29 January 2009

The Rt Hon Alistair Darling MP
Chancellor of the Exchequer
H M Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

Thank you for your letter of 29 January setting out further details of the Asset Purchase Facility. The facility provides the Bank with an additional tool to improve financing conditions in the economy. Purchases of assets by the Bank of England could help to improve liquidity in credit markets that are currently not functioning normally. This might stimulate further issuance of some credit instruments by corporate borrowers and encourage the resumption of capital market flows.

In line with the objective set out in your letter, the Bank will target these asset purchases carefully in order to improve the availability of corporate credit while minimising the distortions to the longer-term functioning of the United Kingdom’s capital markets. As you note, the Bank will purchase types of assets for which it is satisfied that there is genuine private demand in normal conditions. Moreover, in order to control the financial risks associated with such transactions, the Bank will purchase only high-quality assets.

As Governor of the Bank, after consultation with the two Deputy Governors, I will agree a schedule of asset purchases, based on recommendations prepared by the Executive Director for Markets and the Executive Director for Monetary Analysis & Statistics. These purchase plans will take account of the importance of different markets and instruments as a source of credit to companies operating in the domestic economy, together with analysis and market intelligence concerning the current functioning of these markets. They will also take account of the overall size and structure of the markets involved.

The Bank will monitor developments in financial and credit markets carefully to assess the impact of its interventions on the availability of credit being extended to companies. In conducting this assessment, the Bank will monitor data on the price of corporate debt and on primary and secondary market activity. It will also monitor evidence on the availability of credit to companies gathered from aggregate lending data, the Bank’s network of regional Agents, the
Bank’s quarterly Credit Conditions Survey and from contacts operating in credit and financial markets. These assessments will be important in informing the Bank’s subsequent asset purchase plans. The Bank will review on an ongoing basis the case for proposing that the list of eligible assets and currencies be expanded.

Details of the mechanisms through which the Bank plans to conduct its initial asset purchases will be set out in a Market Notice during the week beginning 2 February. The Bank will focus initially on purchases of corporate bonds, commercial paper, and paper issued under the CGS. At the same time, the Bank will also consult closely with market participants about plans to purchase syndicated loans and asset backed securities created in viable securitisation structures. The purchase mechanisms may vary depending on the market structure for each asset. I expect the amounts of assets purchased to increase gradually in the early stages of the facility. This will provide scope to assess the impact of those operations on market liquidity. However, even in these initial stages, I hope that by offering to purchase assets on a regular and ongoing basis, the facility should help to improve market liquidity.

As normal conditions return, the Bank will wind down the portfolio of assets it has purchased, in part as existing assets mature but also potentially through sales. The Bank will consider the appropriate mechanisms for selling assets, having due regard for the impact of those sales on the prices achieved.

A new company is being established to undertake these transactions. This will provide a clear, transparent mechanism for monitoring the operations conducted under the facility. The company will be instructed to undertake transactions in line with the decisions of the Governor, with the Bank conducting the necessary operations on the company’s behalf. The Bank will ensure that the operations comply with the terms set out in your letter and the risk standards agreed between the Bank and the Treasury, and will provide Treasury officials with the information necessary for them to monitor the operation and financial performance of the facility.

As you note in your letter, it is important that the Asset Purchase Facility is operated in an open and transparent manner. The Bank will publish a quarterly report on the transactions undertaken as part of the facility, shortly after the end of each quarter. Where appropriate, information on specific transactions and operations will be made available through regular market announcements. Information on the scale of operations will also be provided through the Bank’s statistical publications on a monthly basis, alongside its other operations.

The Monetary Policy Committee will keep under review whether it wishes to undertake asset purchases for monetary policy purposes. If the Committee were to conclude that this would be a useful additional tool for meeting the inflation target, I would inform you so that you could authorise the changes to the scale and operation of the facility that might be required. I note that in such circumstances a further exchange of letters would take place setting out the new arrangements.

I am copying this letter to The Rt Hon John McFall MP.