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Ms Laura Mountford
Debt and Reserves Management
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Dear Ms Mountford

Cash ratio deposit scheme

Thank you very much for giving the Building Societies Association the opportunity to comment on the forthcoming review of the cash ratio deposits scheme. Given the relatively short time to respond, our comments are high level only.

Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, 20% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 31% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Executive summary

The fundamental changes in the regulatory landscape since the last review of the statutory cash ratio deposit scheme suggest that its underlying concepts and framework need a thorough re-examination. What was fair, appropriate and proportionate five years ago may not be so in 2012.

The effects of the Bank's unremunerated policy work are felt far more widely than the sterling deposit takers (essentially building societies and banks) that currently fund it. We propose that the Bank investigates adopting the model of other central banks[1] whose activities, almost universally, are funded from general income including that arising from seigniorage and foreign exchange reserves. Alternatives would be (i) to abolish the scheme and fold the costs of the Bank's policy work into FSA/ PRA fees or (ii) to retain the current scheme and widen the pool to include other financial institutions that benefit from the Bank's unremunerated work. An obvious example of the latter is insurers.

Our members are best placed to answer questions on the impact the scheme has had on them. But we are aware of certain concerns in the sector about the aims and rules of the scheme.

[1] Review of the Cash Ratio Deposit Scheme - consultation on proposed changes, HM Treasury, August 2007.

1. Current scheme operation

The costs of the Bank of England's unremunerated functions - monetary policy and financial stability operations - are funded by non-interest bearing deposits that building societies and banks ("eligible institutions") are required to place at the Bank. Eligible institutions are those with over £500 million eligible liabilities; they are required to place a percentage (currently 0.11%) of deposits over that threshold. The deposits obtained from building societies and banks are invested in interest-yielding assets.

Surplus CRD income is subject to corporation tax and then shared equally between the Exchequer and the Bank of England's reserves. Similarly, any deficit would reduce the Bank's total income and its retained profits. Pre-financial crisis the scheme yielded a higher than forecast income. The Bank[1] thought at the time that this might have been driven by a greater demand by firms and households to hold money balances, coupled with a greater willingness of the banking sector to supply money. Post-financial crisis the level of CRDs and market interest rates have, of course, dropped and the Bank's spending has increased.

We note that income generated by the scheme reached a high point in financial year 2007/8 of £147.6 million falling to its lowest point in recorded years in 2011/12 of £99.2 million. We are surprised the drop has not been greater given the fall in interest rates over recent years. Our conclusion is that the fall has been mitigated by investment in longer term assets where interest rates are higher, and have fallen, proportionately, less than at the short end of the market. Further information on the Bank's investment policy would be welcome and would perhaps confirm our thinking.

We note that after the threshold was raised by £100 million in 2003, 18 institutions were initially excused from paying. But by 2007, 13 of these were once more over the threshold. In total, in June 2007, there were 150 eligible institutions (*no later figures are available*).

The 2003 and 2007[1] reviews examined the financing arrangements of other national banks. The findings of the earlier review were re-affirmed in 2007:

"Central banks, almost universally, 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. No central banks were identified that funded their activities from general taxation revenues collected by government.

All the central banks looked at in the study state monetary policy and financial stability as among their core objectives…."

This suggests that the Bank of England's current model is perhaps an outlier. We strongly recommend that the 2012 review revisits the model of other central banks as part of its commitment to assess "the continuing suitability of the scheme itself compared to alternative sources of funding"[2].

A move to seigniorage would be in keeping with the Bank's aim in 2007[3] "to keep the base of the scheme broad while not introducing a new regulatory burden on smaller institutions".

Both earlier scheme reviews also examined the fee-based funding arrangements of the Financial Services Authority and both concluded that this method was not appropriate for calculating how to fund monetary and financial stability activities. We disagree. The "FSA method" has in its favour that those firms that broadly benefit from the FSA's work pay for it. While we understand why the Bank would not wish to introduce such a complex system, we do urge it to consider incorporating its policy costs into future PRA regulatory fees but for a wider range of institutions, particularly larger

[2] Written ministerial statement, HM Treasury, 18 September 2012
[3] Impact assessment to Review of the Cash Ratio Deposit Scheme: summary of responses, Apri 2008

ones, than are currently part of the scheme. As the PRA will become part of the Bank of England, it seems logical for it to assume responsibility for setting and collecting all associated prudential regulatory fees. But this would, of course, apply only if a move to seigniorage was ruled out.

Another reason to look again at how to fund the Bank's unremunerated activities is the shortfall in funding since 2009/10. The most recent annual report[4] shows a figure of £20 million. The shortfalls have been caused by a drop in the level of CRDs and market interest rates as well as an increase in Bank spending. They underline the fact that the current model is not sufficiently responsive to work in times of prolonged stress and historically low interest rates.

2. Purpose of the scheme

The objective of the cash ratio deposit scheme is 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 HM Treasury's objective of promoting stable, fair and efficient financial markets, for users and the economy.

A fundamental challenge to the scheme would be to ask who really are the beneficiaries of the Bank's operations. It is certainly a wider group than the eligible institutions which currently pay the costs. Monetary and financial stability is in the interest of the economy as a whole and it would not seem unreasonable if the costs were met by the Bank of England's general income including that arising from seigniorage rather than by charging the building society and bank sector alone. As we argue above, this is the model followed by the majority of central banks across the world. At the very least, we would like to know why this part of the Bank of England has to be funded differently.

Should the Bank not wish to change the funding of its unremunerated activities so fundamentally, we urge it to consider spreading the costs of its policy work more fairly and widely across the financial services sector, particularly the larger players. Insurers are an example of financial institutions that need, *inter alia*, financial stability to stay in business; investment firms too would not be able to operate without stability. Yet they do not contribute.

One way to achieve this would be abolish the scheme and fold the costs of the Bank's unremunerated policy work into future PRA fees. Another, less drastic way would be too widen the pool of contributors to the current scheme. Contributions from non-deposit takers could be based on alternative criteria such as assets under management, number of transactions or fee income.

A continuing concern of members is the apparent lack of accountability of the Bank to those institutions that fund its activities. The Bank's annual reports provide the aggregate figures for monetary policy and financial stability functions' expenditure but little else. The 2003 CRD review[5] said the Bank 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. We have not seen the spirit of this recommendation carried through although we note that CRD income started to be identified separately in 2004. As a bare minimum, we believe these figures should be broken down so eligible institutions can see how the CRD income – should the scheme continue - is comprised, invested and spent, with all sets of figures provided at more regular intervals. Eligible institutions may also welcome the opportunity to consider the potential for greater efficiencies and whether there is net value derived from the activities.   For potentially new contributors – such as other classes of eligible institutions – this is particularly pertinent.

Concern about the apparent lack of accountability at the Bank is not new. We note the Treasury Select Committee concluded[6] *inter alia* that the Bank needed to be more open about its work, and had to be held more clearly to account than it had been in the past. Making changes to the cash ratio deposits scheme would be a good start.

[4] Bank of England annual report 2012
[5] http://www.hm-treasury.gov.uk/d/crd_279.pdf
[6] Accountability at the Bank of England, Treasury Select Committee, November 2011

3. Statutory nature of the scheme

The CRD scheme was extended to include building societies, and was placed on a statutory basis, when the Bank of England Act became law in 1998.

If the scheme is to continue in its current form, ways should be found to make the costs proportionate for eligible institutions. This might include finding ways to reduce the number of smaller eligible institutions such as the majority of building societies that are required to participate. Their overall contribution is minimal yet the administration – to the Bank as well as the institutions themselves - is a cost. The funds released could be used elsewhere in the business such as lending.

One solution would be to introduce a suitable index to adjust the threshold, annually, over future years.

4. Range of eligible liabilities and institutions

Eligible liabilities[7] consist of sterling deposit liabilities, excluding deposits with an original maturity of over two years, plus net foreign currency liabilities. Interbank liabilities (excluding cash ratio and special deposits with the Bank of England) are also included on a net basis. If the scheme were to continue in its current format, we do not believe changes need to be made to the range of liabilities for building societies and banks.

Elsewhere in this letter we argue for widening the pool of eligible institutions so do not repeat those comments here.

5. Current level of CRDs

The income needed to pay for the Bank's unremunerated activities must be steady and sufficient to cover costs. This has not been the case over recent years. As we argue above, we believe the answer is to widen the pool of contributors, either by abolishing the scheme altogether or by including new classes of financial institutions, and to introduce transparency and real accountability, on the part of the Bank, to those contributors.

We hope these comments will be of help and look forward to discussing the future of the scheme with you in more detail later.

Yours sincerely

Adrian Coles
Director-General

[7] http://www.bankofengland.co.uk/statistics/Pages/faq/faq_crds.aspx