Regulatory Policy Committee

Cash Ratio Deposit Scheme

HM Treasury

RPC rating: fit for purpose

Description of proposal

The Bank of England's monetary policy and financial stability activities are funded by the banking industry under the Cash Ratio Deposit Scheme. This scheme requires eligible institutions (largely banks and building societies with eligible liabilities in the "threshold value band" (above £600 million) to place a percentage of the value of their eligible liabilities on deposit with the Bank. The Bank then invests these deposits in gilts (safe, low-interest government bonds) and uses the earnings produced to fund its activities.

The percentage of eligible deposits to be treated in this way has historically been reviewed every five years; during the past review period, the bank's spending has substantially outstripped earnings, because: the Bank has taken on increased responsibilities; eligible liabilities above the CRD threshold have not grown as much as expected; and gilt returns were below the level expected the last time the scheme was reviewed. Given the long-term trend in gilt rates over time and the impacts of these on the Bank's portfolio, the Department expects any discrepancies to be largely negative over the next few years, so that correcting them would impose costs on business over the period of the appraisal. This is because the Bank's earliest gilt purchases, which bear much higher rates of interest than are available at present, are maturing and being replaced by newer purchases at lower rates.

The current proposal has two elements:

1. An increase in the costs of the Bank's policy activity as a result of recent changes to the regulatory frameworks surrounding financial stability; and
2. A change to the approach for setting the percentage of eligible deposits, which under the preferred option would be automatically linked to prevailing gilt yields and recomputed semi-annually. This would smooth the differences between the earnings from deposits and the Bank's actual costs.

Impacts of proposal

Where changes to the Bank's policy activities result in specific regulation of the financial sector, those are accounted for in assessments of the detailed regulations. This assessment therefore covers the cost to businesses of the increase in the Bank's costs (which is passed through to them) and changes to the update mechanism. It also describes the wider impacts of changes to the Bank's policy activity, where these in themselves affect businesses.

In principle, the scheme covers 352 institutions; the number with eligible deposits above the £600 million threshold value varies slightly over time and is reviewed every six months. For the purpose of the IA, it is assumed to be 152, which is the number affected as of December 2017.

The main impacts of the proposal are:

1. The costs to business of the increase in the percentage of eligible deposits to be placed with the Bank. The percentage will increase from 0.18% to 0.35% at the beginning of the period. The Department estimates this as the foregone interest on the required deposit, based on the assumption that the deposit displaces some part of a firm's liquid assets, which are typically invested in five-year gilts. This gives an expected cost of £335 million NPV over the five-year appraisal project;
2. The benefits to business of the proposed approach to adjusting the CRD ratio, which smooths deposits so that the initial deposit need not be so large. The Department estimates these at around £35 million NPV over the period.
3. Costs resulting from adjustments to firms' balance sheets to meet capital and liquidity requirements, which the Department treats as indirect on the grounds that they depend on individual firms' asset management choices. It does not monetise these costs on the grounds that it is difficult to anticipate these decisions effectively; it expects them to be small because in most cases firms hold sufficient headroom to cover the amounts required without making changes;
4. Benefits arising from the Bank's increased activity, which it describes (with supporting evidence based on consultation responses) but does not monetise, on the grounds that the benefits due to increases in activity are difficult to separate clearly from those due to existing activity. The Department treats these as indirect, on the grounds that they are contingent on actions of the Bank and other market participants. They include increased access to the Bank's Sterling Monetary Fund framework and liquidity insurance and increases in overall stability of the financial system.

Quality of submission

The Department's assessment of the impacts of the measure (both EANDCB and overall impacts) is fit for purpose; in particular, it has made good use of consultation evidence to support its assumptions and to help it to describe and evidence the non-monetised benefits of the policy. It has used as a counterfactual the existing 0.18% fixed rate for the scheme.

It has also considered a range of options (based on a review of approaches used by other central banks, and including a fee-based model and changes to the threshold value for entry into the scheme) and set out clearly the reasons for its choice of options at this stage. In particular, it explains clearly why it has chosen not to alter the threshold value for entry into the scheme, and why it has not chosen at this stage to introduce alternative funding models such as fee-based models (though it notes that it will explore alternative options in more detail in the future).

It does not discuss in any detail the market effect of any scheme with an entry threshold – in particular the competitive advantage to smaller firms of the resultant drag on smaller firms. This is an indirect effect, but the IA could be improved by discussing it more clearly and by considering it as part of the SaMBA.

The key variable driving the scale of costs and benefits is the performance of gilts over the appraisal period, and the Department has carried out appropriate sensitivity analysis around this variable.

As presented, the impact assessment is laudably concise, and largely clear in its presentation of the complex subject matter; in some places, and particularly in its description of indirect costs and benefits, the assessment could have been improved by making more concessions to the lay reader. In particular, a clear summary of the various assumptions underpinning the Department's analysis would have been extremely helpful.

Finally, the Department presents a brief SaMBA noting that no small or micro businesses are directly affected. It has also committed to reviewing the approach in 5 years' time. It does not set out its approach to the review, but the RPC is pleased to see the commitment.

Departmental assessment

Classification	Under the 2015-17 framework: regulatory provision with net costs (IN)
Equivalent annual net direct cost to business (EANDCB)	£55 million
Business net present value	-£300 million (over 5 years)
Overall net present value	£19 million (over 5 years)

RPC assessment

Classification	Under the 2015-17 framework: regulatory provision with net costs (IN)
Small and micro business assessment	Sufficient

Anthony Browne, Chairman