European Rates Watch

Borrowed time – end of abundant reserves in sight for UK

28 February 2024

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QT not constrained by liquidity requirements says BoE

Yesterday's speech by BoE's Dave Ramsden ('Bond trading, innovation, and evolution: a Bank of England perspective', 27 Feb 2024) was noteworthy on several counts:

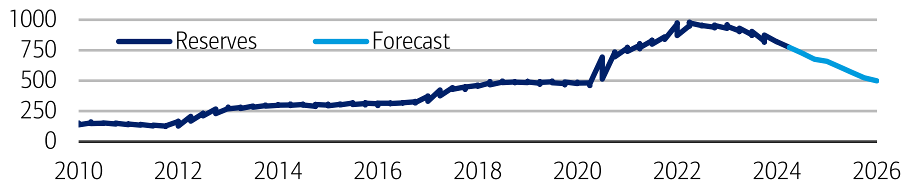
- It was the first time that the BoE has explicitly suggested the possibility of unwinding the APF fully, if the MPC judged this necessary for policy reasons.
- By adding that *"the level of the PMRR should not affect this judgement"* the BoE signalled trust in its STR facility, currently supplying unlimited one week reserves at Bank Rate against Gilt collateral, and any facilities that might be expanded upon or introduced in the future.
- The BoE's encouragement to banks to *"continue to develop and maintain a stable [TFSME] repayment profile that takes into account how the actions of other firms will affect the cost of this refinancing"* implicitly confirmed that the TFSME will not be extended.

In this note, we update our BoE balance sheet forecasts (incorporating our estimated TFSME repayment schedule), discuss what continuing the APF unwind would mean for "active" and "passive" QT, and outline implications for UK rates, UK banks and GBP.

Preferred Minimum Range of Reserves on the horizon

We now forecast reserves at the BoE to drop by some £40bn per quarter on average in 2024 and 2025 (we assume a smooth TFSME early repayment schedule and QT continuing at £100bn per year). Our estimates – shown in Exhibit 1 - suggest reserves will be very close to the Bank's last estimate for aggregate PMRR of £335-495bn by end-2025 (Hauser, 3 Nov 2023). This conclusion is not different from our previous take (BoE reserves: Preferred minimum closer than you think, 7 Dec 2023). But the new early TFSME repayments assumption results in a smoother, slightly earlier drop than before.

Exhibit 1: BoE reserves incl. BofA forecast, £bn
Reserves to approach the upper bound of PMMR by end-2025



Source: Bank of England, BofA Global Research

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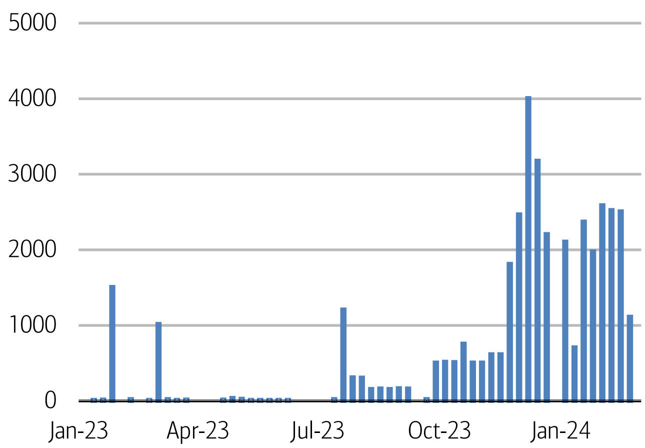
Abbreviations:

BoE: Bank of England
MPC: Monetary Policy Committee
APF: Asset Purchase Facility
MPC: Monetary Policy Committee
PMRR: Preferred Minimum Range of Reserves
STR: Short Term Repo
TFSME: Term Funding Scheme with additional incentives for SMEs
QT: Quantitative Tightening
Ronia: Repurchase Overnight Index Average
DMO: Debt Management Office
QE: Quantitative Easing
CB: Central Bank

STR in action: so far, so good

In his speech, Dave Ramsden highlighted the uncertainty around the level of the PMRR and the timing for when it will be reached. So far, usage of the STR facility has been stable (Exhibit 2). The facility is intended to allow the Bank to focus on monetary policy considerations in setting its strategy for the APF unwind, without concern for its ability to align short-term market interest rates with Bank Rate. The Ronia spread to Bank rate has been trading in a tight 5bp range (Exhibit 3), pointing to orderly market conditions. A pick up in STR volumes as repo cheapens indicates a dissipating cash/collateral imbalance. For now, we remain of view that under the current framework, funding pressures may have a more limited impact in the UK relative to Europe given the more attractive pricing of current CB lending operations. We position for potential funding pressures in the Eurozone via FRA-OIS wideners (European Rates Alpha, 2 Feb 2023).

Exhibit 2: BoE STR facility usage, £mn
Stable usage at higher level since late 2023



Source: Bank of England, BofA Global Research

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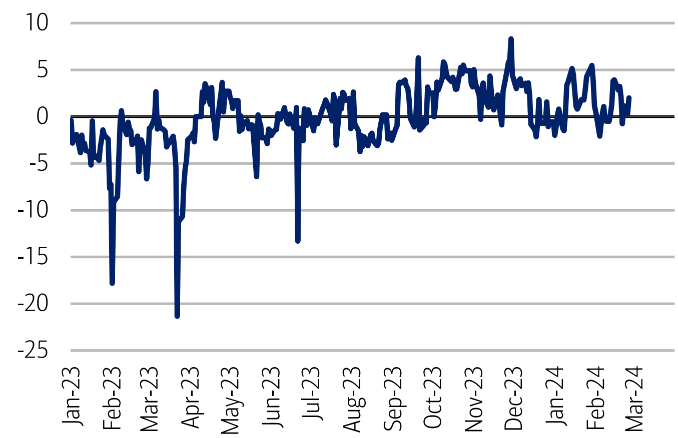
Exhibit 3: Ronia vs. Bank rate spread, bp
Within 5bp range recently



Source: Bloomberg, BofA Global Research

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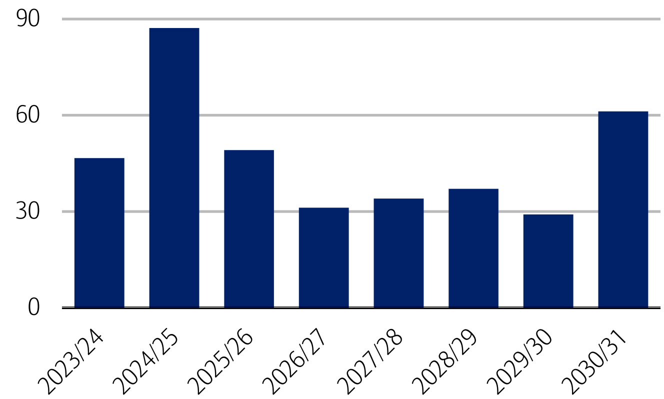
APF unwind: another macro vulnerability in our bucket list

With the BoE's current "QT year" running from Oct 2023 to Sep 2024, we read Ramsden's comment on the possibility of a complete APF unwind as an implicit message that the approaching PMRR ceiling should not lead to any slowdown in the pace of APF rundown. With £87bn of "passive" QT due between Oct 2024 and Sep 2025, we were wondering if the BoE might choose to pause "active" QT, testing the waters near PMRR.

In our reserves forecasts, we now assume the Bank will continue conducting QT at £100bn per "QT year". For next year, this would mean the BoE perhaps conducting one or two quarters of "active" QT to bridge the £13bn gap to £100bn. The Bank could even consider increasing the £100bn total slightly (to £125bn perhaps) in order to conduct "active" Gilt sales throughout the year, bringing down BoE reserves slightly faster than in our projections. With "passive" QT falling back towards £50bn after the 2024/25 "QT year" and staying around £30bn in years 2026/27 to 2029/30 (Exhibit 4), "active" Gilt sales will re-accelerate in the not-so-distant future on an unchanged QT pace.

The possibility of the whole current £735bn APF stock of Gilts unwinding – even if at a relatively slow pace of £100bn/year – adds to our list of UK macro vulnerabilities (the current account deficit, weak public sector balance sheet, large external liabilities and a more structural inflation problem, to name but a few). We remain comfortable being bearish UK rates, although we trimmed our positions tactically ahead of 6 March budget (Rates – UK of Global Rates Weekly, 23 Feb 2023). The existing skew shorter in BoE Gilt sales and likely increasing skew shorter in DMO Gilt sales will continue posing cheapening pressures to shorter-dated Gilts relative to Sonia.

Exhibit 4: APF Gilt maturity profile per "QT year", £bn
APF redemptions subside after 2024/25



Source: Bank of England, BofA Global Research

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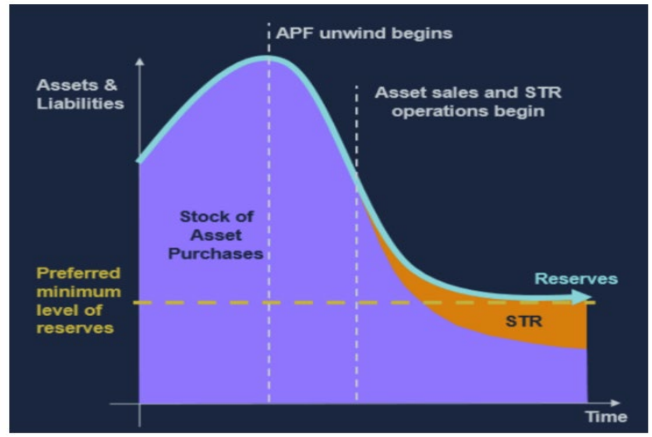
Exhibit 5: Stylised supply of reserves during APF unwind
Increasing usage of STR as BoE reserves unwind



Source: Bank of England

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Unanswered questions for smaller UK banks

The BoE is now clear in intending to shrink its balance sheet by as much as £300bn over the next two years. This implies a potentially massive expansion in STR usage (Exhibit 5 shows BoE's own stylised evolution of STR during APF and TFSME unwind), unless the regulatory arm of the Bank enables a lower liquidity coverage ratio.

UK major banks' 160% LCR traps above the theoretically required level of 100%. The major UK banks have over £1tn in unencumbered collateral, which should provide the BoE with confidence in its holistic liquidity access, even at an LCR more like 105%.

The BoE communicating this publicly would enable the banks to run down cash holdings along with the shrinking of the BoE balance sheet. in the absence of such joined-up communication from the BoE, STR usage could become very large and effectively permanent.

Smaller banks typically have less or little eligible, unused collateral and we see the repayment of TFSME as a material funding piece of work ahead for them.

GBP implications

The history of QE/QT has had mixed implications for the FX market. The most visible manifestation of this was 2013 "taper tantrum" in the US as yields rose sharply and USD rallied. The critical nuance in assessing the impact of changes in the balance sheet is the context to that decision. Through the Global Financial Crisis, central bank QE was seen as a positive for the currency despite the flood of liquidity that ensued and significant easing in financial conditions. The BoE announcement to fully unwind the APF occurs in much more benign conditions which suggests a more textbook FX response.

The relative shift in G10 balance sheets under the proposals outlined by Ramsden would suggest that the UK would have a smaller balance than its peers. Our priors would suggest that this would lend support to GBP versus the likes of USD and EUR as UK financial conditions tighten and UK rates stay higher than expected. The longer-term relationship between GBP and the CB balance sheet is mixed in large part to backdrop to balance sheet adjustment. But if the BoE can manage to engineer a larger drawdown without impacting the function of the Gilt market, this would be supportive of sterling.

The risk of course, is a US-style taper tantrum and rising volatility that could deliver negative externalities for the pound.

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