Questions for Donald Kohn from House of Commons Treasury Committee

Personal/General

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 a member of the FPC?*

No

2. *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 have decided to stay for another term because I want to participate in moving the work of the FPC further along. That work, implementing macroprudential policy by building financial resilience and leaning against credit cycles, is critical for fostering economic stability in the UK without the need to turn to UK taxpayers for support. Getting it right will help the UK avoid costly crises, enhance macroeconomic stability more generally, and enable the MPC to concentrate on achieving price stability and damping economic cycles. The UK, through the FPC is trying to do this in a key, open, globally integrated financial center, which makes our task harder because it opens avenues of arbitrage and avoidance, and also means that our actions can have global implications. Any success we achieve, while preserving the benefits of the free flow of capital, can be an example for other similarly situated economies, including the United States. Parliament has created a governance structure for financial stability that has great promise: a single committee is tasked with looking at overall financial stability; it is populated with people with expertise in policy and financial markets; that committee is in the process of being granted most of the tools it needs; it is up to the FPC to realize that promise. I believe I have something to contribute to this important task.

Our thinking about how to preserve financial stability has evolved as we have thought about risk and implemented policy. One dimension of that evolution has been toward greater specificity in how we set standards. The private sector needs numerical objectives to shape its actions and give us feedback on the effects of our proposals. For example, the interim financial policy committee initially issued recommendations on capital that were more hortatory than concrete; that was much less successful than the more specific capital recommendations that resulted from the "headwinds exercise" we eventually undertook in early 2013 to quantify the amount of needed capital. Similarly, the FPC had trouble getting private sector reactions to its leverage ratio proposals until it populated those proposals with specific numbers. Another aspect of the evolution of the FPC has been in its thinking about the sources of financial instability. Our focus has mostly been on the resilience of financial institutions, but in considering the housing sector, we acted to safeguard the resilience of household borrowers because of the potential effect of household debt servicing problems on financial and economic stability. This experience reinforced my view that the ability of the FPC to safeguard financial stability will be enhanced by giving it the additional housing related powers of direction it has requested.

I do not plan any changes in my approach to my work in my new term. I believe I bring valuable experience of the US and the global financial systems to the table; I have systematically augmented my knowledge of conditions in the UK by discussions with participants in UK financial markets. In the FPC's meetings, I have argued my perspective, but also been active in seeking consensus for our decisions. I have worked with my colleagues on the FPC and with the staff at finding ways to express our decisions and their rationale as clearly as possible.

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

Yes.

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 am particularly interested in working with my FPC colleagues and the Bank staff on developing the indicators we use to judge risks to financial stability and the setting of our powers of direction. No set of indicators can be complete; we will mostly be looking for "tail events" that have small probabilities but possibly great effects; and any set of indicators will be just an entry point into a deeper analysis of points of vulnerability and the methods to mitigate risks to financial stability. But we need to be better at spotting risks, and a good set of indicators should make our actions more predictable and help the Parliament in holding us accountable for our reasoning and actions. My academic and policy contacts in the US could be helpful to this effort.

I have helped to lead the FPC's efforts at promoting greater transparency by UK banks. Although great strides have been made, more helpful transparency is always possible and I hope to continue working in this area. For example, together the FPC and the PRA should be looking for ways to use publication of stress test results to enhance the ability of the private sector to judge the creditworthiness of major UK banks.

And I intend to continue to think about the intersection of monetary and macroprudential policy. This was the subject of a talk I gave at Oxford (http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech692.pdf), and it is an area of ongoing research and analysis in the academic and policy communities.

Financial stability and the Financial Policy Committee

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

We are transitioning from concept to implementation. We have spelled out the tools we think we need to foster resilience and protect financial stability. Through our recommendations we have done much to set a path to implementation of capital standards, though that is not complete, with requirements for ring-fenced banks yet to be determined; we initiated the macro, simultaneous stress test process that was run for the first time in 2014 to gauge capital adequacy, and we and the PRA will work to make those tests even more useful at spotting potential weaknesses. We are determining the countercyclical capital buffer and publishing our decision each quarter, though, as noted above, I believe the set of core indicators could be further developed. We are preparing to publish guidance on how we would use new housing market and leverage tools, but have not yet been formally granted the authority and will need to learn from implementation over time.

The FPC has identified three medium-term priorities. Completing the capital framework is discussed in the previous paragraph,; the other priorities are ending too big to fail and ensuring diverse and resilient sources of market-based finance. An important component of the former will be putting in place conditions for resolving systemically important institutions without endangering financial stability. The latter requires not only encouraging nonbank finance, but also monitoring risks that may be arising outside the heavily regulated banking and insurance sectors and making recommendations regarding the scope of regulation if the migration of risk as tougher requirements are put on banks seems to be creating potential systemic problems. Successfully addressing both priorities will require international cooperation, especially given the globally integrated character of UK financial institutions and markets. The FPC can help to shape the global debate on these issues, and it will need to monitor the implementation in the UK of international understandings to assure itself that the stability of the UK financial system is adequately protected.

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

In my view, the most significant risks to financial stability in the UK originate outside the country. The UK housing market has cooled some and the FPC has put in place measures to forestall risks building up as a consequence of developments in housing. And growth in credit to households and businesses is still limited. With bank capital and liquidity having been increased substantially over recent years, the UK financial system appears to be on track toward enough resilience to withstand adverse surprises generated domestically, as was indicated by the results of our recent stress test. But economic growth has been disappointing almost everywhere except in the UK and the US. Strains are especially evident in the euro area, and global geopolitical risks are numerous. Important UK banks have global footprints. They should be fine if the global economy follows its most likely path for moderate growth and price stability; but downside risks abound and could materialize in unanticipated, sharp movements in financial markets, declines in confidence, and deterioration in loan performance. As the Record of our last meeting noted, these global risks and their implications for the UK are likely to be the focus for the 2015 stress tests.

7. *What have been the successes of the statutory FPC, and where is there still work to be done?*

The FPC has had a number of accomplishments over the past two years. We initiated and ran the stress tests of important UK banks and building societies, in collaboration with the PRA. We made recommendations that were implemented to enhance the transparency of UK banks, especially around their capital calculations. We heightened the attention to cyber risk in the public and private financial sectors. We made recommendations that were implemented to head-off a deterioration in mortgage underwriting standards. And we formulated requests for powers of direction over certain aspects of mortgage lending and to align leverage requirements with the various buffers associated with risk-based capital requirements.

My answer to question 5 identifies areas where I believe there is work left to be done.

8. *Has the FPC operated free of all political interference?*

Yes. The Treasury representative attends our meetings and participates in the discussion when it touches areas associated with Government policies. But I have never felt any pressure from him or from anyone else in the Government or Parliament to deviate from my best judgment on issues under consideration.

9. *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 received the support I have needed. Externals are assigned both a personal assistant to help with scheduling and logistics and policy staff to help with the substance of our work on the FPC. All have been excellent.

I can't think of changes that could be made to enhance the support we are already receiving.

10. *How well do you think the public understands the work of the FPC, and how important do you think it is that they do? How have you worked to increase the public profile of the FPC?*

I suspect public understanding is limited, though our housing market recommendations undoubtedly raised our profile. However, much of the work of the FPC touches the general public mostly through the indirect effects of its actions on the pricing and supply of credit, and it overlaps with the PRA, so it is unlikely that we will ever be able to achieve as complete an understanding as we might like. But it is important to try. Our job is to lean against credit excesses and build resilience, and we will need to be particularly vigilant when everything appears to be going well. Public support and understanding will be essential when we act under circumstances in which threats seem small and distant and when our actions can make credit harder to get for some.

I could do more in this regard. I have made two regional visits and had a few interactions with reporters, but my talks have been mostly to industry and academic groups in the UK and abroad. I will work with the Bank's staff to make a greater contribution to fostering public awareness and understanding of the FPC over the next three years. I have shared my experiences on the FPC in the US –both in public and with key policymakers. Fostering an understanding of what we are doing in the FPC promotes international cooperation and helps the US policymakers think about how they are carrying out macroprudential regulation, and I expect to continue to play this role.

11. *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, through the Bank and the PRA and by the individual efforts of myself and other members, has considerable interaction with financial institutions. These interactions, together with the background of several FPC external members, have contributed to increased communication with financial firms and understanding of their concerns. As noted in the answer to question 2, it has been helpful to the private sector when we have been concrete in our proposals, rather than just conceptual. We take careful account of the comments we and the PRA and FCA receive on changes in regulations we have proposed. As I noted in my talk to the BBA in September http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech755.pdf , the FPC and the financial sector have a shared interest in the financial stability of the UK, and we need to understand each other and work together as much as possible to realize that goal. That said, listening to the concerns of the financial sector is important, but the mandate of the FPC is for financial stability, not pleasing financial firms.

12. *How well are the FPC's financial stability indicators integrated in the work of the FPC, and how you personally think about financial stability?*

The FPC looks at the indicators as we consider the risks to financial stability and especially as we consider whether we should adjust the countercyclical capital buffer or sectorial capital requirements. And indicators that highlight the most significant or increasing vulnerabilities get particular attention. For example, the last FSR had a box on the interpretation and implications of the deeply negative UK current account. And we will be expanding the set of indicators for prospective housing and leverage powers. As noted, however, the indicators are a starting place for considering financial stability, and I believe we should be working to see whether they can be improved as early warning signs of potential risks.

As for my own approach, I use the indicators, but I also look to the risks identified by other macroprudential regulators, by international organizations, by other central banks, by chief risk officers consulted by the Bank, and by my contacts in the UK and US financial sectors. I think about what information the FPC would need to gauge the resilience of the UK financial system to these risks and then about whether the information I already have suggests deficiencies that need to be corrected. In some cases, the risks identified can be worked into the stress tests of UK banks to gauge the system's ability to handle particular tail events.

13. *How well do you think the power of recommendation has worked so far?*

I think it has worked very well. The CEOs of the FCA and PRA are sitting at the table and have helped us shape our recommendations to be most effective. To date, both individuals and their organizations have shared our concerns and implemented our recommendations expeditiously. The Treasury representative also has been helpful in guiding formulation and implementation when his organization has been the subject of recommendations.

14. *Do you agree with the conclusions and recommendations of the Warsh review as they concern the FPC?*

Yes. The publication of transcripts of FPC meetings would hamper the flow of information, which of necessity in a concentrated financial system, often includes discussion of individual systemically important institutions. And it could impede discussion leading to consensus. Given the desire for consensus it is especially important that individuals feel completely free to state their views and disagree with each other before arriving at a common decision. My experience at the Federal Reserve only reinforces my views in this regard. Once members of the FOMC became aware that discussion transcripts would be published they increasingly came to meetings with prepared remarks and reacted much less to what they heard around the table.

But Warsh also emphasized that in part his position was related to the FPC being in its early stages, and he recommended that we reexamine our policies on transcripts after several more years of experience, and I agree. And as he recommended, we should be looking at how we can enhance our institutional disclosures through the Record of its meetings and otherwise to foster greater public understanding of the factors that went into its decisions.

15. *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?*

We have had good discussions in which alternative views are expressed and positions adjusted to find consensus. The Governor is careful to make sure that everyone has an opportunity to be heard. My impression is that consensus has not been difficult to achieve.

As for myself, the most difficult decision concerned the calibration of the leverage ratios that fleshed out our request for powers of direction over leverage. I came into the meeting favoring higher leverage requirements than supported by the majority. But I could see the benefits they emphasized of keeping the relationship of the leverage to the risk-weighted requirements constant as buffers rose and fell. And I was reassured by the international proposal to require substantial amounts of total loss absorbing capital; by the FPC's intention to make the leverage-ratio minimums meaningful through including a leverage hurdle in the bank stress tests and requiring the same corrective actions for shortfalls in leverage as shortfalls in risk-weighted ratios; and by the FPC's intention to be proactive in moving the countercyclical capital buffer in response to rising risks, which would raise the leverage requirement as well. As a consequence, I was comfortable that the consensus was sufficient to safeguard the financial stability of the UK.