Questions for Anil Kashyap, from the House of Commons Treasury Committee

Personal

1. **Do you have any business or financial connections, or other commitments, which might give rise to a conflict of interest in carrying out your duties as an external member of the FPC?**

   No. I have reviewed the Bank guidelines on the Code of Practice regarding conflicts of interest and am in compliance with them. I also have shared the details of my personal financial assets with the Bank Secretary and my arrangements are in compliance with the Bank's rules. Finally, for the last few years I have been voluntarily disclosing my paid outside activities each year on my website (http://faculty.chicagobooth.edu/anil.kashyap/about-me.html)

2. **Please explain how your experience to date has equipped you to fulfil your responsibilities as an external member of the FPC. How would you rate your experience and knowledge of the UK economy and financial system?**

   I have published a number of articles in top peer-reviewed journals, books and policy-oriented conference proceedings that are of direct relevance for the FPC. Some examples include my research on the foundational reasons for the existence of banks, principles for macroprudential regulation, liquidity regulation, the design of bank reserve requirements, contingent capital, the Japanese banking crisis, and the transmission of monetary policy. The book I co-authored as part of the Squam Lake Group on the design and reform of financial regulation was widely praised. I teach an MBA course on financial crises and another on central banking.

   I have served in a variety of advisory positions for the official sector. The ones most relevant for this job include chairing the Research subcommittee of the U.S. Office of Financial Research Financial Research Advisory Committee, serving on the International Monetary Fund's Advisory Group on Macroprudential Policy, and being part of the academic advisory group for the UK Fair and Effective Market Review. Through my membership in the Bellagio Group and other advisory bodies, I have strong relationships with many senior officials at central banks and finance ministries around the world.

   I have also been sought out as a consultant by a number of central banks. I have served in different capacities at the Bank of England, the Federal Reserve, the European Central Bank, the Riksbank, and the Central Bank of Finland.

   In my central banking course, each year I spend at least 10% of the course examining issues facing the Bank of England. Given London's role as a financial center, for many years I have followed developments in the UK financial system.

   I have a good knowledge of the UK economy and the financial system, and look forward to the opportunity to learn more about them.

3. **Do you intend to serve the full term for which you have been appointed and apply for a further term?**

   I am committed to serving the full term to which I have been appointed. While I expect to apply for a re-appointment, I would like to see how the first term goes before deciding for sure.

4. **Are there any areas in particular where you intend to focus your FPC work during your term?**

   I will be the only academic on the committee so I hope I can especially contribute to some of the more conceptual issues confronting the committee. Macroprudential policymaking is in its infancy and the Bank of England is on the cutting edge of the practice of implementing policies. Having a chance to help with design of the framework is one of the most exciting aspects of this job.

UK financial stability and the Financial Policy Committee

5. **What is your current assessment of the financial stability implications, if any, of:**

   a. **The vote to leave the European Union and the forthcoming exit process**

   b. **The recent depreciation of Sterling**

   c. **The UK's balance of payments deficit**

   d. **Recent growth in buy-to-let mortgages**

   e. **Global risks to stability, such as credit growth in China and the Euro crisis**

   f. **Any other threats to financial stability that you would highlight**

There is considerable overlap on your list and the risks that the FPC identified in its most recent Financial Stability Report (FSR). So I will first comment on the areas of overlap and then take up the issues related to the vote (which the FPC did not break out separately). To remind you, the FPC labeled their top risks as:

1) Financial market fragility
2) Current account with the potential for swings in sterling and risk premia
3) Commercial Real Estate developments
4) Household indebtedness -- because of second round effects on the economy that could arise from higher interest rates if households have to cut back on spending to service debt.
5) Global environment

Here are my comments on the risks noted in the FSR.

I am particularly worried about contagion from stress coming from the European banks and whether there might be linkages (perhaps indirect) between them and the largest UK banks. (The FPC appeared to discuss this more in the global environment – I consider this more of a financial market fragility issue.) The FSR says that total exposure of UK banks to the euro area is 200% of their Core Tier 1 capital. However, the impact of problems in the euro area on UK banks will also depend on the exposures of individual banks, and indirect links.

For example, rumors about the health of various large European banks have been reported by the media on and off for the last few months. I have no personal information about the accuracy of these reports. Nevertheless, if any were to need a substantial recapitalisation, it is possible their lenders will reassess exposures to all their counterparties. We know from 2008 that anticipating how panicked customers will respond to such news is difficult. If a major UK bank were perceived to be exposed to an impaired bank, the UK bank could face funding pressures. This is the kind the scenario that could be explored in a stress test.

I do not see the current account deficit as a big financial stability risk. For the macroeconomy, a reversal in the current account could be important, so in that sense it would have implications for the financial sector. However, the direct effects on financial stability do not appear large.

I also don't think the movements in the exchange rate so far have created financial stability risks. However, had I been on the Committee ahead of the referendum, I would have been asking for details about banks' foreign currency funding (e.g. how much of it is used to fund sterling assets and how much of this is not appropriately hedged) to further inform my view.

Commercial real estate (CRE) valuations are elevated. It is, therefore, particularly appropriate that a stress test is underway to assess any risks from a price reversal. It is comforting to note that major banks were assessed as resilient to the observed stresses in the CRE market in the Bank's 2014 and 2015 stress tests. If the stress tests show that CRE holdings are now posing a threat, then the FPC should be prepared to consider some changes to sectoral risk weights.

The household debt and buy-to-let pressures ought to continue to be monitored. The actions the FPC took a couple of years ago seem warranted and to have been effective. In particular, the total share of new mortgage lending for borrowers with loan to income ratios above 4.5 is well below the 15% limit set by the FPC. So share of potentially vulnerable households obtaining mortgages is not rising. Nonetheless, UK indebtedness is still high by historical standards and further vigilance is warranted.

The latest Prudential Regulatory Authority "Underwriting Standards for Buy-to-Let Mortgages" are wise. It seems appropriate to me that they have emphasised that lenders must carefully consider income affordability and that they are having the lenders undertake stress tests regarding the impact of higher interest rates. However, if the FPC comes to the view that potential pro-cyclical behaviour of buy-to-let landlords poses risks to the financial system, it might still be appropriate to apply loan-to-income limits on lending to buy-to-let landlords.

Aside from the banking linkages, I am not very concerned about a slowdown in Emerging Market Economies creating financial stability risks in the UK. I read the results from the 2015 stress test as supporting this conclusion. The remarkable amount of credit growth in China seems unsustainable, but I do not expect a slowdown to create problems for the UK.

The vote and the exit process create a couple of risks. While it seems like the initial macro effects have been modest, I am still very concerned about the possibility of a slowdown. A temporary increase in uncertainty will lead to a strong increase in what economists call the "option value of waiting" (for either hiring or investing): delaying investment or recruitment decisions until the uncertainty is resolved becomes very appealing, and a pause can reduce aggregate demand. In contrast, a permanent increase in uncertainty does not have the same impact on the option to wait, because you cannot indefinitely delay decisions. Ninety three percent of the panelists polled by the Centre for Macroeconomics agreed with a statement saying that the possibility of Brexit would substantially increase financial market and economic uncertainty in general. (http://cfmsurvey.org/surveys/brexit-and-financial-market-volatility).

A second consideration is the impact on the direction of financial regulation. To the extent that EU and UK regulations wind up diverging, there is a chance that some firms will try to exploit any inconsistencies between them. Regulatory arbitrage in general is something I worry about. I am especially concerned because the rules for banks have changed so much that there will be temptation from that to re-label activities and move them outside the banks to escape regulation. This is something we have to keep watching.

A different way to put my concern about regulatory arbitrage is to step back and take a broad view of where we stand 8 years after the financial crisis. The Bank of England and FPC have done a lot to make banking groups as a whole more resilient and resolvable. They have also worked on ring-fencing, which further increases the resilience of key retail banking activities. However, financial stability risks are not confined to retail banking activities. Many wholesale banking activities sit outside the ring-fence. In fact, risks can even emerge entirely outside of the regulated banking system. This is why we need to monitor shadow banking. I hope that the international community will continue the Financial Stability Board's work on shadow banking and that eventually we create "Basel Committee on Shadow Banking" to coordinate these efforts internationally.

6. Which of the above do you see as the most significant risk to financial stability currently facing the UK?

The weak condition of some of the large European banks worries me most. As indicated above, we do not really fully understand all the potential channels of contagion that could arise if a major bank on the continent required recapitalisation.

7. Do you think that the FPC has sufficient tools to meet the Bank's Financial Stability Objectives? Are there any additional tools that you think are required?

I believe that the FPC does have the tools it needs. I do think we need to be continuously monitoring the shadow banking system and perhaps expand the measurement of financial flows to get more granular data on the interconnections in the financial system.

I believe the bigger challenge is deciding on the appropriate threshold that must be reached before a tool is deployed. We don't have much experience with some of these tools, e.g. sectoral capital requirements, so deciding when to try to deploy them requires judgment calls. Unfortunately in making these judgments we cannot consult very many past episodes.

8. The FPC generally reaches its views and decisions by consensus, rather than a vote. Do you think this is the most appropriate method of decision-making? Do you see any disadvantages?

I believe that given the limited experience we have with so many aspects of macro-prudential regulation, it would be hard to reduce many of the policy decisions to the point where a simple binary vote would work. Instead it seems like the macroprudential policy decisions might well turn out to be multi-dimensional. Viewed in this way, it seems reasonable to me that the committee should try to operate by consensus. Perhaps in the future, some aspects of the policy choices will become clear enough that it would be reasonable to switch to a one-person one vote model. I will have to see once I am on the committee whether my perspective matches the way things actually work.

Regarding disadvantages, I suppose the one I worry about is whether the committee might have to bend too much to include everyone in a consensus. While I understand that in the context of the setting of the countercyclical capital buffer, the possibility of a vote has already been mooted, I can imagine that reaching a consensus in other cases could be difficult too. If there were something like a 9 to 1 split on some issue, I could imagine it could be valuable in such a case to move ahead without unanimity and let the dissenter have that noted on the record. Again I will have to see how the committee actually works to see if this is a real problem or not.

9. The FPC operates with less transparency than the Monetary Policy Committee. Do you think it is appropriate for the FPC only to publish records of its meetings, rather than more detailed minutes?

I believe anyone who does a bit of checking can easily find out where the FPC stands on the major issues it is facing. For all the reasons I just listed in my previous answer, the consensus decision making model seems like the right one to be using for the committee. Given that model, I think the committee must give the public enough information about how decisions are reached for the public to understand the basis for all important decisions. I do not believe that complete details on all aspects of the meeting are needed to achieve this outcome. In some cases involving confidential information about individual institutions, detailed minutes would be clearly inappropriate. Rather the records should concentrate on the major topics covered and highlight the considerations that led to the consensus.

Provided the records meet this standard, then individual members can elaborate on their views in speeches or through testimony. Ideally this kind of process would capture the benefits of operating by consensus without forcing the committee to fall into a pattern of group-think.

10. What are the consequences for financial stability of the MPC's August monetary stimulus package? Are the Bank's monetary and financial stability objectives currently in conflict?

A pronounced recession could be a threat to financial stability. As I understand it, the MPC was trying to reduce that risk. If I had been on the MPC I would have supported that package and I do not think the decision raises the financial stability risks.

Nonetheless, there are limits to what monetary policy can do to offset the "option value of waiting" channel that I have discussed above.

I do not think the monetary and financial stability objectives are in conflict currently.

11. How do you assess the public profile and reputation of the FPC? Is it important that the public understands its role and decisions?

Speaking from my own experiences in the US, despite the Federal Reserve being constantly in the news, the US public still does not really know or understand much about the Federal Open Market Committee. Given how new the FPC is, and that its powers are less well understood than the tools for setting monetary policy, I would therefore expect that the UK public is not very well informed about the FPC.

I believe it is important that the public comes to understand its role and its decisions. A democracy requires accountability and part of accountability comes from explaining decisions to both parliament and the public. I hope to help raise awareness of the FPC through participating in public events, giving speeches and through testimony like the one scheduled on October 11.