HM Treasury

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Dame Meg Hillier MP
Chair of the Treasury Committee
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Dear Dame Meg,

CHANGES RELATING TO THE ASSET PURCHASE FACILITY

I wanted to take this opportunity to write to you on upcoming changes to the Bank of England's plans for backing notes in circulation.

The Asset Purchase Facility (APF) has been authorised by previous Chancellors to hold assets, primarily for monetary policy purposes. It was the facility used to buy bonds to meet the Bank's inflation target and encourage growth when interest rates were already near 0%. In addition, the Chancellor today authorised a segregated portfolio of APF gilts to be held for non-monetary policy purposes.

At its peak, the APF held £875bn in gilts. These purchases were financed by the issuance of central bank reserves. Since 2009, banknotes have primarily been backed by a deposit from the Issue Department balance sheet to the Banking Department (the "Issue Deposit"), which itself is indirectly backed by gilts held in the APF. In 2022, following the decision by the Monetary Policy Committee (MPC) to begin Quantitative Tightening (QT), the Bank began the process of unwinding these holdings. This has been achieved by either allowing bonds to mature, actively selling them, or both. At time of writing, the holdings of the APF have been reduced to £488bn.

The MPC has today voted to unwind the APF through an annual sales pace of £20bn in purchase proceeds terms until gilts held for monetary policy purposes are fully unwound by the end of 2034. Taking the maturity profile into account, this is equivalent to an average annual stock reduction of £46bn. The MPC has statutory independence to set monetary policy to pursue its objectives, as set out in law and specified by the government.

BACKING NOTES IN CIRCULATION

The Bank is required under the 1928 Currency and Banknotes Act (the '1928 Act') to maintain sufficient assets in the Issue Department to back the currency – specifically, banknotes in circulation. Currently, the Issue Department holds a deposit with the Banking Department as the majority asset backing the notes liability. The Banking Department in turn holds assets against that deposit, currently the relevant asset is a portion of the loan from Banking Department to the APF. This loan is then ultimately backed by the gilts held within the APF. As a result, the APF gilts indirectly back notes.

The MPC's intention to continue QT until the stock of gilts held in the APF for monetary policy purposes is fully unwound gives the Bank Executive greater certainty when assessing the long-term implications of QT on the banknote-backing framework; the Bank Executive has therefore taken the opportunity to clarify future arrangements, in consultation with HMT.

The Bank Executive continues to judge that gilts are the appropriate asset to back a stable liability like banknotes. Gilts are a credible, stable and low-risk asset base which is important for supporting public confidence in the currency. Banknotes are a non-interest-bearing liability for the Bank. As such, there is no mismatch between the income the backing assets earn and a floating rate payment, as there is for reserves.

The Bank Executive, in consultation with HMT, considered which gilts specifically might be best. In the medium term, the Bank Executive has decided to retain £120bn of the longest-dated gilts in the APF; these will no longer be gilts held for monetary policy purposes and will instead remain in the APF to indirectly back banknotes. This formalises the existing balance sheet arrangement and ensures notes in circulation continue to have suitable and sufficient backing assets as QT progresses. The use of APF gilts will avoid incurring unnecessary transaction costs and the risk of simultaneously buying gilts for notes backing purposes onto the Issue Department balance sheet and selling gilts for QT purposes from the APF. The Bank judges it can meet its policy objective of appropriately backing banknotes through the proposed arrangements. Furthermore, as policy considerations have been met, retaining the gilts in the APF also avoids the upfront costs associated with transferring the assets to the Issue Department. Setting these gilts aside for indirect notes-backing therefore maintains an orderly transition as the APF winds down while delivering value for money to the taxpayer.

As the Chancellor set out today, the gilts will continue to be indemnified under the terms of the existing APF indemnity, but will no longer be available for sale as part of QT. As gilts from this APF notes-backing portfolio mature, the Bank Executive intends to purchase gilts in the secondary market to be held on the Issue Department balance sheet. We expect this reinvestment to start in 2049.

Looking ahead, HMT and the Bank have also considered the point in the future when a portfolio of gilts is held directly on Issue Department. The National Loans Act 1968 currently requires that the assets held in the Issue Department are valued at market prices at least once in each financial year, and in practice this is done quarterly. The Bank is required to pay profits to HMT under the 1928 Act and the 1968 Act requires those profits to be paid to the NLF. Where there is a shortfall, HMT assumes a liability to the Issue Department under the 1968 Act, which is charged on the NLF and is settled immediately. Under the existing framework, the market valuations, and corresponding transfers of cash, occur even where no realised profit or loss has crystalised (i.e. no gilt has been sold or matured) which results in needless transfers back and forth of cash every quarter.

To eliminate these unnecessary transactions, HMT in agreement with the Bank intends to propose legislative changes to the 1968 Act to remove the requirement to value assets at least once in each financial year according to market prices. This will better reflect the Bank's intention to hold the gilts to maturity as it will allow any changes in the value of the asset to be transferred from or to the NLF at the point at which the loss or profit crystallises, rather than tracking market value when it is unlikely the gilt will be sold. The proposed legislative change will instead provide for valuation of the assets for the purpose of cash transfers at such times and in such manner as agreed between HMT and the Bank. As the Bank intends to hold the gilts to maturity, it is appropriate for the individual gilt to be valued when a profit or loss crystallises. Subject to Parliamentary approval of the proposed changes, the Bank and HMT therefore intend to adopt a policy of valuing individual gilts and making required cash transfers for those gilts as they mature or, in very exceptional circumstances, when they are sold. For gilts held within the Issue Department, HMT will continue to be liable for any shortfall between the purchase value and value at redemption or sale via the NLF. HMT and the Bank are both committed to ensuring there continues to be transparency in the reporting of the impacted gilt portfolio and HMT's liabilities under both the National Loans Act 1968 and the APF Indemnity. Any legislative change is of course subject to Parliamentary time and approval.

THE IMPLEMENTATION OF QT

It is also worth noting that today the Chancellor and the Governor of the Bank of England announced that progress has been made over the course of the year by officials from the Bank and HM Treasury to review the Bank Executive's future approach to implementation of QT, to ensure it continues to maximise value for money by minimising cost and risk over the lifetime of the APF, continues to support gilt market functioning and predictability of sales, whilst continuing to align with the MPC's QT principles. You will of course be updated should this work result in material changes to the APF or the future implementation of QT.

I am copying this letter to the Chancellor, the Minister for Pensions and James Bowler as Principal Accounting Officer of HMT.

Yours sincerely,

Brian Bell

Chief Economic Advisor