

# **Review of the Cash Ratio Deposit Scheme and Consultation on proposed changes**

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August 2003



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## **Review of the Cash Ratio Deposit Scheme and Consultation on proposed changes**

### **Summary**

Under the cash ratio deposit scheme, certain institutions authorised under the Financial Services and Markets Act 2000 to accept deposits (such as banks and building societies) place non-interest bearing deposits at the Bank of England. The Bank invests these deposits and the income earned is used to fund the costs of the Bank's sterling liquidity, monetary policy and financial stability operations, which benefit sterling deposit takers. The scheme was placed on a statutory footing in the Bank of England Act 1998, with effect from 1 June 1998. At that time, the Government made a commitment to review the scheme after five years. This paper sets out the conclusions of that review.

As part of the review, the Treasury has already consulted all institutions that are currently eligible institutions under the scheme, and their representative bodies, about their experience since 1998. Two representative bodies and 25 eligible institutions responded.

In summary, the review reached the following conclusions:

- The cash ratio deposit scheme continues to be a suitable method of funding the Bank of England's sterling liquidity, monetary policy and financial stability operations.
- The definition of eligible liabilities should not be brought into line with the definition of deposits used by the FSA as a basis for calculating the fees it collects from deposit taking financial institutions.
- The ratio should remain at 0.15 per cent. The Government will keep the ratio under review during the operation of the scheme.
- The minimum threshold for making deposits should be raised to £500 million, freeing 18 institutions from the scheme and benefiting all remaining contributing institutions by reducing the level of their deposits by £150,000 each.

- The Bank of England should consider ways in which the transparency of the scheme could be enhanced, for instance by publishing a more detailed breakdown of expenditure by function.
- The Government will continue to monitor the effect of the cash ratio deposit scheme and will conduct a further formal review at the latest in five years' time.

### **Recommendations of the review**

This consultation affects eligible institutions throughout the UK. The purpose of publishing this document is to enable any interested parties to make representations on the following recommendations:

- (i) The proposal to increase the threshold to £500 million but leave all other parameters of the scheme unchanged;
- (ii) Whether there are any technical aspects of the operation of the scheme that could be improved; and
- (iii) The proposal to enhance disclosure of the working of the scheme, ensuring that interested parties have the information they need to assess its financial operation and to make representations to the Treasury if they consider the parameters should be altered in the future.

We are sending this consultation to all eligible institutions under the scheme, and their representative bodies. Following receipt of responses, we will inform the interested parties of the results and the action that has been decided on, or contact them with further questions that have been raised as a result of this consultation.

Responses are invited by 31 October 2003 and should be sent to:

David Curtis  
Head of the Expenditure Branch  
Debt and Reserves Management Team  
HM Treasury  
1 Horse Guards Road  
LONDON  
SW1A 2HQ  
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to whom any questions or comments about the consultation should also be addressed. Representative bodies are requested to make clear on whose behalf they are making their submission. Responses may be made public unless confidentiality is specifically requested.

This consultation is being made in accordance with the terms of the Government's Code of Practice on written consultations.

## **Introduction**

1. Under the cash ratio deposit scheme, certain institutions authorised under the Financial Services and Markets Act 2000 to accept deposits (such as banks and building societies) place non-interest bearing deposits at the Bank of England. The Bank invests these deposits and the income earned is used to fund the costs of the Bank's sterling liquidity, monetary policy and financial stability operations, which benefit sterling deposit takers. The scheme was placed on a statutory footing in the Bank of England Act 1998, with effect from 1 June 1998. At that time, the Government made a commitment to review the scheme after five years. This paper sets out the conclusions of that review.

## **The review**

2. The review was announced by the Paymaster General by written statement to the House of Commons on 25 February 2003. The review was led by a steering group, whose members were:

Professor Forrest Capie, Faculty of Finance, Cass Business School  
Sue Owen, Director, Macroeconomic Policy and International Finance,  
HM Treasury  
Clifford Smout, Finance Director, Bank of England

As part of the review, the Treasury consulted all the institutions that are currently 'eligible institutions' under the scheme.

## **Background**

3. The cash ratio deposit scheme has the following main features. Financial institutions potentially liable to make deposits are defined as 'eligible institutions' under the Act. These are, broadly:

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

- European institutions not authorised by the FSA but having permission under paragraph 15 of Schedule 3 to the Financial Services and Markets Act 2000 to accept deposits or other repayable funds through a branch in the UK.
4. The size of an eligible institution's cash ratio deposit is calculated by applying two factors:
- The size of its average eligible liability base above a minimum threshold. In 1998, the threshold was increased from £10 million to £400 million. The current definition of eligible liabilities is given at Annex A; and
  - A ratio, applied above this threshold, set in 1998 at 0.15 per cent of the average eligible liability base. This ratio has been kept under review by the Treasury and the Bank of England since then.

### **Parameters of the cash ratio deposit scheme**

5. The cash ratio deposit scheme was designed to fund the Bank of England's unremunerated activities: provision of sterling liquidity; financial stability; monetary analysis, statistics and operations; and, since 1998, monetary policy. In 1998, the costs of these activities were projected as follows:

- The Bank's average total costs (in 1998/99 prices) for the period 1998 to 2002 were estimated at £190 million per annum.
- Cost recoveries, from charges for specific services, were estimated at £111 million per annum.
- Therefore, the unrecovered costs to be funded through the cash ratio deposit scheme were £79 million per annum.
- Two assumptions were made: that the average investment yield over the period from the deposits would be around 7 per cent; and that both the average eligible liability base and the Bank of England's own costs would grow in line with nominal GDP at 4.5 per cent per annum.

- Using these assumptions, cash ratio deposits of £1,130 million were needed to fund the costs (£79 million divided by 7 per cent).
- Given the eligible liability base at 1 June 1998, the necessary ratio to generate £1,130 million of deposits was determined to be 0.15 per cent above a threshold of £400 million.

### **Operation of the scheme 1998 to 2003**

6. The review found that since 1998, the scheme has met its objective of funding the Bank of England's unremunerated activities.

7. In detail:

- The total cost of the Bank of England's sterling liquidity, monetary policy and financial stability functions over the last five years has been £473 million, an average of £95 million per annum;
- Cash ratio deposits have grown from £1,147 million at 1 June 1998 to £1,737 million at 1 June 2003, an annualised rate of growth of 8.7 per cent; and
- The average investment yield achieved by the Bank on the deposits has been 7.4 per cent. This figure was predominantly determined by the initial portfolio of assets rather than changes in short term interest rates, and was therefore significantly higher than the opportunity cost to the depositing institutions (see paragraph 14 below).

8. The cash ratio deposit scheme has yielded a total income (estimated at £534 million) which has more than met the total costs of the Bank of England's unremunerated activities (£473 million for the full five years). When the parameters of the scheme were set, it was recognised that there were scenarios in which the scheme might yield more, or less, income than the costs incurred. Any surplus income is subject to corporation tax and then shared equally between the Exchequer and the Bank of England's reserves. Any deficit would, symmetrically, reduce total income and retained profits.

9. The review examined why the growth in eligible liabilities and hence in cash ratio deposits had been at 8.7 per cent and not in line with nominal GDP, which had grown by 5.0 per cent per annum. The review found that eligible liabilities had grown approximately in line with the growth of M4 (the broad monetary aggregate). M4 grew faster than nominal GDP, probably reflecting rapid growth in household wealth.

### **Projecting future costs and income**

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

- the projected total costs of the Bank of England's unremunerated activities are of the order of £575 million over the five year period from March 2003 to March 2008;
- the investment yield achieved on the deposits is expected to average around 6 per cent, assuming that investment and accounting policies remain unchanged; and
- over the five year period the gap in M4 growth and GDP growth could be expected to narrow if wealth, and in particular housing wealth, grows less rapidly than over the last five years.

11. The review considered different scenarios for the future of the scheme. If the parameters of the scheme (that is, the definition of eligible liabilities, the minimum threshold and the ratio) remain unchanged and eligible liabilities grow broadly in line with nominal GDP, at 4.5 per cent per year, then the level of deposits at the end of the five-year period would be nearly £2,200 million. The total income from the deposits would be very close to the projected total costs of sterling liquidity, monetary policy and financial stability activities - £575 million - if the average income yield over the period is 6 per cent.

12. However, if the growth in eligible liabilities continues at a rate above 4.5 per cent, then the income would be greater. Table 1 below provides three possible scenarios.

**Table 1: Sensitivity of income to growth of CRDs**

Average growth rate of CRDs	Deposits after five years (£ million)	Estimated income over five years (£ million)
4.5%	2165	577
6.5%	2380	603
8.5%	2612	630

13. These factors are subject to uncertainties, but the review found that, without changing the parameters, income from the cash ratio deposit scheme was expected to be close to the budgeted costs of the relevant functions over the next five years. The parameters of the scheme should be kept under review, so that if this in fact does not turn out to be the case, they can be altered. In any event, a further formal review will be undertaken at the latest in five years' time.

### **The impact of the scheme on the financial sector**

14. The review examined the opportunity cost to the financial sector of placing non-interest-bearing deposits with the Bank of England. The financial impact has reduced in both nominal and real terms since 1998, as a result of the overall fall in the repo rate. The impact has reduced from £76 million in the first year (commencing 1 June 1998) to £65 million four years later.

15. When the scheme was placed on a statutory footing in 1998, the minimum threshold for making deposits was raised from £10 million to £400 million average eligible liability base. The review found this change had a significant impact, freeing around 250 institutions from making deposits. As at 1 June 2003 there were 149 eligible institutions making deposits. For reasons

of confidentiality under the Act only aggregated information about deposits can be given, as follows.

16. Analysis by the review showed that the level of cash ratio deposits for the majority of institutions is small, with 80 per cent of the deposits made by just 24 institutions, and eleven institutions each contributing more than £50 million. While the mean deposit is £11.4 million, the median is only £2.4 million. Thus the main incidence of the scheme is on larger institutions.

17. The review also examined the proportions of deposits made by UK-owned and foreign-owned institutions. Table 2 shows these proportions. UK-owned institutions contribute 81 per cent of the deposits made.

**Table 2: Proportions of deposits made by UK and non-UK institutions as at 1 June 2003**

<b>Group</b>	<b>Deposits (£ million)</b>	<b>%</b>
<b>UK</b>		
Major British Banking Groups	1,184	68
Building societies	195	11
Other UK institutions	33	2
<b>Non-UK</b>		
Subsidiaries of foreign banks in the UK	80	5
Branches of European institutions	178	10
Branches of non-European institutions	67	4
<b>Total</b>	<b>1,737</b>	<b>100</b>

18. The review examined the case for raising the minimum threshold for making deposits. The review found that a new minimum threshold of £500 million (an increase of a little more than twice Retail Price Inflation since June 1998) would reduce the total cash ratio deposits collected at present by £21 million. While the overall financial impact would be small, raising the

threshold to £500 million would have the benefit of freeing a further 18 institutions from contributing under the scheme. The figures are set out in Table 3.

**Table 3: Proportions of deposits made by UK and non-UK institutions, if the minimum threshold were raised to £500 million as at 1 June 2003**

<b>Group</b>	<b>Deposits (£ million)</b>	<b>%</b>
<b>UK</b>		
Major British Banking Groups	1,181	69
Building societies	192	11
Other UK institutions	31	2
<b>Non-UK</b>		
Subsidiaries of foreign banks in the UK	77	4
Branches of European institutions	172	10
Branches of non-European institutions	63	4
<b>Total</b>	<b>1,716</b>	<b>100</b>

19. On the basis of a higher threshold of £500 million, Table 1 would be modified as shown in Table 4.

**Table 4: Sensitivity of income to growth of CRDs with a higher threshold of £500 million**

Average growth rate of CRDs	Deposits after five years (£ million)	Estimated income over five years (£ million)
4.5%	2138	570
6.5%	2351	596
8.5%	2580	623

## **Comparison with alternative funding arrangements**

20. The review examined the financing arrangements of several other national central banks. Almost universally, central banks fund their activities from general income including that arising from seigniorage (no interest is paid to holders of banknotes) and foreign exchange reserves. In the United Kingdom the income from both these sources passes to the Government: the profits of note issue are paid in full from the Bank of England to the Treasury, and the Exchange Equalisation Account belongs to the Government, not the Bank of England.

21. The Reserve Bank of India is, like the Bank of England, not able to charge expenditure against seigniorage income but funds its activities from reserves income. There is no known case in which “public good” activities of a central bank are financed out of general taxation revenues collected by government.

22. The review also examined the fee-based funding arrangements of the UK’s Financial Services Authority (FSA). The underlying principle here is that the fees applied to each firm should relate to the costs of regulating that firm; that is, to the likelihood of problems emerging with that firm and the impact of any problems on the FSA's objectives. Some other FSA activities not related directly to the costs of regulating particular firms, for example those relating to international regulatory discussions and internal corporate activities, also incur costs, which are covered by fees.

23. This method would not be appropriate for calculating fees payable to fund sterling liquidity, monetary policy and financial stability activities, as these are benefits to the whole banking sector rather than costs incurred relative to individual firms within it. Although there are parallels here with the way the FSA incurs costs in international regulatory discussions, which are still covered by fees, the general principle used by the FSA is that those firms that incur higher costs pay higher fees. And a change from cash ratio deposits to a fee-based scheme would require primary legislation.

24. The review considered whether there were aspects of the FSA system that could be incorporated into the cash ratio deposit scheme. For example, if the two systems used the same measure of business size, this would reduce the regulatory impact on institutions.

25. The FSA uses a measure of business size that is defined differently from eligible liabilities as defined in the Bank of England Act. Eligible liabilities are used as a measure of an institution's ability to lend in sterling to non-banks. So their main focus is sterling liabilities; liabilities in foreign currencies only score as a net liability (liabilities minus assets) and only where this result is positive. The cash ratio deposits are recalculated twice a year using an average eligible liability base over the six-month period. In contrast, the FSA measure scores non-sterling positions in the same way as the sterling positions. The fees are called once a year (in April) based on liabilities for the quarter to end-December.

26. A change to the definition of eligible liabilities would only require secondary legislation. However, the steering group did not consider that a change to bring the definition in line with the FSA definition would bring benefits, because the rationale for the current definition of eligible liabilities reflects the benefit institutions receive from the Bank of England's liquidity operations in sterling only.

### **Summary of review proposals**

27. In summary, the review reached the following conclusions:
- The cash ratio deposit scheme continues to be a suitable method of funding the Bank of England's sterling liquidity, monetary policy and financial stability operations.
  - The definition of eligible liabilities should not be brought into line with the definition of deposits used by the FSA as a basis for calculating the fees it collects from deposit taking financial institutions.

- The ratio should remain at 0.15 per cent. The Government will keep the ratio under review during the operation of the scheme.
- The minimum threshold for making deposits should be raised to £500 million, freeing 18 institutions from the scheme and benefiting all remaining contributing institutions by reducing the level of their deposits by £150,000 each.
- The Bank of England should consider ways in which the transparency of the scheme could be enhanced, for instance by publishing a more detailed breakdown of expenditure by function.
- The Government will continue to monitor the effect of the cash ratio deposit scheme and will conduct a further formal review at the latest in five years' time.

## **Consultation**

28. As part of the review, the Treasury has already consulted all institutions that are currently eligible institutions under the scheme and their representative bodies about their experience since 1998. Two representative bodies and 25 eligible institutions responded.

29. The purpose of publishing this document is to enable any interested parties to make representations on the following recommendations:

- (i) The proposal to increase the threshold to £500 million but leave all other parameters of the scheme unchanged;
- (ii) Whether there are any technical aspects of the operation of the scheme that could be improved; and
- (iii) The proposal to enhance disclosure of the working of the scheme, ensuring that interested parties have the information they need to assess its financial operation and to make representations to the Treasury if they consider the parameters should be altered in the future.

The increase in the minimum threshold for making deposits will require a change to secondary legislation under the Bank of England Act. The statutory instrument concerned is the Cash Ratio Deposits (Value Bands and Ratios)

Order 1998 (SI 1998/1269), made under paragraph 5 of Schedule 2 to the Bank of England Act 1998. For information, a draft of the necessary statutory instrument is attached as Annex B.

30. Responses are invited by 31 October 2003 and should be sent to:

David Curtis  
Head of the Expenditure Branch  
Debt and Reserves Management Team  
HM Treasury  
1 Horse Guards Road  
LONDON  
SW1A 2HQ  
Email: [CRD-review@hm-treasury.gov.uk](mailto:CRD-review@hm-treasury.gov.uk)

to whom any questions or comments about the consultation should also be addressed. Representative bodies are requested to make clear on whose behalf they are making their submission. Responses may be made public unless confidentiality is specifically requested.

## **Annex A**

### **Definition of Eligible Liabilities**

The formal statutory definitions are contained in the Cash Ratio Deposits (Eligible Liabilities) Order 1998 (SI 1998/1130). The Schedule to that Order lists the following items, and article 3 of the Order defines the eligible liabilities of an eligible institution as the sum of items **1** to **7** less the sum of items **8** to **13**:

- 1.** The amount of the eligible institution's liabilities in respect of sterling deposits (other than those evidenced by an instrument falling within paragraph 2 below) made with United Kingdom offices of the eligible institution, except for over two year deposits.
  
- 2.** The amount of the eligible institution's liabilities in respect of certificates of deposit, commercial paper, bonds, notes and other similar instruments denominated in each case in sterling and issued by United Kingdom offices of the eligible institution on terms requiring repayment not later than five years from the date of issue.
  
- 3.** The amount of the eligible institution's liabilities to make payments in sterling for the purchase of, or otherwise in return for the transfer to it of, securities or other assets under retransfer agreements entered into by United Kingdom offices of the eligible institution, other than any such agreements entered into with the Bank.
  
- 4.** The amount of all sterling items in suspense held by United Kingdom offices of the eligible institution.
  
- 5.** 60% of the amount of sterling credit items in the course of transmission by United Kingdom offices of the eligible institution to the Bank, any other United Kingdom office of the eligible institution or a United Kingdom office of any other eligible institution.

6. The amount of the eligible institution's liabilities to make payments in sterling for the purchase of securities or other assets under sale and repurchase agreements entered into by United Kingdom offices of the eligible institution with the Bank in connection with the Real Time Gross Settlement system operated by the Bank, which the Bank has allowed to remain outstanding overnight.

7. The amount (if any) by which the total liabilities of the United Kingdom offices of the eligible institution denominated in currencies other than sterling, as reported to the Bank, exceed the total assets of those offices denominated in such currencies, as so reported.

8. -

(a) The amount of any sterling deposits made by United Kingdom offices of the eligible institution with the Bank (other than cash ratio deposits made with the Bank pursuant to Schedule 2 to the Act or any such deposits made prior to the commencement of the Act and any other deposits which the institution may from time to time be required by or pursuant to the provisions of any enactment to make with the Bank).

(b) Sterling amounts payable by the Bank to United Kingdom offices of the eligible institution under the terms of any finance lease.

9. -

(a) The amount of any sterling deposits made by United Kingdom offices of the eligible institution with, and sterling loans made by such offices to, United Kingdom offices of other eligible institutions (including certificates of deposit and commercial paper which are –

(i) denominated in sterling;

(ii) held by United Kingdom offices of the eligible institution; and

(iii) issued by United Kingdom offices of other eligible institutions;

but excluding any instrument which falls within paragraph 11 below).

(b) Sterling amounts payable to United Kingdom offices of the eligible institution by United Kingdom offices of any other eligible institution under the terms of any finance lease.

(c) The amount of sterling cheques passed by United Kingdom offices of the eligible institution to United Kingdom offices of other eligible institutions for collection.

**10.** The amount of the eligible institution's claims to receive payments in sterling for the sale of, or otherwise in return for the transfer by it of, securities or other assets under retransfer agreements entered into by United Kingdom offices of the eligible institution with United Kingdom offices of other eligible institutions.

**11.** The value of the preference shares, bonds, notes and other similar debt instruments (other than certificates of deposit and commercial paper but including subordinated loan capital not represented by the issue of securities) denominated in sterling and issued by a United Kingdom office of any other eligible institution on terms requiring redemption or repayment not later than five years from the date of issue which are held by United Kingdom offices of the eligible institution for its own account.

**12.** 60% of the amount of sterling debit items in the course of collection by United Kingdom offices of the eligible institution from the Bank, any other United Kingdom office of the eligible institution or a United Kingdom office of any other eligible institution.

**13.** The amount (if any) by which the eligible institution's sterling deposit liabilities to non-resident offices exceed the institution's net sterling liabilities to non-resident offices.

## Annex B

### Draft Statutory Instrument

*Draft Order laid before Parliament under section 40(2) of the Bank of England Act 1998, for approval by resolution of each House of Parliament.*

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#### STATUTORY INSTRUMENTS

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**2004 No.**

### **BANKS AND BANKING**

#### The Cash Ratio Deposits (Value Bands and Ratios) Order 2004

*Made - - - - 2004*

*Coming into force - - 1st June 2004*

*Whereas a draft of this Order has been approved by a resolution of each House of Parliament pursuant to section 40(2) of the Bank of England Act 1998(a);*

Now therefore, the Treasury, *having consulted the Bank of England, such persons as appear to them to be representative of persons likely to be materially affected by the following Order and such other persons as they think fit, and having regard to the financial needs of the Bank of England*, in exercise of the powers conferred upon them by paragraph 5 of Schedule 2 to the Bank of England Act 1998 hereby make the following Order:

#### **Citation and commencement**

**1.** This Order may be cited as the Cash Ratio Deposits (Value Bands and Ratios) Order 2004 and comes into force on 1st June 2004.

#### **Revocation**

**2.** The Cash Ratio Deposits (Value Bands and Ratios) Order 1998(b) is revoked.

#### **Value bands and ratios**

**3.** For the purposes of paragraph 4 of Schedule 2 to the Bank of England Act 1998, the value bands and ratios applicable to them, expressed as a percentage, are as follows:

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(a) 1998 c.11.  
(b) S.I. 1998/1269.

<i>Value band</i>	<i>Ratio</i>
£0-£500 million	0%
Over £500 million	0.15%

Date

*Name*  
*Name*  
Two of the Lords Commissioners  
of Her Majesty's Treasury

#### **EXPLANATORY NOTE**

*(This note is not part of the Order)*

Schedule 2 to the Bank of England Act 1998 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 paragraph 1(1A) to (1C) of Schedule 2 to that Act, referring back to section 17. The Bank is empowered by paragraph 3 of that Schedule to give such an institution a written call notice specifying the amount of cash ratio deposit 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 specifies new value bands and the ratios applicable to them, taking effect on 1st June 2004, and revokes the Order which specified previous value bands and ratios.

