BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon Philip Hammond
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
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21 June 2018

Dear Chancellor,

In response to your letter, I confirm formal adoption of the June 2018 update to the Memorandum of Understanding (MoU) on the Financial Relationship between Her Majesty's Treasury (HMT) and the Bank.

Our teams have agreed a new capital and income framework for the Bank, and this update to the MoU codifies how it will work. This collaborative effort is a great achievement, resulting in a ground-breaking financial arrangement between the Bank and the Treasury. Its objectives are to ensure that the Bank's policy work is fully funded, and that the Bank is equipped with capital resources consistent with the monetary and financial stability remits it has been given by Parliament, whilst maintaining responsible stewardship of public funds.

This framework provides a robust and transparent system that ensures the credibility of the Bank's policy actions in even the most stressed environment. The framework reflects the Bank's much wider range of responsibilities including banking supervision, macro-prudential policy and resolution. These responsibilities create a range of potential new calls on the Bank's balance sheet. The framework also reflects the new ways in which the Bank provides liquidity. It is capable of lending against a wider range of collateral, to a wider range of counterparties, for longer terms, and at lower prices than ever before.

To achieve these ends, a new capital maintenance and income-sharing framework for the Bank is codified in the MoU. At its heart is a risk-based capital target, reflecting forward-looking risks to the balance sheet over the next five years. Its level is determined by evaluating the loss impact of severe but plausible stress scenarios which are to be reviewed annually and discussed with HMT The Bank's capital will be capped by a ceiling, above which all net profits are transferred to HMT as dividend. The framework also ensures that capital remains above a floor, below which a rapid recapitalisation to the target is triggered. In addition, a variable income retention mechanism is introduced, whereby no dividend is paid to HMT when capital is below target, and 50% of net profits are paid as dividend when capital is between the target and the ceiling.

The current values of the capital parameters are £0.5bn for the floor, £3.5bn for the target, and £5.5bn for the ceiling. The commitment of a capital injection of £1.2bn before the end of the 2018/19 financial year will bring the Bank's capital from its current level of £2.3bn to the £3.5bn target and will enable the Bank to take the Term Funding Scheme on balance sheet without an indemnity from the Treasury.

These parameters will be formally reviewed by the Bank and HMT at least every five years at the same time as the Cash Ratio Deposit (CRD) process underpinning the funding of the Bank's policy work. However, in circumstances where the risk environment faced by the Bank changes fundamentally, an intermediate review may be warranted.

As to the funding of the Bank's policy work, the revised CRD scheme came into force on 1 June 2018 following a public consultation. The scheme has been amended so that it is now responsive to changes in gilt yields. That is achieved by moving from a single fixed ratio to a variable ratio, indexed to gilt yields and calculated every six months. Such responsiveness avoids future funding shortfalls if gilt yields fall, whilst also protecting CRD payers from overfunding the Bank if gilt yields rise.

In return for more sustainable financial resources, the Bank has agreed to provide more information to allow an effective, open and transparent monitoring of the use of its financial resources. Accordingly, the Bank will periodically share updates with HMT on the Bank's performance against the budget, the level of the Bank's capital, the risks borne by it and, where appropriate, notes explaining the key drivers.

The new financial framework will have a number of practical benefits. The upcoming capital injection will mean that, as a backstop, the Bank is able to provide up to several hundred billion pounds of additional funds through normal facilities, against a broad range of collateral, without needing to ask for an indemnity. It will provide the Bank with an ongoing ability to undertake operations such as the Term Funding Scheme, as necessary and in discussion with HMT as per the Monetary Policy Committee (MPC) remit, to reduce the effective lower bound for interest rates to zero.

In the event that any recapitalisation is required, the framework is set to restore the Bank's capital to the target swiftly and smoothly and underpins the Bank's responsibility as a back-stop and last resort, of unquestioned creditworthiness.

Because the capital framework and its accompanying injection better align the Bank's financial resources to its mission, they will allow for less frequent recourse to government indemnities.

These arrangements should not, however, mean that the Bank would automatically take on any level of financial risk without recourse to HMT, particularly where that risk might be extremely large – so large that holding capital against it would not be the best use of public funds – or would involve potentially sensitive actions. In those cases, the Bank would expect to consult with HMT and where necessary seek indemnities.

Yours