The Funding for Lending Scheme as the Bank of England's incentive to boost lending

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Introduction

Central banks of the leading industrialized nations have been forced to introduce unconventional monetary policies in the wake of the global financial crisis. The United Kingdom's central bank, the Bank of England (BOE), was no exception and it too has adopted quantitative easing (QE) since March 2009 as an unconventional monetary policy. Specifically, it conducted Large Scale Asset Purchase (LSAP) of government

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bonds, which it described as QE. This is in contrast to the Federal Reserve System (FRS), the U.S.' central bank, which has almost never used the term QE by themselves.

The QE adopted by the BOE cannot be described as having been a major success. The BOE also adopted the Funding for Lending Scheme (FLS), which gives commercial banks access to cheaper money by allowing them to borrow UK Treasury Bills (TB) in exchange for eligible collateral. However, the scheme did not lead to an increase in bank lending. The BOE made some minor changes to the scheme, which put more emphasis on lending to small and medium-sized enterprises (SMEs). However, this move did not achieve much success either. This paper will study the BOE's crisis management efforts. The purpose is to show the limitations of the policy by studying the reasons why the policy did not achieve its objective of increasing lending.

I. BOE's QE as an emergency response

The default in subprime loans in the United States also had serious repercussions on financial institutions in Europe. In Great Britain, for example, Northern Rock suffered a liquidity crunch in September 2007. It caused a bank run that was described as Great Britain's first in 140 years. Northern Rock was originally a building society that became a bank in 1997. It then began to take an expansionary policy and grew to become a major mortgage lender. It depended on the market to raise funds such as through the issuance of mortgage-backed securities (MBS), rather than on retail banking. However, in August 2007, BNP Paribas froze some of its funds (that were invested in MBS among others in the United States), causing turmoil in the market. Northern Rock's MBS (consisting of the bank's domestic housing loans) failed to sell and the bank was threatened with a liquidity problem.

In response, the BOE provided Northern Rock with a liquidity support facility. In normal times, Great Britain adopted the lagged reserve accounting system for its reserve requirements. It is unique in that financial institutions are able to choose their own reserve requirements. Under the system, the BOE fully provided the macro demand for reserves known at the start of the reserve requirement period on an average balance basis throughout the term, while it required that individual financial institutions hold an average balance to within 1 percent, either higher or lower, of its voluntary reserve target. The system was designed so that both shortfalls and excesses of reserves relative to the bank's own target would result in a penalty. The penalty is that the balance is not remunerated at the Bank Rate.

There are neither excess reserves above the top of the target range or shortfall of reserves below the bottom of the target range under ordinary circumstances. I will omit a detailed explanation [1], but if the BOE had injected liquidity for Northern Rock this would have led to excess reserves in macro terms. Thus, to avoid having to impose a penalty for excess reserves, the BOE at this point responded by expanding the target balance.

However, it was difficult to conduct either QE or LSAP under these circumstances. Thus the BOE set the Bank Rate at 0.5 percent, in the neighborhood of zero in March 2009. At the same time it introduced a QE policy by aiming to increase the reserve deposit through the large-scale purchase of government bonds. At this point banks were not required to report their target balance, and the reserve deposit accounts are remunerated at the Bank Rate in full.

Moreover, the massive purchase of gilts was not conducted directly by the BOE but through its subsidiary, the Asset Purchase Facility (APF). The BOE provided money to the APF to purchase the gilts. Another characteristic of this British system is that the government will cover any loss incurred by the APF.

At the time of March 2009, the government had set a maximum ceiling of 150 billion pounds for the APF to spend in buying bonds. Later in August of the same year, the ceiling was raised to 175 billion pounds. It was lifted again to 200 billion pounds in November. This purchase of assets was temporarily suspended in January 2010 and the ceiling was left unchanged.

The scale of asset purchases through the APF was increased to 275 billion pounds

[1] See Saito [2014] for details

in October 2011. It was hiked to 325 billion pounds in February 2012 and 375 billion pounds in July of the same year. There has been no change up to the present to the ceiling.

At the time of its introduction, the BOE provided the public with a very simple monetarist explanation for the effectiveness of its QE policy. It said that the supply of base money would lead to an increase in money supply, which in turn would help boost consumer prices and stimulate the economy. However, as is clear from Japan's experience with QE, in Britain to the increase in the supply of base money did not lead to a rise in the money supply.

The BOE was thus forced to abandon its explanation to the general public about the effectiveness of its QE policy. It then adopted the following explanation to replace it. It said that the BOE (or APF) was mainly buying gilts from institutional investors such as pension funds and insurance companies. The price of government bonds rose due to massive buying by the BOE, causing the long-term interest rate to decline. Pension funds and other institutional investors made a profit from the sales of gilts to the BOE. The use of the money (bank deposit) gained would be applied to buying other assets (such as corporate bonds), which would cause the price to rise (meaning a decline in interest rates). The reasoning was that the increase in value of assets and the decline in borrowing costs due to a slide in the interest rates would lead to a rise in expenditure and output for the whole economy[2].

Former Bank of England Governor Mervyn King, while frankly acknowledging that it was unclear how effective these measures were, said there was a strong possibility that the economy would have been hurt if these QE measures had not been introduced[3]. As has been demonstrated, it cannot be said that the BOE's massive purchase of gilts had a clear positive influence. This can be seen as a policy that was introduced experimentally after policy interest rates were around zero and its effectiveness and its side effects were not

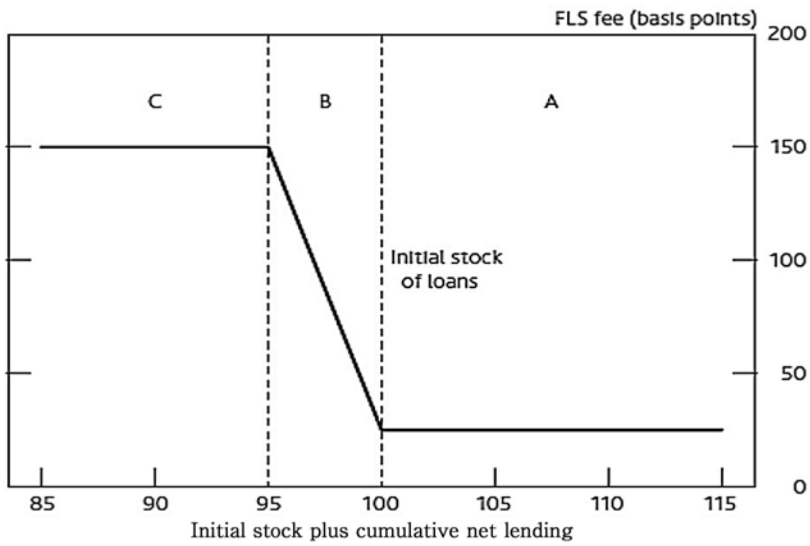
[2] See McLeay et al. [2014b] for an explanation of the effectiveness of the BOE's QE. The paper is worthy of note also for completely denying the money multiplier approach that the base money supply leads to an increase in money supply.

[3] See King [2012]

necessarily clear.

II. The FLS as a means to cut funding costs for financial institutions

QE was not the only policy that the BOE adopted to fight the crisis in question. Another policy was the Funding for Lending Scheme (FLS), which was established in July 2012[4]. (The actual operation of the scheme began in August 2012). This scheme was adopted because excess reserves due to QE did not lead either to an increase in lending nor to a rise in the money supply. The scheme aims to encourage banks to increase their lending by lowering the cost to raise funds.



(a) All numbers are indexed relative to the initial stock of loans = 100.

Figure 1 : Fee charged on FLS funding (a)

Source: Churm et al. [2012] p.309.

Under FLS, commercial banks are able to exchange collateral for Treasury Bills (TB) at a fee of 0.25% per year. This allows banks to use the TBs as backing to borrow funds at low rates, and it was hoped that the initiative would have a positive impact on lending. The BOE and the Treasury jointly designed the scheme, and the TB exchanged

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[4] Churm et al. [2012] provides comments from BOE staffs on FLS

was created specifically for this scheme.

Each financial institution was eligible to borrow TBs equivalent to up to 5 percent of its stock of existing loans as of the end of June 2012. Furthermore, financial institutions could borrow additional TBs equal to any positive net lending from June 2012 to December 2013. The fee for this was set at 0.25 percent a year. No upper limit was set. However, banks that contract their stock of loans by more than 5 percent pay a maximum fee of 1.5 percent. (Figure 1) It is fair to describe this measure as designed to provide financial institutions with incentives to increase lending in order to expand the money supply.

It goes without saying that banks that do not wish to increase lending, or which anticipate a decline in lending need not join the scheme. (HSBC, for example, did not join.) It tried to stimulate lending by imposing a penalty in this manner. However, it is safe to say that the system did not increase lending significantly. Lending in particular to corporations remained in a slump. Lending to individuals increased a touch, and some have pointed out that this stimulated speculation in housing and was one reason housing prices in areas such as London skyrocketed.

The participating banks' loans outstanding amounted to 1.36 trillion pounds at the end of June 2012. Five percent of this amount is 68.0 billion pounds. Banks drew down 4.36 billion pounds in TBs in the third quarter of 2012. In the fourth quarter, it was 9.472 billion pounds. These cannot be described as a large amount. Although actual loans increased by 923 million pounds in the third quarter of 2012, they fell by about 2.635 billion pounds in the fourth quarter. The results were the opposite of that aimed by the scheme. The loans outstanding increased in the second quarter of 2013. It inched up after this, but the value of TBs withdrawn amounted to about 41.876 billion pounds at the end of January 2014. The cumulative increase in lending was 10.289 billion pounds. (Table 1)

Table 1 : FLS T-Bill drawing and net lending (First Part)

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn) (B)	(B)/(A)%
1,401,434	243	−2,635	−1,089	1,813	6,174	5,782	10,289	0.7%
	Quarterly net FLS T−Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	4,360	9,472	2,621	1,118	5,524	18,785	41,876	

Source: Bank of England

The cumulative increase in the TBs that were drawn down was far from 70 billion pounds, which is about 5 percent of loans outstanding at the end of June 2012. In other words, the initially desired amount of drawdowns was not achieved. In addition, the increase in the cumulative lending was a mere 0.7 percent in contrast to the balance of lending.

III. Minor changes made to the FLS to encourage lending to SMEs

The FLS was initially due to run from August 2012 to January 2014, but the scheme was extended by one year in April 2013. The scheme was not achieving the desired result, but it appears to have been judged important to provide financial institutions with an incentive to lend money. However, it is true at the same time that the situation called into question whether the initiative should be continued. Moreover, the scheme was expanded to include non-banks in addition to banks and building societies.

The FLS failed to achieve its initial desired results, and minor changes were introduced in the second part of the scheme that began in February 2014. One of the changes was that each participant was entitled to an Initial Borrowing Allowance (IBA) that is equal to ten times its net lending to SMEs from April to December 2013. The fee was 0.25 percent across-the-board. It was at this point that the FLS' policy of emphasizing lending to SMEs was clearly established.

At this time, Mark Carney was serving as the governor of the BOE after assuming the post in July 2013. Carney, who was Canadian, attracted attention as the first non-British person to head the Bank in the central bank's history of more than 300 years. He has since become a British citizen. No changes have been made in the Bank Rate or the APF's asset purchase ceiling since he became the BOE governor.

The decision to extend the FLS was made during the term of Carney's predecessor, Mervyn King, but the minor changes to the scheme were introduced after Carney became the Governor. The implementation of the FLS was again extended by one year to January 2016 in December 2014 under Carney. Further changes were also made to the program.

This was the condition of the Additional Borrowing Allowance (ABA) provided under the second part of the FLS. For loans to SMEs, each participant will receive an ABA that is five times its net lending during January to December 2014. It will be able to draw down TBs that is equal to its net lending during that period for other businesses. Here again, the fee was 0.25 percent across-the-board. It is worth noting that loans to households were excluded. In 2013, Non Bank Credit Providers (NBCP) and housing related non-banks were included in the scheme.

In addition since January 2015, conditions were set for Further Borrowing Allowance (FBA) to promote lending to SMEs. Each participant will generate a FBA that is five times net lending to SMEs in 2015. For NBCPs, the drawdown in TBs will be equal to net lending in 2015. However, housing related non-banks were excluded from the NBCP.

The reasons for the revision to the system can be attributed to the BOE's concerns about the rise in housing prices. The central bank concluded that it should take steps to try to curb an increase in mortgage lending. In October 2014, the Financial Policy Committee (FPC), which is a BOE committee in charge of financial stability, announced that it has been given new powers to place limits on mortgage lending. It said it planned to study introducing new restrictions. Specifically, FPC was given powers to make recommendations to the Prudential Regulation Authority (PRA) -- which is a subsidiary of the BOE -- and the Financial Conduct Authority (FCA) – which is an independent financial regulatory body. The FPC made recommendations on maximum Loan to Value (LTV) ratios and Loan to Income (LTI) rations. Steering of the monetary policy faced challenges also in terms of risk management.

The achievements of the second part of the FLS are also rather poor. First, let us look at the overall TB borrowing allowance. The Initial Borrowing Allowance (IBA), which is equal to the participants' net lending from April to December 2013, was 36.772 billion pounds. In contrast, the net TB borrowed was limited to 18.726 billion pounds. Moreover, the Additional Borrowing Allowance (ABA) – which is calculated from net lending in 2014 -- fell dramatically to 10.362 billion pounds because only a handful of financial institutions reported an increase in loans and also because loans to households were excluded, a matter that I will go into further detail later. In addition, the Further Borrowing Allowance (FBA), which is based on net lending in 2015 (limited to the first quarter of 2015), was 3.073 billion pounds.

The big issue here is the fact that the net lending of financial institutions posted a negative. Lending fell by 15.818 billion pounds in 2014. A breakdown shows that lending to large firms fell by a sharp 14.087 billion pounds. Those to SME's, which is the target of the policy, tumbled by 1.986 billion pounds. These figures clearly demonstrate the failure of the system. (Table 2)

Table 2 : FLS T-Bill drawing and net lending (Second Part)

(£mn)

	Stock of loans to UK PNFCs and NBCPs				FLS drawings 31/03/2015	
	Total	large corp.	SMEs	NBCPs		
31/12/2013	247,552	138,222	108,908	422	57,287	IBA(①)
	Net lending flows				FLS drawings	36,772
Q1 2014	−2,649	−2,101	−730	−183	2,012	ABA(②)
Q2 2014	−3,822	−3,455	−345	−22	3,243	10,362
Q3 2014	−2,477	−2,265	−100	−81	1,957	FBA(③)
Q4 2014	−6,900	−6,266	−811	178	8,441	4,911
Q1 2015	635		615	20	3,073	①+②+③
					(Total) 18,726	52,045

Source: Bank of England

IV. Trend among top banks

The borrowing allowance of TBs has increased despite the decline in overall volume of lending because while on the one hand there are financial institutions reporting a decrease in the value of their loans and their borrowing allowance are near zero, there are financial institutions reporting increases in borrowing allowance. This situation makes it important to study the situation of each financial institution individually. In this section I will focus on the condition of the top banks. This is because under the British financial system the large banks have a strong influence over the whole industry.

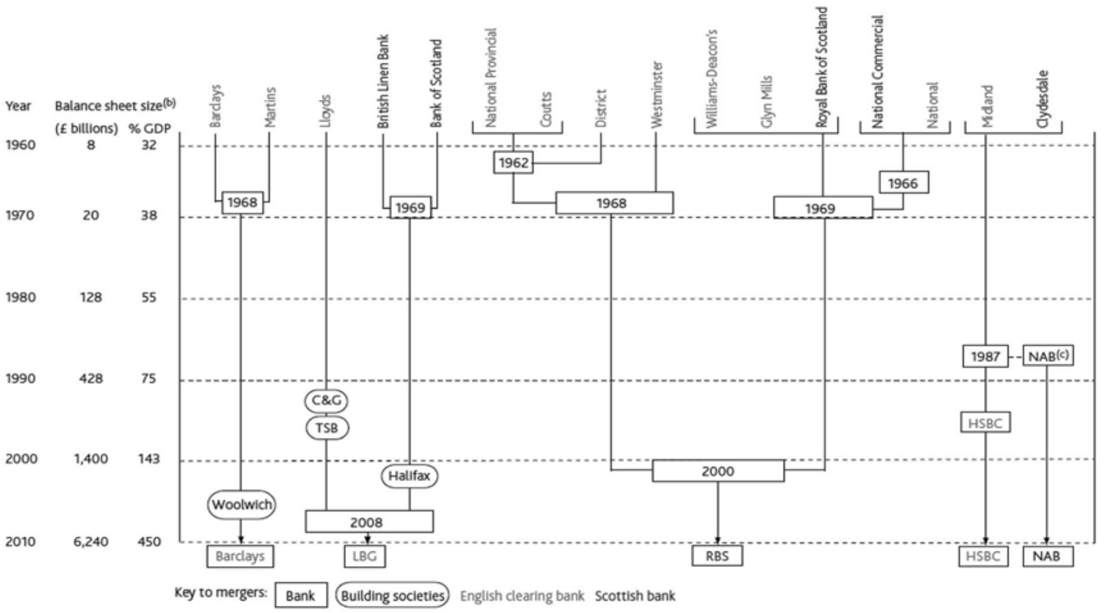
I would first like to provide a broad overview of the British banking system. In the latter half of the 19th century, private banks were converted to joint-stock banks. This eventually led to the creation of the so-called "Big Five" in the 1910s. In 1968, two of the five merged making it the "Big Four." These were Barclays, Lloyds, Midland and the National Westminster. The four banks at one point dominated the payment system. They were also referred to as the clearing banks.

Major changes occurred after the 1990s, and the financial crisis forced further consolidation in the banking industry. The Midland Bank -- the world's largest bank in the 1920s -- was acquired by the Hong Kong and Shanghai Banking Corporation (HSBC) in 1992 due to a slump in its performance. HSBC rebranded all of Midland Bank's branches. Furthermore, National Westminster Bank became part of the Royal Bank of Scotland (RBS) Group in 2000 after becoming the target of a takeover battle. Lloyds, which reported strong growth in the 1990s, merged with the Trustee Savings Bank (TSB) in 1995 and became the Lloyds TSB Group. In 2000, Barclays took over Woolwich, which was originally a building society but later became a bank. A year later in 2001, the Bank of Scotland, which had participated in the takeover battle over National Westminster, merged with Halifax, once a top building society, to form the HBOS.

The British financial system went through further dramatic changes after the financial crisis of 2007. The RBS was nationalized in 2008 after its business deteriorated. In the same year, HBOS was acquired by Lloyds TSB after it suffered losses. A year later, the Lloyds Banking Group was effectively nationalized. Moreover, in 2008 Barclays was a leading contender to buy Lehman Brothers. It eventually acquired the North American investment banking business of the bankrupt U.S. firm after it was dismantled. (Figure 2)

Other important financial institutions in addition to the above "Big Four" are

Santander (a Spanish banking group) that acquired Abbey National, a former building society in 2004. Abbey National was the No. 2 building society before its conversion. Another key financial institution is Nationwide Building Society. It is the only top building society that chose not to demutualize and become a joint-stock bank. In the following pages, I will study the application of the FLS among top financial institutions and the loan situation.



(a) The figure shows bank mergers involving the 16 London and Scotish clering banks present in 1960, together with their acqisitions of building societies.
(b) The balance sheets of institutions are included from the point of merging or acquisition.
(c) Clydesdale was owned by Midland Bank until 1987 when it was sold to National Australia Bank.

Figure 2 : Consolidation of the UK banking sector 1960 to 2010 (a)

Source: Davies et al. [2010] p.323.

(1) Barclays

As I mentioned earlier, HSBC was a member of the “Big Four” that did not participate in the FLS. Barclays, on the other hand, participated in the first part of the FLS but not in the second part of the scheme.

In its participation in the first part of the FLS, Barclays’ outstanding loans amounted to 188.209 billion pounds as of the end of June 2012, while its borrowing of TBs was 12 billion pounds, the largest among the participating financial institutions. This is a ratio of 6.4 percent against the outstanding loans. (Table 3) The increase in lending, 4.3 percent, was larger than that of either Lloyds or RBS. It is not quite clear why Barclays chose not to take part in the second part of the FLS, but one can imagine that the exclusion of loans to households played a big part in its decision.

Table 3 : FLS T-Bill drawing and net lending (First Part): Barclays

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn) (B)	(B)/(A)%
188,209	3,803	1,898	1,123	668	−822	1,443	8,103	4.3%
	Quarterly net FLS T-Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	1,000	5,000	−	−	−	6,000	12,000	

Source: Bank of England

(2) Lloyds BG

Lloyds Banking Group received public funds in 2009, and was effectively nationalized in 2009. The poor financial state of HBOS – formed by the merger of Halifax and the Bank of Scotland -- that Lloyds took over has been largely blamed for the need for the injection of public funds. After it received public funding, Lloyds reduced the number of its outlets and reduced staff.

A look at Lloyds BG's first part participation in the FLS shows that its outstanding loans as of the end of June 2012 was 443.225 billion pounds, while its borrowing of TBs amounted to 10.15 billion pounds, which is a ratio of 2.3% against the outstanding loans. Growth in lending during this period was a low 0.5 percent. (Table 4-1)

Table 4-1 : FLS T-Bill drawing and net lending (First Part): Lloyds BG

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn) (B)	(B)/(A)%
443,255	−2,508	−3,100	−930	1,333	3,143	487	2,126	0.5%
	Quarterly net FLS T-Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	1,000	2,000	−	−	3,000	4,150	10,150	

Source: Bank of England

Lloyds also took part in the second part of the FLS. Lending in 2014 fell 9.109 billion pounds. Lending to large corporations tumbled by a large 10.570 billion pounds, and was a key factor that contributed to the decline. Lending to SMEs rose by 1.227 billion pounds during this period. The IBA that is calculated from the increase in lending during April to the end of December 2013 (including lending to households) amounted to 15.996

billion pounds. The amount of TB that was actually borrowed in 2014 amounted to 10 billion pounds. However, the ABA, which is calculated using the increase in lending in 2014 was zero because lending to large corporations fell, while lending to households are not included in the calculation. For the record, the FBA calculated from the increase in lending in the first quarter of 2015 (the increase in small and medium-sized businesses and NBCP) amounted to 2.107 billion pounds. The withdrawal record was zero. (Table 4-2)

Table 4-2 : FLS T-Bill drawing and net lending (Second Part): Lloyds BG

(£mn)

	Stock of loans to UK PNFCs and NBCPs				FLS drawings	
	Total	large corp.	SMEs	NBCPs	31/03/2015	
31/12/2013	93,441	64,055	29,159	238	20,000	IBA(①)
	Net lending flows				FLS drawings	15,996
Q1 2014	−2,039	−2,730	536	154	2,000	ABA(②)
Q2 2014	−2,078	−2,446	384	−16	2,000	0
Q3 2014	−979	−1,195	304	−88	−	FBA(③)
Q4 2014	−4,103	−4,199	2	184	6,000	2,107
Q1 2015	409		425	−15	−	①+②+③
					(Total) 10,000	18,103

Source: Bank of England

(3) RBS

In 2000, the Royal Bank of Scotland (RBS) won a takeover battle that it fought against a rival Bank of Scotland to acquire National Westminster Bank. It was a case of a smaller bank swallowing a much bigger bank as National Westminster was one of the "Big Four" banks. This development represented a watershed as the RBS began, after this point, to take an expansionary policy. However, this policy backfired. The company's troubles grew following its investment banking division's deep involvement with U.S. structured credit, including collateralized debt obligations (CDO). The exposure of the bank's difficulties in the autumn of 2007 coincided with the RBS' acquisition of Dutch rival ABN Amro, which deepened the crisis. A year later in the autumn of 2008, the RBS accepted the British government's 20 billion-pound bail-out and was effectively nationalized. The government eventually spent a total of 45.2 billion pounds to rescue the bank.

Under these circumstances, the RBS had to reduce its assets and was in no position to aggressively expand financing. A look at the RBS's participation in the first part of the FLS shows that its outstanding loans as of the end of June 2012 was 214.793 billion pounds, while its withdrawal of TBs was a net zero. Lending during this period fell 4.1 percent. (Table 5-1)

Table 5-1 : FLS T-Bill drawing and net lending (First Part): RBS

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn) (B)	(B)/(A)%
214,793	−677	−1,681	−1,620	−2,793	245	−2,303	−8,830	−4.1%
	Quarterly net FLS T−Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	750	−	−	−	−	−750	−	

Source: Bank of England

Like Lloyds BG, the now nationalized RBS had no choice but to participate in the second part of the FLS. However, the bank's lending during 2014 fell by 5.095 billion pounds. Lending to large firms fell by 2.375 billion pounds and those to SMEs fell by 2.450 billion pounds. The IBA calculated from the increase in lending from April to end December 2013 (including loans to households), as well as the ABA calculated by the increase in lending during 2014 were both zero. For the record, the FBA calculated from the increase in lending in the first quarter of 2015 (the increase to SMEs and NBCPs) was 563 million pounds. But the record of withdrawals was zero. The data underscores that while the RBS participated in the FLS, its use of the scheme is virtually zero. (Table 5-2)

Table 5-2 : FLS T-Bill drawing and net lending (Second Part): RBS

(£mn)

	Stock of loans to UK PNFCs and NBCPs				FLS drawings 31/03/2015	
	Total	large corp.	SMEs	NBCPs		
31/12/2013	89,101	46,020	42,924	158	−	IBA(①)
	Net lending flows				FLS drawings	0
Q1 2014	63	774	−737	26	−	ABA(②)
Q2 2014	−1,500	−1,129	−360	−11	−	0
Q3 2014	−1,375	−1,215	−165	5	−	FBA(③)
Q4 2014	−2,280	−1,696	−567	−17	−	563
Q1 2015	136		107	29	−	①+②+③
					(Total) −	563

Source: Bank of England

(4) Santander

Santander took over Abbey National, which was previously the second largest building society. Abbey National was the first building society to take advantage of the Building Societies Act of 1986. It demutualized and became a bank in 1989. Even after its conversion, it did not actively provide financing to corporations. (It provided loans to commercial real estates, but withdrew from the business after experiencing some failures). In terms of asset, it mostly conducted its business through housing loans. When Spain's Santander acquired Abbey National in 2004, it attracted the industry's attention as the first cross-border M&A of a leading British retail financial institution. However, the business continued to remain centered on housing loans even after the acquisition.

This is also demonstrated in the fact that its outstanding loans, including those to households, amounted to 188.320 billion pounds at the end of June 2012. The amount, excluding those to households, amounted to 25.056 billion pounds at the end of December 2013.

Table 6-1 : FLS T-Bill drawing and net lending (First Part): Santander

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn) (B)	(B)/(A)%
188,320	−3,513	−2,851	−2,293	−1,768	−2,137	−1,390	−13,952	−7.4%
	Quarterly net FLS T−Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	1,000	−	−	−900	−	−	100	

Source: Bank of England

Santander's withdrawal of TB in the first part of the FLS was a net 100 million pounds. Its outstanding loans fell 7.4 percent. (Table 6-1) Thus the IBA in the second part of the FLS was zero. The ABA calculated by excluding loans to households in 2014 grew 2.190 billion pounds, reflecting the increase of 467 million pounds in loans to SMEs. The withdrawal of TBs was 2.175 billion pounds, using up most of its allowance. (Table 6-2)

Table 6-2 : FLS T-Bill drawing and net lending (Second Part): Santander

(£mn)

	Stock of loans to UK PNFCs and NBCPs				FLS drawings 31/03/2015	
	Total	large corp.	SMEs	NBCPs		
31/12/2013	25,056	16,435	8,619	2	2,175	IBA(①)
	Net lending flows				FLS drawings	0
Q1 2014	132	−49	179	2	−	ABA(②)
Q2 2014	195	96	99	−	500	2,190
Q3 2014	332	224	107	−	800	FBA(③)
Q4 2014	−335	−417	82	−	875	110
Q1 2015	23		22	1	−	①+②+③
					(Total) 2,175	2,299

Source: Bank of England

(5) Nationwide Building Society

The 1990s saw a rush of demutualization by large building societies to become banks. This can be attributed in small part to the restrictions imposed on building societies when tapping the market for large-lot funds. However, a large part of the attraction was that members of the society received shares when the building society demutualized and converted to banks and became a public limited company owned by shareholders. Many members thus supported the move to demutualize. Nationwide Building Society was the only one of the large building societies that chose not to demutualize. It subsequently became the top firm in the industry.

Housing loans was the main business of the Nationwide Building Society. This fact is supported by data. The building society's lending outstanding, including those to households, at the end of June 2012 amounted to 152.155 billion pounds. The balance excluding those to households totaled 16.030 billion pounds at the end of December 2013.

Nationwide Building's withdrawal of TBs in the first part of the FLS was 8.510 billion pounds. This was 5.9 percent in terms of the ratio against its lending outstanding at the end of June 2012. This reflects the fact that lending, which was mainly to households, rose 7.7 percent. (Table 7-1)

Table 7-1 : FLS T-Bill drawing and net lending (First Part): Nationwide BS

Certified Base Stock of loans as at 30/06/12(£mn)(A)	Quarterly certified net lending flows to UK households and PNFCs(£mn)						Cumulative net lending	
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Amount(£mn)(B)	(B)/(A)%
152,155	1,834	1,766	1,192	2,261	2,724	1,988	11,766	7.7%
	Quarterly net FLS T-Bill drawings(drawings less repayment)(£mn)						FLS drawing as at 31/01/2014	
	510	1,500	500	–	–	6,000	8,510	

Source: Bank of England

However, Nationwide Building's lending to households increased by 8.391 billion pounds from April to end December 2013. This is in contrast to its lending to SMEs which fell 1.530 billion pounds during the same period. The calculation for the IBA in the second part of the FLS is increased ten fold even if lending to SMEs fell, and thus the allocation was zero and there was no TB withdrawal. In addition, the ABA was zero as the loans outstanding to SMEs during 2014 dipped by 1.530 billion pounds. Subsequently the ABA and FBA were also zero. (Table 7-2)

Table 7-2 : FLS T-Bill drawing and net lending (Second Part): Nationwide BS

(£mn)

	Stock of loans to UK PNFCs and NBCPs				FLS drawings 31/03/2015	
	Total	large corp.	SMEs	NBCPs		
31/12/2013	16,030	7,771	8,260	–	8,510	IBA(①)
	Net lending flows				FLS drawings	0
Q1 2014	−472	−66	−406	–	–	ABA(②)
Q2 2014	−364	137	−501	–	–	0
Q3 2014	−482	−191	−290	–	–	FBA(③)
Q4 2014	−511	−177	−333	–	–	0
Q1 2015	−325		−325	–	–	①+②+③
					(Total) –	0

Source: Bank of England

As can be seen from the analysis of the trends of the leading financial institutions, the FLS failed to contribute to the policy goal. It is clear that the scheme did not contribute to an increase in lending, particularly to SMEs.

V. Reasons the FLS did not lead to increased lending to SMEs

As we have seen so far it is safe to say that the FLS, which was implemented by the BOE to boost lending, has so far failed to achieve its desired goal. In the first place, the

FLS was introduced as an additional easing measure because QE did not prove to be very effective.

The BOE's QE measures have not been very effective so far. The BOE initially explained its QE in very simple monetarist terms. It said that the supply of base money would lead to an increase in money supply, which in turn would raise prices and increase output. However, the supply of base money by the BOE did not lead to a significant increase in the money supply. This forced the BOE to revise its explanation. It acknowledge that the central bank's massive purchase of government bonds had raised bond prices (lowering interest rates) and that buyers such as pension funds had purchased high-yielding bonds with the money they raised through the sales which only had limited impact to stimulate the economy.

It follows that lending to companies did not increase as a result of QE because the reserves was to blame for holding it back in the first place. This was the reason the FLS was introduced as a complementary response to efforts to stimulate lending. The modest reduction in procurement cost that the scheme provided, however, did not have much positive influence. This is perhaps natural, given that the decline in the Bank Rate did not

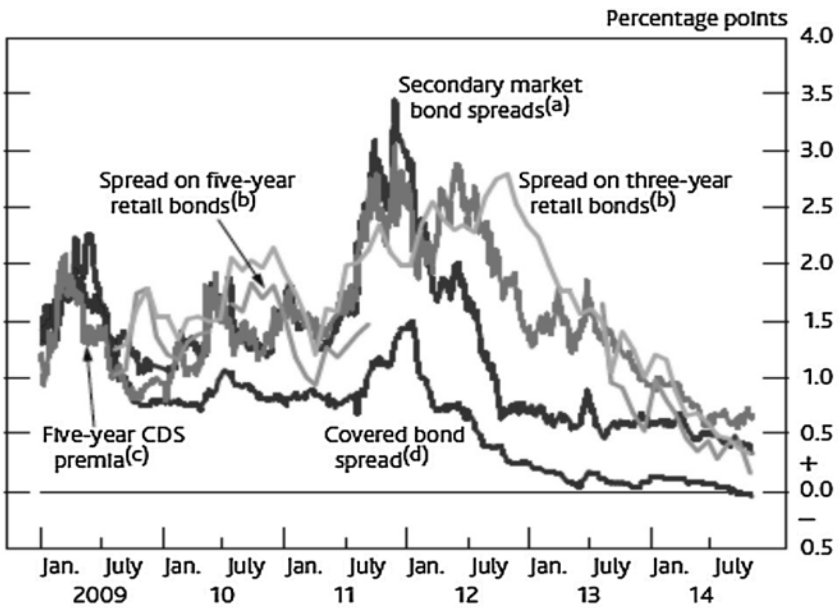


Figure 3 : Long-term funding spreads for major UK banks

Source: Beau et al. [2014] p.12.

have such a positive impact. Even after the Bank Rate remained pegged at 0.5 percent and the procurement costs for banks fell, there was no marked increase in lending. (Figure 3)

The goal to facilitate corporate financing has not been achieved amidst the decline in the function of the credit market and the banking sector. Why did the second part of the FLS fail to achieve its goal to promote corporate financing to SMEs? This can be blamed largely on the weakness of the SME's fund demand.

The "Macmillan Gap" noted in the Macmillan Committee report released in 1931 is well known relating to the subject of fund raising among SMEs in the United Kingdom. The report noted that SMEs faced difficult in accessing capital markets. It proposed that a financial institution be created to fill this gap for SMEs facing difficulties raising money. This proposal was realized when the Industrial and Commercial Finance Corporation (ICFC) was established in 1945. The ICFC was never very active and it became a venture capital widely known as the 3i in 1987.

On the loan guarantee, the Small Firms Loan Guarantee Scheme (SFLGS) was provided by the Department of Trade and Industry in 1981. This is being managed by the Small Business Service (SBS), which was launched in 2000. The British Business Bank opened for business in November 2014 in the wake of the financial crisis. However, enough time has not yet passed to conduct an analysis of this in this paper. All told, SMEs have been forced to rely on bank loans to procure the funds they need. To this day, the "Macmillan Gap" has failed to be resolved.

One reason that bank lending to SMEs did not expand, despite efforts by the central bank to implement measures to stimulate lending under these conditions, was the basic lack of healthy funding needs. A study conducted by the BOE (March 2013) shows that revisions were made to repayment conditions of about 6 percent of top banks' SME clients. That accounts for some 14 percent of the loan exposure of lending offered to SMEs. (Table 8) This percentage is in itself not a large figure. According to the banks, the level is such that it can withstand the situation even if a rise in interest rates leads to cases where the loans cannot be repaid. (Table 9)[5] This underscores the weakness of fund demand among SMEs.

Table 8 : Forvearance by UK lending sector

Sector	Bank exposure in forbearance (per cent)	Stock of bank lending covered by forbearance survey (£ billions)	Current stock of bank lending to sector in question (£ billions)(a)
Household secured(b)	5–8	903	1,043
Commercial real estate(c)	35	153	188
Leveraged loans(d)	28	35	n.a.
SME (excluding CRE lending)(e)	14	81	122

(a) As at end-2013Q3.
(b) Survey results as at June 2012.
(c) Survey results as at June 2011.
(d) Survey results as at December 2011.
(e) Survey results as at March 2013.

Source: Allowsmith et al. [2013] p.298.

Table 9 : Reported impact of higher interest rates on potential SME bank loan defaults

Interest rate	Percentage of customers likely to default(a) in the next twelve months		
	Currently receiving forbearance	Not receiving forbearance	All
No change	2.7	0.5	0.6
50 basis points	2.9	0.5	0.6
100 basis points	5.9	0.8	1.1
200 basis points	13.7	1.6	2.3
400 basis points	25.5	3.3	4.7

(a) Where individual bank relationship manageres reported that the provability of a company defaulting was 50% or more.

Source: Allowsmith et al. [2013] p.300.

To begin with, lending to households accounts for a major part of the bank loan

[5] See Arrowsmith et al. [2013]

business in the United Kingdom. This can be attributed in part to the fact that many banks were originally building societies. A look at the lending of leading banks shows that lending to the non-bank private sector is less than one-third that to households. This fact is supported by data. There is a large difference between the outstanding loans that includes those provided to households (as of June 30, 2013) as seen in Table 1 and those offered to non-financial companies and non-banks excluding households (as of December 31, 2013) as seen in Table 2. Even among SMEs, loans to the manufacturing sector are very low. On the other hand, the percentage of loans to commercial real estate is high. The large risks from loans to commercial real estate after the financial crisis is another reason why lending to SMEs have failed to grow significantly.

It is also possible that the ability of banks to take risks has weakened following the financial crisis. The need to strengthen capital adequacy requirements (Basel III) was an added factor to dampen lending. However, it is also necessary to remember that banks can usually respond to a healthy need for funds, and that they can improve their capital requirements from their gains. These are lessons learned from the failures of the Incubator Bank of Japan and Shinginko Tokyo, which were established against a backdrop of criticism about the banks' reluctance to lend. Banks that respond to fund needs that are not healthy fail.

This brings us to the question of why the need for funds among companies, particularly SMEs, is weak in the United Kingdom. The structure of the British industry itself is at the crux of the matter. It is the adverse influence of giving little weight to industries that produce goods. It must also be noted that it exposes the limitations of a policy promoting a nation founded on money and banking.

The FLS, which tried to stimulate lending by lowering the procurement costs of financial institutions, did not achieve its initial goal. It tried to promote lending to SMEs after a minor change, but this too failed to achieve the desired result. As a rule monetary policy should purely follow its set goal in supplying funds to certain sector. This is because it is the economic policy that is the responsibility of those in charge of financial affairs. The failure of the FLS demonstrates, not only the difficulty of conducting an unconventional monetary policy, but it also appears to call on us to once again study where to draw the boundaries for monetary policy.

Conclusion

The additional credit easing measures that were introduced after policy interest rates were near zero is described as unconventional monetary policy. Broadly speaking these are ① QE ② credit easing and ③ forward guidance. To begin with, there is an element of uncertainty in easy money policy because the economy's response to lower policy rates is opaque. In addition, the element of uncertainty is even stronger in unconventional monetary policy compared to the usual easy money policy. Recent experience has taught us that simple ① QE is not effective; ② credit easing policy is effective when certain markets are in a state of confusion; ③ forward guidance has some influence in flattening the yield curve.

It is possible to see the FLS conducted by the BOE as a ② variant credit easing policy. The program has not been effective so far. One reason for this can be attributed to the fact that the measure was not implemented in response to market needs. The BOJ also launched measures similar to the FLS from December 2012 when it "supplied funds to help boost lending." However, the move does not appear to have had a significant impact. In June 2010, the BOJ "supplied funds to boost growth," similar to the second part of the FLS. This was a system that showed some characteristic of being a move to intervene in the distribution of funds, but this too failed to have much impact.

I would like to repeat that monetary policy should as a rule avoid intervening in the individual allocation of funds. Moreover, there is little benefit in introducing measures to forcibly promote lending when there is no demand for funds. The reason why the BOE and the BOJ promoted these measures despite their futility is because the influence of the LSAP is not very large. They were probably created as a step other than the LSAP at a time when the central banks were under outside pressure to implement a monetary easing policy. What has happened is that the measures were taken experimentally but failed. Or perhaps the central banks had factored in the failure of the measures and that the aim was always to achieve an announcement effect.

Refereces

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