Bank of England

The Rt Hon Jeremy Hunt MP
Chancellor of the Exchequer
HM Treasury
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London
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Andrew Bailey
Governor

4 November 2022

Dear Jeremy,

Measures to restore gilt market functioning

From 28 September to 14 October, the Bank of England initiated a series of measures to restore market functioning to meet its financial stability objective.

The Bank continues to monitor developments in financial markets closely in light of the significant asset repricing observed in late September. It has also been working with the relevant UK authorities to address risks to the resilience of Liability Driven Investment (LDI) funds arising from volatility in the long-dated and index-linked government bond (gilt) market.

The Bank's gilt purchase operations

On 28 September, the Bank announced that it would make temporary and targeted purchases of long-dated conventional gilts through the Asset Purchase Facility (APF), to help restore market functioning and reduce any risks from contagion to credit conditions for UK households and businesses.

The start of the week beginning 10 October saw a further significant repricing of UK government debt, particularly index-linked gilts. In response, the Bank announced on 11 October that it would widen the scope of its operations to also include purchases of index-linked gilts. This enhancement to our operations was in effect from 11 October 2022 until 14 October 2022 alongside the Bank's existing daily conventional gilt purchase auctions.

The Bank of England's Financial Policy Committee (FPC) noted the risks to UK financial stability from dysfunction in the gilt market at the outset of the intervention.

It recommended that action be taken, and welcomed the Bank's plans for temporary and targeted purchases in the gilt market on financial stability grounds at an urgent pace.

The Monetary Policy Committee (MPC) was also informed of the temporary and targeted financial stability operations. This was in line with the Concordat governing the MPC's engagement with the Bank's Executive regarding balance sheet operations. The MPC judged that these operations did not affect its ability to undertake monetary policy.

The Bank's purchases of both conventional and index-linked gilts under these temporary and targeted financial stability operations are fully indemnified by HM Treasury under the terms of the existing APF indemnity.

Consistent with this, on 28 September HM Treasury authorised an increase in the maximum size of the APF by £100bn to £966bn, which was intended to enable financial stability operations to be undertaken in the size that may have been necessary to address risks.[1] Following the final purchase operations on 14 October the Bank had purchased a total of £19.3bn of gilts.[2] As purchases have now concluded the maximum size of the APF can be adjusted down, from £966bn to £886bn. We have agreed to write again separately in the coming month to confirm a further reduction in the authorised maximum size in relation to the ongoing unwind of assets held in the APF for monetary policy purposes.[3]

In addition to the multiple actions taken with a view to restore financial stability above, the Bank's Executive also decided to postpone the beginning of gilt sale operations that were due to commence on 3 October. Gilt sale operations in relation to the MPC's annual target commenced on 1 November. The MPC's annual target of an £80bn stock reduction is unaffected and unchanged. In addition, the Bank temporarily paused its Corporate Bond Purchase Scheme sales operations which recommenced in the week beginning 24 October.

<u>The Temporary Expanded Collateral Repo Facility (TECRF)</u>

On 10 October, the Bank announced additional measures to support market functioning and an orderly end to its temporary and targeted gilt purchase scheme. These included the expansion of the scale of its remaining gilt purchase auctions and the launch of a Temporary Expanded Collateral Repo Facility (TECRF) through which banks would be able to help to ease liquidity pressures facing their client LDI funds through liquidity insurance operations. The application window for this facility will be open until 10 November.

The launch of the TECRF was intended to mitigate the need for LDI funds to sell large quantities of gilts at fire sale prices within a short timeframe by providing such funds with an alternative way to meet their short-term liquidity requirements by accessing funding against other assets. In this way, it aims to help maintain orderly functioning in the core gilt market.

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[1] See here: https://committees.parliament.uk/publications/30129/documents/174330/default/

[2] Comprising £12.1 billion of conventional gilts and £7.2 billion of index-linked gilts.

[3] In line with the regular semi-annual process agreed by exchange of letters in May 2022.

Under the TECRF, the Bank accepts collateral eligible under the Sterling Monetary Framework (SMF), including index-linked gilts. It will also accept lower rated corporate bond collateral than is normally eligible under the SMF. The Bank's analysis of the risk shows that the Bank can accommodate this lower quality collateral within its current published haircuts. While that will result in a temporary increase in risk, the Bank is of the view that it can support the TECRF with its existing level of capital without need for indemnification. This judgment is sensitive to a set of assumptions around the profile of the assets and in particular the total demand for the facility which is not fully known. Were these assumptions to change based on further intelligence there is a possibility the Bank would need to reconsider the need for either risk sharing or full indemnification.

<u>The Bank's approach beyond 14 October</u>

The Bank will design and announce a sales programme for the gilts purchased during these financial stability operations that returns them to the market in a timely but orderly way, consistent with the Bank's statutory objectives for monetary and financial stability. Orderly disposal includes not selling gilts into febrile markets whereby the Bank's sales might increase the level of dysfunction, such that value for money cannot be achieved.

Although covered by the existing Asset Purchase Facility Indemnity, a breakdown will be provided to HMT of the income and costs relating to the gilts purchased during these financial stability operations relative to those acquired under monetary policy operations. Where appropriate, the Bank will also provide a breakdown in its public reporting (for instance, in its published APF quarterly reports).

In line with the HM Treasury Accounting Officer's requirement to protect the rights and assets of the taxpayer and ensure value for money – recognising the distinct purposes and characteristics of the two types of intervention – the risks, financial flows and operations involved with these financial stability operations will be subject to oversight, reporting, accounting and competitive sales processes of equivalent rigour to those applied to monetary policy operations.

Bank officials are working with HM Treasury officials to ensure that HM Treasury is able to monitor taxpayer exposure and report on it to Parliament. In the spirit of the arrangement set out in my previous letters on APF asset sales, Bank officials will also liaise with the UK Debt Management Office (DMO) when developing plans to sell gilts purchased in recent weeks, in order to minimise interference with the DMO's own issuance programme.

Yours sincerely

Andrew Bailey