Bank of England

Dame Meg Hillier MP
Chair, Treasury Committee
House of Commons
London
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Andrew Bailey
Governor

28 May 2025

Dear Chair,

I followed the Treasury Committee's recent hearings with banks and building societies with interest and thought it might be helpful to add a few points. These are related to the discussions of remunerated central bank reserves and the implications of ring-fencing of core UK retail banking services, respectively.

Interest payments on reserves

As I set out in my previous letter of 10 April, remunerated reserves held by the banks at the Bank of England are central to our statutory objectives for monetary policy and financial stability.[1] From a monetary policy perspective, it is by remunerating reserves that we steer interest rates in the economy to achieve price stability consistent with the Monetary Policy Committee's decisions on Bank Rate. From a financial stability perspective, precautionary reserve holdings by banks insure against costly liquidity crises that could otherwise threaten the stability of the financial system.

However, holding central bank reserves is not compulsory for the banks as was suggested in your hearing on 20 May. For financial stability purposes, liquidity regulation requires banks to hold enough high-quality liquid assets, or HQLA for short, that they can meet stressed liquidity needs, e.g. in case they face significant deposit outflows. These regulations were introduced after the global financial crisis, which had clearly shown that banks' high-quality liquidity buffers needed to be much larger than they had been in the past. But banks can hold HQLA in the form of gilts or high-quality corporate bonds, or even some forms of equity, as well as central bank reserves.

[1] Treasury Committee: Correspondence from Andrew Bailey, 10 April 2025

While there are limits to how much of banks' HQLA buffers can be held in equity, the regulation treats central bank reserves and high-quality bonds, such as gilts, as interchangeable.

The advantage of central bank reserves – the ultimate form of money – is that they can be deployed without delay and without incurring liquidation costs. Other forms of HQLA must first be monetised through sales or repurchase agreements before payments can be made. This introduces some additional risks in times of stress where ultimate liquidity in the form of central bank reserves may be needed at short notice. It has financial stability benefits, in other words, that banks choose to hold some of their precautionary HQLA directly in the form of central bank reserves.

Any change in the remuneration of reserves, e.g. through a tiering system, would incentivise banks to reduce their holdings of central bank reserves. Since holding reserves is not mandatory for the banks, if some reserves were left either less remunerated or unremunerated, banks would likely shift to holding other forms of HQLA on which they would continue to earn the market return, allowing them to provide the required return overall to attract investors and cover their cost of funding. Any presumed benefit to the public purse from reducing interest payments in this way would in that case be illusory as banks would simply reduce their demand for reserves. This is a key point that is often missed in the exchanges.

Finally, I should add that contrary to a point made at the hearing, the reserves regime is the same for banks and building societies of all sizes. There is no distinction between large and small banks.

Ring-fencing and lending to small and medium-sized enterprises (SMEs)

Along with ensuring that banks' high-quality liquidity buffers are sufficient, the importance of maintaining strong and effective regulatory standards was another important lesson from the global financial crisis. Ring-fencing of core UK retail banking services should be seen in this context. The ring-fencing regime was established as an essential part of the UK regulatory framework to protect financial stability. It works to protect core banking activities – such as deposits of, and lending to, UK households and businesses including SMEs – from the activities conducted by other entities within banks. In this way, it insulates domestic depositors from financial contagion, a particular challenge in the United Kingdom with our very large and internationally diverse financial sector.

With this separation, ring-fenced banks have collectively provided significant support to UK households and businesses, directly benefitting the UK economy. Based on the data they provide to us, 99% of ring-fenced banks' lending in 2024 was to domestic customers, compared to only 32% for entities in the wider banking groups that sit outside the ring-fence. Removing the ring-fence would most likely have a negative effect on UK lending, both in terms of cost and quantities, with banks directing funding from retail deposits away from UK households and SMEs and towards investment banking activities or activities outside the United Kingdom.

I would emphasise that there are no restrictions on lending by ring-fenced banks to UK non-financial corporates and SMEs. At end of 2024, SME lending by the large ring-fenced banks, as a share of their total assets, ranged from 2.6% to 5.3%, and we think there is capacity for the banks to lend more should they wish to do so. The 'near-term reforms' that came into force earlier this year allow ring-fenced banks to provide more support to UK SMEs through permitting exposures to a broader set of small and medium-sized businesses, as well as enabling banks to acquire shares in them, or via investment undertakings that invest at least half of their capital in UK SMEs.

Further, the regime ensures that ring-fenced banks are structurally separable in the event of firm failure, thereby facilitating the effective and orderly restructuring of a major UK bank, known as 'resolution', and helps to safeguard public funds and the taxpayer as well as the UK economy. The Bank's Financial Policy Committee has judged that the optimal capital levels for banks are 5 percentage points lower than they otherwise would be due to the role that effective resolution arrangements play. [2]

The resilience that ring-fencing provides also means that ring-fenced banks are perceived to be safer: research shows that banking groups that contain a ring-fenced bank benefit from cheaper funding, with investors lending to ring-fenced groups at lower rates.[3] And that lower cost of funding is important for the lending that ring-fenced banks undertake. One major benefit of this is that UK households have benefitted from lower mortgage pricing.

Moreover, by separating deposits from global trading activity, the ring-fencing regime allows the UK to operate an open cross-border regime for international wholesale business, supporting the competitiveness of the UK as a major global financial centre. Unlike in the global financial crisis, UK deposits have been insulated from a number of shocks to the global financial system over the past half decade or so. That is in no small part thanks to the ring-fencing of core UK retail banking services. It means that we can be more confident about having an open regime that puts the wider UK financial system at the heart of global trading activity. Without any separation between retail deposits of UK households and SMEs and the global trading activity hosted in the United Kingdom, we would need to adopt a more restrictive approach to overseeing the international businesses that make up such a large part of the UK financial centre in order to protect domestic lending from global risks.

It is worth noting that the United Kingdom is not unique globally in requiring the separation of deposit taking from investment banking activity. The United States and Japan have structural separation of financial activity in different forms, for example, and there are also restrictions on proprietary trading in France, Germany and Belgium.

I hope you find this information useful. I would be happy to expand on it further at our upcoming hearing at the Treasury Committee.

Yours sincerely,

[2] **Financial Stability Report December 2019 | Issue No. 46**

[3] **The ring-fencing bonus | Bank of England**