HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

29 November 2011

Mervyn King
Governor
Bank of England
London
EC2R 8AH

Dear Mervyn,

APF LIMIT FOR ELIGIBLE PRIVATE SECTOR ASSETS

In my letter to you of 6 October 2011, I stated that the Treasury was exploring policy options to address impairment of the flow of credit to some parts of the real economy, notably small and medium sized businesses. In today's Autumn Statement, I am announcing a package of credit easing interventions.

It is clear that the spillover from the euro area crisis is leading to heightened funding pressures for UK banks. This has been made more acute by a financial sector which is still recovering from the 2008-09 financial crisis. This combination places further pressure on the cost and availability of finance for businesses, in particular smaller businesses that are less able to raise money from sources other than banks. The cost and availability of finance in the UK are already showing strains, particularly among smaller enterprises. If more difficult conditions persist there is also a risk that banks will have to further limit the quantity of new lending. This would have a detrimental effect on growth and employment.

As you set out to the Treasury Select Committee on 25 October, the objective of using the Asset Purchase Facility (APF) for the purchase of eligible private sector assets was to reinvigorate corporate capital markets so those markets would start functioning normally. When the APF began making purchases of commercial paper and corporate bonds there were clear difficulties in both markets. You explained that, by acting as market maker of last resort, the Bank has achieved the objective of normalising conditions in those markets. It has been shown over the life of the APF that this objective can be delivered by undertaking asset purchases of substantially less than the ceiling set by the previous Government of £50 billion.

You also explained in your recent speech on 18 October that while private sector asset purchases by the APF were effective in normalising conditions in these markets, and therefore improving credit conditions for large companies, they do not address the issue of improving access to credit for small and medium-sized enterprises (SMEs), which are constrained to borrow through the banking system. You said that you shared the

Government's concern about the ability of SMEs to obtain credit and that "by far the most effective way of helping SMEs quickly would be to provide incentives for lending by existing banks". As you have pointed out, measures which seek to influence the allocation of credit to particular sectors in this way are more appropriate for HM Treasury to take rather than the central bank.

The Government agrees, and is taking action to ease the flow of credit to businesses which do not have ready access to capital markets. I am therefore reducing the maximum APF limit for purchases of eligible private sector assets by £40 billion to a ceiling of £10 billion, financed by the issuance of central bank reserves, Treasury Bills and the DMO's cash management operations. The level of APF purchases financed by central bank reserves remains at £275 billion as set out in my letter of 6 October. The maximum size of the APF is therefore £285 billion. As set out in the letters from my predecessor of 29 January and 3 March 2009, HM Treasury stands behind the Bank and therefore provides an indemnity for any losses arising out of, or in connection with, the APF. The maximum limit of that indemnity has therefore been reduced by £40 billion to £285 billion.

This provides scope for the Government to announce a package of interventions of up to £21 billion to ease credit for businesses which do not have ready access to capital markets. This includes up to £20 billion for the National Loan Guarantee Scheme and an initial £1 billion for the Business Finance Partnership. The scale of the credit easing schemes will be subject to review and could be increased as necessary in light of prevailing economic conditions and evaluation of the interventions.

The Risk Management Framework agreed with the Treasury continues to apply to the Bank's management of the APF.

I am copying this letter to Andrew Tyrie, Chair of the Treasury Committee, and depositing a copy in the library of both Houses.

Best wishes,

George

GEORGE OSBORNE