The Funding for Lending Scheme

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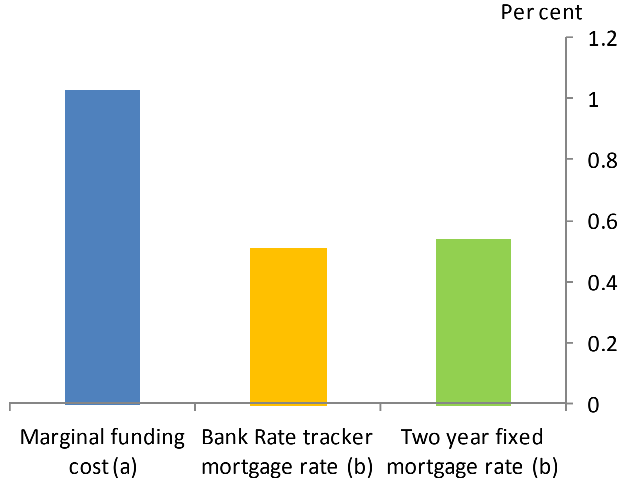
The aim of the Scheme is to boost the incentive for banks and building societies to lend to UK households and non-financial companies. The Scheme is designed to reduce funding costs for banks and building societies so that they can make loans cheaper and more easily available. Access to the Scheme will be directly linked to how much each bank and building society lends to the real economy. Those that increase lending will be able to borrow more in the Scheme, and do so at a much lower cost than those that scale back their loans.

Why is the Scheme being launched?

The crisis in the euro area has led to a marked deterioration in the outlook for the UK economy over the past twelve months. The euro-area debt crisis has also revealed severe vulnerabilities in the European banking system, which has inevitably affected the UK financial system. Export growth has slowed, and uncertainty about the future has led UK households and firms to cut back on spending, in turn reducing incomes and increasing unemployment.

UK banks have built up considerable buffers of loss-absorbing capital. Nevertheless, the UK banking system has not been immune to the general increase in market uncertainty and widespread risk aversion associated with the problems in the euro area. That in turn has caused funding costs for banks to rise sharply, leading to higher interest rates (Chart 1) and lower credit availability for household and corporate borrowers in the UK. Quoted rates on new mortgages have risen by around 0.5pp since summer 2011. The Bank of England's 2012 Q2 *Credit Conditions Survey* of UK banks suggested that household secured and corporate lending rates were expected to rise further.

Chart 1: Change in bank funding and lending rates between 31 July 2011 and 31 May 2012



(a) The estimated marginal funding cost of extending variable-rate sterling-denominated loans. For a full definition see the footnote under chart 1.11 on page 15 of the May *Inflation Report*.
(b) 75% Loan-to-value.

The Scheme will complement other policy actions. The Monetary Policy Committee has responded to the weakness of demand in the economy, and the risk that inflation may fall below the target in the medium turn, by maintaining interest rates at a historically low level and increasing the size of its asset purchase programme (known as 'Quantitative Easing'). This policy action has helped to increase the amount of money circulating in the economy and raised the prices of assets such as bonds and shares, boosting the value of wealth and lowering the cost of finance for those firms who can access capital markets. But it has not been able to deal directly with the problem of elevated bank funding costs.

The interim Financial Policy Committee has recommended that, taking into account each individual institution's risk profile, the FSA works with banks to continue to build a temporary additional cushion of capital to increase their resilience against the currently heightened risk of losses. Higher levels of capital should provide more capacity for firms to extend credit. But given the widespread level of risk aversion, bank funding costs are likely to remain elevated in the absence of further policy action, impairing the flow of credit from banks to households and businesses. The Funding for Lending Scheme is designed to tackle this problem.

The operation of the Scheme

Form of the loans

Over the eighteen months to the end of January 2014 – the 'drawdown period' – the Bank of England will lend UK Treasury Bills to banks and building societies (hereafter 'banks'). These will be lent for up to four years, for a fee. As security against that lending, banks will provide collateral – in the form of loans to businesses and households and other assets – to the Bank of England.

This type of transaction is known as a 'collateral swap'. When the loans from the Bank of England mature after up to four years, the collateral will be swapped back again. This arrangement ensures that the risk from the loans remains the responsibility of the originating bank.

Banks can use the Treasury Bills they access in the Scheme to borrow money at rates close to the expected path of Bank Rate. Taking that rate together with the fee paid to the Bank of England gives the cost of funding for a bank using the Scheme.

Quantity

Each participating bank will be able to borrow an amount up to 5% of its stock of existing loans to the UK non-financial sector – 'the real economy' – as at end-June 2012, plus any expansion of its lending during a 'reference period' from that date to the end of 2013. There are strong incentives for banks to boost lending because every pound of additional lending increases the amount that a bank can borrow by a pound. For example, a bank that had a stock of lending to the real economy of £100bn in June 2012, and then lent a further £7bn by the end of 2013, would be eligible to borrow a total of £12bn in the Scheme (an initial allocation of £5bn plus a further £7bn additional lending). 5% of the stock of existing loans is equivalent to roughly £80bn across all eligible banks and building societies. There is no upper limit on the size of either individual or aggregate bank borrowing under the Scheme. That will depend on factors such as how much lending the banks can do and how much collateral they have to post.

Any expansion of lending will be calculated on a ‘net’ basis – new lending into the real economy minus repayments. To count, lending must be in sterling to UK resident households or private non-financial corporations and in the form of drawn loans. Banks’ holdings of securities will not count; neither will undrawn facilities. Purchases or sales of loans will not affect this measure, because they leave unchanged the total amount of credit to households and companies in the economy. Write-offs will also be excluded from the measure of net lending used under the Scheme.

Price

The price of each bank’s borrowing in the Scheme will depend on its net lending between 30 June 2012 and the end of 2013. For banks maintaining or expanding their lending over that period, the fee will be 0.25% per year on the amount borrowed. For banks whose lending declines, the fee will increase linearly, adding 0.25% for each 1% fall in lending, up to a maximum fee of 1.5% of the amount borrowed for banks that contract their stock of lending by 5% or more.

How will this help to support the economy?

The Scheme is designed to reduce funding costs for banks. In turn that will allow banks to increase lending to UK households and firms, both by lowering interest rates and increasing credit availability. Easier access to cheaper bank borrowing should boost spending in the economy, for example by allowing families to purchase homes, or by allowing firms to finance investment in new and productive enterprises. In turn, higher spending should create jobs and raise incomes.

The Scheme is designed to encourage broad participation by banks. It is structured so as to incentivise all banks to lend more to households and firms than would otherwise be the case.

Some banks need to reduce certain parts of their lending activities, consistent with the continued adjustment of their business models in the wake of the financial crisis. While that adjustment should continue, the fees charged in the Scheme encourage those banks that are planning to restrict their lending to households and companies to cut back by less than would otherwise have been the case.

A bank with an initial lending stock of £100bn that plans to shrink its lending by 5% can access £5bn of Treasury bills for a fee of £75m per year (a 1.5% annual fee). But if the bank shrinks its aggregate lending by 3% instead, it can save £30mn on its annual fee (it pays a 1% annual fee). That saving can be used by the bank to reduce loan rates so that it can achieve a 3%, rather than 5%, fall in lending.

The Scheme also encourages banks that had already been planning to expand lending to do so even more. They can gain additional access to the scheme, pound-for-pound with any increase in lending, provided they have sufficient collateral. A bank in this position can fund new lending at a cost of roughly Bank Rate plus 0.25%, much lower than current market term funding rates, even for the strongest banks. These lower costs can be passed on to borrowers, allowing such a bank to expand its lending by more than planned before the Scheme.

Taken together, the design of the Scheme provides a strong incentive for all banks to raise lending to the real economy.

The amount borrowed from the Bank of England, and the amount lent to households and firms, by each participating institution will be made public by the Bank of England on a quarterly basis.

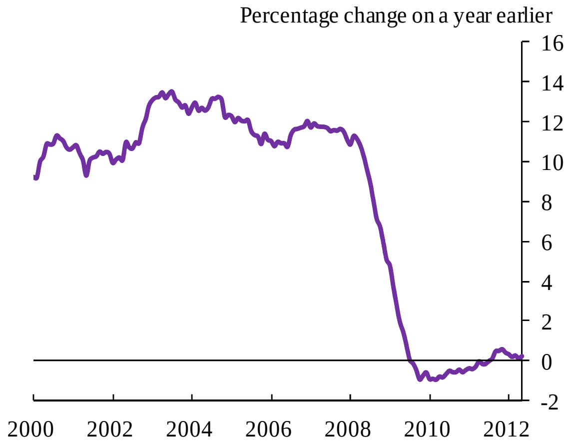
How will we know if the Scheme has worked?

We should expect the Scheme to have an impact on both the quantity and price of lending to households and firms. But, like all such policy actions, it will be difficult to quantify the exact impact, because we cannot know what would have happened in its absence.

The Scheme is launched at a time when the cost of bank lending to households and firms is expected to rise. To the extent that banks are able to fund themselves more cheaply under the Scheme, that rise should be prevented. Indeed, banks should actually cut the cost of lending on some products in order to stimulate more borrowing.

We also expect bank lending to UK households and companies to be higher than in the absence of the Scheme. As shown in Chart 2, lending to the real economy has now been broadly flat for over three years. Indeed, we know that some banks are planning to shrink new lending over the next few years, consistent with the continued adjustment of their balance sheets to the post-financial crisis environment. Prior to the announcement of the Scheme, UK bank lending was more likely to decline than increase over the coming eighteen months. The success of the Scheme will depend on the extent to which it can prevent that projected outcome.

Chart 2: Lending to households and PNFCs[a]



(a) Based on Scheme definition. Sterling loans by banks and building societies (including related specialist mortgage lenders) to UK resident households and private non-financial corporations.

Protecting taxpayers' money

The Funding for Lending Scheme is not something that would be undertaken in normal times. It is a response to the exceptional challenges facing the economy – and specifically the banking sector. The Bank has therefore sought and received an assurance from the Government that the objectives of the Scheme lie within its remit (as noted in the exchange of letters between the Governor and Chancellor on 13 July). And the Funding for Lending Scheme itself will be overseen by a joint Bank/HM Treasury Oversight Board, which will meet on a quarterly basis.

As in all of its operations, the Bank of England takes a prudent approach to risk management and will only lend in the Funding for Lending Scheme to banks and building societies which meet the Bank's minimum standard of creditworthiness. To protect its balance sheet, Scheme participants will also be required to deliver a greater value of collateral than the quantity of UK Treasury Bills supplied. If any of the loans to households and firms posted as collateral – whether funded by the scheme or otherwise – are not repaid, then the associated losses will be borne by the lending bank. If any bank fails to return the Treasury Bills when due, the Bank can sell or retain the collateral taken to make good any loss it may face.