from the Bank to HM Treasury and the Bank's retained profits.

7.5 Lower-than-expected CRD income has arisen largely because the average investment yield expected to be achieved by the Bank on CRD deposits over the period from March 2008 to February 2013 is 4.25% (including a forecast yield for 2012/13 of 3.8% only), compared to an estimate of 5.0%. This is due to the lower prevailing rate on new gilt investments and the lower Bank Rate.

7.6 In addition, cash ratio deposits have grown less quickly than forecast, from £2,275m at 2 June 2008[1] to £2,483m at 1 December 2012, an annualised rate of growth of 1.95%. A rate of growth of 4.5% had been assumed.

7.7 Looking to the future, the review examined whether the current assumptions were still valid, and the implications of this for the parameters of the scheme. The review found that:

a) The projected total costs of the Bank of England's monetary policy and financial stability functions will be in the order of £670m over the five-year period from March 2013 to February 2018. This estimate takes into account:

    i. The additional cost of the supervision of central counterparties (CCPs) and securities settlement systems (SSSs) that will become the responsibility of the Bank from April 2013.

    ii. That the Bank of England will achieve efficiency savings from operating a shared corporate services model across the Bank and the Prudential Regulation Authority (PRA), which have been accounted for in projected spending to be met by the cash ratio deposit scheme.

    iii. The ongoing effect on average salary levels of a two-year pay freeze that was in force from March 2011 to February 2013.

    iv. Following the adjustments above, the Bank's objective is to limit spending growth to 2% nominal per annum (given constant responsibilities) so that over time there is no increase in the Bank's policy costs in real terms. This extends the approach taken over the past ten years.

b) The investment yield achieved on the deposits is affected mainly by gilt yields and is forecast to average 3.2%[2], assuming that investment and accounting policies remain unchanged.

c) Growth in eligible liabilities is expected to return to 4.5% per annum growth (in line with long-run nominal GDP) and average 3.3% per annum over the CRD period.

d) Scope for additional efficiency savings has also been identified in corporate services areas, which will be implemented during the next five-year period. HM Treasury (HMT) will review efficiency savings identified by the Bank once the PRA shared corporate services model has been established. HMT will consider the implications of identified efficiency savings for the Bank of England's monetary policy and financial stability funding requirements through the CRD scheme.

7.8 Given the assumptions above, and on the basis of the current parameters of a 0.11% ratio, minimum threshold of £500m and the existing definition of eligible liabilities, the CRD

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[1] This is the date at which the Cash Ratio Deposit (Value Bands and Ratios) Order relating to the 2008 CRD review became effective.

[2] The Government does not forecast gilt yields. The assumptions of future yields in this document are based on market expectations as derived from the Gilt yield curve

scheme would generate income of £436m, significantly short of the projected £670m cost of the Banks policy functions.

7.9 The review found that if average growth of 3.3% in eligible liabilities over the period were assumed, increasing the ratio to 0.18% whilst increasing the minimum threshold to £600m would result in forecast income from the CRD scheme (£657m) that was expected to be close to the forecast costs of the Bank’s policy functions over the next five years (£670m).

8. Consultation outcome

8.1 The Government issued a consultation paper: Review of the cash ratio deposit scheme: consultation on proposed changes. The consultation period closed on 15 March 2013 and three responses were received. Only one respondent addressed specific changed to the scheme. None of the respondents made direct comments on the draft Orders published as part of the consultation.

9. Guidance

9.1 The Treasury does not propose to issue guidance on the content of these Orders.

10. Impact

The following impact assessment was included in the consultation document published on the HM Treasury website on February 18. The Consultation closed on March 15 and only received three responses. A summary of responses will be published after the Easter recess. The full consultation document, including the impact assessment is available here: http://www.hm-treasury.gov.uk/consult_review_of_the_cash_ratio_deposit_scheme.htm

10.1 The level of cash ratio deposits for the majority of institutions is small. In December 2012, 86% of the deposits were made by just 20 institutions, with eight institutions each contributing more than £50m in CRDs. While the mean deposit was £17.9m, the median was only £2.4m. Thus the main incidence of the scheme is on larger banks and building societies.

10.2 Under the new parameters, some CRD payers (financial institutions) will need to hold higher deposits with the Bank of England. The increased costs as a result of these changes will fall to the larger banks and building societies (those with eligible liabilities of over £750m) who will need to increase their deposits by a total of £1,558m in 2013/14 (which will be in addition to £2,480m of deposits held in 2012/13).

10.3 The income generated on these deposits will be retained by the Bank to fund its monetary policy and financial stability functions, which benefit the whole of the banking sector as well as the wider pubic. This forecast income is therefore used as a proxy measure for the cost - or interest foregone - to the financial institutions. This is calculated over each of the next five years on the basis of the assumptions set out in the remainder of this document.

10.4 Administrative (i.e. operational) costs to affected financial institutions of accommodating such a change are expected to be negligible. There will be no changes to reporting requirements to the Bank of England and hence no systems changes in affected institutions will be required.

10.5 The best estimated cost is £221m (£208.4m NPV), within a range of £149m-£307m (£141.1m - £288.2m NPV).

10.6 The best estimate is based on the assumption of an average return on CRDs of 3.0% pa, based on market interest rate expectations, and an average rate of annual growth in eligible liabilities of 3.3%, based on the Bank's forecast growth of M4 excluding intermediate other financial corporations, consistent with the central forecast contained in the Bank of England's November Inflation Report (available at: http://www.bankofengland.co.uk/publications/Pages/inflationreport/ir1204.aspx). The range of costs is based on lower than expected returns and annual growth (2.6% and 0.5% respectively), and higher than expected returns and annual growth (3.5% and 6.1% respectively. A discount rate of 3.0% is applied for the NPV.

10.7 The increase to the eligible liabilities threshold will remove 14 institutions from the scheme altogether, and will reduce the deposits being held by a further 12. These benefits have been calculated on the same basis as above, with a best estimate of approximately £1.5m.

10.8 The change to the benchmark interest rate to become the Bank Rate will provide greater clarity to eligible institutions regarding the rate to be charged for depositing an inappropriate amount of CRDs. The Bank Rate can be higher as well as lower than the previous benchmark interest rate, depending on financial market conditions at a given point in time.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 The Treasury will keep the Orders under review.

13. Contact

James Fairburn at HM Treasury Tel: 020 7270 6504 or email: James.Fairburn@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.