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

2 December 2014

Dr Mark Carney
Governor
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Dear Mark

FUNDING FOR LENDING SCHEME

Thank you for your letter dated 2 December 2014, setting out the objectives and rationale for the extension of the Funding for Lending Scheme (FLS) that you and I have agreed. Reflecting the success of the FLS, and as economic conditions have begun to normalise, the scheme will be further tapered to focus its incentives towards supporting lending to SMEs.

The FLS was launched in an environment of unprecedented financial market distress and uncertainty. The continued effects of the global financial crisis and the uncertainty surrounding the euro area combined to push bank funding costs higher and credit conditions across the economy were expected to deteriorate further. Since the scheme was announced, the FLS has successfully contributed to driving down significantly funding costs in the UK.

This fed through to a marked improvement in household credit conditions, which was reflected in the earlier tapering to the scheme, in November 2013, to remove incentives on household lending and focus the scheme on business lending. Since then, credit conditions for all businesses have improved, including for SMEs. Large businesses report credit availability and pricing to be at its most favourable in seven years, in part reflecting strong equity and bond issuance that has been able to replace bank lending, which continues to decline. SMEs rely much more heavily on finance from banks, and although the rate of decline in net lending to SMEs has eased, it is important that the scheme continues to support lending where it is most required, for SMEs.

It is logical therefore to taper the scheme further to remove large business lending. As your letter highlights, further borrowing allowances during 2015 will be generated by net lending to SMEs, which will continue to be heavily incentivised by allowing participants to draw £5 of funding for every £1 of net lending. Net lending to financial leasing corporations and factoring corporations, which are important sources of finance for some SMEs, will also continue to generate borrowing allowances. In this sense, the FLS will complement wider measures both the Government and Bank of England are pursuing to support SMEs access to finance, including through the British Business Bank.

More broadly, given the risks from developments in the global economy, it is right that the scheme continues to provide certainty of funding, and act as a backstop facility for banks in the event of shocks that could affect funding or constrain lending over 2015. Allowing participants to continue to access the significant amount of borrowing allowances they have built up through net lending in the current phase of the scheme, while retaining the fee for drawings at 25 basis points, will help to ensure the FLS is able to act as an effective backstop facility as the scheme is tapered.

I am confident that these changes will build on the success of the scheme so far and will continue to support a further easing of credit conditions where it is most required, for SME lending. As your letter sets out, the FLS will continue to be overseen by the joint Bank/HMT Oversight Board and I confirm that the scheme is within the remit of the Bank.