BANK OF ENGLAND
LONDON EC2R 8AH

9 November 2012

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

Thank you for your letter of 9 November outlining the agreement we have reached to transfer gilt coupon payments received by the Asset Purchase Facility (APF), net of interest costs and other expenses, to the Exchequer.

The previous arrangement was for these cash flows to accumulate on the APF's balance sheet. Because the APF is indemnified by the Government, any gains or losses it makes are ultimately due to the Exchequer. So the gilt coupons received by the APF amount to payments from one part of the public sector to another. As the scale and likely duration of the APF has increased significantly since its inception, I agree that it now makes sense to normalise the cash management arrangements for the APF.

While transferring the APF's net income to the Exchequer will result initially in payments from the APF to the Government, it is likely to lead to the need for reverse payments from the Government to the APF in the future as Bank Rate increases and the APF's gilt holdings are unwound by the Monetary Policy Committee (MPC). Indeed, under reasonable assumptions it is likely that the majority of any transfer of funds to the Government will eventually need to be reversed. An important part of the agreement we have reached is that these return payments will be met by the Government on a timely basis. I am therefore content that this action poses no risk to the Bank of England's balance sheet.

During its meeting of 7-8 November I briefed the MPC on the agreement we have reached. The Committee was content that its ability to set the appropriate stance of monetary policy would not be affected by this action. But the Committee noted that its policy setting would need to take account of the effect of this action, which amounts to a small loosening of monetary conditions. This is because, as the Committee noted, your intention is to use any funds transferred to the Exchequer to reduce the stock of outstanding government debt. As a result the private sector will hold fewer gilts and more money than otherwise. That implies an easing in monetary conditions relative to the present position in which the coupon payments are held on deposit by the APF. The Committee therefore views the use of coupon income to reduce the stock of outstanding gilts as having an effect similar to the MPC purchasing gilts of the same value.

The Committee also noted that the gilts held by the APF would begin to mature in March 2013. Repayments of principal will not be transferred to the Exchequer. The MPC retains the option to maintain the size of the APF without it having to borrow additional funds from the Bank. As is now the case, the appropriate size of the asset purchase programme will be reviewed and decided by the MPC at each policy meeting in the light of the medium-term outlook for inflation. So the size of any asset purchases or sales will need to take into account the repayment of maturing bonds.

Yours sincerely

Mervyn King