

The Bank of England's Asset Purchase Facility

Fiscal impacts and proposals to expand the UK Government's fiscal space

This policy brief has been written by
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Summary

- The Bank of England created the Asset Purchase Facility (APF) after the global financial crisis to implement its quantitative easing (QE) programme.
- The Bank's recent tightening of monetary policy has caused the APF to incur substantial losses, at great cost to the public finances.
- The APF has cost the Treasury £61 billion since October 2022, and its total cumulative losses could reach £270 billion by 2035. This comes at a time when substantial public investment is needed, including to drive the UK's transition to a net zero economy.
- A range of policy options are available to minimise the fiscal burden, from accounting adjustments that would create greater fiscal flexibility to more significant policy changes that would generate real fiscal savings.
- To create greater fiscal flexibility, the Treasury could adjust the fiscal rules to exclude APF losses from its debt targets. Alternatively, it could seek legislative changes to remove the APF's indemnity, which would shift losses onto the Bank's balance sheet.
- To generate real fiscal savings, the Bank could implement a 'tiered reserves' system, thereby reducing the amounts it transfers to commercial banks. Alternatively, the Treasury could recoup losses by imposing a windfall tax on commercial banks.
- These measures could result in substantial savings, which could be used to increase public green investment by the 1% of GDP (roughly £26 billion) needed to facilitate the UK's transition to a net zero, climate-resilient economy. But such proposals come with risks that require careful assessment.

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Introduction: the fiscal impacts of the Asset Purchase Facility

After the global financial crisis of 2007–08, the Bank of England created the Asset Purchase Facility (APF) to implement its quantitative easing (QE) programme. This was undertaken to lower longer-term interest rates and stimulate the economy. By the end of 2020, the APF had purchased government bonds worth £875 billion and corporate bonds worth £20 billion.

Under the APF's legal arrangements, the Treasury receives the profits that the APF makes and is in turn required to compensate the APF for any losses it incurs. Between 2013 and 2022, £123.8 billion accrued in profits to the Treasury. However, since Bank Rate started increasing in 2022, the Treasury has transferred around £61 billion back to the APF (Office for National Statistics, 2024).

The scale of the losses has caused the APF to be targeted for the expansion of 'fiscal headroom', a concept often interpreted as the Government's buffer to increase spending or cut taxes without breaching its self-imposed fiscal rules (Conway, 2024).

The Bank's latest projections suggest the APF could generate cumulative losses of up to £270 billion over the next decade, exceeding previous cash flows to the Treasury by up to £145 billion (Bank of England, 2024). This represents a significant drain on the public purse.

In this policy brief, we examine the policy options available to minimise this fiscal burden and create greater savings that could be usefully directed elsewhere: including towards much-needed green investment projects that are vital to creating jobs and facilitating the UK's net zero transition.



£270 billion

Possible APF losses
by 2035

Box 1. Definitions

Bank Rate: The interest rate that the Bank of England (BoE) pays to commercial banks on their central bank reserves (sometimes referred to as the 'Bank of England base rate').

Bank reserves: Deposits held by commercial banks at the central bank (the Bank of England in the UK context). Banks use reserves to settle payments with each other.

Public sector net debt (PSND) and public sector net debt excluding the Bank of England (PSND ex BoE): The two main measures of UK Government debt used in policymaking and forecasting.

Quantitative easing (QE): An unconventional monetary policy tool involving the Bank of England purchasing bonds through the creation of new reserves.

Quantitative tightening (QT): The reverse of QE, involving the Bank of England selling previously purchased bonds, thereby destroying reserves.

Steady state of reserves: The size of the Bank of England's balance sheet after unwinding its unconventional monetary policy operations.

How is the APF incurring losses?

The APF is a subsidiary of the Bank of England. It is funded by the Banking Department, which finances the APF’s operations at Bank Rate. When the Bank lends to the APF, new reserves are created as liabilities of the Banking Department. As a result of the QE implemented by the APF, in 2009 the Bank changed the way it sets monetary policy, moving to a ‘floor system’ in which it primarily relies on paying Bank Rate on all reserves. This ensures banks do not lend reserves to each other at rates below Bank Rate, allowing the Bank of England to maintain control of short-term rates.

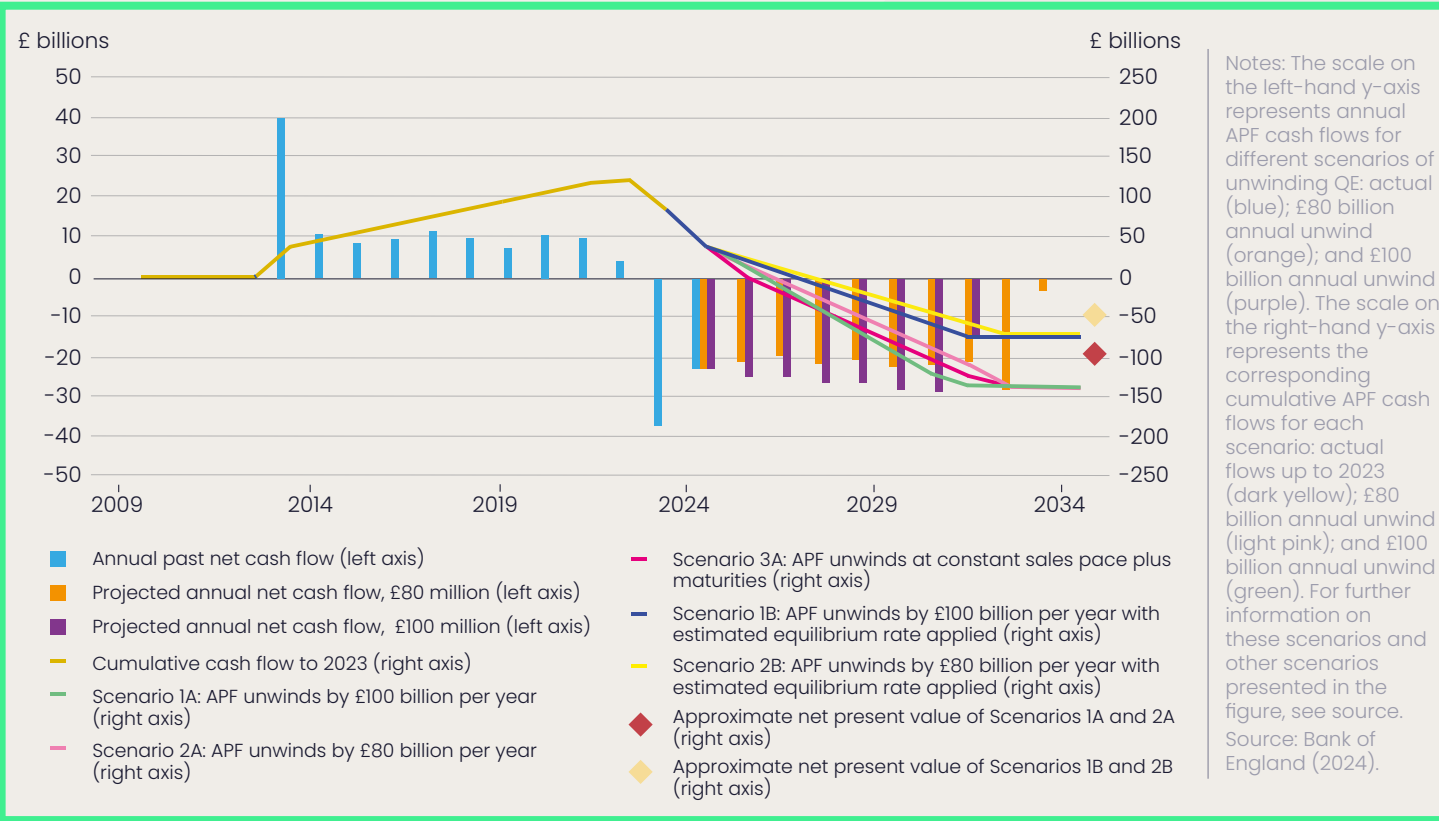
Increases in Bank Rate generate two important effects: first, the Bank pays higher interest to commercial banks on their reserves; and second, as other market rates also increase, the market value of the APF’s bonds decreases. As a result, the APF incurs three types of losses:

- **Interest losses:** The difference between the amount the APF pays in interest on its loan from the Bank and the amount it earns in interest on the bonds it holds.
- **Redemption losses:** The difference between the par value of bonds that the Bank holds to maturity and the value at which they were purchased.
- **Sale losses:** The difference between the sale value of bonds that the Bank actively sells and the value at which they were purchased.

Redemption and sale losses together deliver what are referred to as the APF’s valuation losses. An increase in the pace of quantitative tightening (QT) would reduce interest losses but increase valuation losses in the short term, and vice versa, although long-term losses are not very sensitive to the pace of QT (Nangle, 2024). A reduction in Bank Rate would reduce all three types of losses.

“Increases in Bank Rate generate two important effects, which can lead the APF to incur three types of losses.”

Figure 1. APF cash flows (actual and projected)



Options to minimise the fiscal impacts of monetary policy

We identify two sets of policy options to minimise the fiscal impacts of the APF: (i) policies that create more fiscal flexibility within the Government's fiscal framework; and (ii) policies that improve the Government's fiscal position.

Options that create fiscal flexibility

Adjusting the fiscal rules

The most common proposal for how to address the fiscal impacts of the APF is to exclude its losses from the Treasury's debt rule, which requires the debt-to-GDP ratio to be falling within a five-year horizon. This would enable the Government to refinance the APF's losses by borrowing without being constrained by the rule. According to recent analysis, such a revision could expand the Government's fiscal headroom by around £17 billion, increasing it from £8.9 billion to £25.8 billion (Fleming and McDougall, 2024).

Alternatively, the Treasury could shift the target of the debt rule from public sector net debt excluding the Bank of England (PSND ex BoE) to public sector net debt (PSND) (Stockton and Zaranko, 2024). This would be beneficial for two reasons:

- PSND would more quickly be reduced as it includes liabilities from the Bank's Term Funding Scheme, the loans of which are currently being paid back.
- PSND ex BoE registers the APF's QT valuation losses more suddenly and with a time lag: at the point when the Bank calls on its indemnity, rather than as those losses occur. This can interact unhelpfully with the Government's commitment to reduce PSND ex BoE in the final year of the five-year forecast horizon.

However, targeting headline PSND would primarily affect the profile rather than the level of government debt.

Removing the APF indemnity

Another option available to the Treasury is to remove its indemnification of the APF. The Treasury would thus no longer be liable for the APF's losses, but they would still end up on the Bank of England's balance sheet. Barclays, among others, has suggested treating the APF's losses as a 'deferred asset', similarly to how the US Federal Reserve handles its losses (Ashworth, 2024). Assuming the Bank operates to maintain positive equity, this would require it to hold sufficient revenue-generating assets to pay down the deferred asset at some point in the future.

The Bank of England's Governor Andrew Bailey has expressed scepticism about this proposal, primarily on the basis that the Bank does not retain any seigniorage income. The Bank pays its seigniorage revenues to the Treasury, as stipulated in the 1844 Bank Charter Act and the 1928 Currency and Banknotes Act. The Government would have to modify these laws to enable the Bank to retain seigniorage revenues, which would mean the Treasury foregoes this income until the deferred asset is paid down; this income stands at around £4 billion per year at the current rate (Bailey, 2024). As would happen were the fiscal rules adjusted, this would simply delay the losses incurred by the Treasury and fail to substantially improve the true fiscal position of the Government.

"The most common proposal to address the fiscal impacts of the APF is to exclude its losses from the Treasury's debt rule."

Options that improve the Government's fiscal position

Implementing a tiered reserves system

Tiering reserves would entail the Bank of England paying an interest rate below Bank Rate on a certain portion of reserves, thus reducing the total amount of transfers from the Bank to commercial banks. The remaining reserves could then be remunerated within a 'corridor system', whereby the Bank establishes deposit and lending facilities around Bank Rate, allowing it to maintain control of short-term rates (Tucker, 2022). Whatever its precise design features, tiering reserves can be seen as a stealth tax on banks, or alternatively as removing a transfer to banks' shareholders. Regardless, this measure results in real savings for the Government by reducing payments to commercial banks.

Versions of this system already exist, albeit serving different purposes. For example, when the European Central Bank sets negative interest rates, it only remunerates marginal reserves at this rate, while remunerating inframarginal reserves at a positive rate (in this case the tiering acts as a subsidy). The exact savings the UK Government could generate would depend on several factors, including: the pace of quantitative tightening; the Bank of England's steady state level of reserves; the future path of Bank Rate; the minimum reserve requirement; and the rate of remuneration. The New Economics Foundation estimates that the Bank could save up to £55 billion in the next five years if banks were forced to hold some reserves with no remuneration (Caddick, 2024).

Taxing commercial banks

Imposing a windfall tax on commercial banks is another way to tackle APF losses in a way that improves the Government's fiscal position. This can be done in a few different ways. For example:

- The Government could introduce a 2.5% levy on banks' non-interest-bearing deposits, which could bring in additional revenues of around £10.2 billion. This measure is identical to the Thatcher Government's approach in the 1980s following a period of high profitability for commercial banks.
- The Government could bring the current 3% surcharge on bank profits in line with the 35% windfall tax on energy companies, which in 2023 would have generated £14 billion from the UK's four largest banks alone (Musto, 2024). The surcharge was introduced in 2015 in recognition of the risks generated by the banking industry, but the Conservative government reduced it from 8% to 3% in 2022. Meanwhile, the bank levy also gradually decreased between 2015 and 2021: the short-term rate dropped from 0.21% to 0.10%, and the long-term rate from 0.11% to 0.05%.



“Tiering reserves results in real savings for the Government by reducing payments to commercial banks.”

An assessment of the UK Government's policy options: benefits and drawbacks

Adjusting the fiscal rules and removing the APF indemnity

This set of policy options would create much-needed fiscal flexibility. Changing the fiscal rules enables the Government to expand its room for manoeuvre as defined by the rules, and removing the indemnity enables the Treasury to shift its losses onto the Bank of England's balance sheet. These outcomes have the potential to generate important behavioural effects. They could unlock critical capital required to facilitate the green transition, crowd-in private investment and create a virtuous cycle of growth in green sectors, which could in turn improve the Government's fiscal position.

However, these proposals are essentially accounting tricks that do not improve the real fiscal position of the Government. A change in the fiscal rules would still require the Treasury to pay for the APF's losses, and removal of the indemnity would not change the Government's de facto ownership of the Bank of England. Real fiscal savings matter, particularly as the APF's overall net losses are projected to exceed £100 billion, and the real interest rate is currently significantly above the real growth rate. While the latter does not justify limiting public investment, it does nonetheless put pressure on the debt-to-GDP ratio.

A tiered reserves system and taxing commercial banks

This second set of policy options would generate real fiscal savings and, furthermore, result in more equitable outcomes. The recent Bank Rate hikes have generated significant profits for commercial banks. If the Bank of England's interest payments to commercial banks were reduced via tiered reserves or recouped via taxation, these funds could instead be spent on investment and public goods.

Taxation would recoup valuation losses from commercial banks in addition to interest losses, while tiering would only eliminate the latter. Tiering reserves would also ensure that any future episodes of QE would not result again in an unfair advantage to commercial banks.

Despite these benefits, because taxes and tiering of reserves involve redirecting actual cash flows, such measures also come with greater risks. They may reduce competitiveness or be passed through to customers in the form of higher costs – although it would likely be harder for banks to pass through costs from a windfall tax than from tiered reserves. They could also undermine capital adequacy and banks' resilience to shocks. The exact implications of these proposals would depend on analyses of private data held by the Bank of England, and any further decisions should therefore come after a risk assessment by the Government.

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Savings from the two scenarios and how they can contribute to sustainable growth

In both scenarios, the sums involved are significant. The £17 billion additional headroom generated by modifying fiscal rules is more than twice the budget allocated to the Government's National Wealth Fund for green investment (£7.3 billion). The real savings from tiering reserves or taxing commercial banks are even larger. When combined with the National Wealth Fund, public green investment could be increased by at least 1% of GDP (roughly £26 billion), which according to a recent estimate is the minimum additional investment needed to facilitate the UK's green transition and drive long-term sustainable growth (Zenghelis et al., 2024).

Conclusion

As the Government experiences increasing constraints on fiscal policy, the APF's drain on public finances is becoming increasingly burdensome and untenable. The Government has previously expressed a sceptical view about all the proposals outlined in this brief – but it is facing significant fiscal pressures that it must address. To minimise the APF's fiscal impacts, the Treasury and the Bank of England should carefully consider the full range of policy options available, especially those that would result in real changes to the Government's fiscal position.

“To minimise the APF's fiscal impacts, the Treasury and the Bank of England should carefully consider the full range of policy options available.”



Bank of England. Photo: Alicja Ziaj/Unsplash



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Authors' declaration

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