HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

9 November 2012

Mervyn King
Governor
Bank of England
Threadneedle Street
London
EC2R 8AH

Dear Mervyn,

Transfer of excess cash from the Asset Purchase Facility to HM Treasury

I am writing to confirm our agreement to transfer the Asset Purchase Facility's (APF) excess cash holdings to the Exchequer. As you are aware, my predecessor agreed that the APF be fully indemnified for all losses by the Treasury and hence any gains or losses are due to the Treasury.

With the purchases of the APF having reached £375bn, this Facility has now accumulated a large cash balance. As the scale and likely duration of the scheme has increased significantly since its inception, it makes sense to normalise the cash management arrangements for the APF.

Holding large amounts of cash in the APF is economically inefficient as it requires the Government to borrow money to fund these coupon payments. Transferring the net income from the APF will allow the Government to manage its cash more efficiently, and should lead to debt interest savings to central government in the short-term. It would bring these arrangements into line with standard cash management practices for government activities, and is also in line with the practices of the Federal Reserve and the Bank of Japan.

We have agreed that from now on the APF transfers its excess cash to the Treasury, including the excess cash that has accumulated since the inception of the APF in 2009. Excess cash here is broadly defined as the APF's coupon income, net of the interest paid by the APF on its loan from the Bank of England and other cash flow items such as operating costs.

I would like this to take place on a quarterly basis, with the exception of the initial transfer of accumulated coupons at the beginning, which will need to be staggered for operational reasons. These cash transfers will be based upon the actual net cash flows of

APF such as coupon income and loan interest payments owed to the Bank. Unrealised mark-to-market profits due to movements in the gilt price will not be transferred as part of this regular process.

The MPC will retain the option to reinvest the principal received from any redemptions, and to maintain the size of the Asset Purchase Programme without having to borrow additional funds from the Bank. I would like you to confirm that the MPC is content that this will not affect its ability to set the stance of monetary policy that it deems appropriate. These payments and the arrangements around them should be seen as entirely consistent with the different roles and actions taken by the Treasury and the Bank in relation to the APF.

At some stage it is likely that the cash flows from the APF to HM Treasury will need to be reversed in order to meet the terms of the indemnity, as monetary conditions normalise and Bank Rate rises, or capital losses crystallise as gilts are sold or allowed to redeem without reinvestment. I am happy to reaffirm my predecessor's commitment that any future losses incurred by the APF will be met in full by the Government. For this reason, net coupon income transferred from the APF to HM Treasury should be used solely to benefit the public finances and to reduce debt.

Consistent with the arrangements for transferring cash surpluses from the APF to HM Treasury, cash transfers to the APF in respect of the indemnity will be based on the net cash flows of the APF, including the net coupon income and any shortfall needed to repay the original loan from the Bank upon sale or redemption of the APF's assets. Cash to cover mark-to-market losses due to movements in gilt prices that have not been crystallised by sale or redemption will not be transferred as part of this regular process.

In addition, as you have previously noted, in exiting from QE it will be important to avoid disruption to the gilt market and to maintain the ability of the MPC to implement QE exit, and the settlement of amounts owing along the way will need to be factored into the process. The Bank has committed to consult with the Debt Management Office on any asset sales programme and this should help to reduce the likelihood of any significant disruption.

Best wishes,

GEORGE OSBORNE