BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon Philip Hammond
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London
SW1A 2HQ

4th August 2016

Dear Chancellor,

At its meeting ending on 3rd August 2016 the Monetary Policy Committee (MPC) agreed to implement a package of monetary policy stimulus measures in order to strike an appropriate trade-off between supporting growth and returning inflation sustainably to the target over an appropriate horizon.

This follows a material change in the MPC's assessment of the outlook for inflation, growth and employment in the light of the vote to leave the European Union, set out in the *Inflation Report* published today. Given this, the Committee judges that, in the absence of monetary stimulus, the amount of spare capacity in the economy would be expected to undergo a persistent increase, resulting in undesirable volatility in output and employment, while making a sustainable return of inflation to the target materially less likely to be achieved in the medium term. Indeed, a lasting shortfall in aggregate demand below the economy's productive capacity would, in all likelihood, drag inflation below the target beyond the forecast period once the effects of a lower exchange rate have passed through to the level of consumer prices. These judgements are discussed further in the *Report* published today and in a letter accompanying this one which sets out the MPC's strategy for ensuring a sustainable return of inflation to the target.

The UK is a highly flexible, dynamic economy. These characteristics will help it to move to a new equilibrium as its future relationship with the European Union becomes clear and new opportunities with the rest of the world open up. Many of the adjustments needed to move to that new equilibrium are real in nature, and are not the gift of monetary policy makers. Nonetheless, monetary policy can still play a role in smoothing part of this adjustment by appropriately balancing the forces acting to push inflation above the target with those expected to push activity below the economy's new path for potential output.

In light of this, I am writing to request a number of changes to the authorisation of the Asset Purchase Facility (APF) and confirm some existing arrangements about how the Facility is used.

Existing Authorisations

As set out in your predecessor's letter of July 2012, the APF is currently authorised to purchase up to £375bn of assets financed by the creation of central bank reserves. Assets eligible for purchase under this arrangement include gilts and high quality private sector assets, including corporate bonds, as specified in the exchange of letters at the time of the Facility's inception. The APF also has authorisation to purchase eligible private sector assets using Treasury Bills and the DMO's cash management operations, though the maximum total authorised amount of private sector asset purchases financed by Treasury Bills, the DMO's cash management operations or central bank reserves is £10bn.

The use of the APF for monetary policy

At its August meeting, the Committee judged that the level of Bank Rate needed to support growth and ensure inflation returned to target over an appropriate horizon had fallen, and it voted to reduce Bank Rate to 0.25%. The MPC took the additional step of announcing a Term Funding Scheme (TFS) in which central bank reserves would be lent to banks and building societies for an extended period at a rate close to Bank Rate. Having discussed with the Financial Policy Committee (FPC) and considered detailed analysis by the Prudential Regulation Authority,[1] the MPC judged this step was warranted in order to ensure the very low level of Bank Rate was passed through to lending rates in the real economy faced by households and businesses.

The Committee also judged that it would be appropriate to impart further stimulus through additional asset purchases. The Committee judged it was appropriate to purchase corporate bonds in order to improve credit conditions for companies by lowering their cost of borrowing. The Committee expects that a corporate bond purchase programme will encourage further issuance of private debt securities. On balance, it expects corporate bond purchases to impart more stimulus that the equivalent amount of gilt purchases. However, the size of the existing outstanding stock of sterling corporate bonds means that the pace of purchases in that market will be limited. So the Committee also judged it appropriate to conduct further purchases of gilts, which will stimulate demand in the economy by increasing a broad range of asset prices, reducing borrowing costs, and by affecting expectations and confidence.

For these reasons, I am requesting that the APF is authorised to purchase up to a further £70bn of assets financed by the creation of central bank reserves, of which up to £10bn can be eligible private sector assets (which will include high quality sterling corporate bonds issued by companies that make a material contribution to economic activity in the UK). In addition, in order to finance the new TFS, I am requesting that assets eligible to be held in the APF are extended to include secured lending of central bank reserves backed by the full range of collateral eligible in the Bank's Sterling Monetary Framework. The value of this lending would increase in line with the amount outstanding in the TFS and could reach around £100bn – though in practice the amount will be determined by the usage of the scheme. Consistent with this, I am requesting that you authorise an increase in the total size of the APF of £170bn to £545bn.

These changes to the APF would further enhance the MPC's ability to pursue its remit by delivering the stimulus it judges necessary to strike the appropriate trade-off between supporting the economy and returning inflation sustainably to the target. Given the large size of the measures proposed by the MPC relative to the Bank's balance sheet, the Bank judges that they are most appropriately undertaken through the APF to benefit from its Government indemnity.

The use of the APF to support liquidity in credit markets

As well as being used for monetary policy purposes, the APF has the ability to purchase private sector assets to help improve liquidity in credit markets that are not functioning normally. In the past, the APF has used several mechanisms to facilitate these purchases including the Commercial Paper Facility, the Secured Commercial Paper Facility, and the Corporate Bond Secondary Market Scheme. By providing backstop demand for such assets, these initiatives had a beneficial impact on market function. And, consistent with their intended catalytic effect, as conditions improved their usage declined materially. None of the facilities have been used since 2013. Reflecting this, and the fact that markets are currently functioning normally, I wanted to draw your attention to several changes we will be making.

The Commercial Paper Facility closed in November 2011, reflecting improvements in market function relative to when it was opened. The Secured Commercial Paper Facility has not been used since 2011, and we therefore intend to close it too. In 2013 the Corporate Bond Secondary Market Scheme was

[1] See the box in Section 1 of the August *Inflation Report* that details the joint meeting of the MPC and FPC.

moved to operating only if warranted by market demand. Since there has been no indication of such demand in the intervening period, and bearing in mind the APF will be purchasing corporate bonds for monetary policy purposes, we also intend to close this scheme.

The Bank will continue to stand ready to act in exceptional circumstances to improve the liquidity of one or more markets whose illiquidity poses a threat to financial stability or is judged to be important to the transmission mechanism of monetary policy.

Governance, transparency and accountability

The operation of the APF, including the implementation of monetary policy decisions of the MPC, is managed through a wholly owned subsidiary of the Bank – the Bank of England Asset Purchase Facility Fund. The Government indemnifies the Bank and the APF from any losses arising out of or in connection with the facility. Accountability, transparency and risk management are hence an important part of the framework of the APF.

The MPC remains accountable for its use of the APF in the same way that it is for any monetary policy decision. It will continue to explain its actions through the Monetary Policy Statement and Minutes which are published alongside its decisions, through the *Inflation Report*, and through its regular evidence to the Treasury Committee through which the Bank is accountable to Parliament.

The Bank will continue to operate the APF in an open and transparent manner. Details of how the Bank intends to carry out its operations will continue to be set out in Market Notices. The Asset Purchase Facility Quarterly Report will include details of all of the transactions undertaken, as it has done since the Facility's inception.

In line with the requirements in the monetary policy remit, because these amendments to the APF could have potential effects on the allocation of credit and pose risks to the Exchequer, officials at the Bank and HMT have already discussed how the proposed amendments affect the governance of the APF and agreed enhanced oversight arrangements.
The risk control framework between the Bank and the Treasury – under which the Bank is responsible for managing the risks in the APF - will remain in place, subject to amendments to be agreed by our officials, including to reflect the addition of secured lending to the APF for the first time. The APF will also benefit from changes the Bank introduced during 2015, which expanded our financial risk management arrangements, with separate departments responsible for first-line risk management and second-line activities, including risk challenge, reporting to a senior Executive Risk Committee and through that Committee to Court.

The Bank will provide Treasury officials with enhanced information to allow them to monitor the operation and financial performance of the facility. There will also be the opportunity for HMT to provide views to the MPC on the design of the TFS and private sector asset purchases, in light of their broader economic objectives and in view of the risks posed to the public sector balance sheet. Any changes to the maximum size and composition of assets held in the APF will continue to be agreed through an exchange of letters between you and I. Changes to the parameters within the risk control framework will also continue to be agreed between Bank and Treasury officials.

When, in the future, a reduction in the monetary stimulus provided by the APF becomes appropriate in order to achieve the inflation target, the MPC will take every step to ensure such a reduction is implemented in an orderly fashion. A reduction in the size of the APF could be achieved in part as assets and loans mature. Were asset sales judged to be appropriate, the Bank would liaise with the DMO in order to minimise interference with the DMO's own issuance programme, and would consider the views of market participants as to how best to minimise disruption in private asset markets. The decision and final responsibility, nevertheless, would be with the MPC.

I would be grateful if you could authorise the changes in size and composition of the APF that I have requested in this letter, confirm the other existing arrangements set out above, and for the purposes of transparency and accountability confirm that the Government will continue to indemnify the Bank and the APF from any losses arising out of or in connection with the facility.

I am copying this letter to Andrew Tyrie MP, Chair of the Treasury Committee.

Yours,

Mark