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In Practice

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Mandatory costs and the liquidity crisis

Mandatory costs, along with the London Interbank Offered Rate ('LIBOR') (for floating rate loans) and the margin, comprise the three elements that determine the rate of interest paid by borrowers on most large-scale corporate loans. Mandatory costs are payable by banks to comply with certain regulatory funding requirements. They consist of reserve asset costs and supervisory fees payable to the Financial Services Authority.

RESERVE ASSET COSTS

These costs are payable under the Cash Ratio Deposit ('CRD') scheme, a statutory scheme established by the Bank of England Act 1998 (now replaced by the Financial Services and Markets Act 2000 ('FSMA')). The scheme only applies to Eligible Institutions, which are generally any institution which has the authority under FSMA to accept deposits in the UK. These Eligible Institutions are obliged (provided that their Eligible Liabilities exceed a threshold set at £500m) to place a non-interest bearing cash deposit of 0.15 per cent of their Eligible Liabilities with the Bank of England, which invests them and uses the income earned to fund its supervisory functions and running costs. Banks in the loan market usually recover the cost of complying with the Scheme from borrowers under the mandatory costs charge.

The Supervisory fees are calculated by reference to Modified Eligible Liabilities ('MELS'), which are in broad terms a combination of the Eligible Liabilities and one third of each banks' foreign currency liabilities. The rate in the UK has decreased in recent years and is currently set at roughly £30 per every £1m MELS. Although relatively small amounts, the Loan Market Association has advised banks to recover these costs from borrowers through mandatory costs.

REVIEW

On 10 August 2007, HM Treasury published a review of the scheme (Review of the Cash Ratio Deposit Scheme – Consultation on proposed changes). The Review concludes, amongst other things, that there should be a reduction from 0.15 per cent to 0.11 per cent in the proportion of Eligible Liabilities above the £500m threshold which a financial institution must hold at the Bank of England. This would not only benefit the financial institutions, but would reduce the calculation of mandatory costs on sterling loans contained in a typical loan agreement and charged to the borrower.

The Review proposes this reduction as the cost of running the Bank of England between 2003 and 2008 is expected to be £531m and at the current rate of 0.15 per cent the CRD Scheme is expected to yield £613m. The reason for the growth in the CRD deposits has been accredited to a greater demand for households and firms to borrow money, together with an increased willingness of banks to lend, thereby increasing their Eligible Liabilities.

CURRENT MARKET CONDITIONS

Comments on the Review were invited by 2 November 2007. In light of recent market conditions, debate is likely to become more focused as to whether it is wise for the Bank of England to reduce the CRD. Not only is there likely, at least in the short term, to be a reduced demand for debt by consumers, the banks are likely to become less willing to lend. The recent experience of Northern Rock, which resulted in the bank being forced to request an emergency liquidity line from the Bank of England, suggests that a reduction in funding may be inappropriate at this stage of the credit cycle. Although the Bank of England is only ever regarded by commercial banks as a lender of last resort, any discussion of the level of its funding will need to take into consideration current concerns with the level of liquid reserves currently held by banks.

The recent liquidity crisis highlights a trend over the last few decades for banks to reduce their cash reserves and liquid assets in favour of reinvesting a greater ratio of total liabilities in order to maximise profit. In the 1950s, liquid assets were generally around 30 per cent of a bank's total assets, including approximately 8 per cent of cash reserves, (consisting of vault cash and a deposit held at the Bank of England). In comparison, in 2007 cash reserves are around £11.2bn as against total liabilities of £3,150bn. This equates to cash being about 0.5 per cent of total liabilities and liquidity generally being approximately 1 per cent.

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The main issue for commercial banks is that holding cash reserves is not profitable. Notes and coins sitting in a vault earn no interest and liquid assets only yield returns at slightly above money market rates.

The difference between today's climate and that of the past is striking and whereas this reduction in the liquidity ratio has been good for banks' profits, it is a risky strategy which exposes their lack of liquidity. The Bank of England has limited capital (with equity of only around £2bn) and it cannot be expected to continue to bail out commercial banks which fail to maintain sufficient liquidity. Food for thought in the light of the current Review. ■

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