Credit Conditions Review

2017 Q3

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This publication presents the Bank of England's assessment of the latest developments in bank funding and household and corporate credit conditions. It draws mainly on long-established official data sources, such as the existing monetary and other financial statistics collected by the Bank, and other data sources such as surveys of businesses and data from other organisations. The analysis also draws on the results of the Bank of England's *Bank Liabilities Survey* and *Credit Conditions Survey*.(1)

These data are supplemented by discussions between Bank staff and the major UK lenders; this intelligence is reflected in the report. The major UK lenders(2) are Banco Santander, Barclays, HSBC, Lloyds Banking Group, Nationwide and Royal Bank of Scotland; together they accounted for around 70% of the stock of mortgage lending, 50% of the stock of consumer credit (excluding student loans), and 65% of the stock of lending to businesses at end-June 2017. The *Review* also draws on intelligence gathered by the Bank's network of Agents and from market contacts.

The *Review* covers data and intelligence gathered up to end-September 2017. Unless stated otherwise, the data reported cover lending in both sterling and foreign currency, expressed in sterling.

The 2018 Q1 *Credit Conditions Review* will be published on 12 April 2018.

(1) The *Bank Liabilities Survey* and the *Credit Conditions Survey* for 2017 Q3 were conducted between 21 August and 8 September 2017. These surveys can be found at www.bankofengland.co.uk/publications/Pages/other/monetary/bls/default.aspx and www.bankofengland.co.uk/publications/Pages/other/monetary/creditconditions.aspx.
(2) The definition of the group of major UK lenders is based on the provision of credit to UK-resident companies and individuals, regardless of the country of ownership.

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Executive summary

Banks continued to have ready access to funding in 2017 Q2 and Q3, with the cost of most funding instruments at, or near, post-crisis lows. Indicative measures of wholesale funding spreads over relevant reference rates have continued to fall over the past two quarters, while there has been little movement in retail deposit spreads. Respondents to the Bank of England's *Bank Liabilities Survey* reported that transfer prices had continued to fall during this period.

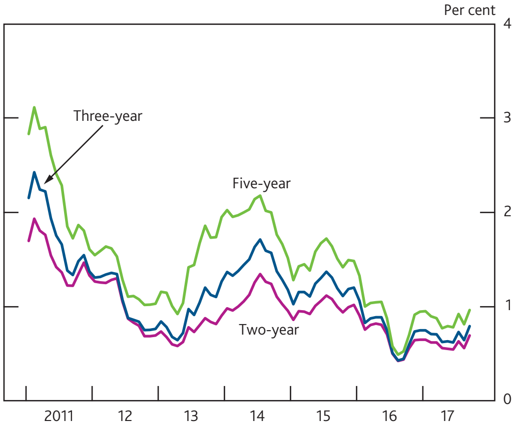
The mortgage market has remained broadly stable in recent months. Competition between lenders remains strong and mortgage rates have fallen slightly further over the past six months. Annual growth in consumer credit fell slightly to 9.8% in August 2017. Although competition and growth in this market remain strong, there are tentative signs of a slight tightening in lending criteria, with lenders expecting further tightening in Q4.

Credit supply conditions continue to be broadly favourable for corporate borrowers, but there are some tentative signs that credit conditions may have tightened at the margin — in particular to smaller companies and in certain industries. Net finance raised by businesses — from capital markets and banks — has been relatively strong over the past six months, driven by larger businesses and a small number of mergers and acquisitions. More generally, however, demand for credit appears to have remained somewhat subdued across firms of all sizes.

1 Bank funding

Banks continued to have ready access to funding in 2017 Q2 and Q3, with the cost of most funding instruments at, or near, post-crisis lows. Indicative measures of wholesale funding spreads over relevant reference rates have continued to fall over the past two quarters, while there has been little movement in retail deposit spreads. Respondents to the Bank of England's *Bank Liabilities Survey* reported that transfer prices had continued to fall during this period.

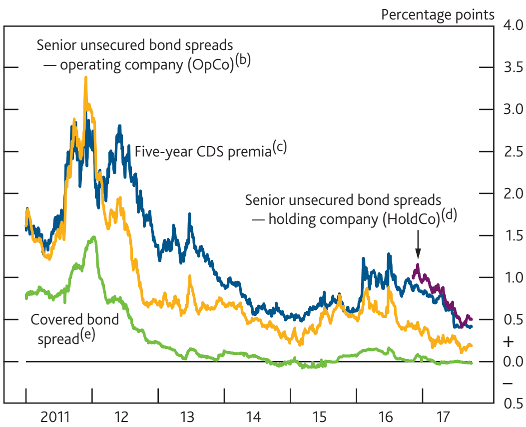
Chart 1.1 Swap rates at different maturities(a)



Source: Bloomberg.

(a) Data are to end-September 2017 and are monthly average observations. Sterling swap rates.

Chart 1.2 Indicative long term funding spreads(a)



Sources: Bloomberg, IHS Markit and Bank calculations.

(a) Data are to end-September 2017.
(b) Constant maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro-denominated senior unsecured bonds issued by the operating company or a suitable proxy when unavailable.
(c) Unweighted average of five-year euro-denominated senior CDS premia for the major UK lenders.
(d) Constant maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro-denominated senior unsecured bonds issued by the holding company or a suitable proxy when unavailable. For further details on the difference between this measure and the one corresponding to the operating company, see the box on page 6.
(e) Constant maturity unweighted average of secondary market spreads to swaps for the major UK lenders' five-year euro-denominated covered bonds or a suitable proxy when unavailable.

Funding costs and transfer prices

The cost of bank funding influences the interest rates charged to households and corporates. It can generally be decomposed into the prevailing level of a given reference rate (such as a swap rate) and the spread over that reference rate in financial markets.

Banks continued to have ready access to wholesale funding in 2017 Q2 and Q3, with the cost of most funding instruments at or near post-crisis lows. In part, this reflects swap rates remaining at very low levels during 2017 (**Chart 1.1**). These have, however, ticked up in recent weeks due to market expectations of a rise in Bank Rate.

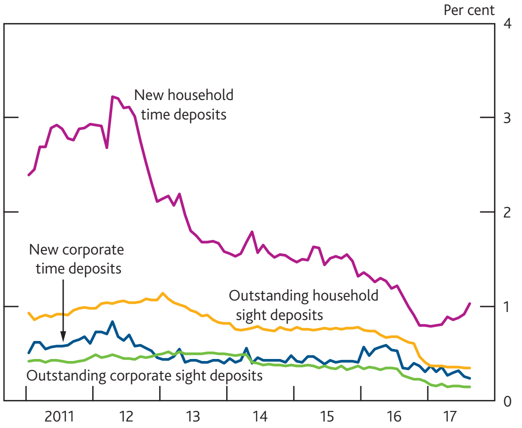
In addition, indicative measures of wholesale funding spreads over the relevant reference rates — such as senior unsecured bond spreads — have continued to fall over the past two quarters (**Chart 1.2**).[1] The falls observed so far in 2017 largely reflect broader financial market conditions, with relatively high levels of liquidity and investor demand for risky assets. There was little market reaction attributed to the Monetary Policy Committee's (MPC) announcement that the drawdown period of the Term Funding Scheme (TFS) would be closed on 28 February 2018, as envisaged at the start of the scheme.[2]

Interest rates on household and corporate deposits were broadly unchanged in the first half of the year and remain low by historical standards (**Chart 1.3**). In recent months, however, there have been some small increases in the rates paid on household fixed-rate deposits.

The reductions in lenders' funding costs appear to have been reflected in their transfer prices — the internal prices charged to business units to fund the flow of new loans. Respondents to the Bank of England's *Bank Liabilities Survey* (*BLS*) reported that the transfer price had continued to fall significantly during

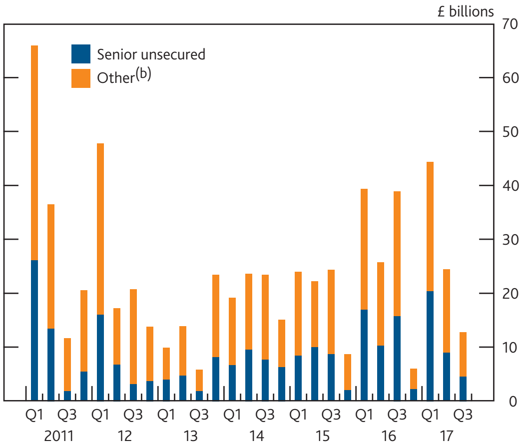
(1) For further details on the difference between senior unsecured bond spreads shown in **Chart 1.2**, see the box on page 6.
(2) This announcement was made on 3 August 2017; www.bankofengland.co.uk/publications/Pages/news/2017/005.aspx.

Chart 1.3 Effective rates on household and PNFC deposits[a]



(a) Effective rates on sterling household and PNFCs deposits. The Bank's effective rate series are currently compiled using data from up to 19 UK monetary financial institutions (MFIs). The effective rate is an average monthly rate. Non seasonally adjusted. The rates on sight deposits show rates on interest-bearing deposits only. Data are to August 2017.

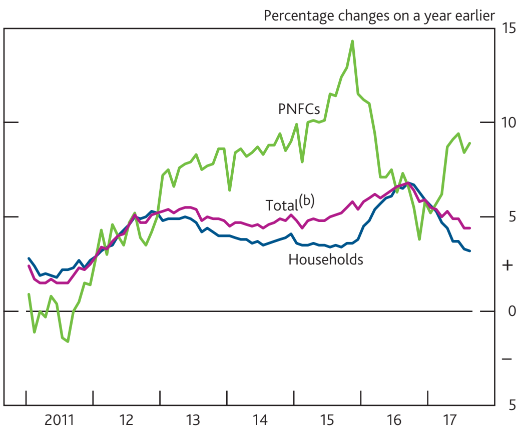
Chart 1.4 Gross wholesale term issuance by UK lenders in public markets[a]



Sources: Thomson Reuters Deals Business Intelligence and Bank calculations.

(a) Term issuance is defined here as issuance with maturity exceeding 18 months. UK lenders are defined by the nationality of the operations of the issuer's parent company. Data include issuance in all currencies, expressed in sterling. Non seasonally adjusted.
(b) Other is composed of: asset-backed securities; commercial and residential mortgage-backed securities; covered bonds; subordinated unsecured debt and secured or subordinated medium-term notes.

Chart 1.5 Household and PNFC deposits[a]



(a) Rate of growth in MFIs' M4 liabilities. Seasonally adjusted. Data are up to August 2017.
(b) Total is the rate of growth of PNFCs' and households' deposits together.

the past two quarters, mainly due to falls in the spreads on wholesale funding.

Funding volumes

UK banks continued to have ready access to funding markets during 2017 Q2 and Q3. *BLS* respondents reported that total funding volumes had increased during both quarters.

Gross wholesale term issuance by UK lenders has been slightly lower during 2017 Q2 and Q3 than the average issuance in the comparable period over the past few years (**Chart 1.4**). In recent discussions, most major UK lenders suggested that this lower issuance could, in part, reflect banks having access to the TFS. Over the past two quarters, banks have drawn down approximately £32 billion from the scheme.[1]

Retail deposits continued to represent a cheap and stable source of funding for banks, although their rate of growth has been slowing since mid-2016. The annual growth rate in household retail deposits fell a little during Q2 and Q3, but remains similar to growth rates seen during 2013–15 (**Chart 1.5**). Lenders reported in the *BLS* that the supply of deposits from households had declined during Q2 and Q3.

Capital instruments are also a source of bank funding, and banks' capital positions will influence their funding cost. In June, the Financial Policy Committee (FPC) decided to increase the countercyclical capital buffer rate, levied on banks' total risk-weighted UK assets, from 0% to 0.5% and said that it expected — absent a material change in the outlook — to raise the rate further, to 1%, at its November meeting.[2] Those changes are expected to lead to a small increase in banks' overall funding costs.[3]

(1) Data on TFS drawings can be found in table D2.3.4 under Monetary & Financial Statistics; www.bankofengland.co.uk/statistics/Pages/bankstats/default.aspx.
(2) This statement was maintained at its September meeting. For more detail on the FPC's decision, see the June 2017 *Financial Stability Report*; www.bankofengland.co.uk/publications/Documents/fsr/2017/fsrjun17.pdf.
(3) For more detail on the link between macroprudential capital policy and UK credit conditions, see Harimohan, R and Nelson, B (2014), 'How might macroprudential capital policy affect credit conditions?', *Bank of England Quarterly Bulletin*, Vol. 54, No. 3, pages 287–303; www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q303.pdf.

Senior unsecured bank debt: the difference between operating company and holding company issuance

Senior unsecured wholesale debt is an important funding instrument for UK lenders. Historically, the majority of this type of debt has been issued by lenders' operating companies (OpCo), which are the legal entities that lenders typically use to undertake their lending and other business activities. Since early 2016, however, UK lenders have significantly increased the proportion of senior unsecured wholesale debt that is issued by the lenders' holding companies (HoldCo). These are the parent companies of banking groups, which may own multiple OpCos operating across different markets and jurisdictions.

The primary reason for this change is to comply with a regulatory requirement set by the Bank in its capacity as the UK's Resolution Authority. This requirement, known as the Minimum Requirement for Own Funds and Eligible Liabilities (MREL), ensures that if a lender fails and enters resolution, it has sufficient loss-absorbing capacity in the form of debt and equity that can be 'bailed-in' to absorb losses and recapitalise it back to its minimum capital requirements. This supports the continued operation of the lender without recourse to public funds, or disruption to critical functions it provides to the economy. By 2022, lenders subject to bail-in resolution strategies must meet an MREL of two times the minimum capital requirements.

The subordination of MREL resources to other liabilities is likely to be reflected in how investors price it — this is sometimes referred to as the 'MREL premium'. To be eligible as MREL, a bail-in lender's debt resources must be subordinated to the group's senior operating liabilities. This means that in the event of insolvency, its creditors can only expect repayment after the claims of senior creditors (such as the holders of derivatives and corporate deposits) have been settled. Senior unsecured debt issued at HoldCo level is structurally subordinated to these operating liabilities and therefore can count towards MREL, subject to meeting the other eligibility criteria set out in the Bank's MREL Statement of Policy.(1)

Given these developments, it is important to monitor how the cost of issuing both OpCo and HoldCo senior unsecured debt evolves when assessing bank funding conditions. Spreads — over appropriate reference rates — on both types of debt have fallen during 2017. This reflects broader developments in financial markets, as described in Section 1. Spreads on HoldCo debt have fallen by more than those on OpCo debt. This is consistent with the market for HoldCo debt becoming more established as issuance has increased, although the market remains comparatively young.

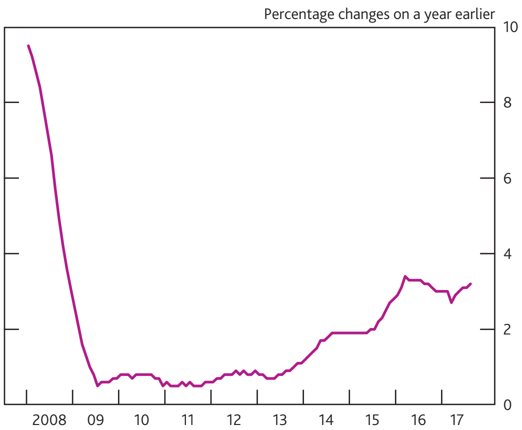
(1) This can be found at www.bankofengland.co.uk/publications/Pages/news/2016/082.aspx.

2 Household and corporate credit conditions

The mortgage market has remained broadly stable in recent months. Competition between lenders remains strong and mortgage rates have fallen slightly further over the past six months. Annual growth in consumer credit fell slightly to 9.8% in August 2017. Although competition and growth in this market remain strong, there are tentative signs of a slight tightening in lending criteria, with lenders expecting further tightening in Q4.

Credit supply conditions continue to be broadly favourable for corporate borrowers, but there are some tentative signs that credit conditions may have tightened at the margin — in particular to smaller companies and in certain industries. Net finance raised by businesses — from capital markets and banks — has been relatively strong over the past six months, driven by larger businesses and a small number of mergers and acquisitions. More generally, however, demand for credit appears to have remained somewhat subdued across firms of all sizes.

Chart 2.1 Secured lending to individuals[(a)]



(a) Sterling net lending by UK monetary financial institutions (MFIs) and other lenders to UK individuals. Seasonally adjusted.

Secured lending to households

Overall, the mortgage market has been broadly stable over the past six months. The annual growth rate of secured lending was 3.2% in August 2017, in line with outturns over the past year (**Chart 2.1**).

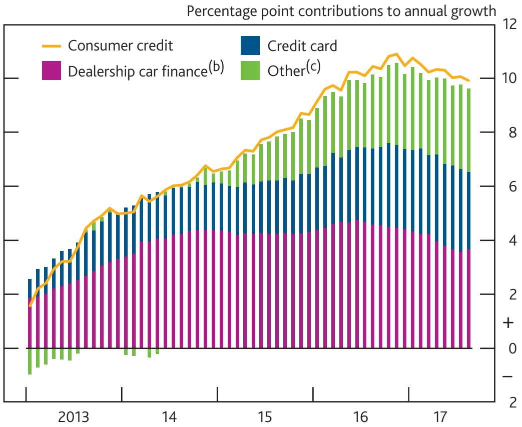
Demand for secured credit for house purchase was reported to be little changed during 2017 Q2 and Q3, according to respondents to the Bank of England's *Credit Conditions Survey* (*CCS*). In contrast, demand for remortgaging increased according to the most recent survey.

There has been strong competition and a desire to increase market share among lenders in the secured lending market. This has contributed to a slight increase in the availability of secured credit over the past six months, according to the *CCS*. Consistent with this, quoted rates on most fixed-rate mortgage products and effective rates on both new mortgages and the outstanding stock have continued to decline in recent months. In particular, the quoted rate for the five-year 75% loan to value (LTV) mortgage fell 25 basis points between March and September 2017. How mortgage rates evolve will depend, in part, on lenders' reaction to recent increases in swap rates as discussed in Section 1.

Consumer credit

While annual growth in consumer credit remains high relative to recent years, it fell slightly to 9.8% in July and August 2017. This is the first time it has fallen below 10% since April 2016. This decline was mainly due to weaker growth in lending for

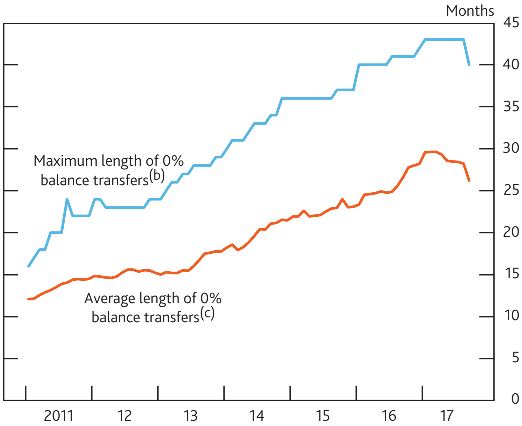
Chart 2.2 Consumer credit[(a)]



Sources: Bank of England and Bank calculations.

(a) Sterling net lending by UK monetary financial institutions (MFIs) and other lenders to UK individuals (excluding student loans). Non seasonally adjusted.
(b) Identified dealership car finance lending by UK MFIs and other lenders.
(c) Other is estimated as total consumer credit lending minus dealership car finance and credit card lending.

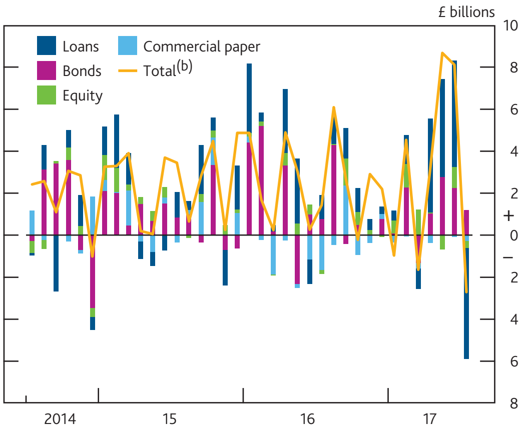
Chart 2.3 Maximum and average duration of 0% balance transfers on credit cards[(a)]



Sources: Moneyfacts Group and Bank calculations.

(a) Whole market end-month data, excluding values of zero and nil returns.
(b) The maximum 0% balance transfer term available across all lenders.
(c) The average 0% balance transfer term is the average of the maximum 0% balance transfer term available for each lender.

Chart 2.4 Net finance raised by UK PNFCs[(a)]



(a) Monthly data. Finance raised by PNFCs from UK MFIs and capital markets. Bonds data cover debt issued by UK companies via UK based Issuing and Paying Agents. Seasonally adjusted. Bonds and commercial paper data are non seasonally adjusted.
(b) Owing to the seasonal adjustment methodology, this series may not equal the sum of its components.

dealership car finance, although this continues be a key driver of consumer credit (**Chart 2.2**).

Competition in the consumer credit market remains strong and quoted rates for personal loans remain around historic lows. There have, however, been tentative signs of modest tightening in this market. Lenders responding to the *CCS* reported that the availability of unsecured credit fell in both Q2 and Q3. There have also been some signs of this in other indicators. In particular, the average period for 0% interest-free balance transfers on credit cards has fallen by around three months since the peak in March 2017, while the maximum period has fallen to 40 months (**Chart 2.3**). In recent discussions, some lenders also reported that they had slightly tightened their credit criteria for some products. Motivations for this included concerns about customer indebtedness and the squeeze in real incomes.

The performance of consumer credit lending appears to have remained generally strong over recent months. However, some lenders reported a few signs of a marginal deterioration. According to the *CCS*, default rates on consumer credit increased slightly over the past six months.

Looking ahead, lenders responding to the *CCS* expect a further reduction in the availability of consumer credit in Q4. The Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) have been monitoring developments in the consumer credit market and both have recently published statements.[(1)]

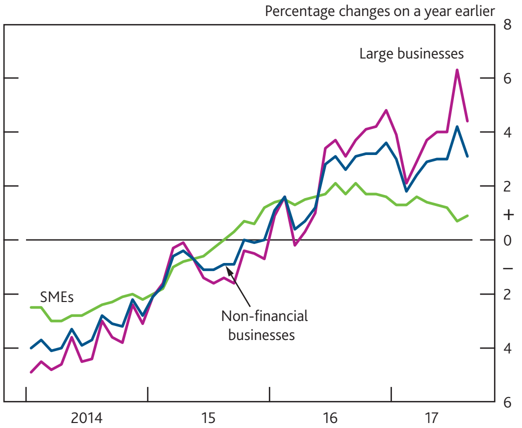
Lending to corporates

Businesses can raise funds from capital markets (such as by issuing bonds, commercial paper or equity) or by borrowing from banks. Net finance raised by UK private non-financial corporations (PNFCs) from UK monetary financial institutions (MFIs) and capital markets has been relatively high over the past six months (**Chart 2.4**). This strength mainly reflects developments in bank lending, but also continued robustness in corporate bond issuance.

The relative strength in net finance raised appears to have been driven by larger businesses. The rate of growth in bank lending to large businesses has strengthened, while lending to small and medium-sized enterprises (SMEs) has slowed gradually since mid-2016 (**Chart 2.5**). The volume of net finance raised by large corporates in recent months has been due, at least in part, to a small number of mergers and acquisitions (M&A) taking place between May and July. Looking forward, M&A activity may continue to support companies' demand for finance because corporate valuations are favourable for owners looking to sell. In addition, the level

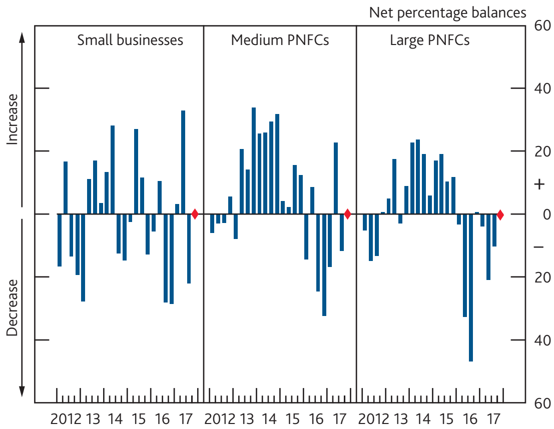
(1) For more detail, see www.bankofengland.co.uk/publications/Pages/news/2017/009.aspx and www.bankofengland.co.uk/pra/Documents/publications/reports/prastatement0717.pdf.

Chart 2.5 Lending to UK non financial businesses(a)



(a) Rate of growth in the stock of lending. Lending by UK MFIs. Data are to August 2017. Non seasonally adjusted. Large businesses are those with annual debit account turnover on the main business account over £25 million. SMEs are those businesses with annual debit account turnover on the main business account less than £25 million.

Chart 2.6 *Credit Conditions Survey*: changes in corporate demand for lending by firm size(a)(b)



(a) Net percentage balances are calculated by weighting together the responses of those lenders who answered the question. The blue bars show the responses over the previous three months. The red diamond shows the expectation for the next three months.
(b) Small businesses are defined as those with annual turnover of less than £1 million; medium-sized corporates are defined as those with annual turnover of between £1 million and £25 million; and large corporates are defined as those with annual turnover of over £25 million.

of sterling makes UK companies appear relatively cheap to foreign investors. However, the *Deloitte CFO Survey* for 2017 Q2 suggested that the number of firms planning defensive strategies (for example prioritising cost control and cash flow) has increased relative to the number of companies focusing on expansionary strategies (such as M&A).

More generally, corporate demand for credit appears to be somewhat subdued across firms of all sizes, but to have changed little over the past six months. The Bank's network of Agents suggested that demand for finance remained muted in recent months.(1) Lenders reported weaker demand for credit from corporates in the 2017 Q3 *CCS*, although during Q2 the evidence was mixed (**Chart 2.6**). Lower capital investment was reported to be the main factor acting as a drag on corporate demand for credit in both quarters. In addition, according to the latest BDRC Continental's *SME Finance Monitor*, fewer SMEs were willing to borrow to grow in 2017 H1.(2)

Credit supply conditions remain favourable, but there are some tentative signs that they might have tightened slightly during the past months for smaller companies and for certain industries. The Agents' scores continue to suggest that the availability of credit to corporates of all sizes has remained above 'normal'.(3) Furthermore, lenders responding to the *CCS* reported that the availability of credit provided to the corporate sector had been unchanged over the past two quarters, with no change expected in Q4. However, the 2017 Q2 *Agents' summary of business conditions* noted that there have been some reports of banks increasing interest rates on loans to industries they perceived to be more vulnerable, such as retail, construction and hospitality. Additionally, the Agents' score for credit availability for small firms is slightly lower than at the start of the year.

(1) The *Agents' summary of business conditions* can be found at www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.
(2) This is available at http://bdrc-continental.com/products/sme-finance-monitor/.
(3) Agents' scores on credit availability and their definitions can be found at www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.

Abbreviations

BLS — *Bank Liabilities Survey*.
CCS — *Credit Conditions Survey*.
CDS — Credit default swap.
HoldCo — Holding company.
LTV ratio — Loan to value ratio (see below).
OpCo — Operating company.
MFIs — Monetary financial institutions (see below).
PNFCs — Private non-financial corporations (see below).
SMEs — Small and medium-sized enterprises.

Glossary

Bank Rate The official rate paid on commercial bank reserves by the Bank of England.

Businesses Private non-financial corporations.

Consumer credit Borrowing by UK individuals to finance expenditure on goods and/or services. Consumer credit is split into three components: credit card lending, car finance and 'other' lending (including overdrafts and personal loans).

Covered bonds A secured bond issued by a bank or other financial institution. The bond is secured not only on the institution's assets generally, but also on a particular pool of assets, typically mortgage loans, that are specifically designated as collateral.

Effective interest rates The weighted average of calculated interest rates on various types of sterling deposit and loan accounts. The calculated annual rate is derived from the deposit or loan interest flow during the period, divided by the average stock of deposit or loan during the period.

Gross lending The total value of new loans advanced by an institution, or group of institutions, in a given period.

Holding company (HoldCo) Parent company of banking groups.

Loan to value (LTV) ratio Ratio of outstanding loan amount to the market value of the asset against which the loan is secured (normally residential or commercial property).

Major UK lenders Banco Santander, Barclays, HSBC, Lloyds Banking Group, Nationwide and Royal Bank of Scotland.

Monetary financial institutions (MFIs) A statistical grouping comprising banks and building societies.

Mortgage lending Lending to households, secured against the value of their dwellings.

Net lending The difference between gross lending and repayments of debt in a given period.

Operating company (OpCo) Legal entities that lenders typically use to undertake their lending and other business activities.

Other funding This refers to wholesale debt funding, wholesale deposits and funding via central bank operations.

Private non-financial corporations (PNFCs) All corporations (and partnerships) whose primary activity is non-financial and that are not controlled by central or local government.

Quoted interest rates The weighted average of a sample of advertised deposit and loan rates. Weights are calculated from Bank of England statistical collections.

Reference rate The rate on which loans are set, with an agreed margin over the reference rate (typically this will be Bank Rate, Libor or a swap rate).

Retail funding Funding raised by banks in the form of deposits from households and PNFCs.

Senior unsecured debt Debt securities issued by lenders that pay a coupon, along with a final redemption payment, which are repaid before junior liabilities if a bank becomes insolvent.

Swap rate The fixed rate of interest in a swap contract in which floating-rate interest payments are exchanged for fixed-rate interest payments. Swap rates are a key factor in the setting of fixed mortgage rates.

Total funding Retail and other funding, which includes wholesale funding.

Transfer price The marginal absolute cost charged internally to business units for obtaining funding from the treasury unit, ie the cost of funding the flow of new loans.

Write-off rate The value of write-offs divided by the stock of loans outstanding.

Symbols and conventions

Except where otherwise stated the source of data in charts is the Bank of England.

On the horizontal axes of charts, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.

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