

APF indemnity could raise gilt sales by greater amount than the “Growth Plan”

Tim Davis, 10 October 2022

- Through the first year of active gilt sales the Treasury will have to transfer GBP37bn to the BOE’s APF due to the indemnity.
- These costs could exceed the costs of the entirety of the government’s “Growth Plan” (excluding the energy price cap).
- Any transfers to/from the APF to Treasury directly impact CGNCR – to date this has been helping keep borrowing lower, but this is about to reverse significantly.
- This may lead the Bank of England to reconsider the parameters for its active gilt sales programme or the interest rate paid on excess reserves at the central bank.

The Bank of England’s Asset Purchase Facility (i.e. portfolio of gilt holdings bought during QE) is about to become very expensive to the government. The UK Treasury has indemnified the BoE against any losses through the APF and also receives any profits. To the end of August 2022, the Treasury had received GBP123.9bn in the first decade of the APF’s operation. However, assets held inside the APF are valued at their initial purchase price and based on the remaining APF holdings and current gilt prices, the outstanding portfolio is sitting on a paper loss of GBP223bn¹, a figure that would comfortably wipe out any profits.

The Lords Economic Affairs Committee has been concerned about the impact of the indemnity for some time, and Lord Bridges told our Policy Team last year that tighter policy would be a key test of Bank of England independence ([see the full story here](#)).

These losses are only crystallised either as a gilt matures or is sold. Using current market prices, the MNI Markets team estimates that through the first year of active gilt sales the Treasury will have to transfer GBP37bn to the Bank of England (assuming the Bank Rate rises to 4.00%). To put this into context, the entirety of the government’s “Growth Plan” (excluding the energy price cap) is expected to cost GBP27bn in the 2023/24 fiscal year – with the costs of the policies not exceeding GBP37bn until the 2026/27 fiscal year.²

This GBP37bn cost is not a mere accounting loss – it will have to be paid for in cash terms. As with all transfers between the Treasury and BOE regarding the APF, it will directly impact CGNCR. The vast majority of the government’s cash funding needs are met through gilt issuance. So not only will the gilt market have to digest a GBP80bn drop in the size of the BoE’s gilt holdings (split roughly

¹ Itself an increase from the GBP175bn loss if calculated using closing gilt prices the day before the last MPC policy decision was published – and hence also before the government’s “Growth Plan”.

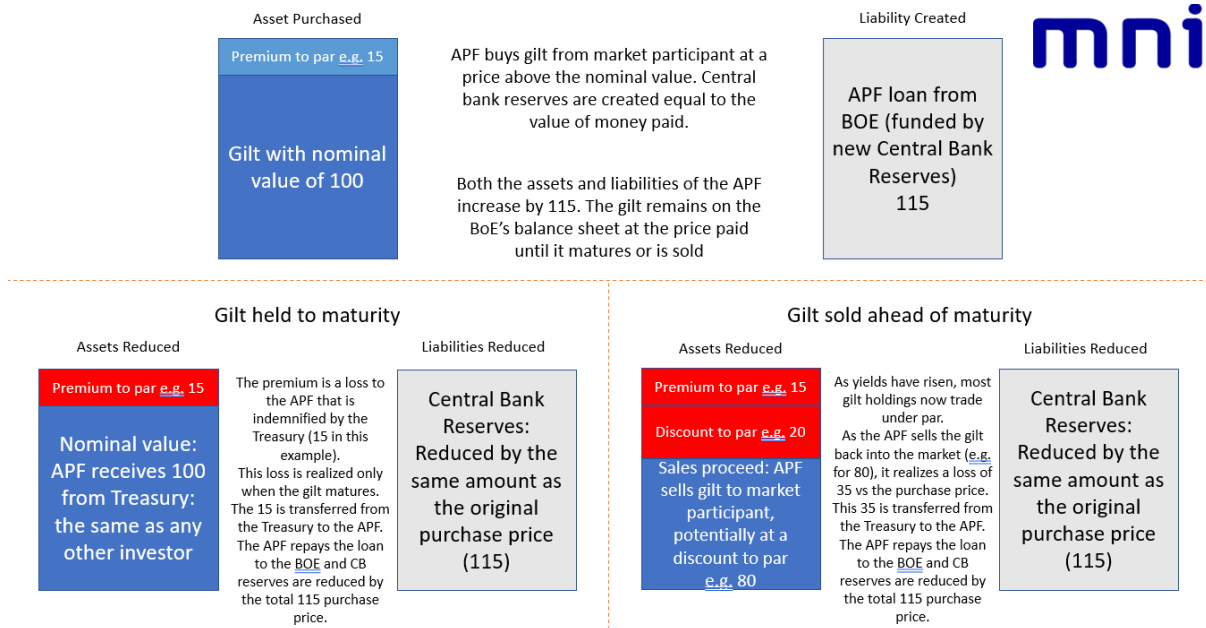
² The Growth Plan 2022, total policy decisions cost on page 26 adjusted for the recent announcement that the additional rate of income tax will not be cut.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1105989/CCS207_CCS0822746402-001_SECURE_HMT_Autumn_Statement_2022_BOOK_Web_Accessible.pdf

equally through active gilt sales and redemptions), there will also be GBP37bln of extra supply purely linked to the costs incurred by the APF.

In this Markets Analysis document, we outline how the accounting for QE works, the underlying assumptions that we have used while calculating these numbers and if there are any alternatives to make the running of the APF less costly.

Figure 1. How the Asset Purchase Programme works



Source: MNI Market News

How the APF purchased gilts and how the indemnity works

Figure 1 shows an overview of how the Bank of England's Asset Purchase Facility works to buy gilts. First the Bank of England loans money to the APF, and an equivalent amount of central bank reserves are created. The APF then purchases a gilt from a market participant (e.g. GEMM, commercial bank, pension fund). Often this was done at a premium to par. The gilt then remains on the APF's balance sheet at the purchase price until it either matures or is sold.

The APF is indemnified by the Treasury and since 2012 all profits/losses have been transferred between the APF and the Treasury on a quarterly basis. This is made up of two factors: the net interest income and the realized profit/ losses of gilts when they mature or are sold. Between 2012 and August 2022, the APF transferred GBP123.9bln of profits to the Treasury, as set out in Figure 2.

Fig 2. APF Transfers to Treasury

Fiscal Year	GBPbln
2012/13	11.3
2013/14	31.1
2014/15	10.7
2015/16	8.5
2016/17	10.3
2017/18	10.0
2018/19	9.7
2019/20	7.1
2020/21	13.7
2021/22	7.2
2022/23 (to Aug)	4.2
Total	123.9

Source: MNI Market News, ONS

Net interest income costs could be GBP17bln assuming Bank Rate of 4%

The net interest income of the APF is made up of the fixed coupon payments from the gilts it has purchased minus the financing of the loan to the Bank of England (with the latter having a variable interest rate equivalent to Bank Rate). Based on the APF's outstanding gilt holdings, it receives coupon interest of around GBP16bln/year (a 1.95% yield to maturity based on the original purchase

prices). Until recently, this has been significantly higher than Bank Rate. However, with Bank Rate having risen to 2.25% in September and expected to rise further, the net interest income is due to become sharply negative.

If we take an assumption of a Bank Rate of 4.00% (the median expected by analysts and lower than market pricing) the gross funding cost will rise to around GBP33bn/year. Assuming that this is done through either hikes at upcoming meetings of 75bp/75bp/25bp or 100bp/75bp – that equates to a net GBP16bn annual loss. This will in itself trigger a reversal of flows through the indemnity with the Treasury. Every 1ppt change in Bank Rate will change this estimate by GBP8.4bn, so a 5% Bank Rate would see a net GBP24bn loss while a 3% Bank Rate would see a GBP9bn net loss.

Active gilt sales could book a loss of GBP20bn

Active gilt sales will potentially trigger equal or potentially even see larger losses than the net interest income component. Gilts now trade at a significant discount to the prices paid. Based on the closing prices of Friday 7 October, short-dated gilts trade at an 18% discount to their purchase price, medium-dated gilts at a 26% discount and long-dated gilts at a 46% discount. With gilts held on the APF’s balance sheet at their purchase price until sale or maturity, this means sales (particularly of long-dated gilts) will produce significant losses.

The Bank of England’s original plan to sell gilts from the APF was originally due to begin on 3 October and see a fortnightly sale of each of the three maturity buckets at a size of GBP580mln. This GBP580mln was based on the sales proceeds, so each operation would be larger in both nominal terms (assuming we are trading below par) and in terms of the initial purchase proceeds.

The expected start of active gilt sales is now Monday 31 October. Let us assume that the programme proceeds with the previously announced parameters and gilts are sold proportionally to the Bank’s holdings. This would mean that the average short-dated operation would book a loss of around GBP130mln, medium-dated operation around GBP200mln and the average long-dated operation would book a loss of around GBP490mln.

These operations are held every 2 weeks, so over a 4-week period GBP1.6bn of losses would be booked. This cost has risen from around GBP1.3bn over the same period if we took gilt prices on 21 September – the day of the MPC’s policy decision.

Figure 3. Expected APF Sales Volumes

Expected APF sales volumes				
	Size of op	Initial equivalent*	Ave discount**	Exp loss per op
Short (3-7y)	580	708	18.1%	-128
Medium (7-20y)	580	784	26.0%	-204
Long (20+ y)	580	1069	45.8%	-489
Total (2 week period)	1740	2561	29.9%	-821

Source: MNI Market News

* Initial equivalent is the expected reduction in terms of initial proceeds - and hence reduction in the size of the balance sheet.

** Average discount vs the weighted average purchase price



The APF could add GBP37bln to issuance needs over a 12-month period

This is equivalent to an annual loss of almost GBP20bln. In addition, there is the GBP1.7bln loss that will have to be booked for the maturing 0.75% Jul-23 and 2.25% Sep-23 gilts. Adding on the expected net interest income costs of GBP16bln would mean that the APF would lose around GBP37bln over a 12-month period following the start of active gilt sales.

The APF cash flows feed directly through to the central government net cash requirement (CGNCR) – which is the metric that the DMO’s issuance remit is based on. So the APF alone has the potential to add more to the funding remit than all of the fiscal policy decisions from the government’s recent “Growth Plan” (excluding energy). The policy document for this showed these policies to cost GBP27bln in 2023/24, GBP31bln in 2024/25 and GBP39bln in 2025/26.³



Bank of England Holdings of Gilts (GBP bln)

Gilt	Total BoE nom holdings	Asset Purchase Facility						Temporary holdings of long-dated gilts (to 7 Oct)				Total nom outstanding	Govt nom holdings	Market holdings*	
		Nominal holdings	Initial cash spent	Weighted-ave purch price	Price Friday 7 Oct close	Current value	Profit/loss vs current	Profit/loss vs nominal	Nominal holdings	Initial cash spent	Weighted-ave purch price				Profit/loss vs current
0.125% Jan-23	-	-	-	-	99.107	-	-	-	-	-	-	-	33.8	0.0	33.8
0.75% Jul-23	14.0	14.0	14.2	101.928	97.715	13.6	-0.59	-0.27					34.4	1.3	19.1
2.25% Sep-23	19.7	19.7	21.1	107.278	98.413	19.4	-1.74	-1.43					35.9	1.9	14.3
0.125% Jan-24	2.9	2.9	2.9	100.376	94.925	2.7	-0.16	-0.01					34.8	0.6	31.2
1.00% Apr-24	19.6	19.6	20.4	103.837	95.415	18.7	-1.65	-0.75					34.8	1.0	14.2
2.75% Sep-24	23.5	23.5	26.3	111.776	97.404	22.9	-3.38	-2.77					35.0	1.7	9.8
0.25% Jan-25	6.0	6.0	6.0	99.553	90.697	5.5	-0.53	0.03					28.7	0.3	22.3
5.00% Mar-25	19.0	19.0	23.2	122.281	101.394	19.3	-3.97	-4.23					36.5	8.9	8.6
0.625% Jun-25	28.8	28.8	29.6	102.799	90.883	26.2	-3.44	-0.81					43.6	1.0	13.8
2.00% Sep-25	26.2	26.2	28.3	108.144	93.912	24.6	-3.73	-2.13					39.0	1.6	11.2
0.125% Jan-26	21.9	21.9	21.8	99.632	87.181	19.1	-2.73	0.08					34.5	0.6	12.0
1.50% Jul-26	28.8	28.8	30.9	107.155	90.155	26.0	-4.90	-2.06					42.7	1.5	12.3
0.375% Oct-26	10.1	10.1	10.0	99.384	85.199	8.6	-1.43	0.06					32.2	0.6	21.5
1.25% Jul-27	27.1	27.1	28.7	105.847	86.513	23.5	-5.25	-1.59					40.1	1.2	11.7
4.25% Dec-27	17.6	17.6	19.6	110.936	99.266	17.5	-2.06	-1.93					32.3	6.9	7.7
0.125% Jan-28	16.7	16.7	16.5	98.507	80.154	13.4	-3.07	0.25					30.3	0.6	13.0
1.625% Oct-28	25.2	25.2	28.1	111.443	85.873	21.6	-6.44	-2.88					37.0	1.2	10.7
6.00% Dec-28	8.9	8.9	11.9	133.538	108.486	9.7	-2.23	-2.99					19.8	6.4	4.5
0.50% Jan-29	1.7	1.7	1.7	97.389	78.804	1.4	-0.32	0.05					17.2	0.2	15.2
0.875% Oct-29	28.6	28.6	30.4	106.292	79.526	22.8	-7.67	-1.80					42.6	1.1	12.9
0.375% Oct-30	23.7	23.7	23.6	99.502	73.652	17.5	-6.13	0.12					38.0	0.7	13.6
4.75% Dec-30	24.9	24.9	32.5	130.253	103.506	25.8	-6.66	-7.54					41.9	6.5	10.5
0.25% Jul-31	13.6	13.6	12.9	94.711	70.795	9.7	-3.26	0.72					39.7	0.7	25.4
1.00% Jan-32	-	-	-	-	74.696	-	-	-					24.3	0.2	24.1
4.25% Jun-32	21.1	21.1	24.8	117.826	100.150	21.1	-3.73	-3.76					39.4	9.4	9.0
0.875% Jul-33 Green	0.8	0.8	0.8	98.374	70.354	0.5	-0.21	0.01					12.5	0.2	11.5
4.50% Sep-34	22.9	22.9	31.4	137.164	101.518	23.2	-8.16	-8.51					35.5	2.8	9.8
0.625% Jul-35	14.1	14.1	13.5	95.818	63.395	8.9	-4.57	0.59					34.0	0.6	19.3
4.25% Mar-36	14.9	14.9	19.8	132.649	97.640	14.6	-5.23	-4.87					31.0	7.9	8.1
1.75% Sep-37	11.5	11.5	13.1	113.639	70.081	8.1	-5.01	-1.57					31.3	1.0	18.7
4.75% Dec-38	11.5	11.5	14.7	128.223	101.664	11.7	-3.05	-3.24					26.2	7.7	7.0
1.125% Jan-39	1.1	1.1	1.1	101.448	60.703	0.7	-0.44	-0.02					14.5	0.2	13.2
4.25% Sep-39	11.3	11.3	14.6	128.737	95.719	10.8	-3.74	-3.25					23.7	2.1	10.3
4.25% Dec-40	11.3	11.3	15.0	133.256	95.690	10.8	-4.23	-3.74					25.9	2.4	12.2
1.25% Oct-41	10.0	10.0	10.8	107.539	58.060	5.8	-4.97	-0.76					33.1	0.7	22.4
4.50% Dec-42	9.9	9.6	12.9	133.720	98.662	9.5	-3.38	-3.25	0.27	0.28	104.460	-0.02	27.7	6.6	11.2
3.25% Jan-44	10.1	8.4	11.1	132.019	82.082	6.9	-4.19	-2.69	1.70	1.50	88.492	-0.11	28.5	1.8	16.6
3.50% Jan-45	9.5	9.4	13.5	144.691	85.188	8.0	-5.57	-4.18	0.10	0.09	89.581	-0.00	28.7	1.5	17.8
0.875% Jan-46	6.2	6.1	5.7	93.830	47.909	2.9	-2.80	0.38	0.14	0.07	49.828	-0.00	20.3	0.3	13.7
4.25% Dec-46	8.3	8.1	11.0	136.570	95.488	7.7	-3.32	-2.95	0.18	0.18	99.670	-0.01	24.6	6.2	10.1
1.50% Jul-47	7.7	6.8	7.3	108.136	55.689	3.8	-3.56	-0.55	0.95	0.59	61.919	-0.06	25.1	1.0	16.4
1.75% Jan-49	18.5	18.5	23.1	125.059	58.674	10.8	-12.26	-4.63	-	-	-	-	29.5	0.8	10.3
4.25% Dec-49	8.0	7.9	11.1	140.052	96.507	7.6	-3.45	-3.17	0.09	0.09	106.315	-0.01	20.6	3.3	9.3
0.625% Oct-50	21.5	21.5	19.3	89.815	39.910	8.6	-10.71	2.19	-	-	-	-	31.2	0.6	9.2
1.25% Jul-51	6.4	4.7	4.8	102.029	48.998	2.3	-2.51	-0.10	1.66	0.89	53.689	-0.08	22.4	0.3	15.7
3.75% Jul-52	12.5	12.2	17.6	144.153	89.339	10.9	-6.68	-5.38	0.34	0.33	97.481	-0.03	24.6	1.8	10.2
1.50% Jul-53 Green	0.9	0.9	1.0	116.551	51.653	0.4	-0.56	-0.14	-	-	-	-	10.6	0.1	9.6
1.625% Oct-54	11.0	10.8	13.6	125.642	53.072	5.7	-7.85	-2.77	0.18	0.11	59.297	-0.01	24.0	0.5	12.5
4.25% Dec-55	10.5	10.4	13.6	130.609	98.111	10.2	-3.38	-3.19	0.08	0.08	104.245	-0.00	27.1	6.6	10.0
1.75% Jul-57	11.9	11.9	15.2	128.378	54.830	6.5	-8.72	-3.37	0.09	0.05	55.431	-0.00	30.1	0.9	17.2
4.00% Jan-60	12.2	12.1	18.0	148.782	95.723	11.6	-6.41	-5.89	0.11	0.12	103.340	-0.01	24.6	2.1	10.3
0.50% Oct-61	6.0	6.0	5.4	90.137	31.223	1.9	-3.52	0.59	-	-	-	-	22.9	0.4	16.5
2.50% Jul-65	5.3	5.2	8.7	167.735	68.059	3.5	-5.15	-3.50	0.11	0.08	73.808	-0.01	20.1	0.9	13.9
3.50% Jul-68	5.0	5.0	9.3	187.025	87.858	4.4	-4.92	-4.32	0.07	0.06	93.178	-0.00	20.3	1.1	14.1
1.625% Oct-71	11.5	11.4	15.5	136.272	49.733	5.6	-9.83	-4.12	0.15	0.08	51.313	-0.00	23.6	0.6	11.5
1.125% Oct-73	0.0	-	-	-	38.865	-	-	-	0.01	0.00	44.472	-0.00	9.9	0.1	9.7
Total	732.0	725.8	837.9			614.4	-223.4	-112.1	6.21	4.60		-0.35	1632.4	119.4	781.0
Ultra-short (0-3y)		159.7	172.1			152.9	-19.2	-12.4							
Short (3-7y)		186.8	199.6			163.5	-36.1	-12.8							
Medium (7-20y)		192.7	228.5			169.2	-59.4	-35.8							
Long (20+y)	192.8	186.6	237.7			128.9	-108.8	-51.0	6.21	4.60		-0.35			

*Mkt holdings = Nominal outstanding - BoE holdings - govt holdings

Source: MNI Market News, Bank of England, Debt Management Office, Bloomberg

³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1105989/CCS207_CCS0822746402-001_SECURE_HMT_Autumn_Statement_2022_BOOK_Web_Accessible.pdf

What are the Bank of England's options

Is there anything the Bank of England could do to reduce the costs of the APF?

1) Reduce interest on excess reserves e.g. through tiering

Unlike other central banks, the Bank of England's monetary policy largely operates through the Bank Rate. There has been very little inclination from the MPC that there are any concerns about the transmission mechanism and the view of "if it ain't broke don't fix it" seems to prevail.

The Bank of England is independent, but the spectacle of the Treasury subsidising commercial banks through the APF indemnity may not stay out of the political focus for too long (irrespective of the GBP123.9bn that has flowed out of the APF to keep government borrowing lower over the last decade). The government could recommend that the Bank of England examine whether it remains appropriate to continue to pay Bank Rate on all of the excess reserves in the system.

2) Slow down the expected pace of active gilt sales

Based on our calculations and current market prices, and assuming that gilt sales are proportional to purchased amounts, MNI estimates that using buckets of GBP580m would actively reduce APF holdings by GBP61bn – almost 50% higher than the Bank's stated target of around GBP40bn/year⁴. One easy way the Bank could change this would be to switch to using bucket sizes of GBP580m based on the initial purchase proceeds – rather than based on the size of sales proceeds as its Market Notice of 1 September stated.⁵

3) Don't sell long-dated gilts from the APF until the temporary purchases have been unwound

Furthermore, it remains unclear quite how the active gilt sales programme for the APF will be combined with sales of long-dated gilts bought more recently under the temporary purchase programme. These gilts are currently worth GBP4.3bn (with a further week of purchases to come) and given they have been purchased much more recently, the average price is much closer to the current market price. As the long-dated gilts in the APF programme are the ones which will produce the most losses if they are sold, this would delay some of the big losses being realised for at least a quarter. The size of the scheme may potentially rise notably in the last week of operations, too, given that the BOE has confirmed the end of the scheme and announced that it will buy up to GBP10bn/day from Monday 10 October.

4) Rebalance gilt sales away from the long end

Ahead of the confirmation of the design of the gilt sales programme, there were discussions over how the long-end of the gilt market would cope with a large increase in supply. Indeed, the DMO when it set its revised remit barely increased issuance of long-dated gilts. The DMO added one additional long-dated auction and the long-dated syndication it added was to launch a new 15-year gilt (which would count as a medium-dated gilt in the BOE's eyes it classes long-dated gilts as having a 20+ year maturity).

⁴ "The amount of APF stock reduction set by the MPC will be expressed in terms of the initial proceeds paid to purchase the APF holdings." <https://www.bankofengland.co.uk/markets/market-notice-2022/2022/sepember/apf-gilt-sales-market-notice-1-sepember-2022>

⁵ "In each auction the Bank intends to sell a fixed value of gilts based on total sales proceeds, including any accrued interest, subject to the bids received." <https://www.bankofengland.co.uk/markets/market-notice-2022/2022/sepember/apf-gilt-sales-market-notice-1-sepember-2022>

Given the volatility and lack of liquidity in the long-end of the gilt curve recently, it may be that the Bank of England prefers not to run down any APF holdings of long-end gilts – instead focusing the APF active gilt sales on the short-dated and medium-dated buckets and only reversing its temporary purchases – with the latter potentially at a much slower pace.

Based on current market pricing the temporary long-dated purchases would only incur a GBP350mln loss if sold in entirety – less than the average loss expected in a single GBP580mln APF long-dated sale.

Conclusion: A GBP37bln Annual Cost for QT is Notable and Could Lead to the BOE Re-examining the Parameters of its QT Programme

Based on our calculations, the combination of active gilt sales and higher Bank Rate would raise CGNCR by GBP37bln over the upcoming 12 months. Unless the government takes offsetting action, this will likely require a further increase in gilt issuance, above that already announced, and therefore includes upside risks to the OBR's revised forecasts which are due by 23 November at the latest. This would be a sharp contrast to the flows that over the past decade have been in the other direction – from the APF to the Treasury – and have helped to reduce CGNCR, and therefore gilt issuance.

This will increase political pressure on the Bank of England to reduce interest on excess reserves – although as noted this would start to call the question of the Bank's independence into question unless it was a decision made by the Bank itself. The Bank may, however, be a little uncomfortable with the whole situation given the sizeable potential for an increase in issuance, particularly since the price of gilts has fallen and more losses than expected would be locked in. This could lead to either a potential slowdown in the expected pace of active gilt sales (not necessarily in terms of the GBP40bln annual pace – but in terms of the size of each auction) or less sales at the long-end – which also appears more vulnerable from a financial stability point of view.

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