Bank of England Rapidly Expands Asset Purchase Facility

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Original post here.

In response to the COVID-19 crisis, the Bank of England (BoE) has expanded its existing Asset Purchase Facility (APF) from GBP 445 billion to GBP 745 billion (USD 950 billion).

BoE created the APF in January 2009 to ease corporate credit conditions during the 2007-2009 Global Financial Crisis. One month later, BoE expanded the APF remit to achieve monetary policy objectives through quantitative easing (QE), and purchased GBP 200 billion of UK government bonds. Last March, BoE relied on QE to restore order to gilt markets and guide price levels towards its 2% inflation target. As global financial conditions tightened due to COVID-19, the BoE's Monetary Policy Committee (MPC) noted that "conditions in the UK gilt market had deteriorated substantially as investors sought shorter-dated instruments that were closer substitutes for highly liquid central bank reserves."

Worldwide, financial market participants moved money away from risky assets and government bonds, and shifted to cash, especially US dollars. Within the UK, fixed-income strategists expected the British government to launch ambitious fiscal stimulus measures to counter the effects COVID-19 on businesses and consumers. Her Majesty's Treasury's (HMT) Budget 2020, announced on March 11, described just GBP 30 billion of coronavirus relief, and the government's five-year macroeconomic forecasts limited the incorporation of additional COVID-19 spending into its projections of fiscal expenditure. On March 17, Chancellor Rishi Sunak announced additional emergency support for both new and existing programs, and the additions were not captured by the Budget 2020's GBP 30 billion figure.

The UK government's successive announcements of COVID-19 interventions stirred concerns about whether investors would have sufficient demand for the gilts that the government would have to issue to pay for the stimulus. By March 19, UK financial markets exhibited heightened volatility: the GBP/USD exchange rate hit a 35-year low, risky asset prices fell, both investment-grade and high-yield bond spreads soared, and gilt yields spiked. After the Debt Management Office (DMO), which is a part of the HMT responsible for government wholesale sterling debt issuance, successfully completed the morning's auction, gilt markets entered into a standstill.

On the same day, the MPC obtained permission from HMT to purchase GBP 190 billion of gilts and GBP 10 billion of non-financial, investment-grade corporate debt from the secondary market to address the deteriorating conditions of gilt markets. "Had the Bank not stepped in, things would have gotten very difficult," said Sir Robert Stheeman, chief executive of the DMO. Gilt purchases commenced on March 25, and corporate bond purchases on April 7.

By June 17, the APF had grown to GBP 613 billion while the MPC maintained the Bank Rate steady at 0.10%. After completing nearly 80% of its emergency asset purchases, the MPC decided to raise the APF target by an additional GBP 100 billion of government debt, bringing the total stock to GBP 745 billion. Though the MPC acknowledged that recent setbacks to output and demand growth were not as bad as previously expected, 12-month CPI inflation remained low at 1.5% in March, 0.8% in April, and 0.5% in May. Some MPC members expressed a concern that inflation would fall even further due to prolonged unemployment. While the MPC's March vote on QE was unanimous at 9-0, the June vote was 8-1: Andy Haldane later explained his belief that the upside news about demand outweighed the negative outlook on British labor markets, so further monetary easing was unnecessary.

The MPC omitted corporate debt purchases in its second round of expansion. The June 17 minutes offer details on high corporate credit demand, stabilization of credit conditions for firms, the UK government's other corporate financing facilities, and already-indebted firms' desires to seek other methods for raising capital. At the same meeting, the MPC decided to slow the weekly volume of asset purchases by about two-thirds because liquidity conditions improved, and asserted that it would be willing and able to raise the volume of weekly purchases if conditions worsened again.

The BoE purchases assets through the Asset Purchase Facility Fund Limited (APF), which is a wholly-owned subsidiary of the BoE, to raise prices and lower the yields on assets held by non-banks. As shown in Figure 1, BoE provides loans to the APF so that it can purchase assets. Depending on the MPC's policy stance, the APF may repay loan principal or reinvest proceeds from gilt redemptions

HMT sets the APF's risk and control frameworks. HMT also fully indemnifies the APF's net financial gains and losses. In a 2013 Quarterly Bulletin, the BoE acknowledged that APF involves large and variable cash transfers between the BoE and HMT, but stressed that the APF's annual losses and gains are not appropriate metrics of success. Rather, the BoE argued, the success of the APF should be determined by its effects on credit conditions, nominal spending, and their effects on the medium-term inflation target.

Within the HMT, DMO has the remit to minimize the government's long-term financing costs. DMO issues gilts to primary market buyers, who trade gilts on secondary markets. After the APF buys gilts from the secondary market, APF may lend a proportion of its gilts to DMO through the Debt Management Account for DMO's short-term repo activities. In exchange for APF gilts, the DMO posts government securities of equal value and longer maturity as collateral, so there is no net change in the value of the APF's gilt portfolio. The purpose of on-lending is to resolve market frictions stemming from the APF's asset purchases.

Since 2016, the APF's asset purchases have mostly maintained the same operating procedures. However, for the expanded APF in response to the COVID-19 crisis, it now includes the following changes:

- The MPC changed the definition of residual maturities from 7-15 years to 7-20 years ("medium") and from 15+ years to 20+ years ("long") to "free up additional headroom to purchase gilts" equally across the maturity sectors.
- On April 22, BoE doubled the gilt lending limit to insulate DMO repo facilities, which use gilts as collateral, from the Bank's extensive gilt purchases, and minimize frictions between the APF and DMO.
- On June 4, BoE expanded the list of eligible corporate debt to include bonds with 3 months-to-maturity par call features.

BoE pledged to coordinate any reduction in the APF with the DMO. BoE Governor Andrew Bailey suggested that an exit strategy could involve gradual asset maturation or sales.

BoE emphasized that the combination of the APF and HMT's programs on workers' support, business assistance, tax deferrals, and other fiscal relief improved confidence in sterling markets: the sterling appreciated slightly, gilt yields fell, and the yield curve flattened. BoE also acknowledged that while the gilt market calmed, repo and money markets remained unstable and LIBOR-OIS spreads were still high. In a June 2020 interview with Sky News, Governor Andrew Bailey said that the BoE's recent APF interventions worked because they restored order to markets. He said that the BoE decided to inject liquidity into the gilt market in order to reach the more illiquid nonbanking markets. At a Financial Times digital event, Governor Bailey acknowledged that the rapid expansion of quantitative easing both calmed the financial markets and smoothed the "profile of government borrowing."

Some commentators have voiced concerns about threats to BoE's independence due to the expansion of the APF. On June 25, 2020 BoE's former deputy governor Paul Tucker claimed that the APF purchased more than what was necessary for market liquidity, and that this was not a "classic market maker of last resort operation" in a virtual Royal Economic Society event. On the other hand, Governor Bailey emphasized that it was a mere by-product of the current economic situation that the government was the largest borrower and the largest beneficiary of BoE's asset purchases.

Though at least one other major central bank has attempted to partially unwind large-scale asset purchases within the last decade, the BoE has not officially planned to decrease the APF's outstanding holdings since beginning quantitative easing (QE1) in January 2009. Over the next decade, BoE conducted successive asset purchases of GBP 175 billion (QE2), GBP 60 billion (QE3), and GPB 10 billion (Corporate Bond Purchase Scheme). The Yale Program on Financial Stability has published cases that cover these programs in greater detail.

Studies suggested that the BoE's asset purchases from 2009 through 2016 had positive effects on price levels, output, and stock prices, and a negative effect on 10-year gilt yields. Some researchers argued that QE also decreased liquidity risk and lowered interbank credit spreads. There is also evidence that BoE's asset-purchase shocks worked better during times of high financial market stress (2008-2010) rather than low market stress (after 2010). Though scholars generally agree that the UK's QE worked, they cannot pinpoint the policy channel through which the purchases were transmitted from the financial system to the real economy.

In addition to the expansion of APF, BoE cut rates by 15 basis points in response to the COVID-19 crisis to a level of 0.10%, the lowest Bank Rate in the Bank's 325 years of operation. It also put forth the Term Funding Scheme with additional incentives for SMEs (TFSME), the COVID Corporate Financing Facility (CCFF), and supervisory and prudential easing.