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Bank of England to buy £65 billion of gilts to "restore orderly market conditions"

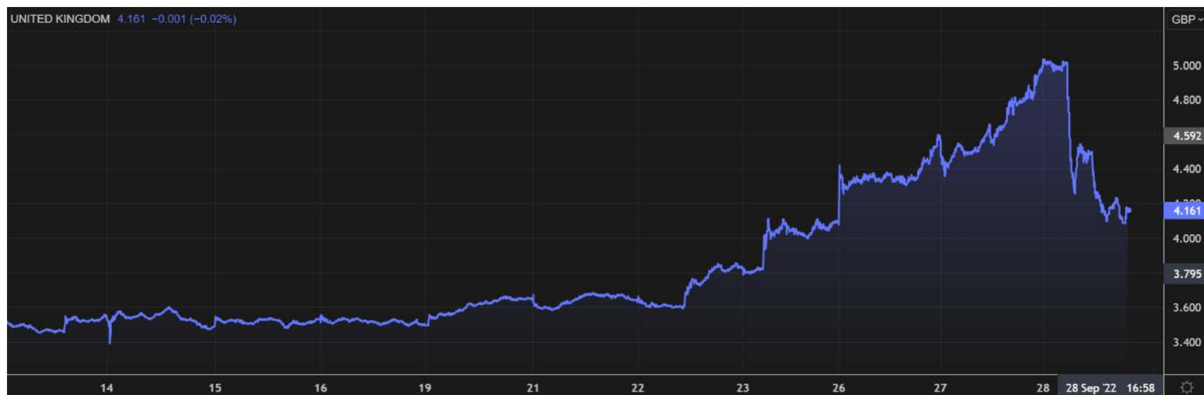
You will have seen in the news yesterday and today, following the recent significant increase in gilt yields over the past few days, that the Bank of England intervened to "restore market functioning and reduce any risks from contagion to credit conditions for UK households and businesses".

"To achieve this, the Bank will carry out temporary purchases of long-dated UK government bonds from 28 September. The purpose of these purchases will be to restore orderly market conditions. The purchases will be carried out on whatever scale is necessary to effect this outcome."

Bank of England announces gilt market operation | Bank of England
Market Notice 28 September 2022 – Gilt Market Operations | Bank of England

The initial plan is to buy £65 billion of long dated gilts over the next 2.5 weeks. Also, the £80 billion per month sale of existing gilts held by the Bank from previous Quantitative Easing exercises will be postponed until 31 October 2022.

The impact of this announcement on 20 year gilt yields was dramatic (ten business day chart below). Yesterday, the 20 year gilt yield fell by 0.9% per annum, which increases the value of a typical DB scheme's liabilities by 20%, although the value of LDI and gilts will also rise substantially.



There are a few key points at this stage (noting that markets and news flow can and are moving quickly):

- There is tremendous pressure on the UK government to change and clarify policy, the BoE to control gilt markets, and the wider industry to adapt to news at short notice. Mistakes, missteps, and misunderstandings are more likely to happen when people are under pressure.
- The press is reporting that some pension schemes were at risk of going bust. This is not what we see with our clients and it is not clear who the BoE was talking with to get that impression. Further information may emerge in due course.
- Some schemes were going through LDI leverage rebalancing events and these are complicated by the large fall in yields. It is possible that some schemes will financially suffer if they were forced to sell gilts on Monday or Tuesday this week to cap the leverage in the LDI fund and then buy the gilts back later at lower yields.
- The £65 billion of gilts will presumably be bought with newly created GBP Sterling, which could weaken GBP Sterling further and lead to higher future price inflation than we would otherwise have expected.

- The UK government is indemnifying any losses the BoE may incur on the £65 billion of gilts (i.e. if yields rise after purchase), as it does for all of the bonds bought through Quantitative Easing since 2009 (currently standing at c. £870 billion). Any losses would ultimately feed through to extra UK government borrowing, ie the issuance of more gilts, (or possibly taxes) which may then need to also be purchased by the BoE.
- Many DB pension scheme trustees would have wanted to buy gilts with those higher yields, of around 5% per annum at the 20 year maturity, but can now no longer do this as the BoE's intervention has reduced the 20 year yield to around 4.25% per annum at the time of writing.
- We do not know the true underlying level that gilt yields would have reached to balance sellers and buyers (excluding artificial buyers such as the BoE). This gilt purchase therefore does not seem to be a long term solution.
- Whilst the BoE intervention may have stabilised (and increased) gilt prices in the short term, it arguably creates more uncertainty/questions for investors and therefore possibly only creates temporary stability (or the need for more QE later). Given that investors generally do not like uncertainty, this makes the gilt market less attractive than it once was, particularly for investors that have no defined liabilities or a regulatory requirement to hold gilts (e.g. multi asset funds, sovereign wealth funds and other overseas buyers, charities, endowment funds, family offices, high net worth individuals). This could increase the chance of further subsequent BoE intervention and/or stronger regulatory requirements for banks, insurance companies and pension schemes to replace that demand for gilts.
- It is not clear why the BoE did not specify that it had a targeted level for gilt yields within its statement (e.g. 5% per annum at the 20 year maturity) to allow investors to "catch up" with market conditions. Forcing gilt yields down is unhelpful and detrimental from a typical well managed DB pension scheme perspective.
- It seems a distinct possibility that the sale of existing gilts will be further postponed if market volatility continues, and indeed that the purchases may continue for longer than 2.5 weeks.

Unfortunately, UK government policy and the BoE intervention seem to provide more questions than answers. We are working through the immediate practicalities whilst also considering any longer term implications for our clients and the wider industry. Please let us know if and when you have any views.

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If you would like to discuss any of these matters further, please get in touch with your contact at Cartwright.

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