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RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

21 NOVEMBER 2012

This is the record of the Interim Financial Policy Committee meeting held on 21 November 2012.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1212.pdf

In June 2010, the Chancellor of the Exchequer set out a plan for fundamental changes to the system of UK financial regulation. In July 2010 and February 2011, the Government published consultation documents on the proposed changes, and in January 2012 introduced the Financial Services Bill to Parliament. The legislation will establish a Financial Policy Committee (FPC). The responsibility of the Committee will relate primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system, and subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment.

The Government intends the FPC to be a Committee of the Bank of England's Court of Directors, and in February 2011 the Court created an interim FPC to undertake, as far as possible, the future statutory FPC's macroprudential role. Although lacking the proposed statutory powers of Direction and Recommendation of the statutory FPC, the interim FPC contributes to maintaining financial stability by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. It also carries out preparatory work and analysis in advance of the creation of the permanent FPC.

The Committee meets at least four times a year and a record of each meeting is published within six weeks.

The next meeting of the FPC will be on 19 March 2013 and the record of that meeting will be published on 5 April 2013.

RECORD OF INTERIM FINANCIAL POLICY COMMITTEE MEETING HELD ON 21 NOVEMBER 2012

The interim Financial Policy Committee unanimously agreed the following policy recommendation:

1. **The Committee recommends that the Financial Services Authority (FSA) takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.**

The macroeconomic and financial environment

1. The Committee reviewed recent financial system and economic developments as described in the November 2012 *Financial Stability Report*. The outlook for financial stability had improved a little since the previous *Report*. Global growth and financial conditions had, however, remained weak.

2. Risks from the euro area had continued to wax and wane in intensity, but were still considerable. Market concerns about severe near-term stresses in the euro area had reduced significantly following a period of heightened concern over the summer. In part, that had reflected further policy initiatives by the European Central Bank, including the announcement of a prospective programme of Outright Monetary Transactions. Nevertheless, economic headwinds remained. In particular, imbalances within the euro area continued to be substantial, with ongoing uncertainty about how they would be resolved in the medium term, and the fragmentation of euro-area credit flows had persisted.

3. UK credit growth had remained weak since the previous *Report*, but there were some signs of improvement looking ahead. The Funding for Lending Scheme (FLS) had contributed to a significant reduction in UK banks' marginal funding costs, which had been partially passed through to some lending rates. That had been consistent with some of the results in the Bank's latest Credit Conditions Survey, which reported that mortgage availability had increased in the third quarter and was expected to improve further in the fourth quarter. The survey had given fewer signs yet of an improvement in corporate credit conditions.

4. Following the Committee's June 2012 recommendation, the FSA had made a number of changes to its liquidity guidance to banks to reduce their incentives to hold excessive buffers of liquid assets. That recommendation had reflected evidence that the largest UK banks' holdings of liquid assets were more than sufficient to cover severe, though nevertheless still plausible, deteriorations in wholesale market liquidity conditions; were well above levels held by international peers; and that banks had significant amounts of collateral pre-positioned at the Bank of England for potential use of the Bank's liquidity facilities in stressed market conditions. Holdings of cash and securities in the liquid asset buffers of the major UK banks had fallen slightly in the second half of 2012, though this had so far tended to be used to repay debt rather than provide direct support to credit growth.

Previous policy recommendations

5. Section 4 of the November 2012 *Financial Stability Report* set out in detail the progress in implementing the Committee's recommendations over the past six months. In summary:

- The Committee's June 2012 recommendation on liquidity guidance was judged to have been implemented following the changes made by the FSA.
- Action continued in response to the September 2011 recommendation to HM Treasury to ensure that EU legislation did not constrain the Committee's use of macroprudential policy instruments. For example, HM Treasury had helped to negotiate changes to the draft texts of the Capital Requirements Directive and Regulation to provide for more extensive national discretion in the use of macroprudential policy instruments, although the final scope for such discretion was yet to be agreed.
- Action was underway in response to the November 2011 recommendation to the FSA to encourage banks to disclose their Basel III leverage ratios by the start of 2013. To underline that this did not imply that firms needed to be compliant with expected future leverage ratio minimum requirements in advance of their coming into force, the Committee saw merit in disclosure of leverage ratios using both Basel III end-point and transitional definitions of Tier 1 capital. UK banks and building societies were on track to meet this recommendation with effect from their end-2012 annual reports.
- A further recommendation, made in June 2012, to ensure greater consistency and comparability of banks' Pillar 3 disclosures was being taken forward by the FSA and the British Bankers' Association. Some specific improvements – including the reconciliation of accounting and Basel III regulatory capital measures – were likely to be made in the end-2012 accounts. But others were likely to take longer to implement.
- Finally, in response to a recommendation made by the Committee in June 2012, UK banks had taken a number of actions to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area. Balance sheets had been adjusted better to match local assets with local liabilities to mitigate potential currency risk and some exposures had been reduced. But the Committee agreed that it was important that banks continued to take action in this area.

6. The Committee agreed that two further previous recommendations – on building a sufficient cushion of loss-absorbing capital against current risks and improving balance sheet resilience, including through prudent valuations – were superseded by the recommendation described below.

7. The Committee had received an update on the UK authorities' contingency planning work. It agreed that its initially private recommendation to HM Treasury from September 2011 on contingency planning should remain in place given that the work was continuing. The Committee would receive a further update on progress ahead of its next meeting in March 2013.

8. The Committee reconsidered the case for publishing the recommendation, along with associated redacted text from the September 2011, November 2011 and June 2012 FPC Records. But the Committee continued to judge that publication now, prior to all of the relevant draft legislation being in the public domain, would be contrary to the public interest. In line with the terms set out in the Financial Services Bill (section 9R(1)), the Committee would keep that judgement under review and would publish the relevant text as soon as doing so was no longer judged to be against the public interest.[1]

Improving the resilience of the financial system

9. The Committee considered what further actions might be taken to improve the resilience of the financial system. In recent years, the UK banking system had faced large losses on both loans and trading assets. Banks had made adjustments to their balance sheets and raised capital in response. But progress in raising capital had slowed, partly reflecting the weakness in UK bank profitability which limited scope to generate capital internally. In order to improve their confidence, investors wanted to see measures taken to improve disclosures about balance sheet positions and fill gaps in capital buffers. The market value of major UK banks' shareholder equity (their net assets) had fallen on average to around two thirds of the book value of the equity.

10. Historical experience suggested that slow progress in tackling balance sheet problems could impede the recovery of banking systems – and, in turn, the wider economy – from financial crises. A large legacy of poor lending decisions and the perception that banks may have inadequately provisioned against future losses, including on loans subject to forbearance, could create uncertainty about bank capital adequacy and prospective earnings. This could both undermine investor confidence and inhibit the ability of banks to extend new loans to the real economy.

11. The Committee examined three factors that may have contributed to an overstatement of the true capital adequacy of the UK banking system.

(1) The text in this and the preceding paragraph were omitted from the version of the Record that was initially published on 4 December 2012. The Committee agreed at its June 2014 meeting to release this text, for the reasons set out in the Record of that meeting.

Expected losses and potential asset overvaluation

12. First, the Committee considered evidence of potential underrecognition of likely future losses on loans. Expected losses, in excess of those that could be recognised within existing accounting conventions, could materialise over the lifetime of banks' assets even if the economy recovered as anticipated. Fuller recognition of these would bring forward provisions, implying weaker profits for banks in the short term and a reduction in current measured capital buffers. While there was a degree of uncertainty surrounding estimates, bottom-up information from supervisory intelligence and banks' own public disclosures painted a consistent picture in this area. They suggested that expected losses on loans were in some cases greater than current provisions and regulatory capital held to meet UK banks' expected losses. For example, provisioning with respect to portfolios of non-performing loans varied considerably across banks. Based on their own disclosures, there were material differences in the current provisioning coverage ratios across banks for certain loan categories. This variation may have reflected, in part, differences in the underlying quality of each bank's portfolio of loans. But the potential for banks to experience greater future losses was consistent with supervisory intelligence and analysis of specific loan portfolios shown to the Committee. Concerns were especially apparent for some portfolios of real estate loans made in euro-area countries that had suffered from particularly sharp housing market corrections and for some UK commercial real estate (CRE) lending. Given falls in prices, a substantial proportion of CRE loans in the UK were now at loan to value ratios at which it would be hard to refinance if current market conditions persisted.

13. Underrecognition of expected losses would imply that the banking book valuations of banks' assets were overstated. Alternative estimates – from major UK banks' own disclosures – of the fair value of their banking book assets also supported the view that in some cases future expected losses would be greater than current provisions and regulatory capital set aside to cover likely losses. But with little information about how banks calculated these fair-value estimates, the Committee was cautious in taking the full extent of these headline fair-value disclosures too literally.

14. The Committee also recognised that there was uncertainty about the appropriate fair valuation of some banks' trading positions – especially those where no reliable market valuation existed and a model-based estimate had to be used instead. In part, it was this inherent uncertainty that had led regulators towards a so-called prudent valuation approach for these positions – which deliberately took a conservative view of fair valuations – for regulatory purposes. But there was

limited evidence available to the Committee that could help to gauge how large an impact any overvaluations of assets held in the trading book might have on the stated capitalisation of banks.

Unrecognised costs for conduct redress

15. Second, the Committee considered whether UK banks might have underestimated and underprovisioned for costs which were likely to arise in connection with conduct redress. In recent years, UK banks had underestimated the costs of redress for payment protection insurance (PPI) mis-selling. And in 2012, the number of identified conduct issues had grown, including for interest-rate swap mis-selling and Libor manipulation. Some external analysts had suggested major UK banks would face further unrecognised costs of between £4 billion and £10 billion for conduct redress relating to PPI and Libor alone. Given the number of conduct issues, and the potential for associated legal challenges, it seemed likely that banks could face additional sizeable costs as a result of this factor.

Risk-weighting of assets

16. Third, the Committee considered whether banks' capital positions could also be overstated because of aggressive application of risk weights. This primarily related to the latitude that banks had to determine the risk weights to apply to assets based on their "internal ratings-based" (IRB) models. Quantifying the magnitude of any implied overstatement was challenging as it was difficult to assess the extent to which bank-by-bank differences in risk weights reflected genuine variation in underlying asset quality. But there were reasons to believe that the overstatement of capital positions owing to aggressive risk weighting was likely to be significant. An exercise conducted recently by the FSA had asked banks to calculate the risk weights their respective IRB models would generate for an identical hypothetical portfolio. It had found that the most prudent bank's calculations implied well over twice as much capital would have been held than the most aggressive bank's calculations. Other exercises, which compared individual UK banks' actual average risk weights for categories of internally rated portfolios with the most conservative average risk weight in the group or applied Basel II standardised risk weights to aggregated portfolios, could imply an even more substantial overstatement of capital ratios.

Capital buffers available to cushion stress scenarios

17. Taking the impact of the above potential sources of capital overstatement together would imply that the major UK banks' capital buffers were not as great as regulatory capital ratios suggested. This was important as these buffers were meant to be able to cushion losses and maintain the supply of credit in the event of a stress scenario.

18. While the likelihood of stress scenarios materialising in the near term had declined, there remained a material possibility of disorderly outcomes, especially in the euro area, which would have major implications for UK financial stability. But it was impossible to determine in advance exactly how such risks might crystallise or the precise impact that they would have on the UK banking system. As well as affecting banks' direct exposures, risks could be transmitted via a range of indirect macroeconomic and financial interlinkages. The Committee noted that the FSA had already issued guidance to banks on the buffers that should be held against a stress scenario, calibrated in part with regard to a severe macroeconomic downturn. The effectiveness of banks' buffers, available to cushion severe but plausible stress scenarios, would need to be restored if they were diminished by correcting for any overstatement of headline capital ratios.

Summary and policy recommendation

19. While the significance of any capital overstatement was likely to vary across banks, the Committee judged that it was likely to be material in the context of the overall resilience of the UK banking system and its ability to support a sustained economic recovery. That conclusion was consistent with disaggregated evidence relating to the three above-mentioned contributory factors. But it was also buttressed by a range of aggregate indicators. For example, the estimated empirical relationship between funding costs and capital buffers suggested that banks would be able to access funding markets at a more sustainable cost, without support from schemes such as the FLS, if capital buffers were expanded significantly. And some members argued that capital overstatement could account for much of the apparently low market valuation of some banks in the current environment, although other members placed more weight on market participants' low expectations of, and uncertainty about, the profitability of future bank activity as an explanation of low valuations.

20. The Committee had examined a wide range of analysis – taken from both an aggregated and disaggregated perspective – to gauge the possible quantitative significance of any capital overstatement. Despite uncertainty around any quantitative estimates, Committee members agreed that, based on estimates derived from a number of different approaches, the aggregate

capital overstatement at the four largest UK banks was of the order of £60 billion–£80 billion, given their current balance sheets. At a disaggregated level, members had greater confidence in the quantitative estimates for some factors than for others. For example, in part because the Committee benefited from the guidance of the Managing Director of the FSA's Conduct Business Unit, it seemed likely that the major UK banks would collectively face further, currently unrecognised, conduct-related costs of the order of £10 billion–£20 billion within the next few years. In contrast, there was a wide range of estimates of possible unrecognised expected losses. But, on balance, the Committee judged that unrecognised expected losses were likely to be around £30 billion–£40 billion, spread unevenly across the major UK banks. Gauging the scale to which capital positions may be overstated by aggressive risk-weighting was even harder. But, considering the range of alternative approaches, the Committee judged that this factor might equate to around £20 billion of capital, given the current structure of the major UK banks' balance sheets.[2]

21. It was possible that any capital overstatement could be corrected over time and that gradual adjustment of balance sheets would slowly return UK banks to a position which would enable them better to support the economy. But, where necessary, taking decisive action to tackle problems in banks' legacy portfolios and remove uncertainty about capital adequacy could help to rebuild confidence and so enable banks to expand their balance sheets more quickly to support new lending and the wider economic recovery. Such action would also allow banks to take advantage of improved market conditions and existing policy initiatives aimed at supporting lending.

22. In light of these considerations**, the Committee recommended that the FSA takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.**

23. As described above, this recommendation replaced previous recommendations in respect of capital raising and was the approach that the Committee asked the FSA (and subsequently the

(2) In the interests of avoiding unnecessary market uncertainty, the Committee decided not to include these initial estimates in the Record of its November 2012 meeting and to defer publication until after further work was complete. In view of the PRA Board's adoption and planned implementation of the Committee's March recommendations, the FPC judged at its June 2013 meeting that it was appropriate to release the text previously omitted from the Record on the initial estimates which led to this work. The background to this is outlined in Section 4 of the June 2013 *Financial Stability Report*.

PRA) to follow for the foreseeable future. Members emphasised the importance of providing clarity to each institution about what it needed to do to improve its resilience.

24. The Committee asked the FSA to report back on the actions that had been taken in response to this recommendation for the major UK banks in advance of its March 2013 meeting and subsequently provide quarterly updates on progress to the Committee. There were a number of possible ways that these banks could strengthen resilience, if necessary. For example, they could increase current core Tier 1 capital directly – either through external issuance or liability management exercises, as well as through continued restraint on distributions and compensation. Or banks could issue contingent capital instruments with high triggers to ensure that they have sufficient capital buffers in stressed circumstances. Or disposal of non-core assets or businesses could be an effective way for a firm to build its resilience, if done in a way that did not hinder lending to households and businesses.

25. The analysis and indicators available to the Committee had been most comprehensive with respect to the largest UK banks. The Committee agreed that it was important that any potential overstatement of the capital position of other UK banks and building societies was investigated more fully using the same approach. The FSA agreed to undertake this task in the coming months.

26. There was a risk that if these factors were highlighted by the Committee in public, without there being clear accompanying actions, confidence in UK banks – and hence financial stability – could be adversely affected. The FSA therefore laid out an initial indication of the likely actions each major bank could take to strengthen their resilience. One major UK bank had recently issued contingent capital instruments, and the FSA had been in active discussions with that bank about issuing further such capital. Another bank had recently announced asset sales which would boost its capital buffer, and it already had a greater cushion of loss-absorbing capital over the FSA's guidance. The feasible actions for the two major UK banks in which there was a significant public stake were more limited, in part because the Chancellor, via the Treasury member, had clearly indicated to the Committee that he was not minded to inject additional public funds into these banks unless absolutely necessary in the interests of UK financial stability. But, amongst other options, there were actions that these banks could take to accelerate the restructuring of their balance sheets, without hindering lending. Moreover, some members argued that the fact that these banks had large public stakes implied that confidence in these institutions was more likely to be maintained even if problems in their balance sheets were revealed. They were, therefore, arguably less likely to pose an immediate threat to financial stability. But the case for taking

decisive action to deal with the legacy problems at these institutions was strengthened by the scale of the issues they appeared to have in the specific areas considered by the Committee. And the substantial share of lending to households and businesses that these two banks accounted for implied that they were more likely to pose a medium-term threat to overall financial stability if they acted as a constraint on a macroeconomic recovery. It was important that the FSA firmed up these initial indications with all of the individual institutions promptly, to ensure that there was no ambiguity about what the FPC's general recommendation implied for each of them.

27. The Committee agreed, however, that it would be contrary to the public interest to reveal the broad quantitative judgements it had made with respect to the overstatement of banks' capital positions across the sector, or the FSA's indications of likely actions that banks might take to rebuild their resilience, at this point.[3]

Structural issues affecting financial stability

28. The Committee's recommendation called for the FSA to ensure that banks developed more prudent approaches to the calculation of risk weights used in determining regulatory capital adequacy metrics. The current framework was complex and opaque, often relying on thousands of estimated and calibrated parameters. This may have undermined investor confidence in the application of the capital adequacy regime.

29. In order to provide market participants with an alternative measure of solvency that did not rely on risk-weight calculations, the Committee had previously recommended in December 2011 that UK banks disclose their Basel III leverage ratios not later than the beginning of 2013. In June 2012, the Committee recommended that the FSA ensures greater consistency and comparability of UK banks' Pillar 3 disclosures, in part to help investors to reconcile accounting and regulatory measures of capital more easily.

30. The Committee discussed and supported a number of other initiatives underway domestically and internationally to improve the calculation of risk weights. In the United Kingdom, the FSA had introduced floors to banks' estimates of some parameters in the calculation of risk weights which should guard against the most imprudent behaviour. And internationally, the Basel Committee had embarked upon a detailed review of risk-weight calculations that would conclude in 2013. That would set out recommendations and options for ongoing monitoring and supervisory activities to foster greater consistency in the determination of banks' risk weights.

(3) The text in this and the preceding paragraph were omitted from the version of the Record that was initially published on 4 December 2012. The Committee agreed at its September 2013 meeting to release this text, for the reasons set out in the Record of that meeting.

31. Furthermore, the Committee welcomed the recent recommendations of the Enhanced Disclosure Task Force (EDTF) – a collaboration of private sector stakeholders established by the Financial Stability Board (FSB) – which had recently developed principles and recommendations for strengthening banks' disclosures. The EDTF's recommendations in the areas of capital and risk-weighted assets were aimed at providing investors with more granular information to help them understand risk-weighted asset calculations across banks and through time. Swift implementation of these recommendations could help to reduce the extent of investor uncertainty about these calculations.

32. The Committee recognised that some authorities had recommended alternative approaches to increase confidence in this area. For example, the Swiss National Bank had recommended that the largest Swiss banks should calculate and disclose risk-weighted assets calculated on a standardised approach, in addition to the model-derived reports already in place.

33. The Committee agreed to consider further the issues raised by the current risk-weighting framework, and would encourage work in international fora to achieve additional improvements in the future.

34. The Committee also discussed the structure of remuneration contracts for bank executives. Inappropriately structured contracts could lead to risks being mismanaged. Steps could be taken to ensure that contracts provided sufficient incentives for executives to consider the full implications for long-term business performance, which would be desirable from the perspective of systemic stability. There were three factors of particular concern to the Committee.

35. First, elements of remuneration could be inappropriately tied to short-term targets unadjusted for risk, such as return on equity. Such targets, without appropriate risk adjustment, could be achieved by increasing leverage, as banks had done in the decade before 2007. The Committee agreed that adjusting for risk was difficult – as illustrated by the concerns about the calculation of risk weights. But it was encouraging that, in recent years, a number of banks had reduced somewhat their reliance on metrics that made no allowance for risk. In the Committee's view, further progress could be made and it was important that the improvements were not reversed in the future, particularly when external conditions picked up.

36. Second, the period over which executives' decisions would have an impact on the bank's performance was typically much longer than the period used to judge management performance as reflected in remuneration. In particular, deferral of the long-term incentive component of variable

remuneration was typically just three years for the executives of the major UK banks – far shorter than the length of the typical business or credit cycle.

37. Third, remuneration contracts could be better structured to expose executives to the potential downside outcomes over the full term of the risks they take. The major components of UK banks' executive remuneration were cash and shares. An advantage of the latter was that – if paid in the form of new shares – it could help banks raise capital in a similar way to retaining earnings. But the Committee also noted that incentives could be better aligned to longer-term outcomes if compensation packages were able to include a greater proportion of suitable debt instruments, for example subordinated debt instruments, or debt instruments which carry the potential for bail-in, as had recently been suggested by the Liikanen Group report.

38. The Committee agreed it would encourage and welcome actions by the appropriate international authorities – the European Commission, the European Systemic Risk Board and the FSB – to consider these issues in further developments of the remuneration codes and emphasised their importance for UK banks' current remuneration round.

The following members of the Committee were present:
Mervyn King, Governor
Paul Tucker, Deputy Governor responsible for financial stability
Charles Bean, Deputy Governor responsible for monetary policy
Andrew Bailey, Head of the Prudential Business Unit of the Financial Services Authority
Adair Turner, Chairman of the Financial Services Authority
Alastair Clark
Michael Cohrs
Paul Fisher
Andrew Haldane
Robert Jenkins
Donald Kohn
John Kingman attended as the Treasury member.

Martin Wheatley, Head of the Conduct Business Unit of the Financial Services Authority and CEO Designate of the Financial Conduct Authority, also attended in a non-voting capacity.

ANNEX: EXTANT FPC RECOMMENDATIONS AS PUBLISHED IN THE NOVEMBER 2012 *FSR*

Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '11/Q3/3' refers to the third recommendation made at the 2011 Q3 meeting.

11/Q3/3: The Committee urged HM Treasury to continue its efforts to ensure that developments in European legislation did not provide an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom, as envisaged in the consultation documents proposing the establishment of the FPC.

11/Q4/3: The Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.

12/Q2/3: The Committee recommends that banks work to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area.

12/Q2/5: The Committee recommends that UK banks work with the FSA and the British Bankers' Association to ensure greater consistency and comparability of the Pillar 3 disclosures, including reconciliation of accounting and regulatory measures of capital, beginning with the accounts for the current year.

12/Q4/1: The Committee recommends that the FSA takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs, and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.