BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London
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2 December 2014

Dear Chancellor,

The Funding for Lending Scheme (FLS) was launched jointly by the Bank and HM Treasury in July 2012, when credit conditions across the economy were deteriorating, and high bank funding costs were being passed onto businesses and households either through higher lending rates or outright restrictions on access to credit. By providing a funding backstop and incentivising banks and building societies to boost their lending to the economy, the FLS supported access to credit across the economy.

Since its launch, the FLS has contributed to a substantial fall in bank funding costs. This has fed through to improvements in credit conditions for households and businesses. In parallel, as the banking system has returned to health, the Bank of England has reinforced its regular facilities. As economic conditions have begun to normalise, the need for a broad funding backstop has diminished.

It is appropriate to taper this temporary scheme as the need for it diminishes. That process began in November 2013 with the removal of incentives to increase lending to households. That decision reflected the significant improvement in credit conditions in the mortgage market.

As credit conditions for large corporations have also eased, it is now appropriate to taper further the FLS by removing specific incentives to lend to large corporates. However, there remains a case for extending the FLS for another year and to concentrate it where support remains most warranted: access to credit for SMEs.

Although credit conditions for SMEs have continued to improve, and net lending to SMEs by FLS participants over the course of 2014 has shown a positive trend, the improvement remains less marked than for other sectors, and net lending by FLS participants in Q3 remained negative. SMEs are also less likely than larger companies to have access to non-bank sources of finance.

As you are aware, there are various initiatives under way to improve the availability of credit to SMEs, which may ultimately have a greater long-term impact than a temporary scheme such as the FLS. These include the work of the British Business Bank, Government and Bank of England initiatives relating to the availability of credit information, and the joint Bank of England-ECB initiative to improve securitisation markets. While they are cumulatively significant, these measures will take some time to have full effect.

As you and I have discussed, there is merit in extending the FLS further in order to complement these measures as they take root. Accordingly, Bank and HM Treasury officials have finalised plans to extend the scheme by one year to allow drawings to the end of January 2016. Participants in the extended scheme will retain allowances earned by lending in 2013 and 2014, but will be able to earn additional allowances in 2015 only by lending to SMEs and to certain non-bank credit providers, which can be an important source of finance for some SMEs. Each £1 of net lending to SMEs will earn an additional allowance of £5 in the Scheme.

I have consulted both the Monetary Policy Committee (MPC) and the Financial Policy Committee (FPC) about these amendments to the FLS. The MPC has judged that there will be no material impact on the stance of monetary policy, and the Financial Policy Committee welcomes the changes.

This extension builds on the success of the FLS to date and ensures that it continues to provide support where it is still needed. I would be grateful if you would confirm that you are content with the proposed changes, and that the scheme remains within the remit of the Bank.

Yours sincerely,