

Final Regulatory Impact Assessment (RIA)

Title of Proposal

Amending the definition of Eligible Liabilities (ELs) for Cash Ratio Deposits (CRDs).

Purpose and Intended Effect of Measure

Objective

To ensure that those who benefit from the Bank of England's sterling liquidity, monetary policy and, financial stability operations continue to contribute financially to their costs. This is consistent with the Treasury's objective of promoting stable, fair and efficient financial markets, for users and the economy.

Who it will affect

It will **directly** affect banks and building societies which have Eligible Liabilities (ELs) in excess of £500 million. We do not foresee anyone being **indirectly** affected to a significant extent.

Background

Under the Cash Ratio Deposit (CRD) scheme, 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 under the Bank of England Act 1998, with effect from 1 June 1998.

The CRD 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 (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 of the Financial Service and Markets Act 2000 to accept deposits

or other repayable funds through a branch in the United Kingdom.

The size of an eligible institution's CRD is calculated by applying two factors:

- The size of its Eligible Liabilities above a minimum threshold, currently at £500 million; and
- A ratio, applied above this threshold, currently at 0.15 per cent of the Eligible Liabilities.

The ratio of cash deposits and the minimum threshold for making CRDs is set out in secondary legislation made by the Treasury – the Cash Ratio Deposits (Value and Bands) Order. This Order was amended in 2004 following the 2003 review of the CRD scheme. It increased the minimum threshold for making deposits from Eligible Liabilities of £400 million to £500 million with effect from 1 June 2004. This freed 13 institutions from the scheme altogether and reduced the level of deposits of all remaining contributing institutions by £150,000 a year.

The definition of Eligible Liabilities (ELs) is also set out in secondary legislation under a separate Order also made by the Treasury called the Cash Ratio Deposits (Eligible Liabilities) Order 1998. The 2003 review of the CRD scheme proposed no change to the definition.

Risk Assessment

The Bank of England as central bank of the United Kingdom undertakes operations in sterling money markets in order to implement the Monetary Policy Committee's (MPC) interest rate decisions while meeting the liquidity needs, and so contributing to the stability of the banking system as a whole. This is consistent with the Bank's core purpose of maintaining monetary and financial stability.

Following extensive consultation the Bank will be making significant changes to its operations in sterling money markets from next year. These improvements will ensure that the Bank's operational framework is at the cutting edge internationally.

The objectives of its proposed changes are to ensure:

- Overnight market interest rates to be in line with the MPC's repo rate, so that there is a flat money market yield curve, consistent with the official policy rate, out to the next MPC decision date, with very limited day-to-day or intra-day volatility in market interest rates at maturities out to that horizon.
- An efficient, safe and flexible framework for banking system liquidity management – both in competitive money markets and, where appropriate, using central bank money – in routine and stressed or otherwise extraordinary conditions.
- A simple, straightforward and transparent operational framework.
- Competitive and fair sterling money markets.

A key feature of these changes is the introduction of **voluntary deposits** which banks and building societies will be able to place with the Bank. Unlike CRDs, they will be remunerated at the interest rate set by the MPC and can be varied on a daily basis. This will provide banks and building societies greater liquidity flexibility, allowing them to either draw down the reserves when needed or to build them up for future use.

Under the current definition of ELs, voluntary deposits placed with the Bank will be an offset in the calculation of ELs i.e. ELs would be reduced by the amount of reserve balances. Given that the size of these voluntary deposits is expected to be about £25 billion this would have the impact of reducing the level of CRDs available to the Bank by about £37.5 million and hence, reduce its CRD income by about £2 million a year.

Options

There are only two feasible options for dealing with the introduction of voluntary deposits - either to legislate this year by amending the definition of ELs or to take no further action.

Option 1- Take no further action

If no amendment were made this year to the definition of ELs then the introduction of voluntary deposits would reduce ELs causing an unnecessary fall in the Bank's CRD income. It would have consequential impact on the level of CRD finances for 2003-08 projected at the 2003 review leading to an imbalance between the

costs and benefits associated with the scheme and therefore, undermine the aims of the CRD scheme.

Option 2 - Amend the definition of Eligible Liabilities this year

Amending the definition this year would ensure that banks and building societies continued to contribute financially to the costs of the Bank's sterling liquidity, monetary policy and financial stability operations, which they benefit from, as envisaged by the 2003 CRD review. It would avoid an imbalance between the costs and benefits associated with the CRD scheme and ensure CRD finances for 2003-08 were in line with those projected at the 2003 review.

Costs and Benefits

Business Sectors Affected

It would be the financial sector in the UK that would be impacted by the proposed changes principally, those who take sterling deposits and have ELs in excess of £500 million – i.e. large banks and building societies.

The table below provides a breakdown of the financial sector, by UK and non-UK institutions, that placed CRDs with the Bank as at 1 June 2005.

Group	Deposits (£ million)	%
UK		
UK Banks	1 348	64
Building Societies	252	12
Non-UK		
Subsidiaries of foreign banks in the UK	221	10
Branches of European institutions	222	11
Branches of non-European institutions	68	3
TOTAL	2 111	100

SOURCE: Bank of England

Assumptions

The following assumptions have been made:

- An investment yield of 6% on CRDs as set out in the 2003 review of the CRD scheme;
- The costs of implementing these money market changes will be met out of the overall level of CRD related expenditure projected at the 2003 review; and
- Value of voluntary deposits of around £25 billion.

Any significant changes to the above assumptions would affect the size of the loss in the Bank's CRD income.

Benefits

Option 1- Take no further action

Banks and building societies will see their level of CRDs fall by about £37.5 million following introduction of voluntary deposits next year. If this sum could be invested at about the rate assumed for CRDs themselves then, they would earn an investment income of about £2 million a year.

Option 2 - Amend the definition of Eligible Liabilities this year.

Banks and building societies will not attain any financial benefits directly from amending the definition of ELs. However, they will be able to enjoy greater benefits from the Bank's proposed money market changes as well as the benefit they already receive and enjoy from the Bank's sterling liquidity, monetary policy and financial stability operations.

These benefits are difficult to quantify in monetary terms but ensuring monetary and financial stability (the Bank's core purpose) is in the interest of all banks and building societies. Also, the proposed money market changes will provide less volatility in overnight interest rates, an efficient, safe and flexible framework for banking system liquidity management; much fairer money markets; and, a much simpler, straightforward and transparent operational framework – **all to the ultimate advantage and benefit of banks and building societies.**

Costs

Option 1- Take no further action

- The Bank of England will lose income from CRDs of about £2 million a year. This would have an unnecessarily negative impact on Bank finances especially at a time when the Bank proposes to provide an enhanced service to banks and building societies.
- The money market changes provide banks and building societies with an enhanced service from the Bank whilst their financial contribution to its costs declines.
- There would be an imbalance between the costs and benefits associated with the CRD scheme and may undermine the aims of the scheme.
- It would be inconsistent with the Treasury's objective of promoting efficient, stable and fair financial markets for users and the economy.

Option 2 – Amend the definition of Eligible Liabilities this year

- It would simply prevent an unnecessary fall in the Bank's CRD income of about £2 million a year when voluntary deposits are introduced. Thus maintaining the Bank's CRD income at the same level.¹
- Ensure banks and building societies continued to financially contribute towards the cost of the Banks' sterling liquidity, monetary policy and financial stability operations, as envisaged by the 2003 CRD review.
- It is fair for those who will enjoy the benefits from the proposed money market changes to also financially contribute towards its costs.
- Voluntary deposits are unrelated to CRDs and, unlike CRDs, are remunerated and able to be flexibly drawn down.
- It would avoid an imbalance between the costs and benefits associated with the CRD scheme.

Environmental and Social Costs and Benefits

¹ Alliance and Leicester highlighted in their consultation response that their CRD related costs would rise by about £100,000 a year because the cash collateral its deposits with the Bank under the Bank of England's Note Circulation Scheme (NCS) would no longer count as an offset in the new proposed definition of ELs. It is the Treasury's view that the definition of ELs should not be amended on this account. No other institution is financially impacted in this way and this arrangement will be reviewed by the Bank and can easily be adjusted separately before its money market reform goes live.

We do not foresee any environmental or social costs or benefits.

Equity and Fairness

Amending the definition of ELs would improve equity and fairness by ensuring that those who benefit from the Bank's sterling liquidity, monetary policy and financial stability operations continue to financially contribute to its costs. This would be consistent with the Treasury's objective of promoting efficient, stable and fair financial markets, for users and the economy.

Small Firms' Impact Test

There is no impact at all on small businesses from amending the definition of ELs.

Competition Assessment

There is no impact on competition from the proposed amendments to the definition of ELs.

Enforcement and Sanctions

The constitutional framework underlying the CRD scheme is set out in the Bank of England Act 1998. However, the proposed new definition of ELs will be set out in secondary legislation – the Cash Ratio Deposits (Eligible Liabilities) Order. The Bank of England enforces the collection of CRDs twice a year – on the first working days of June and December.

Consultation

Responses to the consultation were received from three representative bodies - Association of Foreign Banks; British Bankers Association and Building Societies Association - and four from individual financial institutions - Alliance and Leicester; Bank of Baroda; BNP Paribas and Canara Bank.

The responses to the consultation overall recognised and understood the rationale for making the change and accepted that including voluntary deposits in the definition of ELs would have a net neutral effect on the overall levels of CRDs.

Monitoring and Review

The Treasury is committed to undertaking a review of the CRD scheme every five years. The last such review was in 2003 and the next one is scheduled for 2008. At the next review, we will undertake an analysis of how the proposed change to the definition of ELs has impacted on the scheme and in particular, on banks and building societies. We are making this interim change to the definition of ELs in response to the significant changes the Bank is making to its money market operations.

Summary and Recommendation

Amending the definition of ELs this year would effectively ensure that those who benefited from the Bank's sterling liquidity, monetary policy and financial stability operations continued to contribute financially to its costs. It would also be consistent with the Treasury's objective of promoting efficient, stable and fair financial markets, for users and the economy.

Ministerial Declaration

I have read the final Regulatory Impact Assessment (RIA) and I am satisfied that the benefits justify the costs.

The Rt Hon Des Browne MP
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