

Rewriting the indemnity

Briefing | Dominic Caddick and Isabel Bull | November 2025

Currently, the Bank of England's decisions are exerting fiscal pressure on the chancellor. According to our calculations, the Bank of England's decision to slow quantitative tightening has reduced the chancellor's fiscal headroom to balance the current budget by £1.5bn. However, this pressure on the chancellor could disappear - and even open up room to spend £4.8bn a year by 2029/30 - if the Treasury renegotiated its agreement to pay for losses at the Bank, known as the indemnity. With voters desperate for the government to tackle the cost of living crisis and to fix public services, this is the most painless option to free up headroom this budget.

Understanding the cost of Quantitative Easing and Tightening

The reason the Bank is exerting fiscal pressure on the chancellor is the legacy of quantitative easing (QE), which has now turned into quantitative tightening (QT). During QE the Bank bought £875bn worth of government debt by issuing central bank reserves. Central bank reserves are the money banks use to transact with each other. They work like deposit accounts for commercial banks which are managed by the central bank.

Following the pandemic, the Bank started to engage in QT, reducing its holding of government debt bought during QE. Uniquely, the Bank is actively selling this debt itself and selling debt at a lower price than it was initially bought – leading to losses amounting to billions of pounds a year¹. The Bank also makes some losses when it allows bonds to mature, this is because some bonds were bought at prices below what they pay out at maturity (ie below par.)

There was some relief to these losses in September when the Monetary Policy Committee decided to slow down QT². According to the Office for Budget Responsibility's (OBR) March 2025 Economic and Fiscal Outlook (EFO), the Bank was expecting to make losses on sales (and maturing stock) of around £19.8bn a year in 2029/30³. But due to a reduction in the amount of sales, these losses will now only be around £13.9bn in 2029/30 instead, according to NEF's calculations, meaning a saving of £5.8bn.

¹ Mahon, Christopher. (2025). *When active QT makes sense*. Financial Times.

<https://www.ft.com/content/f86abe99-195f-48a0-98ad-686b78ef91f3>

² Bank of England. (2025). *Monetary Policy Summary, September 2025*.

<https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2025/september-2025>

³ Office for Budget Responsibility. (2025). *Economic and fiscal outlook – March 2025*.

<https://obr.uk/efo/economic-and-fiscal-outlook-march-2025/>

However, the Bank also makes losses as the interest it pays out on central bank reserves outstrips the interest it receives from the bonds it bought via QE operations. By slowing QT the Bank now holds onto debt for longer, increasing the time it makes a loss on these interest payments. This has increased expected losses from £3.3bn in 2029/30, as reported in the OBR's March 2025 EFO, to £4.8bn in 2029/30 according to NEF's calculations. By holding reserves for longer the Bank's losses on interest payments – the difference between the amount of money it receives on bonds and pays out on reserves – will increase by £1.5bn in 2029/30 from an expected £3.3bn to £4.8bn.

These losses are passed onto the Treasury because of an agreement signed by George Osborne in 2012 – the indemnity⁴. However, in the government's accounting, the interest losses are treated as current spending, while sale and maturity losses are not⁵. This means they impact the fiscal rules differently. For example, the current budget rule makes sure current spending is balanced by tax revenues by 2029/30. Therefore, the £1.5bn increase in interest losses should reduce the chancellor's headroom against this rule by the same amount. However, headroom against the debt rule will increase by the total saving which is instead £4.3bn (the £5.8bn saving minus the £1.5bn increased cost).

Given the fiscal rules are currently binding on the current budget rule rather than on debt, along with other expected falls in this headroom due to economic forecast changes, this will have a material effect on the chancellor's ability meet her fiscal rules, requiring fiscal adjustments to meet them. In other words, the Treasury's payment of £4.8bn a year by 2029/30 to cover the Bank's losses on interest payments, will be a factor that is constraining the government's fiscal policy.

The Bank of England should absorb its own losses

The Treasury should renegotiate the indemnity agreement with the Bank to open headroom to increase day-to-day spending. For example, if the Treasury were to stop covering the Bank's losses it would save up to £18.8bn (£4.8bn interest loss savings + £13.9bn sale and maturity loss savings) and this would free up to £4.8bn a year, according to the fiscal rule on the current budget.

The Treasury should renegotiate bilaterally with the Bank and seek agreement on outcomes, to maintain the Bank's independence. Changing the indemnity would involve the Bank absorbing its own losses. In practice, this might look like the Bank of issuing reserves to cover its costs from government bonds to central bank reserves. Such a move is unlikely to affect the government's fiscal rule on debt as it would simply be a change in composition of public sector liabilities. However, how exactly this is accounted for may depend on decisions by the Office for National

⁴ HM Treasury. (2024). Asset Purchase Facility deed of indemnity.

<https://www.gov.uk/government/publications/asset-purchase-facility-deed-of-indemnity>

⁵ Office for Budget Responsibility. (2025). *Economic and fiscal outlook – March 2025*.

<https://obr.uk/efo/economic-and-fiscal-outlook-march-2025/>

Statistics and the OBR, as the Bank absorbing its own losses would be new, it may be treated differently in statistics.

Absorbing losses is normal practice at the Federal Reserve and European Central Bank (ECB). Both take on unique accounting approaches of a 'deferred asset' in the Fed's case⁶ and 'losses carried forward' in the ECB's case⁷. These accounting techniques allow the losses to be paid down by future profits. Recent NEF research found the limits on central banks making a loss are much more political than economic, but central banks may want to avoid making large losses and absorbing these onto their balance sheet in general⁸. The Bank could explore multiple options for limiting losses, including: retaining more profits (currently by law the Bank must pass on all its seigniorage income⁹); exploring other options to make itself more profitable (this could include tiering reserves¹⁰); or simply allow itself to remain in negative equity (requiring a change to the memorandum of understanding between the Treasury and Bank¹¹).

The Bank absorbing its own losses in their entirety (i.e. up to £18.8bn in 2029/30) would relieve pressure on bond markets when they are particularly skittish and would make the Bank more responsible for its own losses. While these are good reasons to renegotiate the indemnity, in terms of unlocking spending for the Treasury, completely abolishing the indemnity payments would only open up £4.8bn of day-to-day spending according to the fiscal rules. Therefore, it may be wise for the Treasury to negotiate with the Bank to only cover this smaller portion of losses, perhaps defined directly as the interest losses it makes, as this limits the losses the Bank has to absorb while maximising the space unlocked in terms of the fiscal rules. For example, if the Bank started absorbing interest losses from 2026/27, by 2029/30 the Bank would have absorbed £23bn of losses onto its balance sheet or 0.7% of 2029/30 GDP. Currently, the Federal Reserve has a deferred asset of \$243bn or over 0.8% of US GDP¹².

Importantly any changes to the indemnity structure itself will not directly alter the mechanics of monetary policy transmission to commercial banks. Indeed, both the Federal Reserve and ECB report that absorbing losses has had no impact on their ability to carry out their monetary policy

⁶ Federal Reserve. (2025). *Federal Reserve balance sheet actions and activities*.

<https://www.federalreserve.gov/monetarypolicy/May-2025-Federal-Reserve-Balance-Sheet-Developments.htm>

⁷ European Central Bank. (2025). *Financial statements of the ECB for 2024*.

<https://www.ecb.europa.eu/press/pr/date/2025/html/ecb.pr250220~eca25e4e21.en.html>

⁸ Caddick, D. (2025). *Breaking the bank? The case for and against central bank losses*. New Economics Foundation. <https://neweconomics.org/2025/09/breaking-the-bank>

⁹ UK Government. (1844). *Bank Charter Act 1844*. <https://www.legislation.gov.uk/ukpga/Vict/7-8/32/enacted>

¹⁰ Van Lerven, F., & Caddick, D. (2022). *Between a rock and a hard place*. New Economics Foundation. <https://neweconomics.org/2022/06/between-a-rock-and-a-hard-place>

¹¹ Bank of England. (2025). *Memorandum of understanding between HM Treasury and the Bank of England 2025*. www.bankofengland.co.uk/news/2025/february/joint-statement-boe-and-hmt-financial-relationship

¹² Federal Reserve. (2025). *Federal Reserve Balance Sheet: Factors Affecting Reserve Balances - H.4.1*. <https://www.federalreserve.gov/releases/h41/20251023/>

duties^{13,14}. If implemented correctly, this policy should therefore have no impact on market confidence and could even improve it, if seen as a credible way to reduce bond market pressure.

The most painless way to open up headroom

Recent Persuasion UK polling has shown tackling the cost of living and fixing public services are key voter priorities¹⁵. Voters are even prepared to tolerate the government breaking its tax, borrowing and spending promises, if these changes are fair and the government delivers on voter priorities. Renegotiating the indemnity must be high up the agenda for savings. Unlike other possible spending cuts, it won't impact on public services and frees up headroom without raising taxes. This could be spent on removing the two-child benefit cap, which is estimated to cost £3.5bn a year, with over a billion left over for other government priorities. Furthermore, while the fiscal rules only take into account what happens in 2029/30, such a policy would make larger savings in earlier years which could be spent on implementing policies that directly tackle the cost of living crisis.

Such a policy would be vital to building public confidence in the budget and help the Treasury position its choices as "fair". If taxes are to go up or public spending is to be cut, it's untenable to continue paying the Bank for funds it transfers directly to the banking sector when it pays interest on reserves. The Treasury should signal it is willing to consider all other options before putting up taxes or cutting spending.

Technical Note

NEF calculates the interest losses on reserves using the OBR's March 2025 EFO, updated for interest rate expectations as of the end of September and the Bank of England's decision to slow quantitative tightening. We assume that slower QT implies that the Bank of England will target £32.5bn of bond sales a year into 2029/30 (as opposed to the OBR's previous assumption of £48bn). This is equal to the average amount of bonds sales per year that have already been announced between 2022/23 and 2025/26 and aligns with the previous methodology the OBR has used to forecast bond sales.

Losses at maturity are calculated from the difference between nominal holdings and purchase proceeds according to the Bank of England. To work out interest rate and sales losses, NEF assumes that the interest rate on Asset Purchase Facility bond holdings and the percentage loss on sales remain in line with what the OBR March 2025 EFO implies per financial year.

¹³ Federal Reserve. (2025). *Federal Reserve balance sheet actions and activities*. <https://www.federalreserve.gov/monetarypolicy/May-2025-Federal-Reserve-Balance-Sheet-Developments.htm>

¹⁴ European Central Bank. (2025). *Financial statements of the ECB for 2024*. <https://www.ecb.europa.eu/press/pr/date/2025/html/ecb.pr250220~eca25e4e21.en.html>

¹⁵ Persuasion UK. (2025). Least worst options: understanding voter attitudes in the run up to the 2025 Budget. <https://persuasionuk.org/research/budget-2025-options>

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