

Paul Fisher: Financial markets, monetary policy and credit supply

Speech by Mr Paul Fisher, Executive Director for Markets of the Bank of England, Member of the Monetary Policy Committee, to Richmond University, London, 2 October 2013.

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Thank you for having me back at Richmond University. In this lecture today, I aim to review the behaviour and development of financial markets over the past year, including the period of heightened volatility since May and the introduction by the Monetary Policy Committee of explicit forward-looking monetary policy guidance in August. I will also assess the working and impact of the Funding for Lending Scheme over its first year of operation.

Developments in financial markets

When I spoke to you a year ago, financial markets were still scarred by the crisis years and there remained a number of significant downside tail risks to the global economy. Contacts were citing: the risks of a breakup of the euro-area; the possibility of a “fiscal cliff” in the US; a slowing in China, alongside already weak growth in the advanced economies; and tensions in the Middle East – especially around the Straits of Hormuz. But those tail risks were seen to be offset in large part by the commitment of central banks to respond. The ECB had announced its Outright Monetary Transactions programme and had been interpreted as publicly committing to do whatever it takes to keep the euro-area together. The FOMC similarly committed to keep the US economy growing, with state-contingent forward guidance being issued in December 2012. The MPC had voted to increase its stock of asset purchases to £375 billion in July 2012 and introduced the Funding for Lending Scheme (FLS). Taken together these factors were generating a growing “hunt for yield”, initially cautious and focussed on relatively simple, liquid financial instruments but gradually expanding, especially in terms of credit risk – for example “high yield” bonds were in particularly high demand, leading to historically compressed spreads.

Since then, we have seen a game of two halves. If I move on to around April this year, the picture had changed substantively relative to the autumn. The previously perceived tail risks were fading from discussions. Europe was making progress on a number of structural reforms, including moving towards a banking union. A mini-crisis in Cyprus had been dealt with, without too many spillovers. Spreads over bunds for sovereign debt of the larger vulnerable euro-area economies had narrowed considerably. The US “fiscal cliff” at end-2012 had passed by with some relief (although concerns about the processes associated with the US fiscal deficit have now resurfaced). While fiscal consolidation might have slowed US growth somewhat, the process of adjustment around the turn of the year had been smoother than feared and the macroeconomic repercussions rather less. China had injected some renewed stimulus and Japan had introduced a far reaching new economic framework of quantitative and qualitative easing to improve the outlook there. At that time, Middle East tensions had not induced further Western military intervention and the oil price had been relatively stable, falling to around the \$100pb mark. One could argue that central banks – and other authorities – had validated expectations.

During this period from the Autumn of 2012 to the Spring of 2013, financial markets were relatively calm but periods of “risk on” were lasting for longer and leading to greater risk taking. Equities and other risky asset prices generally rose. Interest rates were low and stable at the short end and increasingly depressed at longer maturities as the FOMC maintained its asset purchase programme. The hunt for yield intensified, especially down the credit spectrum, with some investors being driven by return targets, mandates and benchmarks rather than a true reflection of risk-adjusted returns. The volatility of market prices also became compressed during this period (*Chart 1*).

Chart 1
Implied volatility from various asset markets

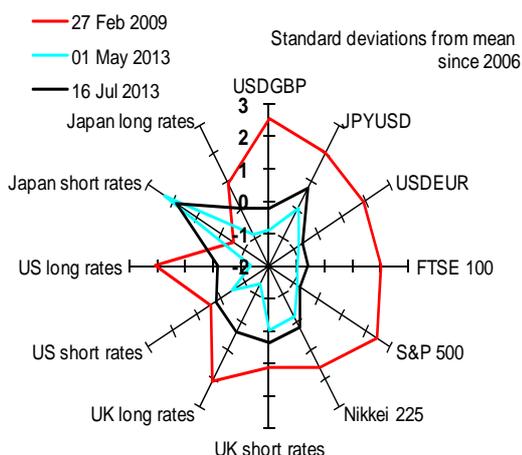
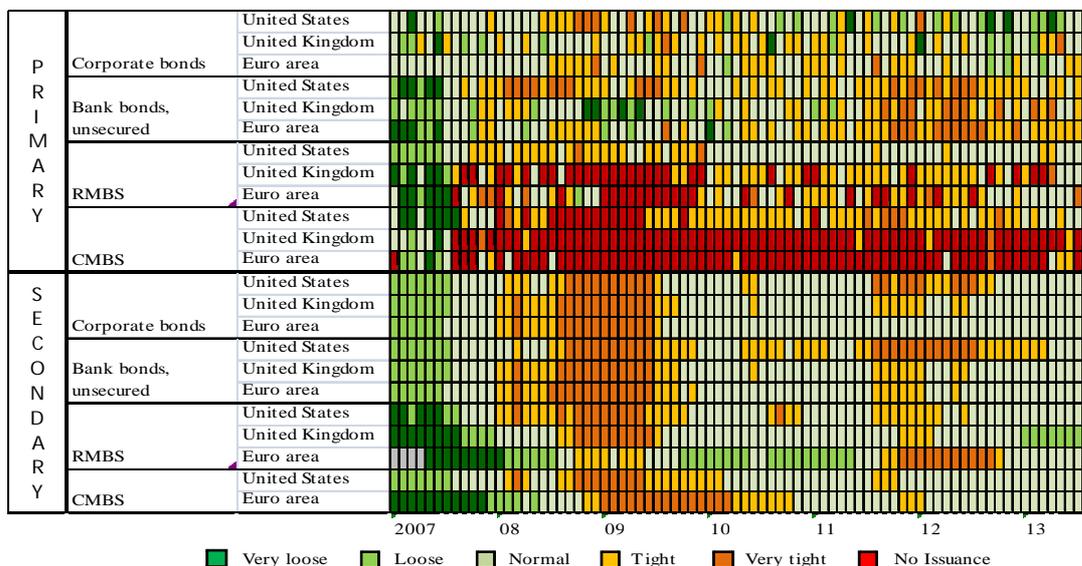


Chart 2 shows a “heat map” constructed by colleagues in the Bank’s Financial Stability Directorate, showing how market functioning has changed over time based on issuance levels and spreads. It tracks how most markets have continued to improve towards normal levels (on these indicators at least). An interesting exception is markets for bank funding instruments in Europe, which have become subdued as commercial banks have de-levered and central bank operations have provided cheap medium-term funding in large scale. Perhaps the worst functioning is the market for CMBS which has still not really returned in the UK (in contrast to CLOs which have made a comeback this year).

Chart 2
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 nominal GDP) and spreads in primary markets, and spreads in secondary markets, expressed as a number of standard deviations from its historical averages, using as much data as available data from January 1998. Primary market indicators reflect the past three months, so smooth volatility. Where spreads are not available, indicators are based solely on issuance.

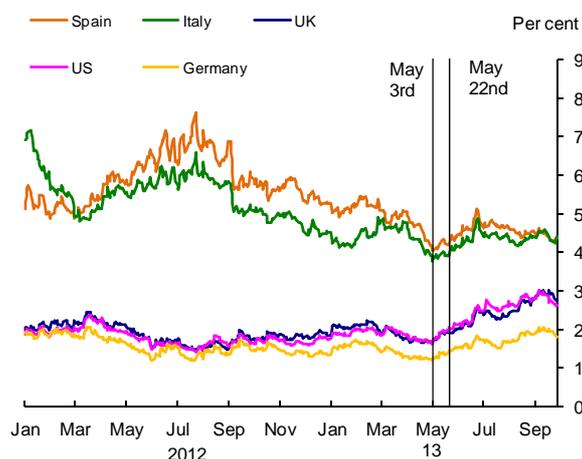
(b) Latest data point is August 2013.

Given such benign conditions it seemed natural to ask whether firms were prepared for the risk of a sudden change in conditions – in particular the possibility of a snap back in interest rates at some point. In early April, such questions to contacts usually evoked a blank response! Those who had been betting on rates rising had consistently lost money and such positions generally had been cut. There were few visible signs of any increase in hedging activity other than reports that some investors preferred floating rate rather than fixed rate products at the margin. A lot of faith seemed to be enshrined in the ability to anticipate the FOMC: that it would signal clearly and early what its strategy would be, leading to a smooth exit from its policy stance. Altogether the market was ripe for some volatility consequent to a change in the policy outlook. That volatility duly arrived.

The initial catalyst was the strong US non-farm payrolls data on May 3rd after which longer term yields started to rise. But there was not a wider market reaction at that point. It was Bernanke’s comments on May 22nd that the FOMC could begin tapering its asset purchases “in the next few meetings” which caused a widespread reassessment of risk positions. What followed was a good illustration of what can happen when there is a general sell-off. Initially asset price correlation increased and liquidity became poor across markets. Because the news related to a prospective policy tightening, risk-free yields generally rose (**Chart 3**), although at least some of this was a change in term premia rather than rate expectations. Equity markets fell. Some contacts described conditions as highly volatile. EME assets in particular were badly affected as leveraged investors cut their risk positions quickly in those markets (**Chart 4**). Eventually, as conditions settled, there was more discrimination between and within asset classes. For example, there has been much more distinction between those EMEs whose fundamentals were seen to be relatively sound and those who were seen to have challenges – in this latter group were especially those with both a large external deficit and high inflation.

Chart 3

Selected ten-year government bond yields^(a)

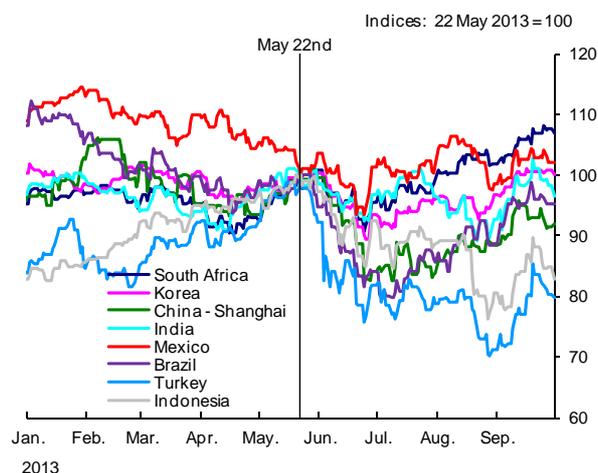


Source: Bloomberg.

(a) Yields to maturity on ten-year benchmark government bonds

Chart 4

Emerging market equity indices



Sources: Bloomberg and Bank calculations

Although the sell-off has been wide ranging and left several EMEs with difficult policy challenges, I don’t sense any long-lived market dysfunction. Market infrastructures worked and prices adjusted to the revised policy outlook. Yes, volatility rose, but not to levels which

are particularly unusual for such episodes (**Chart 1**). The most highly leveraged positions – such as in mortgage REITs¹ – were reported to have liquidated quickly, and some ETFs², primarily fixed-income, came under liquidity pressure. Those institutions with short trading horizons and leveraged positions may have found conditions very difficult at times to adjust portfolios. Although it is clear that a number of firms must have made substantial losses on the positions they had, there have not been many visible signs of severe financial distress. For most longer-term investors the stress has been seen as rather limited. Credit spreads have not particularly blown out with rising “risk-free” rates. For example, yields on Italian and Spanish bonds were remarkably stable for most of this period; advanced economy equity prices largely recovered; and “cov-lite” loans have continued to be issued at a record pace. Overall the system seems to have survived in reasonable shape and for many market participants the “shock” is seen as a healthy correction to what had become a complacent outlook.

As reported in the record of the recent FPC meeting published yesterday, staff from the FCA, PRA and Bank have carried out some analysis of the sensitivity of borrowers and financial institutions to upward movements in long-term interest rates and credit spreads.³ That preliminary work suggested that “a moderate rise in long-term interest rates did not pose an immediate threat to major banks and insurance companies. But borrowers would become more exposed to an increase in interest rates were debt levels to rise. And counterparty classes with higher leverage or exposures to market liquidity risk or credit spreads were more affected...”. The Committee did not draw too much comfort from this assessment and has asked that more detailed work be done to assess the risks.

What have we learned from this episode? I will pick out a few of the highlights for discussion. First let me note that the “stress” so far has not involved any actual exit from accommodative policies in the advanced economies. The change in the outlook was initiated by speculation about the possibility that the FOMC might start to slightly reduce the rate at which it is *adding* stimulus! It would have been a more severe stress if policy rates had actually been changed. Many firms for whom maturity transformation is a major part of their business model will actually be better off if the short-term rates at which they fund themselves are relatively unchanged while longer-term rates rise.

Have markets got it wrong? If so then in my view that was not obviously in the price reactions since May (although the extent of the fixed-income sell-off may turn out to have been overdone, especially for the UK) – rather it was the expectations that had become embedded *prior* to May which had become overly certain even if, at that time, it supported the intent of monetary policy in both the US and Europe.

It is important to remember that monetary policy is about decision making under uncertainty. **Considerable** uncertainty. Policy makers get surprised by economic developments just like everyone else, and that news is often visible to the market before the authorities can even think about the right responses, let alone respond to them. If I, as a policy maker, am uncertain about how policy will evolve, how can the market be so much more certain? I am continually struck by the degree of certainty some market participants seem to have about prospective monetary policy decisions, particularly those of the FOMC. In general, communication from monetary policy setters aims to convey details of our reaction functions – how policy might change in reaction to future data or other news – it is not aimed to convey the outcome of a decision that has yet to be made! The best we can usually do is to set out how we are thinking about the outlook so that market participants and others might be able

¹ Real Estate Investment Trusts

² Exchange Traded Funds

³ Record of the Financial Policy Committee meeting, 18 September 2013 (<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2013/record1310.pdf>)

dynamically to gauge our response as the data and events reveal themselves. Forward guidance, on which more shortly, can add to that understanding but the actual outcome for policy will always be dependent on how the economy, and hence the outlook, evolves.

Can we learn anything about the impact of large scale asset purchases – or quantitative easing – from this recent episode? More work will have to be done on this as a case study but, at face value, the fact that US Treasury yields could move by over 100bps just on speculation of a small reduction in the rate of purchases, confirms that asset purchases in the US must have been having a very sizable effect on market prices, at least as large as the quantitative estimates that have previously been made.⁴ And the degree of reaction in UK gilt yields makes it clear that there have been large international spillovers – a point which some previous research has also noted.⁵ The degree of correlation since May has been striking and for shorter-term rates, it is possible that it has been exacerbated by poor liquidity in money markets and hence over-done. Given how the recoveries have differed in scale and nature – the US economy has grown much more than the UK since the recession, and has not suffered the same collapse in productivity – one would surely expect the prospects for monetary policy to be quite different in the two jurisdictions.

A final issue I want to raise is whether market behaviour has been affected by regulatory changes. Over the past year or so many of the reforms being introduced internationally have been implemented or anticipated. In particular the future rules on capital and liquidity have become clearer, and proprietary trading has largely relocated away from the traditional intermediaries as a result of the “Volcker Rule”. The past five months has been the first stressful period since those changes. Many market contacts have suggested that liquidity during the recent sell-off has been worse than it would have been because the dealers are no longer willing or able to absorb volatility by taking client positions onto their balance sheet. They argue that the dealers’ ability and willingness to make markets has been much reduced. This is a subject of ongoing consideration in the official community. But we have to bear in mind that in a rapidly moving market, regardless of the regulations, no one has ever really wanted to “catch the falling knife”. And investors have always needed to be aware that crowded trades will hit a bottleneck if everyone tries to exit at the same time. On EME assets for example, liquidity during a “risk off” period has always been limited. In my view, we can’t draw any hard conclusions on this topic yet and more evidence is needed.

Forward guidance

It was in an environment of increased volatility that the MPC decided at its August policy meeting to provide some explicit guidance regarding the future path of our monetary policy instruments. Since our announcement it has been suggested that this policy is overly complicated. I disagree. The policy was summarised in a single sentence in our explanatory document:⁶

“In essence, the MPC judges that, until the margin of slack within the economy has narrowed significantly, it will be appropriate to maintain the current exceptionally stimulative stance of monetary policy, provided that such an approach remains consistent with its primary objective of price stability and does not endanger financial stability.”

⁴ For example, Gagnon, Raskin, Remache and Sack (2010) estimated that the Fed’s first round of Large Scale Asset Purchases reduced 10-year term premium by somewhere between 30 and 100 basis points, with most estimates in the lower and middle thirds of this range.

⁵ For instance, Neely (2010) finds evidence of significant spillovers from the Federal Reserve’s LSAPs to other advanced economy sovereign bond markets, with yields falling on average by around half the associated fall in US 10-year yields, while Moore, Nam, Suh and Tepper (2013) find that emerging economy government bond yields fell by around a sixth.

⁶ Monetary Policy Trade-Offs and Forward Guidance, Bank of England, August 2013 (<http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13augforwardguidance.pdf>)

In case that's not sufficiently simple, let me put it the other way round: we remain committed to returning CPI inflation to its 2% target in line with our remit but, in doing so, we will not act in a way which would risk choking off the recovery prematurely, given the potential for a substantial amount of spare capacity in the economy.

The technical details of the policy are needed to make this precise so that it can be implemented and monitored: the MPC intends not to raise Bank Rate from its current level of 0.5% at least until the Labour Force Survey headline measure of the unemployment rate has fallen to a threshold of 7%. The MPC stands ready to undertake further asset purchases while the unemployment rate remains above 7% if it judges that additional monetary stimulus is warranted but will otherwise maintain the stock of asset purchases and will reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility.

This guidance linking Bank Rate and asset sales to the unemployment threshold would cease to hold if any of the following three "knockouts" were breached:

- if, in the MPC's view, it is more likely than not, that CPI inflation 18 to 24 months ahead will be 0.5 percentage points or more above the 2% target;
- if medium-term inflation expectations no longer remain sufficiently well anchored;
- if the Financial Policy Committee (FPC) judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

Explicit forward policy guidance can enhance the effectiveness of monetary stimulus in three ways. First, it provides greater clarity regarding the MPC's view of the appropriate trade-off between the speed with which inflation is returned to the target and the support given to the recovery. Second, it can reduce uncertainty about the future path of monetary policy as the economy recovers. And third, it delivers a robust framework within which the MPC can explore the scope for economic expansion without putting price stability and financial stability at risk.

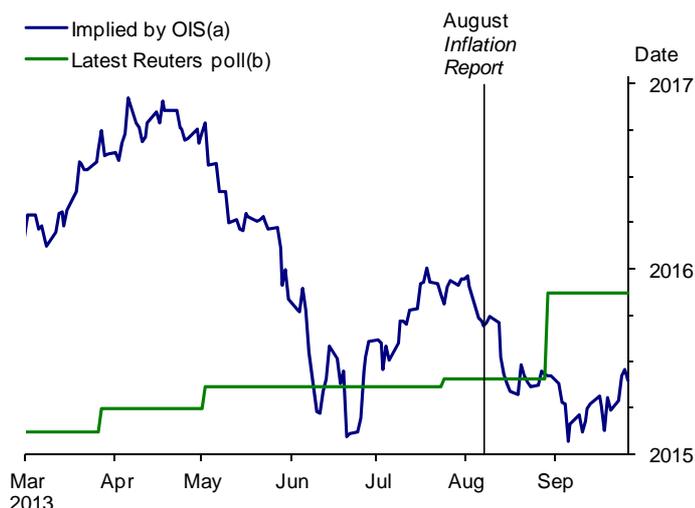
This latter point is especially important to grasp in order to understand the intent of the policy. Since 2008, aggregate productivity in the UK – measured as output per hour worked – has behaved unlike any previous recession/recovery. The level of productivity in the economy as a whole today is around 15% below where it would have been on an unchanged long-term trend. We don't know how much of this productivity gap can be reclaimed. But if even only a small part could be recovered then output should be able to grow strongly for some years without generating much inflationary pressure. In particular, firms should collectively be carrying enough spare labour to expand output without putting pressure on the labour market. Unemployment would consequently fall slowly relative to normal experience, for a given rate of output growth.

It is important to stress that forward guidance is not a guarantee to hold rates where they are for a set period of *time*, as has been widely mis-reported. The guidance is given in the form it is precisely because the outlook is uncertain – it allows us to explore how much spare capacity there really is in the economy before raising Bank Rate.

Much has been made of the market reaction to forward guidance since its launch, with market prices currently implying that Bank Rate will rise by 25 basis points by the middle of 2015, around six months earlier than at the time of our August meeting. I think there are a range of reasons for that and it does not necessarily imply that forward guidance "isn't working". First, gauging the "market reaction" depends who you ask. Surveys of economists by Thompson Reuters and by Bloomberg have indicated that the median expected timing of the first increase in Bank Rate has been pushed *later* since our announcement (**Chart 5**). Second, there has been UK specific news which might have justifiably caused UK rates to

have risen somewhat: the positive flow of economic data since the start of August has been consistently stronger than market expectations. Third, UK rates have clearly been pushed up by international developments. The correlation in short rates between the UK and US is unhelpful given the relatively subdued recovery in the UK and, as I have already noted, somewhat puzzling. It probably, in part, reflects continuing poor liquidity in sterling money markets over this period. It may well be the case that these rates decouple in future as liquidity improves and the outlook for each economy develops further.

Chart 5
Indicators of when Bank Rate is expected to have risen



Sources: Bloomberg, Reuters and Bank calculations

(a) Series is calculated as the first date at which instantaneous forward OIS rates equal or exceed 0.75%

(b) Reuters poll shows the median of economists' expectations of the first rise in Bank Rate. This is based on a survey of economists' responses to the question: "When do you expect the Bank of England to change rates next?"

Whatever the explanation for the recent rise in interest rates, we do not intend to maintain a running commentary on whether the market has got it right or wrong in relation to when Bank Rate will rise. Monetary policy is a medium-term game, and its success or failure cannot be judged over a matter of weeks or by volatile price movements. If market expectations are in the wrong place then market participants will realise that in due course and rates will adjust. In any case, in my personal view, the biggest impact from forward guidance was never going to be from trying to shift the sterling market curve around – it is still pretty flat for 2 years ahead. The important thing is to get the message across to businesses and households about what the outlook for monetary policy really is. Concern that interest rates will rise as soon as growth returns may well have been a factor already holding back the recovery.

It's a case of so far, so good, on that front. The early reactions we are getting from individuals or groups of business people generally suggest that they have got the message and that will be adding to confidence. For example, the Bank's latest public survey shows a marked reduction in the proportion of people expecting a rise in interest rates over the next year – it's currently the lowest reading since Bank Rate was cut sharply in late 2008 at the height of the financial crisis. So in terms of supporting the real economy, I think the policy is working.

Forward guidance is an important part of the broader mixed strategy the Bank is employing, using many of its tools to secure the recovery while not taking risks with inflation or financial stability. For example, the FPC and PRA have been working to ensure UK banks and building societies have sufficient capital to help support and sustain the recovery. And they will remain vigilant to make sure that macroeconomic stimulus does not translate into imprudent lending behaviour. Another strand of policy is the Funding for Lending Scheme, which is where I would like to turn now.

The Funding for Lending Scheme: one year on

It was on the day of this lecture last year that the Bank of England announced the first 13 banks and building societies to have signed up to the FLS. There are now over 40 firms participating, representing over 80% of the stock of lending to the UK economy. The total amount of outstanding drawings under the Scheme is over £17bn and rising. The MPC has been using a wide range of indicators at various stages of the transmission mechanism to help assess the extent to which credit conditions have improved since its launch. Let me run through those.

Stage 1: bank funding costs

Our first objective was to reduce bank funding costs – and this phase has been remarkably successful. Over the past year, those costs have fallen sharply (**Chart 6**). Of course, they are likely to have been affected by developments internationally, including Mario Draghi's "do whatever it takes" remarks in July 2012. But usually sterling funding markets would react by less than euro-denominated markets to European developments. In fact, UK unsecured bond spreads fell further in the UK than in core euro-area countries – indicative of an additional boost from the FLS over and above general market developments.

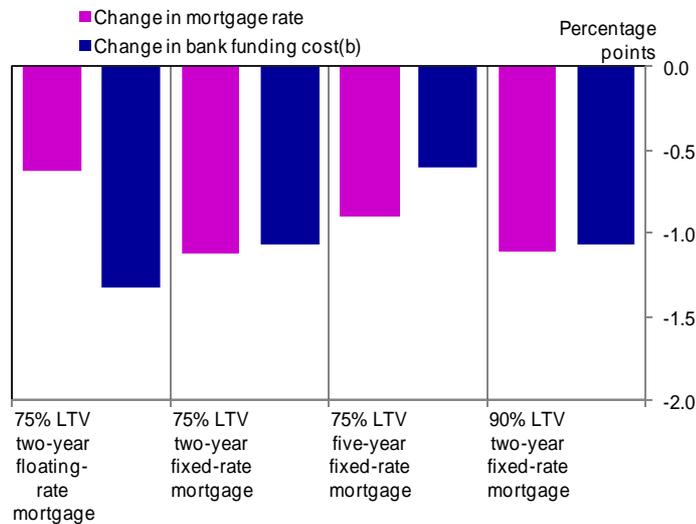
Indeed, funding conditions have improved so much (not just in prices but in terms of quantities) that it is safe to say that bank funding is no longer a constraint on lending for most UK banks – the larger banks tell us that they are "awash" with liquidity. If you were to go back around two years, tightening funding conditions for the banking system was one of the big issues policy makers and banks were discussing, and it's striking to see how conditions have changed completely since then. Costs have come down so much that some banks have been able to get funding in the market as cheaply, or cheaper, than we are providing in the Scheme. This is important to understand – it means the scale of FLS draw downs is not a measure of success. In fact the more stressed market conditions are, and the higher market funding costs rise, the more we would expect banks to draw from the Scheme. Going forward, the FLS should help to keep funding costs down by serving as a backstop marginal funding source if market funding costs were to rise.

Stage 2: quoted terms and credit availability

The second stage in achieving our objective was a reduction in lending rates to the economy and an improvement in credit availability. This has happened, albeit more slowly than initially anticipated. On average we've seen rates on two-year fixed rate mortgage products come down by around 110bps since the FLS was announced, and floating rate mortgages by a bit less (around 60bps) (**Chart 6**). The availability of household credit, particularly secured credit, has improved according to recent Credit Conditions Surveys by the Bank of England.

Chart 6

Changes in quoted mortgage rates and indicative UK bank funding costs over the first year of the FLS^(a)



Sources: Bank of England, Bloomberg and Bank calculations.

^(a) Change between 30 June 2012 and 30 June 2013.

^(b) For fixed-rate mortgages, calculated as the sum of indicative UK bank secondary market bond spreads and the swap rate corresponding to the term of the mortgage. For floating-rate mortgages, three-month Libor is used in place of a swap rate. For more details see Chart 1.8 of the August 2013 *Inflation Report*.

It's harder to measure what has happened to lending rates to businesses as the borrowers and loan products available are less homogenous than in the household sector. Lenders report that loan spreads have fallen for companies of all sizes, and that credit availability has increased, but the improvement has been less marked for small and medium-sized businesses. We have seen banks take different approaches to SME loans: one bank has scrapped some of its arrangement fees, another is offering guaranteed discounted borrowing costs and another offers a cash back scheme. So one can't capture the impact of the FLS on the cost of borrowing for businesses in a single simple, headline, interest rate measure. Survey evidence from the Federation of Small Businesses suggests that the pricing of loans for small businesses was more favourable in 2013 Q2 than in mid-2012 – but availability was reportedly poor. So it's a mixed picture overall for SMEs. Going forward, SME credit conditions should be supported by the extension to the FLS announced in April, which provides additional incentives for participants to increase lending to SMEs both this year and in 2014. A large proportion of FLS participants have indicated their intention to participate in the extended Scheme.

It is likely that any person or business who has borrowed from a bank since the middle of last year will have done so at a cheaper rate than they would have done in the absence of the Scheme. If so then the FLS will have had a monetary impulse on the economy. We think that the FLS will continue to bear down on lending rates to households and businesses in the rest of this year and beyond.

Stage 3: loan applications and approvals

The next stage is for the reduction in rates to induce an increase in the demand for credit. A key parameter for the response in quantities is the price elasticity of demand for credit. We have been hearing lots of positive comments about the state of demand in the housing

market since early in the year: from builders, estate agents, lenders and contacts of our regional network of Agents, and this has recently reflected into an improvement in the data.

Let me note that although the housing market is clearly gathering momentum, and house prices have started to hit the headlines, I must say that don't see any evidence of bubble behaviour as yet, with mortgage lending still subdued relative to what is likely to be normal levels of activity. The housing market is recovering from a number of years of very low transactions, with house prices having risen well below the inflation rate. It is not surprising if we see an adjustment of relative prices when the market recovers and of course London has special demand pressures which are not present elsewhere in the UK, especially for high-end housing. But we may well see a response in new housing supply in due course, limiting the effects of demand on house prices. Let me assure you that the Bank will not be complacent about allowing financial stability risks to build through an over-expansion of the housing market. Both borrowers and lenders need to be careful not to over-stretch themselves. In line with the recent FPC statement, we will be keeping a very close eye on developments, and the Bank has a range of tools that can be used in mitigation of those risks.

Stage 4: the flow of credit

Annual growth in the stock of lending to households and businesses has remained close to zero since mid-2012, similar to rates seen in the run-up to the launch of the FLS. But it is important to bear in mind that prior to the announcement of the FLS, the Bank judged that UK bank lending was more likely to decline than increase over the following eighteen months. The profile of lending seen to date has been broadly in line with our original expectations: the trend in household net lending has been somewhat stronger than expected before the launch of the FLS and net lending to businesses has been perhaps a little weaker.

We were also conscious that the stock of credit depends on both supply and demand. We were sure that the FLS would shift supply but the demand effects were always less certain. The price elasticity for firms in particular is likely to be low. It is possible at the margin that some firms will be better able to repay or refinance loans if their borrowing costs are a bit lower, but this effect is probably small relative to the importance of expected demand for a firm's products. So the scale of response in the overall flow of credit to businesses depends in part on a wider confidence effect shifting the demand curve. We may finally be seeing that restoration of business confidence in which case the flow of credit to businesses should pick up.

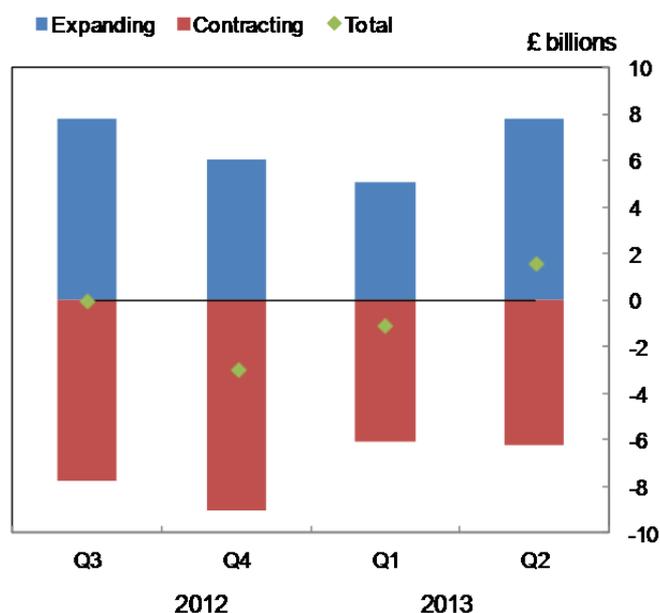
Beneath that aggregate narrative, there are some revealing stories in the details. The data we publish each quarter reveal material differences in net lending volumes across participants in the Scheme.

The main lenders are in quite different places (**Chart 7**). For example, 30 out of 41 participating groups have had positive net lending since the launch of the scheme, despite the slight contraction in the aggregate numbers. Together, these groups lent a net £25bn to the UK real economy, while the eleven groups that contracted their net lending did so by a combined £28bn. That in part reflects a desire by several major UK lenders to reduce the scale of their so-called "non-core" loan portfolios following the financial crisis, or a need to comply with State Aid conditions. So these banks may not see material increases in their total lending, even if they use the FLS to the full to support their core activities.

There are other factors at play. For example, nearly half of bank and building society lending to businesses is to the commercial property sector and a good part of the rest will be secured on property. Pre-crisis, banks lent too much money, too cheaply, to too many borrowers, especially in this sector. Many of those assets remain impaired and are being run off or sold off where possible, negatively impacting banks' lending figures. And given the losses suffered by most banks on these portfolios, there is a natural reluctance to increase lending to that sector again. One reason we've not yet seen a significant expansion in total lending is

that banks have tightened their credit assessment criteria since the crisis and have not changed them following the launch of the FLS. Some borrowers will find that frustrating. But from the banks' point of view it is a prudent thing to have done, so they don't get back into the troubles they were in before.

Chart 7
Net lending by FLS participants^(a)



- (a) Net flows of sterling lending to UK households and private non-financial corporations. Non-seasonally adjusted.
 (b) The sum of net lending by those participants with positive net lending during the quarter.
 (c) The sum of net lending by those participants with negative net lending during the quarter.

When considering the corporate lending numbers, it is important to remember that many companies (particularly large firms) are making increased use of capital markets to raise finance. Bond issuance by UK businesses remained strong in 2013 Q2, following a Q1 figure which was the highest since 2009 Q2. And the Bank's Agents have heard reports of some smaller businesses preferring to seek out non-bank alternatives for finance, including peer-to-peer lending, insurance companies and investment funds to diversify their funding sources. So when assessing trends in credit supply, it is important to consider flows of lending from all sources, not just the banks. The extension to the FLS to include lending related to non-bank credit providers (including finance leasing corporations and factoring companies) recognises the importance of some of these forms of lending to SMEs.

Finally, there are a number of small "challenger" banks who are successfully using the FLS to help expand and take market share from the more traditional lenders.

You sometimes see the phrase "the banks are not lending to SMEs". That is simply not true when you look into the details. The data on SME lending is not fully comprehensive nor of the best quality. But the data we do have suggest that since the launch of the Scheme, gross lending to SMEs has been around £40bn, although repayments have been slightly higher, so the overall picture of slightly negative net lending is the difference between two much larger numbers. Within that aggregate picture there are many individual banks which have expanded their net lending to SMEs whilst others have contracted. That is partly why I have been advising business contacts to "shop around" for credit if they can.

Overall, I believe the FLS has successfully shifted the supply of credit to households and businesses over the past year, and is achieving its policy objectives. Loans have been available at lower cost than previously and a range of indicators suggest that credit conditions are steadily improving for households and firms. How much more borrowing there is in total will depend in part on what happens to the demand for credit, and also (crucially) on banks' assessment of the creditworthiness of borrowers. Bank staff projections for net lending to the real economy, consistent with the MPC's outlook for growth in the August *Inflation Report* and with recent improvements in indicators of credit conditions, suggest that overall credit growth is likely to pick up, becoming modestly positive overall during the second half of the year. This is also consistent with the collective views of the FLS participants.

Conclusion

In conclusion, we have seen some very significant developments over the past year. Financial markets have become less stressed about tail risks in the global economy and more stressed about the outlook for monetary policy, particularly in the US. In the UK we appear to have seen an abrupt resurgence in business and consumer confidence associated with renewed growth, albeit only at around trend rates so far. The MPC remains committed to achieving its 2% inflation target but subject to that, and to continuing financial stability, Bank Rate will not be raised until we have seen unemployment fall to at least 7% so we can explore just how much spare capacity there is in the economy. Meanwhile the Funding for Lending Scheme continues to support the supply of credit in the UK and has become more focussed on encouraging lending to SMEs. The outlook – as always – remains very uncertain. But it is certainly a brighter picture than it was a year ago, and with policy set to be supportive, there are good reasons for expecting that improvement to continue.