Mortgages and The Bank of England

The Bank of England has twice forced interest rates up and pushed the prices of government bonds down sharply in recent months. The first time was around the time of the Kwarteng budget, when the falls in bonds the Bank caused by announcing a large sales programme and hiking Bank rate were made worse by the excess holdings of such bonds through special funds that pension funds could not afford to own outright. The falls in bond prices led to the need for some pension funds to sell more bonds to raise the cash to cover the losses and cash calls on the LDI funds.

A government bond is a savings instrument. The government borrows say £5 bn for 5 years. The people who put up the money are promised a payment of say 4% a year on the money. So if you lend the government £100 you would get £4 of interest every year for five years and would then get your £100 back. If you want your money back earlier you can sell the bond on to someone else. If interest rates have risen since you lent money to the government the price of the bond is less than you paid for it, so the buyer will get a higher return than you were getting. The government will carry on paying £4 of of interest and will repay the £100 to the new owner.The new owner buying at less than £100 will get a capital gain on repayment of the full £100, and will get a higher interest rate than 4% as £4 of interest is more than 4% if the cost of the bond has dropped below £100. Buy the bond for £90 and you get 4.44% interest for the rest of its life, and a £10 capital gain at the end.

In recent days we are living through a re run of last Autumn. The Bank is persisting with a large sales programme of government bonds it bought up in 2020-21 and earlier . It continues with clear signalling it wants interest rates to go higher . The Bank has the sole power to decide what Bank rate should be, the rate that controls the interest rate on overnight borrowings and deposits. The power to decide the price of bonds is shared with the Treasury, who have to sign off on Bank of England bond buying and selling, and who have to pay all the losses on sales.

The rate of interest a saver can get on a 2 year or 5 year government bond depends on the price of these bonds in the market. When the Bank wants the 5 year mortgage rate to go up it can sell bonds to get their price down, as well as talking the market down. Banks and Building Societies offering 5 year mortgages will set a rate related to the latest government borrowing rate in the bond market.

As my recent PQ revealed, the Bank so overpaid for government bonds when it built its huge portfolio that it may now incur losses of £49 bn just this year on holding them and selling some at very depressed prices. It would be a good idea if the Bank got to the Bank rate it thinks it needs this week and stays there whilst inflation come down. It should also stop selling the bonds and making such huge losses which taxpayers have to pay. Mortgage holders are facing enough pain without the Bank trying to force up the mortgage rates even more.