Funding for Lending Scheme extension – explanatory note

In order to continue to support the supply of credit to the UK economy the Bank of England and HM Treasury are extending the Funding for Lending Scheme (FLS).

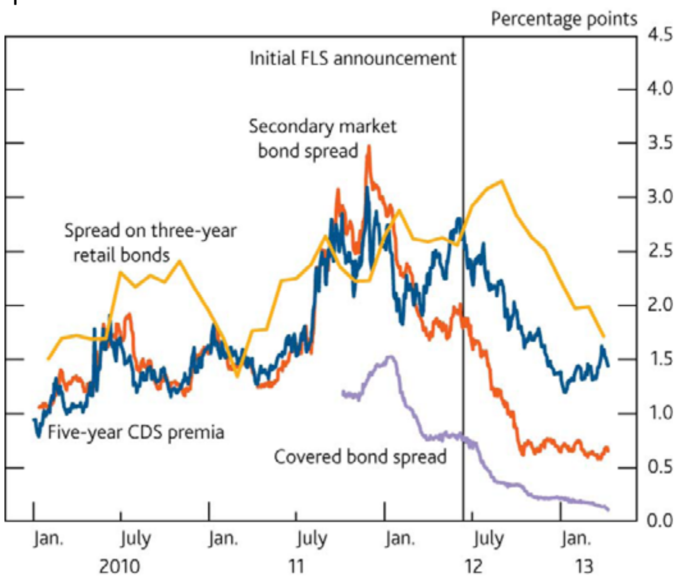
The extension builds on the success of the FLS so far, and has three main objectives: (i) to give banks and building societies (henceforth 'banks') confidence that they will be able to access funding for lending to the UK real economy on reasonable terms until January 2015; (ii) to increase the incentive for banks to lend to small and medium-sized enterprises (SMEs) both this year and next; (iii) to include lending by banking groups involving certain non-bank providers of credit, which play an important role in providing finance to the real economy.

As in the existing Scheme, the amount and price of funding offered to banks will be directly linked to the amount that they lend to the real economy. The FLS is a complement to the Financial Policy Committee's recommendations to ensure that UK banks have adequate capital to absorb unexpected losses and sustain credit availability.

Why is the extension being launched?

The reduction in UK bank funding costs **(Chart 1)** since mid-2012 – in part driven by the FLS – has led to an improvement in credit conditions. Nevertheless, there remain risks of renewed stresses in bank funding markets, triggered for example by adverse developments in the euro area, which might undermine the recovery in credit conditions and, in turn, output. Drawings can be made under the existing FLS until January 2014. The extension to the Scheme will give banks confidence that if they are expanding net lending they will continue to be able to access low-cost, four-year, funding until January 2015.

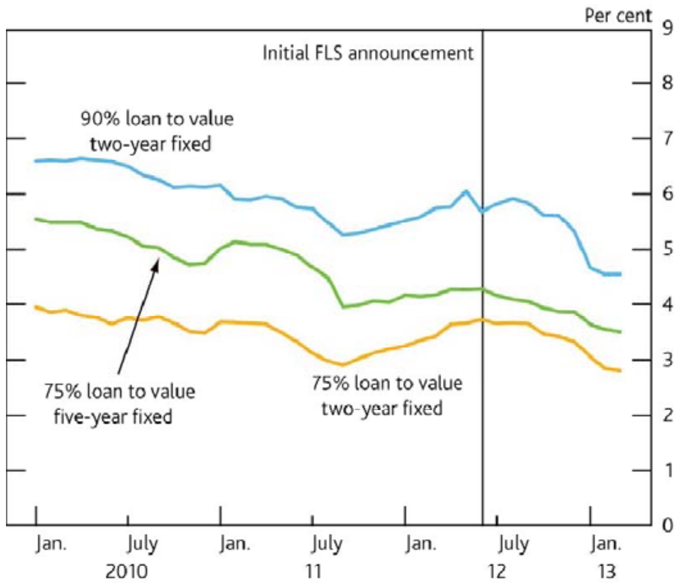
Chart 1: UK banks' indicative longer-term funding spreads[a]



Sources: Bank of England, Bloomberg, Markit Group Limited and Bank calculations.

(a) For more information See footnotes to Chart 2.1, page 9, April 2013 *Trends in Lending*, available at www.bankofengland.co.uk/publications/Documents/other/monetary/trendsapril13.pdf.

Chart 2: Selected quoted mortgage rates[a]



Source: Bank of England.

(a) Sterling only. The Bank's quoted interest rates series are currently compiled using data from up to 23 UK monetary financial institutions. End-month rates. Non seasonally adjusted.

Why are the incentives being skewed towards SMEs?

The extension to the Scheme has been designed in such a way as to provide considerably greater incentives to banks to lend to SMEs. A range of indicators suggests that the improvement in credit conditions since last summer has been more muted for SMEs than for either larger businesses or households. Advertised interest rates on some mortgages have fallen significantly **(Chart 2)**. Because loans to businesses are less homogenous it is harder to track the cost of credit in the same way. But a variety of evidence – from the Bank's Agents and the Bank's *Credit*

Conditions Survey, for example – suggests that since mid-2012, the availability of credit has increased more for large companies than for small businesses. Furthermore, SMEs – who are more dependent on bank finance – have not benefitted to the same extent as large companies from the reduction in the cost of finance from capital markets. In order to create greater incentives for banks to support credit supply to SMEs, the amount of funding available to banks in the extended scheme will depend heavily on their lending to that sector.

Why is the Scheme being expanded to include lending involving non-bank credit providers?

The Scheme is also being expanded to take into account lending by banking groups involving certain non-bank providers of credit that play an important role in providing alternative sources of finance to the real economy. The FLS will now take into account lending by participating groups to financial leasing corporations and factoring corporations (which are a source of credit for SMEs), and mortgage and housing credit corporations.[1] Participating banks also have the option of counting lending to these sectors from 1 April 2013 as part of the existing Scheme.

Incentives to lend – quantity and price of funding

Each participating bank group will be able to borrow an amount determined by its lending to the different eligible sectors of the economy: households; SMEs; large businesses; and non-bank credit providers to the real economy. The borrowing allowance in the extension will have two parts. First, each bank can build up an initial allowance of funding, which will be made available at the start of the extension, based upon its lending performance during 2013 Q2-Q4. That initial allowance will be equal to its net lending to households, large businesses, and non-bank credit providers to the real economy, plus <u>ten</u> times its net lending to SMEs. If this weighted sum is negative for any bank, that bank will receive a zero initial allowance. Second, in 2014, a bank will accrue an additional allowance of funding equal to its net lending during that year to households, large businesses, and non-bank credit providers to the real economy, plus <u>five</u> times its net lending that year to SMEs. If this weighted sum is negative for any bank, that bank will receive a zero additional allowance.

The borrowing allowance is set in this way so that banks have a greater incentive to lend to SMEs, but also to encourage banks to lend to SMEs sooner rather than later. Every pound of additional lending to SMEs in 2014 increases the amount that a bank can borrow by five pounds. But every pound of additional lending to SMEs in the remainder of 2013 increases the amount of funding that banks will be able to draw upon in 2014 by ten pounds. So there are incentives to expand lending to SMEs this year in order to create an effective backstop of funding should conditions deteriorate.

The price of borrowing during the year's extension to the FLS will be determined using the same rule as in the existing Scheme, so as to encourage lending in aggregate, but based on net lending during 2014. It will depend on each bank's aggregate eligible net lending, on an unweighted basis. For banks maintaining or expanding their lending over 2014, the fee will be 25 basis points per year on the entire amount borrowed. For banks with declining lending, the fee will increase linearly by 25 basis points for each 1% fall in lending, as a share of the end-2013 stock of lending, up to a maximum fee of 150 basis points of the amount borrowed for banks that contract their stock of lending by 5% or more. This rate will then apply to each drawing for its whole term of up to 4 years.

[1] Where such non-bank credit providers are part of broader banking groups, intragroup lending will not be eligible and groups will instead directly report the lending of those non-bank credit providers to the real economy within their total lending figures.