Questionnaire in advance of Treasury Committee hearing
Donald Kohn

Personal/General

Q1. 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 a member of the FPC?

No.

Q2. Is there anything you wish to draw to the attention of the Committee from your previous work experience?

I believe my previous work experience has qualified me to make a valuable contribution to the work of the FPC. While on the staff of the Federal Reserve Board I dealt closely with the behavior of financial markets, as liaison between the Board of Governors and the Federal Reserve Bank of New York in the daily execution of monetary policy and monitoring of developments in financial markets. In addition, for many years I oversaw the administration of the discount window for the Federal Reserve System. In these roles, I played an important part in advising the Board of Governors on financial stability issues, especially when stability was threatened.

After I became vice chairman of the Board I attended some BIS meetings as the representative of the Board and chaired the Committee on the Global Financial System. That committee monitored developments in global markets, reported on those to the central bank governors, and published studies on aspects of interest; all this took on added importance after the financial system became more unstable in the fall of 2007. Finally, I was deeply involved in the response of the Federal Reserve to the financial crisis, working closely with Chairman Bernanke and others at the Federal Reserve and with the US Treasury to understand what was happening and to design the response. Among other things, I oversaw the stress tests for the Federal Reserve in the spring of 2009.

My current work experience—in addition to my service on the interim FPC—should also enhance my potential contribution to the FPC. From my position as a senior fellow at Brookings I have participated in a number of panels, conferences and seminars on bank structure and financial stability. I serve on the FDIC's Systemic Risk Advisory Council, am the vice chair of the Financial Research Advisory Committee for the U.S. Treasury Office of Financial Research, and serve on the macroprudential advisory committee of the Monetary and Capital Markets department of the IMF.

Q3. Do you intend to work for the full term for which you have been appointed?

Yes.

Q4. Why have you decided to stay on for a second term? What have you learned from your experience of being on the Interim FPC so far? Do you plan on doing anything differently during your second term?

I applied to serve on the FPC because I believe implementing macroprudential policy will be interesting and important, and I think I can make a contribution. It will be interesting because we are still learning how to identify threats to financial stability and design ways to mitigate those threats before they adversely affect the economy; because the UK is a key center in a globally integrated financial system, with implications for sources of threats and the potential effectiveness of countervailing actions; and because, in the current circumstances, overcoming the economic slump requires that resilience be built without impinging on the ability of the banks to supply credit. It is important to get macroprudential policy right because it has the potential to dampen the inherent procyclicality of the financial sector and contribute to a more stable UK economy—most especially to avoid the sort of crisis that has proven so costly in terms of lost jobs and income; because we must make sure that financial stability is not dependent on UK taxpayers backstopping the system and that participants in financial markets behave in ways that do not rely on that support being called upon again; and because good macroprudential policy should enable monetary policy to concentrate on preserving price stability and stabilizing the economy in the medium term.

My experience has helped me appreciate just how difficult these challenges will be, especially given the starting point for the UK financial sector and economy. We will need to prioritize and be as concrete and specific as possible to get results.

I do not anticipate changing my own behavior in any material way in this term relative to the last few years.

Q5. Please explain how your experience to date has equipped you to fulfill your responsibilities as a member of the FPC. In particular, what areas of the FPC's work do you believe you will make a particular contribution to?

In addition to the knowledge I brought to the FPC initially, as outlined in response to question 2, my experience on the interim FPC has given me a better understanding of the UK financial system. As a member of the committee I have worked to address the systemic issues facing the UK financial system. Moreover, I have made a concerted effort to talk to participants in the UK financial sector—borrowers, investors, and lenders--on my visits to the UK in order to increase my knowledge of the UK financial system and my understanding of potential threats to financial stability.

On the FPC itself, I have played an important role in leading the FPC's efforts to increase the transparency of financial firms, and I hope to continue to do so. Market discipline will never be sufficient to guarantee financial stability; the macroprudential framework entails taking account of externalities—the social benefits and costs of financial stability and instability that cannot be appropriately priced by the market alone. But FPC's task will be easier the better market participants can asses and price risk. My experience with the first U.S. stress test and my evaluation of subsequent efforts have convinced me that the FPC should adopt a similar technique for assessing the resilience of the UK financial system and I hope to contribute to implementing this in the UK. My experience in the US should be useful in patrolling the perimeter of regulation and the risks in some types of wholesale finance, which proved so vulnerable in the US.

Q6. Which of your publications and papers are of most relevance to your future work on the FPC?

The Financial Policy Committee at the Bank of England, At a U.S. Treasury Department conference, December 2, 2011 http://www.bankofengland.co.uk/publications/speeches/2011/index.htm

Enhancing Financial Stability: the Role of Transparency At the London School of Economics, London, England September 6, 2011 http://www.bankofengland.co.uk/publications/speeches/2011/index.htm

The European Crises—Banking Challenges, National Bureau of Economic Research, July 12, 2012. http://www.brookings.edu/research/speeches/2012/07/12-euro-crisis-kohn

Eichner, Matthew J., Donald L. Kohn, and Michael G. Palumbo. "*Financial statistics for the United States and the crisis: what did they get right, what did they miss, and how should they change?*" (2010) Board of Governors of the Federal Reserve System (U.S.), Finance and Economics Discussion Series: 2010-20

Financial stability and the Financial Policy Committee

Q7. What do you regard as the main challenges facing the FPC over your further tenure as an FPC member?

a Continuing to build resilience without reducing incentives to lend.

b Evaluating and refining the list of indicators and more generally increasing our ability to identify risks to financial stability.

c Seeking to employ macrofinancial stress tests to evaluate resilience.

d Looking beyond the banking system for vulnerabilities—including into more lightly regulated sectors that may expand as banks are required to become more liquid and better capitalized.

e Identifying interconnections that may transmit shocks among institutions and recommending steps to reduce the threats; some of these, like central counterparties for derivative trades, are already evident; others may be less obvious.

f Continuing to enhance transparency to both market participants and regulators.

g Increasing public understanding of our mission and our techniques for accomplishing it.

Q8. What do you think is currently the most significant risk to financial stability facing the UK?

The most significant risk to the UK financial system remains economic weakness in the UK and in the eurozone, including, in the eurozone, the remote but nonzero risk of some countries leaving the zone. The eurozone has been in recession and the monetary and fiscal tools to turn the situation around seem to have been limited. The problems are particularly acute in the periphery, which appears to face a still longer period of economic decline and banking system stress as price and labor cost imbalances within the currency area adjust. UK lenders have taken actions to protect themselves, but exposures remain and the economic developments could reveal unexpected vulnerabilities. This risk has been a key factor behind the FPC's recommendations to build capital in UK banks.

Q9. What do you regard as the strengths and weaknesses of the work undertaken by the interim FPC?

The FPC has set a global standard in its work to identify a specific set of indicators, the tools it needs to carry out its mission, and how it will explain its use of those tools. It has tackled very difficult financial stability issues, for example the required levels of capital and liquid assets of banks and how the latter should take central bank liquidity facilities into account. We have taken care in our policy recommendations for greater capital cushions to emphasize earnings retention and capital raising so as to avoid inducing reductions in lending. And we have pushed for greater transparency by UK banks.

In retrospect, we perhaps should have been more specific earlier about our expectations for the level of capital required for financial stability. We relied on exhortation and general recommendations to the banks and the FSA for a while. It was only late last year when we initiated a work stream to determine more concretely what adjustments to bank balance sheets were required to give a more reliable view of capital adequacy. And it was not until this spring that we set a standard to which capital positions so adjusted should adhere. Both the regulators and the banks require the sort of specific instructions that the interim FPC gave this spring to plan and implement programs to bolster financial resilience.

Q10. Has the Interim FPC operated free of all political interference?

Yes. The government, including the Treasury representative at the FPC, have expressed concerns about the effect of our recommendations for more capital on growth and about how the two banks with significant government ownership would meet higher capital standards. We listened and considered but we adhered to the recommendations that arose from our analysis.

Q11. How easy has it been to maintain consensus on the FPC? How far have you had to compromise to achieve consensus?

Discussions have been open and vigorous, with alternative views actively solicited and reflected in the outcome and the record of the meetings. As a consequence, the FPC has been able to arrive at a consensus on all its recommendations, and I have been very comfortable with the recommendations.

Q12. Have you received the support from the Bank that you need to fulfill your role? Are there any changes that the Bank could make to support external members of the FPC better?

Yes, I have had good support from the Bank—most importantly from the staff of the FPC secretariat, but also from the officers of the Bank—and it has been more than adequate for me to fulfill my role.

Logistically, electronic access has been challenging from time to time, but my understanding is that the FPC externals will now be integrated more fully into the Bank's systems and that will facilitate access.

Q13. *How do you assess the public communications of the FPC so far with regard to financial stability policy and decisions? What challenges remain?*

As a new organization with new tools that it has been given to further financial stability in the UK, the FPC needs to continue to build public awareness and understanding of its role. The FPC needs to explain how it identifies risks to financial stability and how its recommendations and directions are related to mitigating those risks. We have a set of indicators we are using, but they are a starting point for deeper analysis. We need to explain how our actions interact with promoting stable growth and how we balanced costs and benefits in arriving at our decisions. All these will be very challenging, but they are necessary.

The Chancellor has emphasized that "clear, focused, and consistent messages" about our policies and actions will reduce uncertainty and boost confidence. I agree. But it is also important to recognize that the public welfare is best served by considering a variety of approaches and hearing a variety of views, and that public confidence is also built by knowing that alternative perspectives were considered in the policy process. Externals are on policy committees to guard against "group think", and I take this responsibility seriously. Once decisions are made, our main communications objective should be to explain them as well as possible and provide consistent messages about the FPC's intentions and strategies.

Q14. What is your assessment of the macroprudential tools that will be available to the FPC? Are there additional tools or powers which you think it would be useful for the FPC to have?

The current tool kit is a good start, but other tools may also prove useful over time. It is appropriate to start with a limited tool kit focused on bank capital. The increase in leverage and thinness of the capital cushion before the crisis was indicative of the extent to which banks contributed to the build up of imbalances on the upside of the cycle and it also contributed to banks' own vulnerabilities, which accentuated the recession and sluggishness of the recovery once the cycle turned, asset prices fell and borrowers had problems meeting obligations. Use of the countercyclical capital buffer and targeted increases in sectoral capital, where imbalances are concentrated, may help dampen the build up of imbalances in the first place and will certainly make the banking system more resilient to any eventual unwinding should imbalances nonetheless develop. When the Basel 3 leverage ratio becomes effective, I expect the FPC will also be able to adjust it to counter cycles.

Over time, I hope we can complement our capital tools with a countercyclical liquidity instrument. The vulnerability of the banking system before the crisis was manifest not only in high leverage but also in increased maturity mismatch as relatively illiquid loans and securities were increasingly financed with short-term funding, especially from wholesale funding markets. This funding ran quickly when lenders began to have doubts about the ability of counterparties to repay and the resulting scramble for liquidity made the crisis much worse. A time varying liquidity tool could help manage this risk in future cycles.

Another category that might be considered in the future is tools to more directly affect the terms of lending—and in particular how much of some purchases are made with credit. This would include loan-to-value (LTV) ratios in mortgage lending and margins on various forms of wholesale funding and derivative contracts. Increases in LTVs and declines in margins added to the excessive easing in credit in the run up to the crisis and their subsequent reversal accentuated the severe tightening in credit during the crisis. LTV restrictions are very blunt tools that can limit some loans that would be perfectly sound and legitimate, so they need to be thoroughly debated and understood by the public and used sparingly if at all. And sectoral capital requirements can be targeted to high LTV loans, raising their cost and limiting the damage they can cause. But there may be circumstances in which those sectoral requirements are not sufficient to dampen a dangerous real estate boom and we should continue to discuss whether the FPC should be given authority to vary LTV or LTI ratios as well. International efforts are underway to judge whether setting through-the-cycle or countercyclical margins in wholesale credit and derivative markets would be feasible and effective, and we should watch the results of those studies carefully.

Q15. What is your assessment of the FPC's core indicators? Which ones do you see as being the most important, and are there any additional indicators that you think should be considered?

Because dangerous imbalances arise from a number of sources and in a number of ways, it is difficult to designate a small number of indicators that will be successful in spotting problems before they develop. Moreover, we necessarily look to experience in designing indicators and the next source of vulnerability could well differ from those that arose in the past. I am satisfied that we have a good list, but as I noted before, it is just a starting point for a full analysis and understanding of developments in the financial system at any point in time. Among the indicators we now have, the ones focused on capital and leverage both in banks and in bank borrowers are critical, as are measures of overall credit growth.

As we move forward and we get additional information from regulatory reporting and enhanced bank transparency, I would like to see whether we can develop better measures of reliance on wholesale funding sources. In addition, there are vulnerabilities that don't show up very well in these aggregate data, such as whether a number of institutions are taking similar positions that could cause systemic problems when prices reverse, and whether there are interconnections among institutions that could transmit shocks in unexpected ways. These are very difficult to get a handle on ahead of time, but we should continue to research ways to reveal these vulnerabilities.

Q16. What is your own initial view of the new FPC remit?

The Financial Services Act sets a clear hierarchy of objectives for the FPC—contributing to the Banks' financial stability objective, and subject to that, supporting the policies of the Government, including for growth and employment. The remit recognizes those objectives and their hierarchy, while putting some emphasis on possible short-term trade offs between them. As the remit recognizes, the two objectives are complementary over time; as we are seeing, financial instability is very adverse for growth. And the short-term trade-offs might very well be quite small or the effects of added capital even positive as it supports lending. But any such trade-offs that do occur may be especially difficult to navigate and assess in the current conjuncture when monetary policy is handicapped by interest rates already at zero, limiting its ability to offset any possible short-term adverse effects on growth. It is entirely appropriate for the Chancellor to expect us to be very careful with the cost-benefit analysis behind our recommendations and to weigh in that calculus any short-term adverse effects on growth. And in these particular circumstances, it may be especially important for the FPC and MPC to understand what and how each is trying to accomplish their objectives and to take account of the other's actions in designing its own policies. Our challenge in meeting the Chancellor's remit will be to weigh and explain any short-term tradeoffs in the context of our primary and over riding objective, as expressed in the Act for the "identification of, monitoring of, and taking action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system".