5 Prospects for financial stability

The outlook for financial stability has improved a little. Global growth and financial conditions, however, remain weak. Risks from the euro area wax and wane in intensity, but are still considerable. In the United Kingdom, progress by banks in raising capital levels has slowed and investor confidence remains low, partly reflecting concerns about likely future losses.

The Committee recommends a series of actions to reinforce the resilience of the UK banking system and so put it in a better position to expand lending to support the real economy. Implementation of these recommendations by the FSA should provide greater clarity to the banks about the capital needed to support their business.

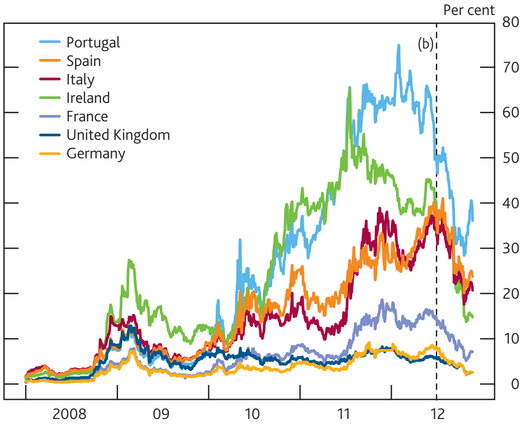
The Committee has examined a number of factors affecting the capital adequacy of the UK banking system. These include: the extent of banks' provisions against expected future losses and costs of redress for past conduct; potential inadequacies in banks' risk-weighting methodologies; and the possible impact of crystallisation of risks in the world economy, including those stemming from the euro area. The Committee had previously discussed these factors and their potential significance. While their significance varies across banks, the Committee judges that, together, they are likely to have material implications for the overall resilience of the UK banking system and its ability to support a sustained economic recovery.

- 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.

This recommendation replaces previous recommendations in respect of capital raising and is the approach that the Committee has asked the FSA (and subsequently the Prudential Regulation Authority (PRA)) to follow for the foreseeable future. The Committee asks the FSA to report back on actions taken in response to this recommendation in advance of its March meeting and subsequently provide updates on progress as part of its quarterly microprudential supervisory update to the Committee.

Sections 1–3 of this *Report* outline developments in the global financial environment and short and medium-term risks to financial stability. Section 4 describes the activity of the Committee and the progress made in implementing its past recommendations. This section sets out the decisions taken by the Committee at its November 2012 meeting, in light of its conclusions about the outlook for financial stability. This section also includes a box explaining a proposed role for the statutory FPC in making recommendations to HM Treasury regarding the boundary between regulated and non-regulated sectors of the UK financial system.

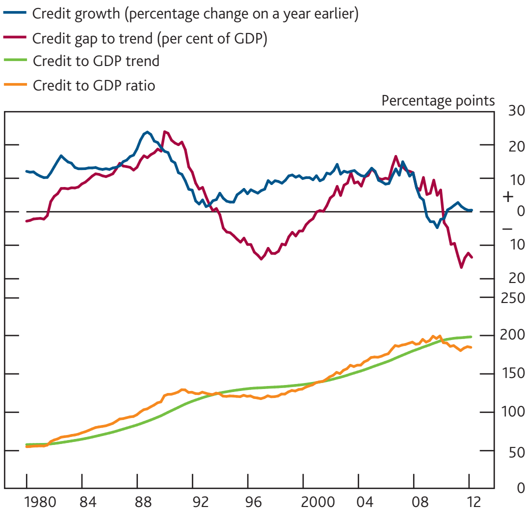
Chart 5.1 Market-implied default probabilities over the next five years for selected sovereign debt[(a)]



Sources: Markit Group Limited and Bank calculations.

(a) Probability of default, derived from CDS premia, from the perspective of a so-called 'risk-neutral' investor that is indifferent between a pay-off with certainty and an uncertain pay-off with the same expected value. If market participants are risk-averse, these measures may overstate actual probabilities of default. A loss given default of 60% is assumed.
(b) June 2012 *Report*.

Chart 5.2 UK credit gap and credit growth[(a)(b)]



Sources: Bank of England, ONS and Bank calculations.

(a) Credit is defined here as debt claims on the UK private non-financial sector. This includes all household liabilities and private non-financial corporations' loans and debt securities excluding derivatives, direct investment loans and loans secured on dwellings. The credit to GDP gap is calculated as the percentage point difference between the credit to GDP ratio and its long-term trend, where the trend is based on a one-sided HP filter with a smoothing parameter of 400,000. Latest value is for 2012 Q2.
(b) Twelve-month growth rate of nominal credit. Credit is defined as above. Latest value is for 2012 Q2.

5.1 Recent developments

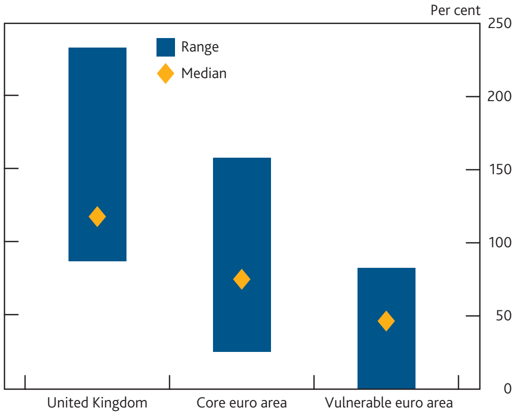
The outlook for financial stability has improved a little since the previous *Report*. Global growth and financial conditions, however, remain weak. Risks from the euro area wax and wane in intensity, but are still considerable.

Market concerns about severe near-term stresses in the euro area have reduced significantly following a period of heightened concern over the summer (**Chart 5.1**). In part, this reflects further policy initiatives by the ECB, including the announcement of a prospective programme of Outright Monetary Transactions. While that has reduced the immediate threat of countries exiting the euro area, the fragmentation of euro-area credit flows, and economic headwinds, have persisted. And imbalances within the euro area remain substantial, with ongoing uncertainty about how they will be resolved in the medium term.

UK credit growth has remained weak since the previous *Report* (**Chart 5.2**). There are some signs of improvement in credit conditions looking ahead. The Funding for Lending Scheme has contributed to a significant reduction in UK banks' marginal funding costs, which have been partially passed through to some lending rates. That is 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. But the survey gave fewer signs yet of an improvement in corporate credit conditions.

As discussed in Section 4 of this *Report*, following the Committee's June 2012 recommendation, the FSA made a number of changes to its liquidity guidance to banks to reduce their incentives to hold excessive buffers of liquid assets. This recommendation reflected evidence that the largest UK banks' holdings of liquid assets were more than sufficient to cover severe, but plausible, liquidity stresses; were well above levels held by international peers (**Chart 5.3**); and that banks had significant amounts of collateral pre-positioned at the Bank of England for use in liquidity stresses. Holdings of cash and liquid asset buffer securities have fallen slightly in the second half of 2012, though this has

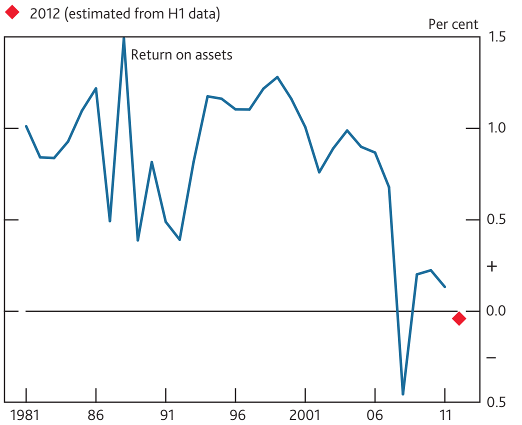
Chart 5.3 Liquid assets as a proportion of stressed outflows by banking sector[(a)(b)(c)]



Sources: Liquidatum and Bank calculations.

(a) Models a three-month market-wide stress, assuming severe, but plausible, retail, wholesale and bank deposit outflows and issuance.
(b) Includes four UK banks, ten core euro-area banks and eleven other euro-area banks.
(c) Estimated liquid assets are calculated by summing stable funding sources, which include unsecured bank and wholesale funding, retail deposits, debt in issue and equity, minus illiquid assets, which are defined as total assets less the sum of securities, cash, insurance assets, reverse repos and derivatives. The difference between these two is assumed to be funds invested in liquid assets.

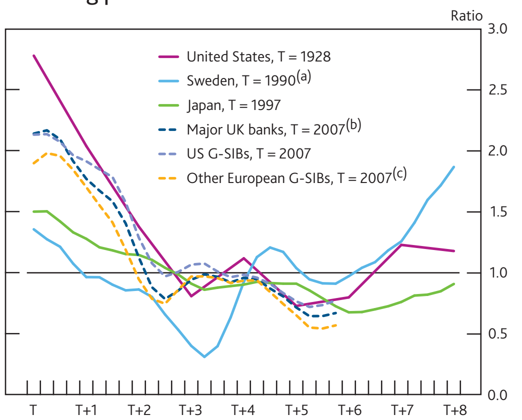
Chart 5.4 Banks' return on assets before tax[(a)]



Sources: Published accounts and Bank calculations.

(a) Calculated as major UK banks' net income (excluding tax) as a proportion of assets averaged over the current and previous year.

Chart 5.5 Price to book ratios of banking sectors following past financial crises



T = beginning of crisis

Sources: Calomiris, C W and Wilson, B (2004), 'Bank capital and portfolio management: the 1930s 'capital crunch' and the scramble to shed risk', *Journal of Business*, Vol. 77, No. 3, pages 421–55, Thomson Reuters Datastream and Bank calculations.

(a) Svenska Handelsbanken and SEB.
(b) Excludes Britannia, Co-operative Banking Group, Nationwide and Northern Rock (from end-2007).
(c) See footnote (d) in **Chart 2.3**.

tended to be used to repay debt rather than provide direct support to credit growth.

5.2 Improving the resilience of the financial system

In recent years, the UK banking system has faced large losses on loans and trading assets. Banks have made adjustments to their balance sheets and raised capital in response. But as described in Section 2 of this *Report*, progress in raising capital has slowed, partly reflecting the weakness in UK bank profitability (**Chart 5.4**). This has limited the scope for internal capital generation. Investor confidence in banks remains low: the market value of major UK banks' shareholder equity (their net assets) has fallen on average to around two thirds of the book value.

As discussed in Box 2 of this *Report* on the Japanese experience, slow progress in tackling balance sheet problems can impede the recovery of banking systems and, in turn, the wider economy. A large legacy of poor lending decisions and the perception that banks may be inadequately provisioning, including against loans subject to forbearance, can create uncertainty about bank capital adequacy. This may both undermine investor confidence (**Chart 5.5**) and inhibit the ability of banks to extend new loans to the real economy.

At its November meeting, the Committee examined a number of factors affecting the capital adequacy of the UK banking system.

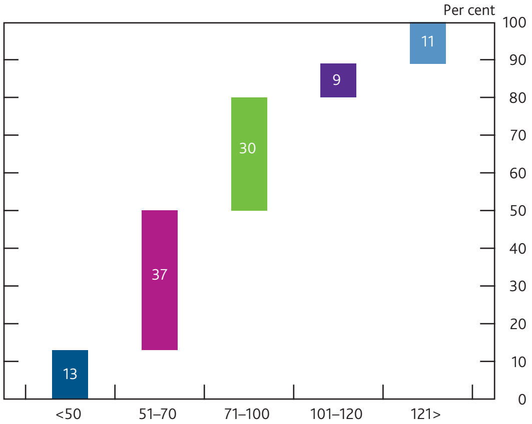
Expected losses and prudent valuation

Factors which may make the stated levels of capital misleading include the underrecognition of expected future losses on loans and inadequate provisioning for future costs of redress for past conduct. Fuller recognition of these expected losses and costs would imply weaker profits in the short term and erosion of current capital buffers.

Information from supervisory intelligence and banks' own public disclosures paint a consistent picture. They suggest that expected losses on loans are in some cases greater than current provisions and regulatory capital deductions for UK banks' expected losses.

For example, provisioning coverage ratios on portfolios of non-performing loans vary considerably across banks. Based on banks' own disclosures, there are material differences between current provisions and what would be implied by the most conservative approach adopted by peer group banks. This variation may partly reflect different underlying loan quality between banks; but the potential for more losses is consistent with analysis of specific loan portfolios shown to the Committee. Concerns are especially apparent for some

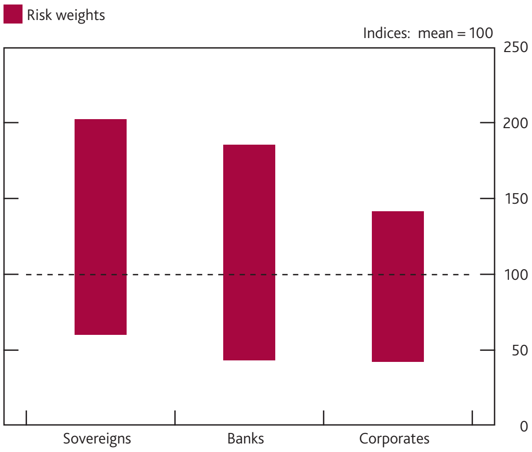
Chart 5.6 Loan to value ratios of UK CRE exposures by proportion of outstanding debt(a)(b)



Sources: De Montfort University and Bank calculations.

(a) Responses were received from organisations holding approximately £190 billion of outstanding debt.
(b) The chart shows an estimation of the proportion of the outstanding debt that had a current loan to value ratio falling within the brackets given.

Chart 5.7 Variability of overall risk-weight estimates in 2011(a)(b)



Sources: FSA and Bank calculations.

(a) Chart shows minimum-maximum ranges. Results have been normalised to mean = 100.
(b) Based on the results of the FSA's hypothetical portfolio exercise for 2011. 'Risk weights' are estimated proxy risk-weighted asset statistics. Sample of six firms' data.

portfolios in vulnerable euro-area economies and on UK commercial real estate (CRE) lending, where a substantial proportion of loans are at loan to value ratios that, if current market conditions persist, will make loans hard to refinance (**Chart 5.6**).

Top-down estimates from UK banks' own disclosures of the fair value of their banking book assets, discussed in Section 2 of this *Report*, also support the view that in some cases future expected losses will be greater than current provisions and capital deductions. But with little information about how banks calculate these values, the Committee is cautious in taking the full extent of these headline fair-value figures too literally.

In recent years, UK banks have also underestimated and underprovisioned for costs for conduct redress, notably for payment protection insurance (PPI) mis-selling. In 2012, the number of identified conduct issues has grown, including for interest rate swap mis-selling and Libor manipulation. Some external analysts have suggested a range of £4 billion to £10 billion for further unrecognised PPI and Libor-related costs alone for major UK banks. It seems likely that banks could face further sizable costs for other conduct redress and potential future legal challenges.

Risk weighting of assets

Banks' capital positions could also be overstated because of aggressive application of risk weights, as discussed in Section 3 of this *Report*.

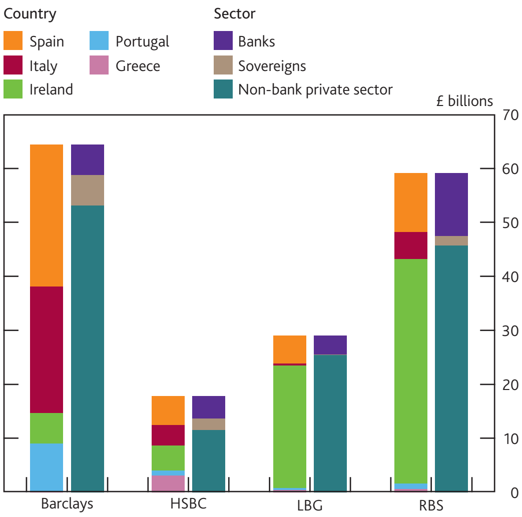
Quantifying the magnitude of any implied overstatement is challenging as it is difficult to assess the extent to which the differences in risk weights reflect variation in underlying asset quality. But hypothetical portfolio exercises recently conducted by the FSA, which ask banks to calculate risk weights for an identical hypothetical portfolio, confirm that this is likely to be significant. For example, in these exercises, the most prudent banks' calculations implied that well over twice as much capital would have been held than implied by the most aggressive banks' calculations for the same portfolios of exposures (**Chart 5.7**). As discussed in Section 3 of this *Report*, other simple exercises comparing UK banks' actual average risk weights with the most conservative in the group or applying Basel II standardised risk weights can imply an even more substantial overstatement of capital ratios.

Capital buffers for stress scenarios

In combination, these factors would imply that UK banks' capital buffers, available to cushion losses and maintain the supply of credit following realisation of a stress scenario, may not be as great as headline regulatory capital ratios imply.

As has been emphasised in previous Committee recommendations, the Committee assesses the threat of

Chart 5.8 UK banks' exposures to vulnerable euro-area economies — country and sector split[a]



Sources: Published accounts and Bank calculations.

(a) All data are as at 2012 H1, gross of provisions.

severe stress arising from risks in the euro area to be considerable. While the immediate risks have reduced, there remains a possibility of disorderly outcomes, which if they occurred would have major implications for UK financial stability. But it is impossible to determine in advance exactly how risks may crystallise or the precise impact that they would have on the UK banking system. While UK banks have significantly reduced their direct exposures to sovereigns and banks in vulnerable euro-area economies, exposures remain sizable (**Chart 5.8**). And, as discussed in Section 2 of this *Report*, the major UK banks' exposures to non-bank private sectors in these countries are likely to remain significant for some time, unless they sell loans or businesses. It is essential that UK banks maintain a capital buffer sufficient to absorb losses and maintain the supply of credit in the event of a stress, in particular if euro-area risks crystallise.

Summary and the policy recommendation

While their significance varies across banks, the Committee judges that, together, the factors discussed above are likely to have material implications for the overall resilience of the UK banking system and its ability to support a sustained economic recovery. These uncertainties about capital adequacy are likely to account in part for the weak market valuation of some banks in the current environment.

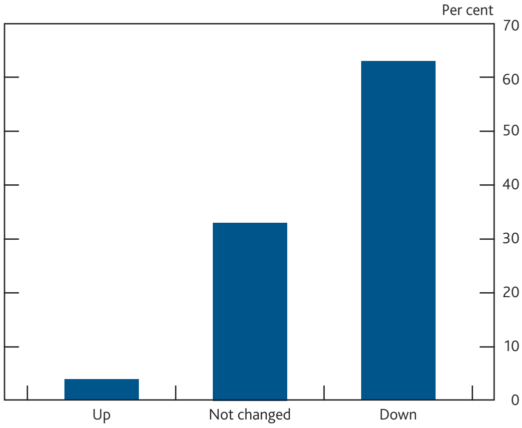
It is possible that these uncertainties may lift over time and that gradual adjustment of balance sheets will slowly return UK banks to a position which would enable them better to support the economy. But where necessary, taking decisive action to tackle problems in banks' legacy portfolios could help 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 other policy initiatives aimed at supporting lending.

Recommendation 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.

This recommendation replaces previous recommendations in respect of capital raising and is the approach that the Committee has asked the FSA (and subsequently the PRA) to follow for the foreseeable future. The Committee asks the FSA to report back on actions taken in response to this recommendation in advance of its March 2013 meeting and

Chart 5.9 Investor perceptions: has your confidence in risk-weighted assets gone up or down?(a)



Source: Barclays Research.

(a) Based on survey responses of over 130 investors carried out in 2012 H1, of perceptions over the past year.

subsequently provide updates on progress as part of its quarterly microprudential supervisory update to the Committee.

There are a number of possible ways to strengthen resilience. For example, banks 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 bank to build its resilience, if done in a way that does not hinder lending to the economy.

5.3 Structural issues affecting financial stability

Risk-weighted asset disclosures

The Committee's Recommendation 1 calls for the FSA to ensure that banks develop more prudent approaches to the calculation of risk weights used in determining regulatory capital adequacy metrics. The current framework is 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 (**Chart 5.9**).

In order to provide market participants with an alternative measure of solvency that does not rely on risk-weight calculations, the Committee previously recommended in December 2011 that UK banks disclose their leverage ratios, as defined in the Basel III agreement, not later than the beginning of 2013. In June 2012, the Committee recommended that the FSA ensure 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.

The Committee supports a number of other initiatives under way domestically and internationally to improve the calculation of risk weights. In the United Kingdom, the FSA has 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 has embarked upon a detailed review of risk-weighted asset calculations for large, internationally active banks that will conclude in 2013, and will consider recommendations and options for ongoing monitoring and supervisory activities to foster risk-weighted asset consistency.

Furthermore, the Committee welcomes the recommendations of the Enhanced Disclosure Task Force (EDTF) — a collaboration of private sector stakeholders established by the Financial Stability Board — which develops principles and recommendations for strengthening banks' disclosures.[1] The EDTF's recommendations in the areas of capital and risk-weighted assets are 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 significantly help reduce the extent of investor uncertainty about these calculations.

The Committee recognises that some authorities have recommended alternative approaches to increase confidence in this area. For example, the Swiss National Bank has 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.

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

The structure of remuneration contracts

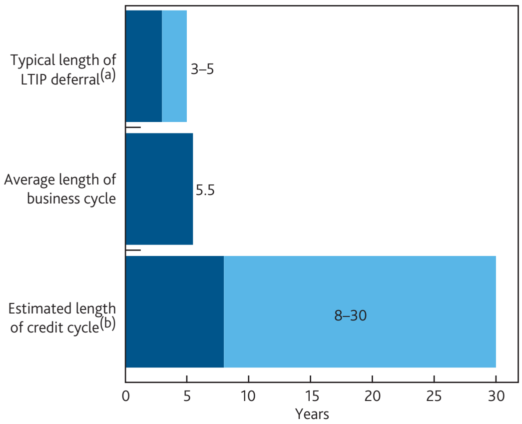
Inappropriately structured remuneration contracts for bank executives can lead to risks being mismanaged. Steps could be taken to ensure that the structures of bank executives' remuneration contracts provide sufficient incentives to consider the full implications for long-term business performance, which would be desirable from the perspective of systemic stability. There are three factors of particular concern.

First, elements of remuneration can be tied to short-term targets unadjusted for risk, such as return on equity. Without appropriate risk adjustment, such targets can be achieved by increasing leverage, as banks did in the decade before 2007. There is evidence to suggest that a number of banks have reduced somewhat their reliance on such metrics over recent years. But there is further to go and there is a risk that this progress could be easily reversed in future, particularly when external conditions improve.

Second, the period over which executives' decisions will have an impact on the bank's performance is 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 is typically just three years for the major UK banks' executives, far shorter than the length of the typical business or credit cycle (**Chart 5.10**).

Third, remuneration contracts could be better structured to expose executives to the potential downside outcomes over the longer term of the risks they take. The major components

Chart 5.10 Typical length of deferral in long-term incentive plans (LTIPs) relative to cycles



Sources: Drehmann, M, Borio, C and Tsatsaronis, K (2012), 'Characterising the financial cycle: don't lose sight of the medium term!', *BIS Working Paper No. 380*, NBER, published accounts and Bank calculations.

(a) LTIPs paid to executive directors at the following UK banking groups: Barclays, HSBC, LBG and RBS. The range of deferral length is shown by the light blue bar.
(b) The minimum and maximum estimates for the length of the medium-term credit cycle are represented by the light blue bar.

(1) www.financialstabilityboard.org/publications/r_121029.pdf.

of UK banks' executive remuneration are cash and shares. But the Committee notes 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 recently suggested by the Liikanen Group report.(1)

The Committee would encourage and welcome actions by the appropriate international authorities — the European Commission, the European Systemic Risk Board and the Financial Stability Board — to consider these issues in further developments of the remuneration codes and emphasises the importance of these concerns for UK banks' current remuneration round.(2)

(1) http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.
(2) The Financial Stability Board has developed 'Principles and standards for sound compensation practices'. See www.financialstabilityboard.org/activities/compensation/index.htm.

Box 4
Regulatory perimeter

The Financial Services Bill proposes to give the Financial Policy Committee (FPC) the ability to make recommendations to HM Treasury regarding the boundary between regulated and non-regulated sectors of the UK financial system — the regulatory perimeter. In particular, the FPC may recommend: (i) what is a regulated activity under the Financial Services and Markets Act 2000 (FSMA); and (ii) which particular activities are prudentially regulated by the Prudential Regulation Authority (PRA). The FPC will do so in support of its objective of removing or reducing systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Note that the UK regulatory perimeter under FSMA is defined in terms of activities (eg deposit-taking, effecting or carrying out contracts of insurance) rather than institutions.(1) This box describes how systemic risk can arise outside the current regulated sector and how the FPC might exercise its powers in relation to the regulatory perimeter to mitigate these risks.

Systemic risk in the financial system

Systemic risk can arise when there is a material disruption to the provision of financial services that are critical to the real economy or to the functioning of the financial system. Critical financial services to the real economy include: credit intermediation; risk management and insurance; and payment services.(2) Financial activities that support the provision of these critical services to the real economy include: the provision of capital and funding to financial institutions; market liquidity services such as market-making and securities lending and repo transactions; risk management and insurance services; infrastructure provision, including payments and clearing; and institutional design features, such as accounting standards and credit ratings.

The vast majority of these activities will pose no systemic risk to the financial system. Of those that do, many will already be subject to regulatory oversight. But some unregulated activities could prospectively pose risks to the financial system — either in and of themselves or via links with regulated entities, such as banks. Indeed, some activities may be undertaken purely in order to avoid financial regulation.

Over the next few years, the global financial system is likely to evolve rapidly, as the new regulatory framework begins to take effect. In such an environment, it will be essential to ensure that systemic risk is not simply transferred from the regulated to unregulated sectors, exposing the system unnecessarily to the possibility of further financial crises.

The FPC's proposed role in policing the regulatory perimeter is intended to guard against this risk. In doing so, there are two key dimensions that the FPC will need to consider when determining whether or not an activity poses a systemic risk to the financial system. First, is the activity systemically important? Second, is the activity inherently fragile?

The FPC's deliberations on whether an activity is systemically important are likely to be guided by a set of standard criteria, that have been developed by the Financial Stability Board (FSB), including:

- **Size**: how important the activity is in terms of the service it provides, either directly to the real economy or to other financial institutions that support the real economy.

- **Complexity**: how difficult it is to understand the risk posed by an activity.

- **Interconnectedness**: how long, strong and complex are the intermediation chains between financial institutions.

Indicators of fragility, meanwhile, may vary according to whether or not an activity is undertaken by a particular set of institutions or within financial markets.

- For **institutions**, fragility relates to those factors that increase the likelihood and impact of failure. In general, institutional fragility is an increasing function of both leverage and maturity transformation. In cases where liquidity or capital can be withdrawn or capital is not truly loss-absorbing, fragility may also be much greater than would otherwise be the case. Banks are fragile as they take significant leverage and engage in maturity transformation. Money market funds, meanwhile, are susceptible to 'runs' on liquidity.

- For **financial markets**, fragility relates to their propensity to close or become severely disrupted. This can occur as a result of poor infrastructure or because the actions of participants drain liquidity and other services essential to the smooth functioning of markets. For example, where a significant proportion of market liquidity is supplied by institutions that are themselves levered, the market might be considered inherently fragile. Pre-crisis, this applied to the UK residential mortgage-backed securities market, for which the majority of the investor base was represented by leveraged and maturity-mismatched institutions.

Exercising the FPC's powers

Whether the FPC will recommend that an activity is brought within the regulatory perimeter will depend not only on whether the risk posed by the activity is systemic, but also on whether regulation of the activity can help to mitigate this systemic risk. Underlying this judgement will be an analysis of the different types of regulatory intervention that could be used to address the risk.

- **Prudential regulation**: designed to promote the safety and soundness of individual institutions.

- **Conduct of business regulation**: designed to establish rules and guidance about appropriate behaviour and business practices.

- **Product regulation**: one element of conduct of business regulation involving limiting or banning particular financial products.

- **Resolution and/or consumer compensation arrangements (eg depositor protection)**: may help where the systemic risk arises as a result of disorderly failure and normal insolvency arrangements will not suffice.

- **Indirect regulation**: limiting or monitoring the exposure of the regulated sector to the activity. This form of regulation may be of particular benefit where the activity takes place outside the United Kingdom.

The PRA will be responsible for the prudential regulation of deposit-takers, insurers and designated investment firms. The FPC may be likely to recommend prudential supervision by the PRA when it is best placed to carry this out given its objectives and capabilities. For example, the largest broker-dealers take principal risk on their balance sheets and the PRA has the relevant expertise for prudentially supervising firms that take such risks.

The process of recommending whether or not an activity should lie within the regulatory perimeter will not necessarily be a one-way process. For example, the FPC could judge that the costs of regulating certain activities are not justified on systemic risk grounds. In this case, it could recommend to HM Treasury that the activity is excluded from regulation. Whether HM Treasury chose to accept such a recommendation would depend on whether it considered there were other grounds for regulating the activity beyond systemic risk.

The FPC will also need to be mindful of other initiatives, both domestically and globally, that may affect the perimeter. For example, many activities presenting a systemic risk that are currently unregulated take place within the so-called 'shadow banking' sector. This is broadly characterised by firms that are leveraged and conduct maturity transformation, both of which serve to instil fragility into the financial system.(3) On 18 November 2012, the FSB published its report on strengthening oversight and regulation of shadow banking.(4) And the European Commission published a green paper on shadow banking earlier this year.(5)

In some cases, legal constraints may further limit HM Treasury's ability to effect any FPC recommendations. For example, HM Treasury does not have jurisdiction to amend the perimeter where a regulated activity is undertaken outside the United Kingdom by an overseas firm. Furthermore, where regulation of particular activities or institutions is required under EU law, HM Treasury may be constrained from making changes that would alter the scope of the perimeter.

To deliver its responsibilities in this area, the FPC will discuss regulatory perimeter issues on a periodic basis. As part of these discussions, the FPC will consider the costs and benefits of making any change. Following these discussions, the FPC may choose to set out analysis in future *Financial Stability Reports* or make recommendations to HM Treasury in respect of amending the perimeter.

Where the FPC decides to recommend to HM Treasury a change in the regulatory perimeter, this will be published in the formal record of the FPC's meetings (unless publication is against the public interest). HM Treasury would decide whether to accept any recommendation and, if it did, it would consult as appropriate.

(1) That is because institutions may change the activities that they carry out over time.
(2) See Bank of England *Annual Report 2010*, page 26.
(3) See Financial Stability Board 'Shadow banking: scoping the issues', April 2011. See also Tucker, P (2010), 'Shadow banking, financing markets and financial stability', available at www.bankofengland.co.uk/publications/Documents/speeches/2010/speech420.pdf.
(4) See www.financialstabilityboard.org/publications/r_121118.pdf.
(5) European Commission, 'Green paper: shadow banking', March 2012.