BANK OF ENGLAND

Mark Carney
Governor

The Rt. Hon. Lord Forsyth of Drumlean
House of Lords
London
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Dear Lord Forsyth,

At my recent hearing with the Lords Economic Affairs Committee, I said I would write to provide further information on two issues: how much funding the Bank has provided through the Funding for Lending Scheme (FLS) and Term Funding Scheme (TFS); and the European Banking Authority's (EBAs) actions in relation to capital requirements for bank lending to house builders.

FLS & TFS

The FLS was launched jointly by the Bank and HM Treasury in July 2012, in response to the euro-area crisis, which had caused a sharp increase in UK bank funding costs, impairing the flow of credit to the real economy.

The objective of the FLS was to encourage lending to households and companies by providing funding to banks and building societies for an extended period, at below market rates, with both the price and quantity of funding provided linked to their performance in lending to the UK real economy.[1] The Scheme was open to all banks and building societies that signed up to the Bank's sterling facilities. The Bank subsequently revised the design and extended the availability of the FLS in April 2013 in order to increase the incentives for banks to lend to small and medium-sized enterprises.

Banks were able to draw on the FLS from August 2012 to January 2018 when the scheme closed to new borrowing. The peak size of the FLS was £70 billion, and in total 47 firms participated. Total outstanding drawings when the scheme closed at end-January 2018 were £31 billion. As of the end of 2019 there were £3 billion drawings outstanding. Some of this reduction reflects refinancing from the FLS to the TFS. The final FLS loans mature in January 2022.

[1] The FLS provided funding – in the form of UK Treasury bills – in exchange for collateral. FLS participants could use the Treasury bills obtained from the Scheme to raise cash in a number of ways. More details on how the Scheme operated were set out in an article in the Bank's 2012 Q4 *Quarterly Bulletin*, The Funding for Lending Scheme.

The Term Funding Scheme (TFS) was announced in August 2016 as part of a package of easing measures to support the UK economy following the EU Referendum, which included a cut in Bank Rate to ¼%. The TFS's main goal was to reinforce the pass-through of this cut in Bank Rate by providing four year funding for banks and building societies at interest rates close to Bank Rate.

In aggregate, 62 participating banks and building societies had obtained £127 billion of funding from the TFS when the scheme closed for new drawings at the end of February 2018. Due to early repayments by participating banks, there was £107 billion outstanding in the Scheme as of close 5 February 2020. The last maturity from the TFS is due in February 2022.

The Bank of England publishes quarterly data on TFS and FLS borrowing with a one month lag, showing amounts outstanding for each participating group. This data can be found on the Bank's website.[2]

EBA capital requirements for lending to house builders

You also asked about the risk weight that the European Banking Authority (EBA) applies to capital requirements on lending to house builders.

The EBA has clarified that loans for 'speculative immovable property financing' – which is defined as loans for the purposes of the acquisition of or development or construction on land in relation to immovable property, or of and in relation to such property, with the intention of reselling for profit – should receive a risk weight of 150% under the standardised approach to credit risk.

The PRA had been aware that some banks in the UK providing finance to house builders were unclear about whether their lending qualified as 'speculative immovable property financing'. So in September 2015 the PRA submitted a question to the EBA to ask for clarification, and the EBA published a Q&A in response in October 2016 confirming that it did[3].

Most UK lending for residential property construction was not affected by this clarification. That is because many of the UK banks that apply the standardised approach to credit risk (the approach used by all smaller lenders) were already applying a 150% risk weighting on lending to house builders prior to the EBA's Q&A. However, some banks applying the standardised approach had, until then, interpreted the requirements differently and were applying a risk weight of 100%, and were therefore affected. The largest banks, which account for a large portion of UK lending for construction, were not affected as they primarily use internal model based approaches to credit risk.

The PRA's judgment is that a 150% risk weight is appropriate for lending to house builders when banks apply the standardised approach. This reflects the short-term and speculative nature of the lending. The Basel Committee on Banking Supervision also determined that a risk weight of 150% is appropriate when it revised the standardised approach to credit risk as part of the finalisation of Basel III.[4]

[2] https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide/results-and-usage-data
[3] https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_2268
[4] See paragraph 20.90, https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20220101

As I noted at the hearing, the PRA would not countenance using risk weights to encourage or discourage lending to particular sectors of the economy, other than to ensure that risk weights are aligned with the risk associated with the lending, taking into account both firm-specific and system-wide risks. Reducing risk weights simply to encourage lending would mean that banks' capital requirements would not be consistent with their underlying risk profile. That would, in turn, risk undermining the PRA's primary objective, to promote the safety and soundness of regulated firms.

Yours,