CHANCELLOR OF THE EXCHEQUER

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

21 June 2018

Mark Carney
Governor
Bank of England
Threadneedle Street
London
EC2R 8AH

Dear Mark

The financial relationship between HM Treasury and the Bank of England

I am writing to authorise a new Memorandum of Understanding (MoU) between HM Treasury and the Bank of England, which sets out the future financial relationship between our institutions. This new MoU has been published in full in parallel to this letter, and shall take effect from today.[1]

Under this MoU, the Bank will operate under a new capital and income framework which reinforces the Bank's independence and resilience, provides greater transparency concerning the Bank's finances, and reinforces the stability of the UK's financial system.

Since the financial crisis, the Bank has operated in a challenging environment and developed new instruments to maintain monetary and financial stability. Over the same period, the Bank has also been granted greater responsibilities by Parliament, including on banking supervision, macro-prudential policy, and bank resolution. The Treasury recognises the need for this expanded remit to be supported by an appropriate amount of loss-absorbing capital, as well as an appropriate degree of risk-sharing between the Bank's own balance sheet and that of the Exchequer. The Treasury also recognises the need for a more flexible income-sharing model, which ensures that the Bank is able to maintain that level of loss-absorbing capital while returning any surplus income to the Exchequer.

The core parameters of this new capital and income framework include:

i. A target level for the Bank's loss-absorbing capital (set at £3.5 billion), which equips the Bank to perform its monetary policy and financial stability functions in the current operating environment.
ii. A floor and ceiling level of capital (£0.5 billion and £5.5 billion respectively), with a commitment from the Treasury to provide additional capital if the Bank's capital base falls below the floor.
iii. A flexible dividend-sharing arrangement between the Treasury and the Bank, involving:

[1] https://www.gov.uk/government/publications/financial-relationship-between-the-treasury-and-the-bank-of-england

a. Full retention of net income by the Bank, if the capital level falls below the target but remains above the floor (£0.5-£3.5 billion);
b. 50:50 dividend-sharing arrangements continuing as at present, when the capital level is above target but below the ceiling (£3.5-£5.5 billion); and
c. Full transfer of the Bank's net income to the Treasury, if the capital level goes above the ceiling (above £5.5 billion).

The Bank's total loss-absorbing capital, supporting its un-indemnified operations, currently stands at £2.3 billion. To increase the Bank's capital to its target level, I intend to provide a £1.2 billion capital injection from the Exchequer to the Bank's balance sheet in the 2018-19 financial year. This will be fiscally neutral, as the injection will stay in the public sector. With this injection, alongside our agreement for ongoing flexible income-sharing arrangements, the Bank will be appropriately capitalised.

The framework also captures a set of principles for determining which monetary policy or financial stability operations should be undertaken on the Bank's balance sheet and which operations should be indemnified by the Treasury. This will provide greater clarity, predictability, and accountability regarding the apportionment and management of the financial risks associated with these operations.

In keeping with these principles, the £127 billion Term Funding Scheme (TFS) will also be transferred to the Bank's balance sheet, and the Treasury indemnity will be removed from this facility during the 2018-19 financial year.

This new financial framework is supported by enhanced information-sharing between the Bank and the Treasury which ensures effective monitoring of financial performance and management of risks, while respecting the Bank's operational independence in the area of monetary policy.

This framework will be reviewed at least every five years, in line with the review of the Cash Ratio Deposit scheme, which was recently amended to ensure that it is more responsive to changes in the market environment, and thereby produces a smoother income profile to cover the Bank's monetary policy and financial stability functions. The Bank has also agreed to provide greater transparency on its cost base for those paying into the scheme.

I look forward to the Treasury and Bank working collaboratively to implement the terms of this MoU over the coming period.

I am copying this letter to the Prime Minister, the Chair of the Treasury Committee, the Chair of the Public Accounts Committee, and the Comptroller & Auditor General of the National Audit Office. I am depositing it immediately in the libraries of both Houses of Parliament and on the Treasury website.

PHILIP HAMMOND