Bank of England

Harriett Baldwin MP
Chair of the Treasury Committee
House of Commons
London
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Andrew Bailey
Governor

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Dear Harriett,

Your letter of 4 December 2023

Thank you for your letter on the subject of the cashflows arising from quantitative easing (QE) and quantitative tightening (QT).

Before I go on to address the specific points you raise, I would like to make a few points about cashflows from the Asset Purchase Facility (APF), and the way in which the Bank's Monetary Policy Committee (MPC) approaches the unwind of asset purchases for monetary policy purposes.

Let me start by reiterating that decisions on the targeted stock of assets in the APF for monetary policy purposes are taken independently by the MPC. This also means that that scale and pace of the reduction in the stock of assets in the APF as part of QT are chosen solely to meet the MPC's policy objectives. The APF is indemnified by HM Treasury to ensure that the MPC can make its decisions in this way, in line with its statutory objectives and the remit given to it by the Government.

As first outlined in the August 2021 Monetary Policy Report, the MPC's decisions on the appropriate pace of APF unwind are guided by three key principles.[1] First, that Bank Rate is intended to be the active policy tool when adjusting the stance of monetary policy. Second, that sales should be conducted so as not to disrupt the functioning of financial markets. And third, to help achieve that, sales should be conducted in a gradual and predictable manner over time. The MPC has also judged that reducing the size of the APF has the important benefit of reducing the risk of a ratchet upwards in the size of the central bank balance sheet over time if successive policy cycles encounter the effective lower bound on interest rates.

[1] Monetary Policy Report - August 2021 | Bank of England.

From the perspective of the wider public sector, QE works as a swap of fixed-rate liabilities in the form of gilts, for variable-rate liabilities in the form of central bank reserves. QT works in reverse to swap variable-rate reserves back to fixed-rate gilts held by the public. As set out by the Office for Budget Responsibility (OBR) in its latest 'Economic and fiscal outlook' for November, these QE/QT operations give rise to a set of cashflows within the public sector accounts.[2] Cashflows in and out of the APF reflect the difference between the interest paid on reserves and the interest received on holdings of gilts as well as changes in the valuation of gilts between the time of purchase and redemption or sale. Between 2009 and 2022, when Bank Rate was lower than the average interest rate paid on gilts holdings in the APF, QE generated cumulative cashflows of £124bn from the APF to HMT. As expected, with a higher Bank Rate and a continuing unwind of the APF, these cashflows have now reversed.

The Bank has been fully transparent about these cashflows and presents a set of cashflow projections in the APF Quarterly Reports. Future APF cashflows are highly uncertain, however, and are sensitive to several factors. In particular, small changes in interest rates, or small relative changes between gilt yields and Bank Rate, can substantially alter the projected lifetime cashflows from the APF. Different unwind strategies would also impact when losses are incurred but not necessarily change the lifetime profit or loss accumulated in the APF. Active gilt sales, for example, incur upfront costs but have the benefit of reducing lifetime net interest costs from carrying gilts on the APF's portfolio.

It is also important to note that the fiscal implications of QE and QT are not simply captured by cashflows between the APF and HMT. Hence, the OBR noted in November that its assessment of lifetime cashflows associated with QE and QT did not amount to an assessment of the overall fiscal, let alone economic, impacts of QE, which reduced borrowing costs, supported the economy and helped stem disinflationary pressures at various points over the past 15 years. The wider implications for the economy and the fiscal position would need to be taken into account in any comprehensive assessment of the impact of QE and QT.

Let me now turn to the specific questions you asked.

The value of gilt holdings in the APF

As at close 12 December 2023, the APF held gilts with a market value of £558.6bn, and a nominal value of £638.5bn. The initial purchase proceeds of the gilts, which relates to the amount initially paid to purchase the gilts, and the size of the loan from the Bank to the APF, was £743.9bn.

APF cashflow scenarios

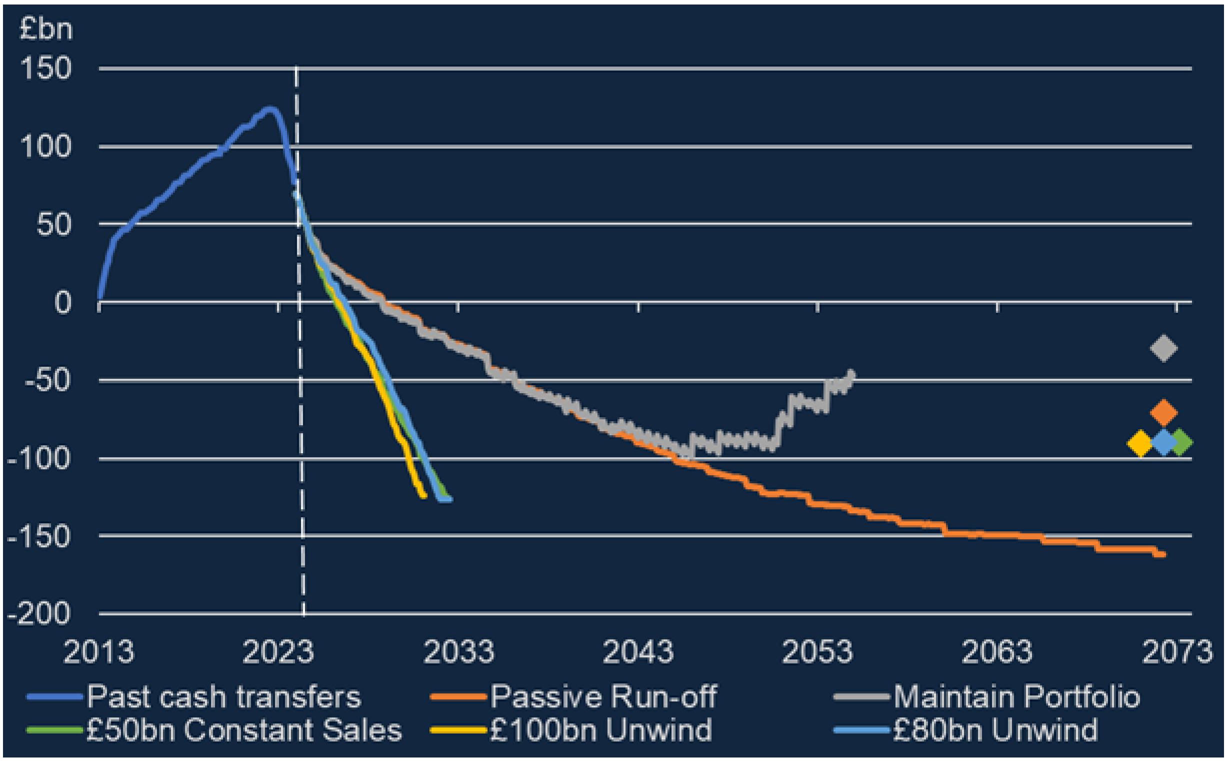
At its September 2023 meeting, the MPC voted to reduce the stock of gilts held in the APF for monetary policy purposes by £100 billion over the period from October 2023 to September 2024, to a total of £658 billion. This is the starting point for the scenarios included in the APF Quarterly Report for 2023Q3.[3] Updated versions of these scenarios using current market data are shown in the Chart below (indicated as '£100bn unwind', '£80bn unwind', and '£50bn constant sales'), along with further illustrative counterfactual scenarios assuming QT is carried out through maturing gilts only ('passive run-off') and with the current stock of gilts in the APF maintained ('maintain portfolio').

The projected cashflows into the APF reported here are noticeably lower than those reported in the APF Quarterly Report, which was based on market data as of end-September 2023. Since then, bond yields have fallen by around 60 basis points across the curve with substantial implications for the projected lifetime cashflows associated with the APF. The net present value (NPV) of projected cumulative

[2] **Economic and fiscal outlook – November 2023 - Office for Budget Responsibility (obr.uk)**
[3] **Asset Purchase Facility Quarterly Report - 2023 Q3 | Bank of England**

cashflow into the APF under market rates has fallen by around £40 billion as a result, illustrating the sensitivity of the projections to changes in market interest rates.

Chart: Cumulative APF cash flows (actual and projected)



Note: Bank calculations based on market data as of 14 December 2023.

The MPC's judgement on the appropriate pace of QT is determined with reference to the three key principles described above, informed by a wide range of financial indicators. An important component of the MPC's annual review process of the pace of QT is an updated staff assessment of market capacity and conditions. The Bank also ensures that QT remains aligned with its key principles through its liaison with the Debt Management Office (DMO) to avoid scheduling conflicts and undue overlaps in supply. The MPC noted in the minutes of its September 2023 meeting that there was no evidence of a negative impact of gilt sales on market functioning across a range of financial market measures.[4] While the Bank has the operational capabilities to sell bonds at a much higher pace, market conditions will ultimately determine what may be feasible in the future.

As illustrated in the Chart, holding the portfolio to maturity could result in lower cash flows from HMT to the APF in the near term as costs from active sales are avoided, but also to larger cumulative cashflows over a longer APF lifetime as the cost of carrying the gilts on the portfolio add up. This is because of the difference between the interest that the bonds yield, and the interest rate payable on the loan from the Bank to finance APF bond purchases, which is set at Bank Rate. This scenario therefore comes with the caveat that it relies on estimates of interest rates over a very long period of time.

However, in terms of NPV, indicated by the diamonds in the Chart, the differences between the 'passive run-off' scenario and the scenarios form the Quarterly Report are much smaller. These values reflect the fact that future cashflows are discounted, and that the current value of cashflows further into the future is generally lower than the value of cashflows in the near term. This illustrates the point that, while they

[4] Bank rate maintained at 5.25% - September 2023 | Bank of England

may shift cashflows over time, different unwind strategies do not necessarily change the lifetime profit or loss accumulated in the APF.

Under the 'maintain portfolio' scenario, the APF would need to keep buying bonds to replace those that are maturing counter to the MPC's current assessment of the appropriate policy. This would result in similar losses for much of the projection maintaining current market pricing. But the projection also shows that cashflows may eventually turn positive in this scenario, which for illustrative purposes has been extended to 2053. The reason is that additional bonds may be bought below par so that gains are realised at maturity, which gradually translates into a positive effect on the overall cashflows.

Value-for-money

In managing the APF portfolio, the Bank has had a longstanding commitment to conducting its operations in a way that minimises cost and risk, subject to meeting the MPC's policy objectives. Such measures have been in place throughout the life of the APF, during periods of QE and QT.

In my letter to the Chancellor in April 2023, I set out some of the measures that the Bank currently takes in this respect.[5] These measures help to ensure that the Bank can achieve the best price available in its auctions, while minimising interference with the DMO's issuance programme. They include:

- The use of auction mechanisms that are carefully designed to maximise demand and competition. For instance, the use of multi-stock auctions allows us to accept only the best-priced bids across a range of bonds and participants. APF auctions also have built-in price protections whereby, for instance, the Bank sets a minimum level for the price it is willing to accept at auction.
- Close liaison with the DMO to ensure that our operations minimise interference with the DMO's own issuance programme and avoid disrupting market functioning.
- The application of comprehensive risk management techniques ensures that the financial risks posed by the portfolio are understood and controlled.
- Detailed public information on activity on the APF, and the design and control of auctions, available in the Bank's Markets Operations Guide, which is updated periodically as our operations evolve.[6]
- Comprehensive governance, reporting and transparency arrangements consistent with the indemnity provided by HM Treasury and the HM Treasury Accounting Officer's requirement to protect the rights and assets of the taxpayer including value for money.

Steady-state level of reserves

The Explanatory Note associated with the August 2022 Market Notice sets out the Bank's arrangements for allowing the MPC to focus solely on monetary policy considerations in setting its strategy for unwinding its stock of asset purchases, without concern for the Bank's ability to align short-term market interest rates close to Bank Rate.[7] Therefore, the notice does not state that QT would cease at a certain level of reserves. Indeed, the arrangements are designed so that the MPC could over time, if it judged this necessary for policy reasons, unwind the APF fully in line with the gradual and predictable approach that it has previously articulated.

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[5] **Letter from the Governor to the Chancellor - April 2023 - APF (bankofengland.co.uk)**
[6] **Bank of England Market Operations Guide | Bank of England**
[7] **Explanatory Note: Managing the operational implications of APF unwind for asset sales, control of short-term market interest rates and balance sheet | Bank of England**

The Market Notice also launched a new market operation – the Short Term Repo facility (STR) – that allows commercial banks to borrow reserves at Bank Rate against gilt collateral on a weekly basis. This is designed to prevent the cost of borrowing reserves in the market rising materially above Bank Rate as reserves supplied by the APF fall. Once reserves supplied by the APF have fallen to, or beyond, banks' preferred minimum holdings, this will be replaced at first by reserves generated by borrowing from the STR.

The future steady state level of reserves may differ from the number cited in your letter. That estimate is based on the August 2022 results of a twice-yearly survey we conduct to estimate minimum level of reserves demanded by banks. But banks' reported demand is likely to vary over time in response to financial and economic conditions and therefore is uncertain. The Bank is currently undertaking analysis on the future steady state level of reserves needed to maintain monetary control and financial stability. This is discussed in more detail in a recent speech by my colleague Andrew Hauser.[8]

The appropriate long-term mix of assets to back that level of reserve supply requires careful consideration of its implications for our policy objectives. Decisions on the asset mix in steady state will be made by the Bank in due course in close consultation with relevant stakeholders, including HMT, on the size and shape of our future balance sheet.

Since the steady state level of reserves is not directly connected with the progression of QT, the best guide to potential cashflows associated with the APF can be found in APF Quarterly Report and the scenarios illustrated above.

Yours sincerely,

Andrew Bailey

[8] **'Less is more' or 'Less is a bore'? Re-calibrating the role of central bank reserves - speech by Andrew Hauser | Bank of England**