



BANK OF ENGLAND

Speech

Developments in financial markets, monetary and macroprudential policy

Speech given by

Paul Fisher, Executive Director, Markets; Member of the Monetary Policy Committee;
Member of the Financial Policy Committee; Bank of England

Visiting Professor in Economics and Finance, Richmond, the American International
University, London.

To Richmond University, London

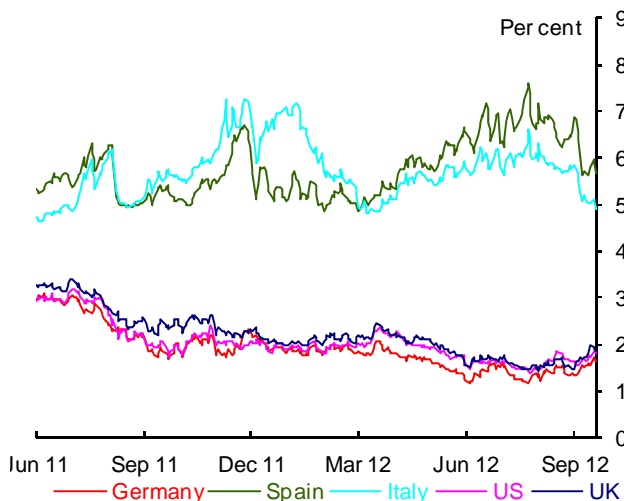
25 September 2012

The author is also chair of the *ifs* School of Finance. I am grateful to Geoff Coppins for helping to prepare this lecture and many colleagues for comments, but none should take any blame: all the views expressed are personal.

When I gave a speech about the state of financial markets in June 2011, I talked about a process of healing as markets recovered from the Great Recession.¹ But since then the patient has not regained anything like a full state of health. In this lecture today, I want to offer a second opinion on the condition of financial markets. But also, as a member of both the Monetary Policy Committee and the Financial Policy Committee, I want to talk about aspects of the monetary and macroprudential policies which are part of the medicine. In particular I want to give some background to a recent initiative by the Bank of England and HM Treasury to revive the economy, the Funding for Lending Scheme.

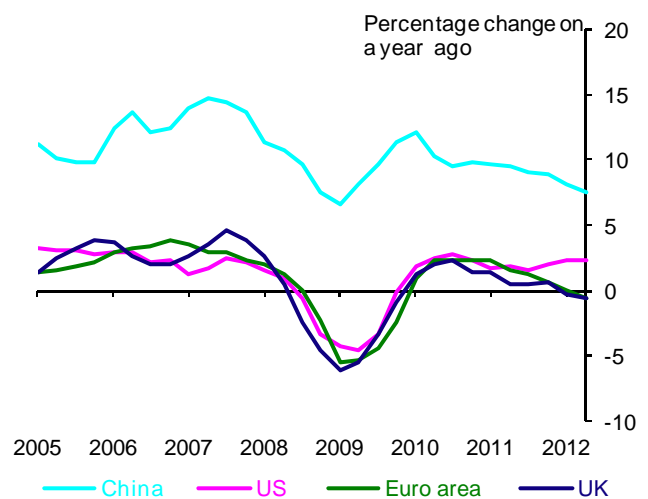
Financial markets have continued to be buffeted by global events over the past year. In particular, the sovereign crisis in the euro area became more acute. It suffered a serious lurch in mid-July 2011 when confidence in Italian politics evaporated and Italian and Spanish sovereign yields rocketed to record euro-era highs (Chart 1). What followed was alarming – a growing fragmentation of euro zone markets as participants positioned themselves to minimise risk in the event of euro break-up. And the story has become more focussed on Spain than Italy. But that has not been the only shock markets have had to cope with.

Chart 1: Ten year government bond yields^(a)



Source: Bloomberg
 (a) Yields to maturity on ten-year benchmark government bonds.
 Data updated to 19 September.

Chart 2 GDP in selected countries and regions^(a)



Sources: Eurostat, National Bureau of Statistics of China, ONS, Thomson Reuters Datastream and US Bureau of Economic Analysis
 (a) Real GDP measures. Figures for China are non seasonally adjusted.

Growth in Europe has been anaemic at best (Chart 2). Growth in the US has been a bit stronger but not enough to reduce an elevated unemployment rate. And we have seen indications of a slowdown in China and other large EMEs. Perhaps the most striking thing about this is the degree of co-movement in GDP growth rates across economies.

¹ Paul Fisher (2011), "The State of the Financial Markets", <http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech507.pdf>

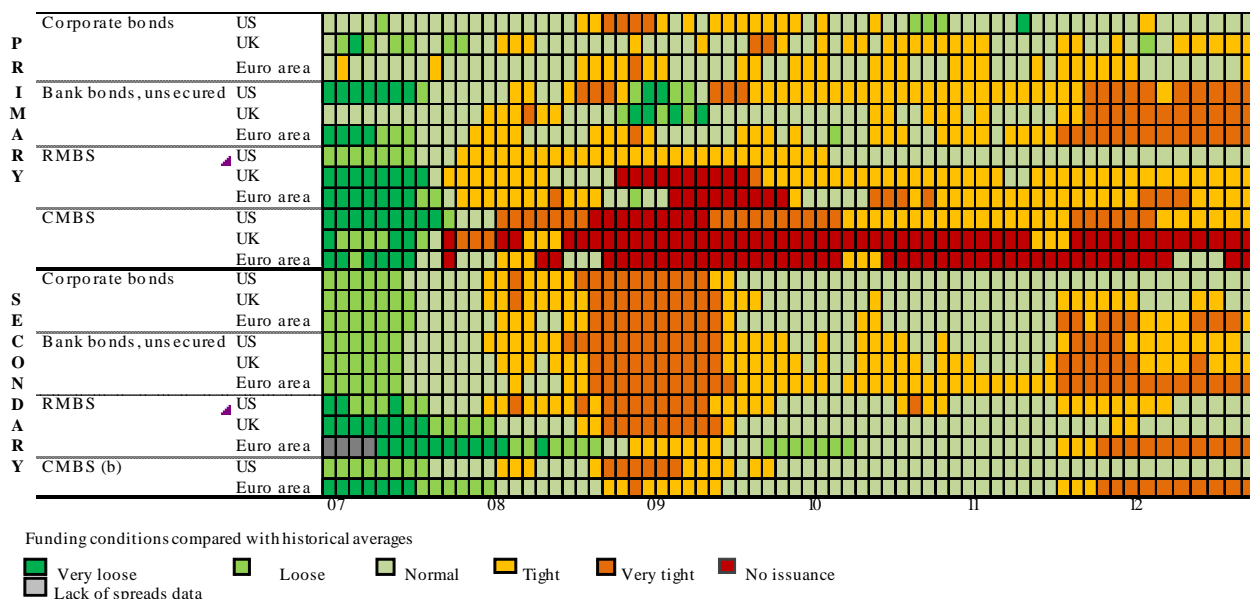
In reaction to the deteriorating outlook, we have seen a stream of policy actions, mostly by central banks as many fiscal authorities have felt constrained by excessive debt, deficits or both (at least in the western hemisphere). Last November, the ECB announced three-year term repos, in unlimited scale. And more recently details of their proposed Outright Monetary Transactions (OMTs). In the United States there is to be more quantitative easing (QE), including open-ended purchases of RMBS. In Japan, just last week we saw a large expansion of their asset purchase programme. In the United Kingdom we have been undertaking extra QE since October 2011 and earlier this summer we activated for the first time our new contingent facility of six month repos against a broad range of collateral – what we call the Extended Collateral Term Repo facility or ECTRs. That was intended to act as a backstop should the risks in Europe deepen and crystallise. Usage has declined sharply since the first two operations suggesting that the degree of stress is not that great at the moment. More recently the Bank and HM Treasury jointly launched the Funding for Lending Scheme (the FLS) - of which more later. The full list of policy actions is much, much longer of course. The length of that list reflects the seriousness of the economic situation and the constrained ability of fiscal authorities. In the world of central banking, unconventional policies are the new normal. At least for now.

Financial markets have not just been suffering from external shocks. A series of home-made disasters have also rocked the sector. The UBS 'rogue trader', the losses at JP Morgan's Chief Investment Office, LIBOR manipulation at Barclays (with others under investigation) and the mis-selling of PPI. These scandals have not so far been institution-threatening, but coming on top of the financial and macroeconomic crisis to date, they have helped to suck confidence from the financial sector just when it might otherwise have been recovering.

Chart 3 shows a 'heat map' of markets generated by colleagues in the Financial Stability area of the Bank. This chart uses indicators such as issuance amounts and bid-ask spreads to monitor market conditions. Red indicates a non-functioning market. The process of 'healing' since 2008/09 that I referred to a year ago is clear. But then the improvement plateaus and starts to reverse in mid-2011. A year ago it looked like conditions were starting to revert to those of late 2008. As the managers of the UK's foreign exchange reserves we experienced some of these deteriorating conditions at first hand. (It is a neglected point that the Bank of England is a significant participant in the market on behalf of HM Treasury through reserves management operations, as well as being the monetary authority for sterling markets.)

In policy meetings during the Autumn of 2011, I started to warn of a growing state of dysfunction as some markets – such as for bank funding – closed completely, others saw bid-offer spreads widen and those firms perceived to be weak found their credit lines from fellow banks being cut. The situation was growing very dangerous. To a large extent it was the ECB three-year LTROs which dealt with that dysfunction – leading to the reopening of bank funding markets in particular.

Chart 3: Market functioning ‘heat map’ based on issuance and spreads data^{(a)(b)}



Sources: Bloomberg, Dealogic, JP Morgan Chase & Co., Bank of America Merrill Lynch and Bank calculations.

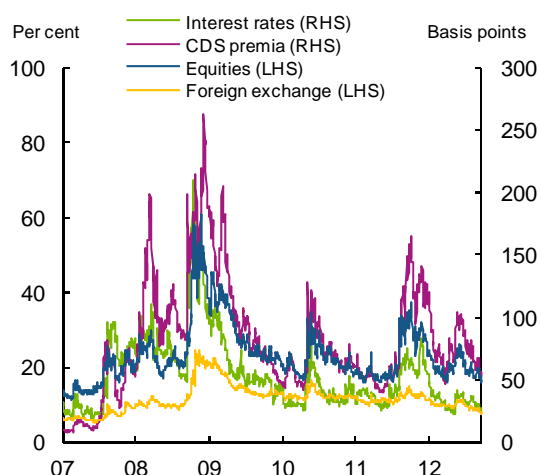
(a) Shading is based on a score that reflects gross issuance (relative to GDP) and spreads in primary markets, and spreads in secondary markets, expressed as a number of deviations from historical averages, using as much data as available from January 1998. Primary market indicators reflect the past three months, to smooth volatility. (Where primary market spreads are not available, mainly affecting the CMBS series in some periods between late 2009 and 2011, primary market indicators are based solely on issuance.)

(b) Updated to end-August 2012.

Market functioning in 2012 has developed in a rather unexpected way. Despite regular crisis points and the fading of the LTRO effect, we have seen (implied) volatility and skews derived from options prices fall to post-crisis lows across a range of markets (Chart 4). One might have thought that the heightened sense of uncertainty about economic developments would lead to the opposite. What has been going on?

I think there are several influences pushing down on market volatility. One is the perception that central banks are on permanent standby to deal with tail risks. Another might be a realisation that certain types of financial protection are not worth having: for example if the counterparty selling the insurance (eg options or CDS) might not survive the tail risk it is selling protection against. And it has been seen as better not to take such risks rather than to try and hedge them. So demand for some types of protection may have fallen for that reason. A further observation is that market participants have to some extent grown accustomed to the perpetual state of crisis and decided that the show – albeit a chaste and less spectacular show – must go on. There are large sums of money arising from savings or other cash balances which must be (re-)invested somewhere. Returns from the safest sovereign assets have been driven to very low yields. And even some risky assets – like bank debt – are getting scarcer as a result of policy actions, directly or indirectly. Where are asset managers putting the money?

Chart 4 Financial market volatility^{(a)(b)}



Sources: Bloomberg, Chicago Mercantile Exchange, NYSE Euronext, JPMorgan Chase & Co. and Bank calculations.

(a) Three-month option-implied volatilities.

(b) Average of FTSE 100, S&P 500 and Euro Stoxx 50 for equities. Average of three-month short sterling, euro-dollar and Euribor for interest rates. Average of five-year on-the-run iTraxx Europe main and CDX North America investment-grade for CDS premia. Average of three month €per£, \$per£, \$per€, Yen per \$, and Yenper€ for foreign exchange.

There has been a renewed search for investible assets going on. Not the old, indiscriminate, invest-in-anything-with-a-high-return-and-ask-no-questions “search-for-yield”. It has so far been a much more calculated hunt. Not so much for return on capital but return of capital. Credit and liquidity risks are now being much more thoroughly appraised. In particular, investment firms have been avoiding the least liquid products. So equity-linked structured notes, for example, have been out of fashion. High yield (non-financial) corporate bonds and Exchange Traded Funds (ETFs) have both been in. But since the risks in some ETFs were highlighted – by the UK’s new Financial Policy Committee amongst others – some of the more complicated ETFs and those with opaque securities lending programmes, have faded somewhat.

It is not that investors are avoiding all credit risk - where it can be properly assessed and a diversified portfolio is possible. For example, the end-investor demand for corporate credit ex-financials is generally very strong.

The announcement of OMTs by the ECB and the other announcements by the US Fed and the Bank of Japan, appear to have led to a collective sigh of relief in recent weeks. Yields on Spanish and Italian debt have fallen since the announcement – by 100bps or so at 10 years - and equity markets are up. I hope that the ECB action lays the foundation for a successful resolution of the European debt crisis. The view of markets so far is positive in that regard. I would caution, however, that we have been here before. Along with every other market participant I hope that this time will be different. But central banks cannot solve fundamental problems in the real economy, even using unconventional measures – they can only give the time and space for governments and private sector agents to do so. There will now be a period of

opportunity for the politicians of Europe to get on with making the changes that would really make a long-term difference, such as improving competitiveness in the countries of southern Europe.

To summarise my assessment of markets at this point I would no longer say that they are healing. Rather, markets are scarring over - adapting and evolving to the new environment. No one is quite sure where the process will end, but the industry has a job to do, including investing large sums of money here and now. And in some fashion, reflecting the enhanced perceptions of risk, that will continue.

Given what happened in financial markets, it is no surprise that there are policy initiatives on financial market regulation everywhere one chooses to look: Dodd-Frank in the US; EMIR, Solvency II and the Crisis Management Directive in the EU; the Independent Commission on Banking (ICB) proposals in the UK; the new Basel 3 rules on capital and liquidity globally (CRD IV in Europe), and numerous initiatives under the auspices of the Financial Stability Board including defining the key attributes for effective resolution regimes. The full list of new rules is much, much longer of course.

Despite the variety of authorities involved, I believe there is a common thread behind the policy reactions. Many of the changes have been prompted by perceived excesses in much of the financial sector. But in my view, the motivation is not, and should not be, to seek some kind of public revenge. The simplest way to understand all these initiatives is that their main collective purpose is to avoid public money being needed in future to bail out the financial sector. Even though some bail outs have ultimately led to profits being made, the sense of injustice around this use of public money makes it extremely unpopular. Solving the 'too big to fail' problem remains key.

Meanwhile a debate has been growing as a result of the slow recovery. Is regulation itself directly responsible for restraining credit and hence limiting economic growth? I have recently argued that this should not be so.² Safe and sound credit institutions are a necessary part of generating sustainable economic growth. If banks hold more capital than they did pre-crisis and are less levered, then they will be in a more secure position to provide credit to support the real economy. Switzerland has made a practical demonstration of the proposition that making banks hold more capital can actually lead to those banks having higher equity prices and lower funding costs. We have recently witnessed an example where capital raising by a Swiss bank was followed by its equity price rising (and its CDS premium fell) on both a relative and absolute basis.

Just as in the debate about output and inflation, there is no clear cut, stable, trade-off between making banks hold a prudent amount of capital and growth in the medium term. A resilient and innovative banking system will support the efficient allocation of capital and therefore technical progress and growth.

² The Forum, City AM, page 20, September 14 2012 (<http://www.cityam.com/forum/why-britain-s-banking-rules-aren-t-restricting-our-economic-recovery>)

Financial markets are fundamentally about risk-taking: credit risk, liquidity risk and market risk are basic components of even the safest and soundest banking systems. As a society, we need risk taking as part of the process of allocating capital to competing ends. And people who take risks – at least with their own money or their own careers – need to be rewarded (appropriately!) for that risk or they won't take it. So we are not in a world where, as a matter of policy, we want to eliminate financial risk.

The key is for financial risks to be properly appraised, priced, managed and provisioned. And we should discourage some of the cross-subsidisation of different types of risk taking if we want risk capital to be appropriately allocated. That includes any perceived public subsidy, which is what the ICB recommendations are about. We also want to avoid profits being made out of dishonest practices such as insufficient provision of information, the deliberate mis-pricing of risk or other market abuses. The new Financial Conduct Authority will have an important role to play in that.

The regulatory reform process will inevitably take time. And while the process is developing there are risks arising from the uncertainty that it brings. We need banks to raise more equity capital. But when we ask potential equity investors in banks what is holding them back, they often cite the uncertainty over the rules which will affect their future risk profiles and profitability. Such uncertainty will add a discount to the price of bank equity (although there are many other important factors too, such as the uncertain valuations of bank assets). Similar concerns about the rules have affected the attitude of debt investors, particularly the debates on 'bailing in' senior debt.

The rule makers are moving as fast as they can. The good news is that, once there is more certainty, we should expect a positive response from investors. Within, say, a year or so from now, I would expect a lot of progress to have been made such that the outlook for the financial sector is much brighter – at least in this regard.

In the short-term, there can be a more explicit trade-off between growth and regulation, particularly with liquidity regulations. Holding extra liquid assets to meet regulatory buffers can compete with other assets such as loans. (That trade off is not the same for capital – capital is not an asset on a bank's balance sheet and the nature of capital is often misunderstood). But how should the authorities introduce much needed new liquidity regulations in these depressed circumstances?

We do not want to see the weakening of new long-term standards because of short-term cyclical concerns. Yet we don't want the introduction of new regulations to make a bad economic situation worse. One could put off deciding on new rules – but the uncertainty would then still act as a drag. The best course seems to be to design and publish the new frameworks but delay their implementation. Even this isn't entirely satisfactory – the market will reward firms who meet the rules early as they will be perceived to have the strongest balance sheets. Competitive pressure will encourage weaker firms to accelerate their own process so as to keep up, possibly reducing the benefits of a relaxed timetable.

The answer to these practical problems of policy making is perhaps in the following key point: the new regulations should be designed as far as possible to be counter-cyclical so that they are less demanding during a crisis such as now, than at other times. Buffers are there to be used. If capital and liquidity buffers could not be used during the bad times then they serve no purpose: they would just be a deadweight loss on the banking system, shifting the point of failure for a firm to a more expensive and hence less efficient location.

Putting this in concrete terms, the Financial Policy Committee recently recommended to the FSA that it make clear that the new liquidity buffers introduced by the FSA in 2010 may be used in part, in the event of a liquidity stress, without regulatory over-reaction. Firms don't need to treat the FSA guidance as a hard minimum and hold an extra buffer on top. The FSA has also been able to lower micro prudential liquidity requirements because of the extra liquidity backstop being provided by the Bank of England - in particular the ECTR and the Funding for Lending Scheme.

This example may be important in a wider sense. One of the challenges facing macroprudential policy is that the instruments may not be symmetric in their impact. Put crudely, we can make firms hold more capital and liquidity when the going is good. We can't force them to use those buffers when the going is bad, even if the rules are relaxed. Taking away the stick isn't the same as offering a carrot. Vegetable metaphors are not always welcomed but I think it's acceptable to suggest that the FLS may be seen as a carrot! And the FPC recommendations are perhaps a first example of macro prudential policy being used in a co-ordinated way (with central bank actions) to support the resilience of the UK financial system, by being counter-cyclical in approach. This ability to co-ordinate may also demonstrate the benefits of some shared membership across the FPC and MPC.

I want to turn now to the Funding for Lending Scheme in the context of our announcements this morning of the first banks and building societies to have signed up and their stock of sterling lending to UK firms and households at end-June 2012 (Table 1) that will be used as a reference point. Together these banks account for around 73% of the stock of lending to UK households and corporates. I should also note that a significant number of other institutions are close to signing up too and we will update this table in due course. In addition, we will publish the first set of drawdown data in December, although you will have seen that one bank has already announced that it has drawn £1bn and plans to draw more. That said, it will probably take some time for banks to review fully their lending plans, and it is likely that drawings from the FLS will be spread out over the full window to end-2013.

Table 1: FLS data

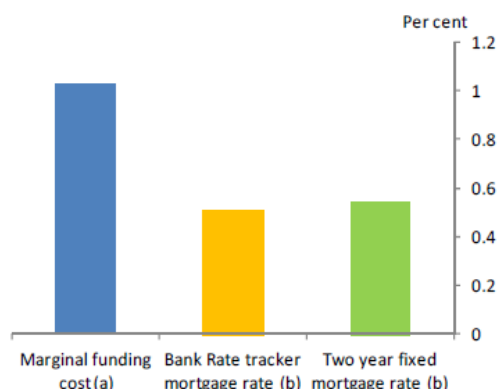
The table below includes all participating groups that had signed up to the scheme and certified their Base Stock of loans by 24/09/2012

FLS Group	Certified lending to UK households and PNFCS (£mn)			Aggregate outstanding FLS drawings (£mn)
	Base Stock of loans as at 30/06/12	Quarterly net lending flow	Cumulative net lending since 30/06/2012	
TOTAL	1,211,736	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Aldermore	1,567	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Barclays	181,020	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Hinckley & Rugby Building Society	433	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Ipswich Building Society	444	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Kleinwort Benson	11	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Leeds Building Society	7,567	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Lloyds Banking Group	443,255	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Monmouthshire Building Society	629	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Nationwide Building Society	152,155	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Principality Building Society	5,408	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
RBS Group	214,816	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Santander	189,339	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Virgin Money	15,093	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>

The FLS measure of lending covers drawn sterling loans to households and private non-financial corporations (PNFCs) by the FLS Group, which includes all UK resident monetary financial institutions and related specialist mortgage lenders within a group.

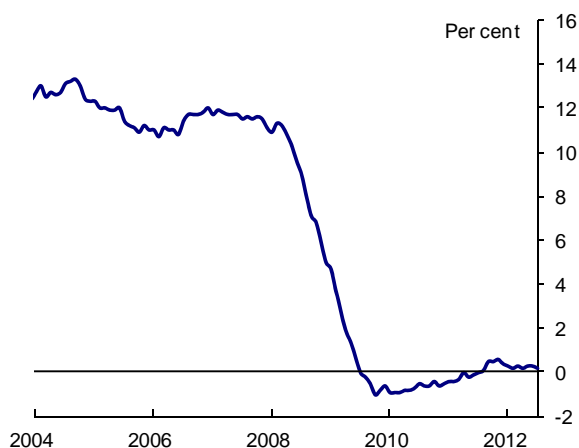
The FLS has been implemented in large part because of the developments in financial markets I have described: an example of the important and powerful linkages between the real economy and the financial sector. The continued uncertainties about the future of the Eurozone and about the European banking system meant that during the past two years bank funding markets have had periodic bouts of closure. And when open, spreads of bank debt over risk-free rates have remained elevated. A number of large UK banks still rely on wholesale markets for funding at the margin and higher wholesale funding costs have spilled over into other funding markets – driving up retail deposit rates for example. Prior to the announcement of the FLS, banks were passing on their elevated funding costs to their lending rates. Over the 12 months to mid-2012, we saw lending rates to businesses and for mortgages rising (Chart 5). Furthermore, 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 5: Change in bank funding and mortgage 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.

Chart 6: Annual lending growth to households and companies^(a)



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

Although only a small rise in absolute terms, according to our business contacts this increase in interest rates was accompanied by generally tighter lending standards, reflected in broader changes in terms and conditions, and came after two years of flat GDP growth and 3 years of declining credit growth to households and businesses in the UK (Chart 6). And despite this being a period in which the MPC re-launched quantitative easing, helping to bring down longer term yields on gilts to record lows.

Central banks should not normally have to intervene to provide banks with medium-term funding at reasonable spreads. But enough was enough! The FLS will not address any of the underlying problems in the euro area or in the financial sector, but given that many of those problems are outside the UK's direct control, it became necessary for us to do something innovative.

I want to use this opportunity today to expound on some of the principles underlying the FLS. It is a deceptively simple scheme and inevitably there will be some misunderstanding about what it is intended to achieve and how it works.³

To begin, I wish to make clear that the FLS has been designed to support the UK economy, not the banks. There were many features of the scheme for which we made different choices because of that over-riding objective – full, quarterly disclosure of usage, bank by bank, being the most obvious.

Let me summarise the key features of the FLS for those who have not followed the details. We will reduce the funding costs for banks and building societies by providing them with relatively cheap liquidity. In practice by lending them Treasury Bills for up to four years in exchange for the widest possible range of

³ The Bank published an explanatory note on the FLS, available here: http://www.bankofengland.co.uk/markets/Documents/explanatory_notefls120713.pdf

collateral that the Bank can accept – including pre-positioned portfolios of loans. Those Treasury Bills can be used as liquid assets to support an expansion of lending or turned into cash if necessary. We will charge a fee of just 25 basis points per annum as long as a bank's stock of lending does not contract over the period to end 2013.

The firms will have that 18 months to draw down the bills. This is essentially a swap of highly liquid assets for illiquid ones and part of a wider programme where the Bank has been extending the range of collateral that it can take in such operations. So portfolios of loans are now eligible collateral for the first time in our market-wide facilities. One of the benefits of this expansion is that our operations are now much more accessible to smaller banks and building societies that don't have large portfolios of tradable securities.

Every firm that signs up to the FLS will be able to borrow an amount equal to at least 5% of their initial stock of lending on a standard definition for which the Bank already collects data.⁴ If the firm expands its lending over the period until end-2013, they will be able to borrow an equivalent additional amount too. There are therefore strong incentives for banks to boost lending because every pound of additional lending increases the amount that a bank can borrow cheaply by a pound.⁵

If a firm's lending stock contracts, however, they can only access up to that 5% allocation and the price of the scheme will also be higher – rising linearly to a maximum of 150 basis points if their lending contracts by 5% or more.

You might reasonably ask some questions:

- Why have we set this minimum access amount and complicated pivot in the price?
- How can we be sure that any increase in credit flows to where it may be most needed? In particular to SME businesses and to first-time home buyers.
- What if there just isn't sufficient demand for credit?
- Won't the banks just pocket the benefits of the cheap funding?

Indeed those are some of the questions I am most often asked and where I want to put some answers on the record today.

The first point I want to make in reply is that banking in the UK is far from a perfectly competitive market. The six biggest lenders account for the vast majority of lending to UK businesses and households – and the seventh largest accounts for less than a third as much as number six. In large part the quantitative success of the scheme will depend on what these larger lenders do.

⁴ Drawn sterling loans to UK private non-financial corporations (PNFCs) and households, by the FLS Group, which includes all UK resident monetary financial institutions and related specialist mortgage lenders within a group.

⁵ If their lending expands by 7% for example, then they can draw down an amount of treasury bills equal to $(7+5=)$ 12% of their initial stock.

But each bank is in a different strategic position to start with. They will all have some portfolios they wish to shrink, and others to expand. But some were planning to reduce their overall stock of lending, given market conditions and their own capital and liquidity positions. And some had been ordered to reduce parts of their lending because they had received state aid. The FLS is not intended to undermine competitive and financial stability objectives by forcing banks to change such strategic decisions. What we do want to encourage is an expansion of their core portfolios. And we want to encourage new entrants to step in and pick up where the major banks cannot.

So the answer to the first question about the minimum allowance and asymmetric pricing structure is that they are designed to encourage more core lending from those banks who nevertheless must shrink their balance sheets in aggregate – the macro impacts of the FLS won't be sufficient unless those banks have an incentive to participate. And the banks who can expand lending will benefit from the lowest price and greater proportionate access. The scheme is designed so that every firm has the potential to use it to support lending.

But what this means is that we cannot expect every bank in the FLS to increase its stock of lending to the real economy over the 18-month period. It is to be expected that some firms still show an overall reduction, even if the FLS is successful. The crucial impact will be whether the FLS enables them to lend more than they would have done in its absence.

The Bank cannot give details of an individual firm's previous or new lending plans. It is for each of them to explain how the FLS enables them to support the economy. Most have already announced reductions in some interest rates or a loosening of other terms and conditions. Some will respond by lending to firms that they would previously not, because they can now earn a return that compensates for the extra risk. All these approaches will help.

Of course, one of the big problems facing a macroeconomic policy maker is the difficulty of setting out ex ante success criteria. We can't perform controlled experiments on the macro economy. What matters is whether policy makes the outcome better than it would otherwise have been – but that alternative reality – the 'counterfactual' in economic speak – is always a matter of conjecture and debate. Nevertheless I believe the scheme provides all the right incentives to increase the supply of credit.

A second problem for macroeconomic policy is that we cannot rely on the usual 'ceteris paribus' assumption of economic theory – when we make large changes in policy then everything else changes too, including the behaviour and expectations of those very people we are trying to influence. And policy effects which are relatively small can nevertheless be absolutely significant if the policy change is large enough. In fact, the FLS is designed to take advantage of the pressures to change behaviour.

The FLS provides strong incentives to banks and building societies themselves – because the more they lend, the more they benefit. Either because of the price effect on those deleveraging and/or quantity effects on those expanding. And we have built in incentives that enhance competitive pressures between the lenders. They cannot afford to miss out on lending opportunities – or their competitors will take advantage.

I think this will help answer the second question about whether lending will go to the people who are perceived as most need in need of it. The FLS does not seek to allocate credit to particular parts of the economy directly – the Bank is not taking a view on this matter. But SMEs and first time home buyers in particular are thought to be credit hungry. Banks will collectively need to meet that demand if they are individually to make the most of the FLS. Not necessarily every bank will support every sector. But if the big firms don't then the smaller banks will. We are relying on the pressures of demand and supply, and competition, to ensure that credit flows to where there is demand.

The normal business model of a bank is that their lending rates are related to their funding rates. The process for doing so is not immediate and funding from different sources – both retail and wholesale, secured and unsecured, might be used to support lending activities. There is no reason to think that the provision of cheaper funding via the FLS will cause a bank to change its business model in this regard. Indeed the incentives in the scheme are for banks and building societies to cut lending rates and hence lend more to get the cheapest funding. Since the scheme was announced we have seen widespread falls in funding costs across different sources and an equally wide variety of lending rate reductions. The final benefit in terms of lower lending rates is uncertain: I can envisage strategies in which the degree of pass through ends up being less than 100% or greater than 100%. The key point is that if the cost of funds is reduced, the supply of credit expands and hence the quantity of lending should rise.

So will the banks make more money as a result of the FLS? Well they should try to! The scheme depends on banks exploiting the opportunity to make more loans and more profitable loans because that is in everyone's interest. If they don't respond by lending more than they otherwise would have done, competition will probably mean that they make fewer profits because other firms will take their business. Shareholders should be urging management to take advantage of the opportunity. The fact that, by signing up, banks and building societies agree to the Bank of England publishing details of their usage of the scheme, means that pressure will be more intense.

What of the question on the state of demand? I have personally talked to businesses in many different parts of the country. Those SMEs who have got the finance they wanted – and many have, despite the unfavourable public commentary – complain about the length of time it has taken, the bureaucratic processes and the onerous terms and conditions. Few have actually complained to me about the price of their new loans – but many have come under pressure to renegotiate existing cheaper arrangements. So how will the FLS help?

Let's be clear on one thing. It is up to the banks whom they lend to. If a firm goes under, or simply can't repay its loan, that bank loses money: under the FLS the credit risk stays with the banks. And it is not our intention that banks put themselves at risk by making imprudent loans. Although there are many good quality businesses seeking extra credit, not every one is as good a credit risk as they might make out to their local journalist or MP, so we need to be wary of judgement by anecdote.

But the FLS will put the pressure on banks to lend where they profitably can. That may 'turn the conversation around' as banks do more to seek out lending opportunities rather than businesses or home buyers struggling to find accommodating banks. If demand for credit turns out to be weak then that will add to the competitive pressures on the supply of credit.

In summary, I am confident that the FLS will help the supply of credit. Before its introduction, it was more likely than not that the stock of credit would contract further over the next 18 months. Perhaps it still may. But any return to positive credit growth would be a better outcome than we could have previously hoped for.

But I want to underline one thing about the expected outcome: I expect banks' usage of the scheme to exceed their lending growth. Partly because I know some banks are acting against a base case of contraction. And partly because some of the funding could be used to refinance existing loans at cheaper rates. But also in the first instance, we have set it up so that the funding can be drawn down in advance or as it is needed, not with a delay. That is just one of the features designed with the macroeconomic benefits in mind. At every stage we asked ourselves how the design choice would best support lending growth. I believe we have made the right choices.

I would like to conclude by noting that one lesson from the crisis is just how important it is to have a properly functioning financial sector, expert in allocating savings to consumption and investment. Financial markets are not there to line the pockets of the participants. They exist because there are social and economic benefits from the services they provide. I believe most of the industry understands and accepts this. We need to focus on policies which encourage those benefits. For policy to be effective, it also needs to be joined up. The FLS, jointly launched by Bank and HM Treasury, and with supporting actions from the MPC, the FPC and the FSA shows that the new arrangements among these authorities can ensure that policies work together to get the economy back on track to meet the objectives of low and stable inflation, sustained growth and financial stability.