Responses to questionnaire from Treasury Committee – 21 March 2018

Donald Kohn

External Member, Financial Policy Committee

Conflicts of interest and performance of role

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 continuing duties as a member of the FPC?

    No. My positions and other roles are listed on the accompanying CV. None of them involves a potential conflict of interest. My spouse, my children, and my siblings do not work for financial institutions and are not involved in organizations or responsibilities that could pose a potential conflict of interest with my work on the FPC.

2. Do you intend to serve for the full term for which you have been re-appointed?

    Yes.

3. Why have you decided to stay on for a further term? What have you learned from your experience of being on the FPC so far? Do you plan to approach your work differently during your further term?

    I decided to remain on the Committee because I find the work interesting and challenging and because I believe I can continue to contribute to the ability of the FPC to meet its objectives.

    I see the main challenges for the Committee as: Refining the structures already put in place for capital requirements and stress testing; further developing our capability to identify financial risks, to determine whether such risks have potential spill overs that would justify intervention by the FPC, and then to design policies that build cost-effective resilience against those risks; working with other agencies and the private sector to bolster defences against cyber-attack; and enhancing our ability to spot and deal with risks outside the core banking sector.

    Moreover, over the next few years, the FPC will need to meet these challenges in the context of the UK adapting to a new economic relationship with the EU. I believe the FPC has already played a constructive role in identifying the risks of possible disruptions in financial systems from the changing relationship and their possible mitigants, and in using its stress test to gain some assurance that the financial system would be resilient to a variety of Brexit-related macroeconomic risks. But we have no real precedents to draw from to anticipate the effects of such an event, and the Committee will need to be constantly updating its assessment and gauging resilience.

    I have learned that the UK has an outstanding institutional set up for meeting its financial stability objectives—the separate macroprudential, microprudential, and monetary policy committees within the Bank of England with overlapping membership. The presence of external members, bringing experience in the financial sector and diverse perspectives has been very important to the work of the FPC.

    In many ways the UK is pioneering in the modern, post-crisis, application of macroprudential policies in a highly developed, globally integrated financial sector.

But none of this is easy or obvious. I am constantly learning about identifying risks and spillovers or externalities from those risks and the challenges of identifying costs and designing policies to maximize odds that the benefits exceed the costs. Given my background in monetary policy at the Federal Reserve, I have taken particular interest in the interactions of monetary and macroprudential policies and have defended placing those functions in separate committees.

I do not expect to change my approach to this work in my new term. I expect the experiences and perspectives I bring from my experience on the FPC, from my past roles at the Federal Reserve and in global groups during the crisis, and from my work at Brookings and elsewhere in recent years will continue to inform my contributions to the work of the FPC. I will continue to work on explaining the work of the FPC to the UK public and to authorities and academics in other counties.

4. In what areas in particular do you hope to focus your work on the FPC in the next period of tenure? What is your main priority for research in your further term?

   I expect to be fully involved with the full range of work of the FPC in coming years. A subject of particular interest has been the indicators of risk in the financial system. The FPC uses a range of indicators and it will always need to do so given the wide variety of potential sources of risks originating in both the financial sector and in the households and businesses that borrow and lend. But we can refine those indicators as we gain experience and fill holes in our data sources. The Bank has a research agenda for aggregating across indicators to help us determine the overall state of the financial system and the appropriate level of the countercyclical capital buffer, and I will try to contribute to that effort. Better indicators will help the FPC's transparency and foster efforts to behave in as predictable and systematic a way as possible.

5. Have you received the support from the Bank that you need to fulfil your role? Are there any changes that the Bank could make to support external members of the FPC better?

   I have been well supported by the Bank and have no suggestions for improving that support. In my experience, the Bank has been quite responsive to identified requirements of the FPC and its external members. A recent example has been the initiation of "teach ins" for the external members prior to the FPC issues meetings; these allow us to meet in a small group with the staff that has been working on an issue and quiz them closely in an informal setting, better preparing us for the larger group discussions.

Financial Stability

6. What do you think are currently the most significant risk to global and domestic financial stability? What do the FPC's financial stability indicators currently tell you about financial stability in the UK?

   Most indicators suggest that risks in the UK financial system are now in the "standard" range—that is they are generally around their average level over many years—well below those that existed just prior to the crisis and above the very constrained risk-taking environment that persisted for some time as markets and institutions were recovering from the effects of the crisis. At the same time, the resilience of the financial system has been greatly enhanced by the build-up of capital, liquidity, and risk management capabilities in banks since the crisis. The judgment that the UK financial system would be resilient to a wide variety of severe risks has been supported by the results of our 2017 stress tests.

Nonetheless, the FPC must continue to identify risks –unusual and unexpected events – and take steps to ensure that this judgment would still be valid should these risks crystallize. In that regard, several situations will require careful monitoring for the foreseeable future. One is the effects of the evolution of the UK's economic relationship to the EU. Without judging what the final form of that relationship might be, the FPC must continue to assess the resilience of the system to an outcome, however remote, in which that relationship has changed quite materially. Any such changes could have effects on the macro economy, and we should try to ensure that those effects aren't amplified by the financial system, and the changing relationship could disrupt existing contractual relationships, with consequences for stability by impinging on risk management and access to services.

A second key risk element that should be the focus of the FPC in coming years is cyber crimes that could disrupt services and undermine confidence. The FPC has long identified this risk and it must continue to develop ways of working with the private sector and other governmental authorities to build sufficient resistance and resilience to preserve stability.

Third, the long period of economic expansion and low interest rates that has characterized the UK and many other economies in recent years is bound to foster some complacency and risk taking that would be tested in a less benign environment. Indeed, we have seen some tentative signs of movement in this direction in the UK financial system. The FPC must continue to apply rigorous stress tests to the banking system, and it must be alert to signs of potentially risky situations developing outside the banking system.

Globally, I see the build-up of debt in some places—for example, China and the US corporate sector—as posing a risk to financial stability that could feed back to the UK. And, although the pickup in global growth has been welcome, it also implies that spare capacity is being absorbed rapidly—a process that is likely to be accelerated in the US by recent fiscal actions. If pressures on prices and interest rates turn out to be much greater than expected, debt servicing obligations would rise appreciably and many assets would need to be repriced substantially, affecting the UK as well as the US. Finally, a material increase in tariffs and trade barriers among globally active economies would damp global growth and increase price pressures, with consequences for asset prices and financial stability that are difficult to predict.

7. How far could banks' business models be affected by open banking and developments in financial technology, and what implications will open banking and Fintech have for financial stability?

Open banking and fintech hold great promise for giving households and businesses greater choice and less expensive options for a broad range of financial services. These developments, however, could put added competitive pressures on bank business models, constraining their ability to generate profits. For the foreseeable future, banks are likely to remain key providers of a range of financial services that cannot be readily duplicated elsewhere, their resilience will continue to be critical to the resilience of the financial system; that resilience rests importantly on their ability to generate profits and raise capital.

In our Biennial Exploratory Scenario stress test in 2017 we asked banks to reflect on the consequences of a number of developments that could constrain their profitability going forward, including fintech. As a generalization, their responses suggested that their thinking on fintech was in early stages, and the PRA has agreed to follow up with them.

From the FPC's perspective, fintech along with regulatory arbitrage also indicate the need to be especially alert to the possibility that systemically important functions will migrate to less regulated venues. We will need to continue to monitor activity outside banking to make sure we have the tools to meet our financial stability mandate.

8. To what extent has the problem of "Too big/important to fail" been solved? Are any institutions in the non-banking sector "too big/important to fail"?

Substantial progress has been made on this issue, and the structures are being put in place to move further toward eliminating the implicit subsidy and inherent risks of too big/important to fail institutions. For one, the probability of failure has been greatly reduced by higher capital and liquidity standards for all banks, with systemically important banks held to even higher standards, reflecting the greater cost to society of their failure. Our annual stress tests gauge the adequacy of that capital to allow these banks to continue to deliver essential services to UK businesses and households even after a very severe stress. The results of those tests indicate that systemically important institutions would not fail, even in severe downturns. Moreover, starting this year, the extra capital required of systemically important institutions—both those identified as embodying global risks and those that are systemically important only for the UK economy--will be included in the minimums they need to have when stresses are most severe in the test.

If, nonetheless, one of these institutions were to fail, a resolution regime is being implemented to allow them fail without endangering financial stability or calling on taxpayer support. They are being required to issue a large volume of debt that is explicitly subject to being converted to equity to support systemically important operations should failure loom, and techniques for bailing in these creditors and keeping critical operations going are being put in place. Having some creditors explicitly at risk also will bring greater market forces to bear on bank management to control risks. It's encouraging that the credit rating agencies have been recognizing the new regime by greatly reducing—indeed nearly eliminating--the "uplift" they give to bank senior debt for any implied government backstop. The elements for resolution are still being implemented, the regime has not yet been tested in real life, and in an extraordinarily severe run on banks that threatened multiple institutions simultaneously, additional steps likely would need to be considered; so perhaps it is too early to declare the problem "solved", but we have made a huge amount of progress and are much closer than we were before and during the crisis.

Yes, some institutions outside the banking system provide services that may be too important to fail; for example, the services of large insurance companies and some market infrastructure, like key central counterparties for derivatives clearing, are likely fall into this category. But oversight of these institutions has been greatly increased since the crisis, including imposing requirements that will keep them operating under severe stress and testing of adherence to these requirements.

9. To what extent is there growing pressure for a lighter-touch regulatory regime in the UK? How do you respond to such pressure? Are there any areas of the financial sector you consider to be over- or under-regulated?

    I have felt no such pressure. And, yielding to any pressure for lighter-touch regulation would in my view be inconsistent with meeting our legal mandate to spot risks and build resilience to preserve financial stability. I strongly supported the FPC's statement in November 2016 that "Irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned, which itself exceeds that required by international baseline standards."

    I do not see particular sectors that are over- or under-regulated at this time, and we have procedures in place to spot such misalignments. We review periodically the regulations the FPC has recommended or put in place to assess whether the benefits continue to exceed the costs. And we regularly survey the financial system outside banking to look for sectors and functions where regulation might not be sufficient to achieve public interest goals for financial stability. Should we see any lapses or weak points, we will make recommendations to the Treasury to address them.

Decision making and communication

10. Has the FPC operated free of all political interference? How have changes to the Chancellor's remit for the FPC changed the way you approach your work?

    Yes, we have operated free of political interference. Of course, in a democracy we should be held to account by elected officials and required to explain carefully why we have arrived at our judgments, and we can expect comment on those decisions. But in my experience, we have always been able to reach decisions without political interference.

    The chancellor's remit has evolved with circumstances—for example now to include reference to Brexit risk—but that evolution hasn't changed the way we approach our mandate.

11. What do you regard as the main institutional challenges facing the FPC over your next period as an FPC member?

    I believe the UK and its financial system have greatly benefited from the institutional structure established after the financial crisis. The FPC works well. We have robust discussions that invite a variety of views, including those of the external members. These diverse views are then reconciled through discussions based on fact and analysis supplied by Bank staff as well as by the members themselves. Communication with the MPC and PRC is maintained by overlapping membership and joint meetings on subjects of mutual interest.

    The institutional challenge will be to preserve and build on these strong beginnings through periods of turnover on the committee. It is imperative that incoming members bring and are willing to express a diversity of perspectives, that some also bring real-world knowledge of how the financial markets and institutions work, and that they understand and support the decision-making process that has evolved with its respect for the views of all participants.

12. How do you think the FPC is regarded by financial firms? How well do you think the FPC communicates with, and understands the concerns of, financial firms?

    The FPC is another layer of oversight for financial firms, imposing limitations and requirements over and above those that would come from market forces or the microprudential authorities. Those added limitations and requirements respond to our mandate to look at the whole system and take account of spillovers and amplification tendencies that would not be priced by the market or addressed by regulators with a bank-by-bank focus, but which could threaten financial stability.

    Nonetheless, we have had a constructive relationship with financial firms, and make considerable efforts to communicate with them and understand their concerns. We listen to their views on the regulatory landscape and have worked as expeditiously as possible to put in place the capital framework and thus address a key concern about regulatory uncertainty as reforms implemented after the crisis. The Bank has an extensive market intelligence operation that feeds into our background briefings to help us understand recent market developments and emerging risk factors. Members of the FPC and staff meet regularly with risk managers to get their perspectives on threats to financial stability.

    Our highlighting of particular risks to financial stability and recommendations to the PRA to make sure the banks are preparing for certain potential developments has intensified bank contingency planning ahead of key events. Our concurrent stress tests have helped banks refine modelling and understand how they stack up against their competitors.

    I have made a practice of visiting financial market participants during each FPC round to inform myself of their concerns and questions, and to get their reactions to our actions and their views on what we should be doing. These contacts have welcomed the opportunity to have their views considered in the FPC policy process and in general have shown an increasing awareness and understanding of our mission.

13. How well do you think the public understands the work of the FPC, and to what extent does it matter if they don't? How have you worked to increase the public profile of the FPC?

    I suspect that for the most part public understanding of the work of the FPC is limited. Our actions mostly affect the general public very indirectly, channelled through banks' response to our decisions; this is unlike the actions of the MPC, which the public sees directly in the returns earned on deposits and rates paid on loans.

    The limited understanding of our actions does matter and should be addressed. Support and understanding from the public and the people they elect will underpin over time the acceptance and sustainability of our actions in a democracy. Some of those actions may be counterintuitive—for example, raising capital requirements in good times when banks are strong and losses are low, and easing those requirements when adverse shocks hit and bank losses begin to mount. Others of our actions can have effects on particular types of borrowers—for example restrictions on mortgage credit for heavily indebted borrowers. For every action we must articulate clearly in as nontechnical language as possible why we have intervened, how we chose the particular action, and how that is related to our financial stability mandate.

I have attempted to contribute to greater understanding of the UK public by engaging in visits to the Bank's agencies through the country. In the course of these visits, I meet with businesses and bankers to explain our views and actions and hear their concerns about how the financial system is meeting their needs. In conjunction with those visits, I have given interviews to regional press to reach a wider audience. I intend to continue these efforts over the next three years.

14. How easy has it been to maintain consensus on the FPC? How far have you had to compromise to achieve consensus? Has there been any decision on which you personally have come close to breaking the consensus?

As I noted in my response on institutional challenges, committee deliberations have been structured to help us reach consensus. Preliminary meetings have been used to narrow options and identify areas for the staff to explore with additional data and analytics. This process has helped to shape a consensus about the actions themselves and about the descriptions of current and possible future actions. I have been comfortable that my views have been heard and taken into account and, after listening to my colleagues, that our actions have been the best approach to fulfilling our mandate. I have not found myself close to dissent on any of our decisions.

15. Does the FPC communicate with one voice on all matters pertaining to financial stability, or only decisions it has reached by consensus?

We are not bound to speak with one voice prior to a decision being made. Members are free to highlight risks or perspectives they have attached particular importance to.

Naturally, we speak with one voice on decisions reached by consensus. There have been no dissents, but I expect that under that circumstance those who dissent would be able to explain their decision in public.