Treasury Committee: appointment hearing questionnaire – Elisabeth Stheeman

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?

As part of the Application Process as an External Member of the Bank's Financial Policy Committee ("FPC") I listed all my external business and financial connections

These are:
- Member of the Supervisory Board, Aareal Bank AG ("Aareal"), Wiesbaden / Germany
- Member of the Supervisory Board, TLG Immobilien AG ("TLG"), Berlin / Germany
- Non-Executive Member of the Board, Korian SA ("Korian"), Paris / France
- Member of Court and Council, London School of Economics ("LSE")
- Member of Council, German – British Chamber of Commerce

I have discussed these subsequently with the Bank's conflicts officer (who had already been consulted by the Treasury during the appointment process). He advised, in the context of the FPC Conflicts of Interest Code of Practice, that there were two areas that might be relevant to the future work of the FPC: first, Aareal has a branch in London and is active in real estate finance, mainly outside the United Kingdom; second, TLG is a commercial property company operating entirely in Germany. I will set out the details in a letter to the FPC ahead of my first meeting, and will propose to manage any conflict by recusing myself from discussion or decisions of the FPC relating to the commercial property market in the EU and, to the extent relevant, in the UK.

I understand that the Bank's process ahead of each FPC round is for the conflicts officer to review the agenda and papers with the FPC secretariat against the register of interests and potential conflicts so that any likely need for recusals can be flagged in advance to the member and to the Governor as Chair.

The conflicts officer did not see my other business connections as likely to involve any conflict with the work of the FPC. He was also content with my current personal financial interests: under the Bank's Code I will have to seek his approval for any financial transactions in the future.

Since July 2017 I have been an External Member of the Financial Market's Infrastructure ("FMI") Board of the Bank. This oversees the Bank's role in the oversight and supervision of payments systems and clearing and settlement systems. The Bank does not see any conflict with my work for the FPC, and has asked me to continue.

I have resigned from my role as senior adviser to the Prudential Regulation Authority ("PRA") which will become effective on my joining the FPC as an External Member.

Under the Bank's Code (to which I have been subject since 2015) I have notified all my personal and financial relationships, and also listed in my pre-appointment questionnaire the following personal connections:

- My husband is the CEO of the UK Debt Management Office, an Executive Agency of Her Majesty's Treasury ("HMT").
- My oldest sister is a private client advisor at Bank Julius Baer in Germany.
- My brother is the Head of Human Resources at Bayerische Landesbank in Germany.

None of these relationships is seen by the conflicts officer as representing a potential conflict, though their existence will be included in the Committee's register of interests. The FPC does not take decisions on individual firms, and neither the PRA nor the FCA supervises the German operations of the two banks.

I should add that the Treasury did not see my husband's position as a Treasury official as a potential issue. The Treasury itself has a seat on the FPC.

I will of course continue to report any potential issues to the Bank and take the conflicts officer's advice on how to manage them.

(Please complete and return to the Clerk of the Committee (reesse@parliament.uk) and to treascom@parliament.uk by noon on Thursday 25 January)

2. ***Do you intend to serve the full term for which you have been appointed?*** Yes
Do you intend to apply for a further term? I see no objection in principle at this stage to serving for six years if HMT should wish me to serve a second term.

3. ***Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the FPC. To which areas of the FPC's work do you expect to make a particular contribution?***

As you might have seen from my CV, I have 35 years of professional experience working in financial services, commercial real estate and the public sector.

Both my executive and my non-executive experience have given me a deep knowledge of the financial sector, both in the UK and internationally. Having started my career in retail banking with Vereins- und Westbank AG in Hamburg I spent almost 25 years at Morgan Stanley in London, working in a number of different areas, including client coverage, capital markets and real estate. In early 2013, I joined Lasalle Investment Management in London and Chicago as Global Chief Operating Officer and Member of Lasalle's Global Management Committee.

For the past 10 years I have had particular exposure to the commercial real estate ("CRE") market, especially during my time as Global Chief Operating Officer of the Morgan Stanley Real Estate Funds and subsequently at Lasalle Investment Management. CRE is of particular importance to Financial Stability (see Q. 4 (ii) Asset Valuations).

I joined the PRA as a Senior Advisor in September 2015. My main responsibilities at the PRA have been the provision of independent advice and senior industry experience and to give effective challenge to the way the PRA works and exercises judgements. My Senior Advisor role at the PRA has included chairing - or being an independent panel member of - internal review sessions for financial services firms supervised by the PRA, leading governance and board effectiveness reviews with supervision teams and being an independent member of interview panels for Senior Management Function ("SMF") interviews.

In July this year I was appointed as an External Member to the FMI Board of the Bank. Since March last year I have been an Independent Member of the Internal Evaluation Office's Senior Advisory Group for the review of the Sterling Monetary Framework. In addition, I have co-chaired a global work stream on behalf of the PRA on the supervision of governance with the Federal Reserve Bank of New York since 2016.

My current non-executive director roles are providing me with a deep insight into the financial and real estate markets. This has given me a comprehensive knowledge of several of the major issues currently affecting financial services, the wider economy and the real estate market (such as competition from FinTech and changes in asset valuations, particularly in CRE – see Q 4.).

As part of my non-executive board roles, I regularly attend and contribute to board meetings with senior executives and fellow non-executive directors to review and discuss current challenges, both for the companies themselves and the markets in which they operate.

I have had extensive involvement with the London School of Economics (LSE) for many years: having completed a post-graduate Diploma there in 1988 I was elected as a lay member of the LSE Court of Governors in 2011 and as a lay member of the LSE Council in 2016. I am an active member of the LSE alumni and mentoring networks and I have been a regular attendee and speaker at LSE events and a contributor to LSE discussion panels.

I am confident that my background and my experience, particularly in financial services and in real estate, both in the UK and internationally, would enable me to make a material and valuable contribution to UK financial stability as an External Member of the FPC.

I am aware that there are some very early opportunities to take part in some of the Bank's outreach programmes with schools and other educational establishments across the UK to help promote a better understanding of the work of the FPC and the Bank more broadly which I would be keen to take advantage of. In addition I plan to take part in regional visits with the Bank's agents to meet small and medium sized companies across the UK to understand their perspective on the UK Economy once I have joined the FPC.

4. *Which do you think are currently the greatest risks to domestic financial stability, and how likely is it that those risks will crystallise?*

Strictly speaking, most tail risks are unlikely to crystallise. Some of the risks the FPC would be most occupied with may also be the least likely. In my view the great value the committee brings is in asking precisely what these possibilities are, even if they are remote, as that is what too few people did before the crisis.

So focusing on what is possible, rather than probable, I see two main risks to domestic financial stability at this point in time:

(i) Potential risks to financial stability arising from Brexit:

There are a number of potential future relationships between the UK and the EU. As I mentioned above, the FPC's value added is to focus on outcomes that would most affect financial stability, and then take action to mitigate the risk or increase resilience. One such outcome would be if the UK departs the European Union without an agreement, particularly if this happened in a disorderly way. This could severely affect the provision of financial services and the wider UK economy, thereby threatening financial stability.

Companies would need to put some contingency plans in place for this scenario and a number of issues would need legislative fixes, for example on the continuation of derivatives and insurance contracts (see below).

For example, one issue I would draw attention to in this context is the risk to the continuity of outstanding cross-border derivatives contracts which could impair financial companies' ability to perform or service outstanding financial contracts. This could affect $26tn of the over-the-counter derivatives trades between the EU and the UK, as well as cleared contracts if UK clearing houses would not be recognised by the EU (for example LCH, a subsidiary of the London Stock Exchange, handles over 90% of cleared interest rate swaps globally; collateral requirements and costs to financial services companies would increase significantly if these contracts would have to be cleared in different locations).

The ability of insurance companies to deliver on their contracts may be affected, especially if they are not enforceable when the UK is outside of the EU: 7% of general insurance and 3% of life insurance contracts are currently written by EEA insurers.

In the longer term, the scenario I described would likely diminish the cross-border trade in financial services, and result in a more complex and fragmented financial system. Complexity and fragmentation could increase risks to financial stability, as the financial system would become harder to supervise and regulate; at the same time, this may well also increase the cost of financing to the real economy.

(ii) Asset valuations, in particular real estate values:

Both lenders and borrowers have become used to very low equilibrium interest rates: this has led to increased valuations of CRE in the UK (particularly in London and the South East). This makes parts of the sector vulnerable to re-pricing, for example if risk premia rose. If rising interest rates put pressure on borrowers' ability to repay loans, banks may experience increased defaults at the same time.

CRE lending creates a potentially large source of credit risk to lenders and there has been a strong link between CRE prices and the wider economy in the past (Bank of England research suggests that every 10% fall in CRE prices leads to a 1% fall in economy-wide investments). While UK CRE prices as a whole remain 13% below their 2007 peak, London prices are currently 22% above their 2007 peak; 60% of respondents to a recent survey of the Royal Institute of Chartered Surveyors ("RICS") have argued that London CRE prices are "expensive" or "very expensive".

In addition most small and medium sized companies (“SMEs”) borrow from banks using CRE as collateral; if CRE prices fall SMEs could experience refinancing issues and/or see their access to credit reduced. While the level of UK CRE debt remained mostly stable in 2017 (at around £ 210bn) compared to the end of 2016, and major UK banks’ underwriting standards remained mostly unchanged, the volume of rental income to service debt has fallen. In addition some lenders (non-banks, international banks and challenger banks) are lending at higher risk metrics than UK major banks).

On the positive side, the Loan to Value (“LTV”) ratios of loans is significantly lower at the current time than it was during the Global Financial Crisis (“GFC”); and banks have lower exposures to CRE than before the crisis.

While the potential risks to financial stability arising from Brexit and from asset valuations have not fully crystallised yet I suspect that they will both need to be among the major areas of focus for the FPC in 2018 (the risk of a decrease in asset valuations was included in the stress tests for UK Banks conducted in the second half of 2017).

In addition to the risks around Brexit and asset valuations, there are, of course, other risks the FPC should monitor. One would be the risk which might arise from debt vulnerabilities in several major economies, such as China. China’s private non-financial sector debt to GDP ratio currently stands at over 210%, having risen around 60 percentage points in the past five years. This risk could be amplified by the Chinese financial sector which has become increasingly complex since the GFC (small and medium sized banks have doubled in asset size as a share of GDP and shadow banking activities have expanded). This could increase the risk of contagion within the Chinese financial system in the event of a shock.

Finally I would mention UK household indebtedness as another risk which could pose risks to UK financial stability. Households which are highly indebted are likely to cut back on spending to service their mortgage. This in turn can increase the risk of an economic downturn. And, fast-growing consumer credit may pose a risk to banks’ balance sheets if they are too optimistic in their risk assessment. The FPC has taken action both regarding mortgage debt and consumer credit so will need to monitor how risks from household indebtedness evolve in light of the FPC's actions.

5. ***What have been the FPC's greatest successes so far, in your opinion? Where is there still work to be done?***

In my opinion one of the greatest successes of the FPC so far has been the fact that the UK banking system is much better capitalised now than it was following the GFC, thereby making the entire UK Financial System considerably more stable than ten years ago.

In addition, the FPC introduced measures such as the leverage ratio and stress testing that make the measurement of risk in the system considerably more robust than it had been in the past.

One of the FPC's aims is to prevent the financial system from amplifying a downturn into a credit crunch or serious financial crisis as it happened in 2008.

The FPC has used its tools to avoid another financial crisis to the extent possible; examples I would mention are the FPC's interventions on housing and on consumer credit to increase the resilience of the system to developments in either of these sectors. At the same time it is important that the FPC balances its objective of a better capitalisation of the financial system with the potential risk that this might lead to a significant restriction in credit supply.

The FPC and the Prudential Regulation Committee ("PRC") coordinate closely with each other on topics such as the annual stress tests for major UK banks, which are discussed at joint meetings between the FPC and the PRC. The PRC complements the FPC by setting firm specific buffers and by making other microprudential decisions on firms supervised by the PRA.

In terms of areas where there is still work to be done, I would mention the relative lack of public awareness of the FPC's actions and the continuing need to participate in the Bank's outreach initiatives to increase the understanding of what the FPC and the Bank as a whole do (see Q. 8 and Q.11.).

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

The FPC has a wide range of different tools to meet the Bank's Financial Stability Objective. These tools have been adapted over time since the FPC was originally established as an Interim Committee in 2011 and subsequently as a statutory Committee in 2013 in response to the GFC.

One important tool is the FPC's power of direction towards both the PRA and the FCA; this power of direction is available for the following "macro-prudential" measures:

1) Housing: "owner occupied" mortgages; the FPC has powers in respect of setting limits over Loan to Value ("LTV") and Debt to Income ("DTI"). The FPC also has powers in respect of limits over LTV and Interest Coverage Ratio ("ICR") for "buy-to-let" mortgages.
2) Leverage Ratio: the FPC has the power to set minimum leverage ratios.
3) Sectoral capital requirements over residential property, commercial property and financial sector exposures.

One of the tools which takes direct effect and which the FPC has used recently is the Countercyclical Buffer ("CCyB"); the CCyB can be used to ensure enough capital is held across the UK's financial system. The CCyB can be adjusted if the FPC perceives that there is a need to hold more (or less) capital. The annual stress test (annual cyclical scenario or "ACS") is among the measures used by the FPC to decide whether a change in the CCyB is required.

In practice, I would expect these powers to be of particular value when the FPC is not aligned with the Prudential Regulation Committee ("PRC") and has to act fast. Given the overlapping membership and frequent consultations between committees, I expect this to be the case only on rare occasions: for example when the FPC makes counter-cyclical judgements, such as relaxing prudential rules at the time of a downturn that may go against the instincts of a microprudential regulator, such as the PRA

In practice, the most frequently used and historically most effective tools the FPC has used since its inception are the powers of recommendation which it can make to the Bank, HMT, the FCA or the PRA. This means that it can recommend new macro-prudential measures and suggest a change to the "regulatory perimeter" (such as the financial institutions which fall under the regulatory regime).

Given the wide-ranging tools the FPC has (which have not all been deployed yet) I do not think there is currently an urgent need for additional powers of direction. Compared to monetary policy, research on macroprudential policy is still in its infancy. Rather than adding any additional tools at this stage another suggestion would be to do more research on when and how best to use the tools that are currently available.

7. 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? What risks do you see with this approach?

Given the focus of the FPC on macroprudential policy I believe that there is some benefit for a consensus approach to decision making rather than by a vote (such as for the MPC). The great majority of issues the FPC reviews and makes a judgement on are much more difficult to quantify (or "boil" down to a specific number or action, such as a "yes or no" vote) than the decision on other committees. As part of my executive and non-executive experience as a member of various boards I have seen many examples of strong decision making when the approach was based on a consensus driven model.

Having said that, in my view it is of particular importance for committees who make decisions based on consensus that there is a full debate which gives all members of the Committee the opportunity to explain their view before a final decision is reached and that the public are aware of the arguments.

I noticed, for example, how the FPC's Record from March 2016 devoted considerable space to different viewpoints on the appropriate level of the countercyclical capital buffer suggesting an extensive debate among members before consensus was reached.

One potential risk one might imagine is that if there is a member of the committee who has a different view to all other members of the committee that (s)he might feel it not as worthwhile to voice their opinion. One mitigating factor to this is the individual accountability which each FPC member has to Parliament and the regular appearance of FPC members in front of the Treasury Select Committee where they have the opportunity to explain their decisions and publicly communicate their views.

8. ***How important is it that FPC members publicly communicate their individual views about the risks to financial stability, and how they might be addressed? Do you intend to make public speeches to this effect?***

In my view it is important that FPC members publicly communicate their views about the risks to financial stability from time to time and to give an indication on how these risks might be addressed. Naturally, this should respect the consensus reached on policy issues. When giving speeches, my focus will be squarely on the statutory remit and objectives of the FPC (i.e. contributing to the achievement by the Bank of the Financial Stability Objective to protect and enhance the stability of the financial system of the UK and – subject to that – supporting the economic policy of HM Government, including its aim for growth and employment).

I would expect to make some speeches to this effect once I have joined the Committee and once I have been through a few FPC meeting rounds (in addition to participating in the Bank's outreach programme with schools, other educational establishments and taking part in regional visits with the Bank's agents (see Q. 3)).

9. ***What is your assessment of the FPC's core indicators? Which indicators are the most important, and are there any additional indicators you think should be***

considered?

The FPC has a wide range of core indicators which it reviews on a regular basis as part of their assessment of the stability of the financial system in the UK.

One class of indicators I find useful is on the level of debt in the economy or subsectors of it, since excessive levels of debt make both lenders and borrowers more vulnerable to financial shocks.

One of the core indicators the FPC considers in this respect is the ratio of household debt to income. This provides the FPC with an indication of the level of indebtedness across households in the UK compared to the average income of those households. While the level of household indebtedness in the UK has fallen since the GFC it still remains high, especially relative to current household income. In particular, the high proportion of mortgage debt as a percentage of total household debt can pose a risk to financial stability in the UK. As households who have a relatively high level of mortgage debt try to service their mortgages before they spend money on new purchases there is a risk that they will cut down their spending thereby potentially increasing the risk of an economic downturn.

Another important indicator which the FPC considers is the ratio of overall credit to gross domestic product ("GDP") ratio. While the ratio of credit to GDP in the UK has fallen since the GFC it remains high by historical standards. Having said that, overall credit growth has been only a little above nominal GDP growth and debt servicing costs have been relatively low. Given the rise in interest rates in the fourth quarter of 2017 I think the credit to GDP ratio is an indicator the FPC would continue to monitor.

Finally I would mention asset valuations as another important class of indicators which the FPC should consider on a regular basis – especially if these are supported by high levels of leverage. Given that the level of interest rates has been at historically low levels in the UK since the GFC households, corporates and investors have been used to the ability to raise debt at relatively low cost. This has led to asset prices (such as the valuation of CRE) increasing. Therefore there is an increased risk of a price correction, especially if interest rates rise and/or the outlook of the economy deteriorates.

I would be interested to explore further - once I have joined the FPC - how the Committee can most effectively use other indicators to assess potential risks to financial stability, especially those which are more difficult to measure by the indicators I have mentioned above; for example the increasing competition to traditional banks through new entrants (such as Fintech firms) and the implications of the recent introduction of Open Banking.

10. What is your view of transparency of the FPC? Do you think it is appropriate that the FPC only publishes records of its meetings, as opposed to more detailed minutes?

In my view the FPC has to balance the need to operate within its current statutory remit and framework (such as the consensus driven approach – see my response to Q.7 –) and provide enough information to ensure that their decisions are well understood.

Having been on a number of public boards I do not think publishing a record of meetings as opposed to more detailed minutes is as different in practice as one might initially think. In my experience many board meetings which are recorded in “minutes” do not specifically attribute comments to board members and some of the discussions, especially when they are of a very sensitive nature, are quite often summarised rather than repeated “word for word”.

The FPC is, in fact, going well beyond private-sector boards when it comes to transparency:

i) The FPC Record is quite a detailed summary;

ii) It mentions if there were differences in views before a consensus was reached;

iii) There is wider transparency of the FPC, e.g. through appearances of FPC members in front of the TSC, press conferences, speeches and regional / outreach visits.

In addition the annual stress test is a transparent process – one example I would mention are the decisions it has made to improve disclosure on country exposures.

The FPC meetings cannot be recorded "word for word" without considerable redactions given the confidential information that are being considered. I therefore believe that the record is the closest one can get for that kind of discussion.

11. What is your assessment of the public profile of the FPC, both within the industry and among the wider public? How important is it that the public understands the role of the FPC and the decisions it takes?

I have been surprised how relatively little known the FPC seems to be (especially compared with the MPC) – both within financial services and across other sectors and particularly among the wider public. One of the explanations for this might be that the FPC is a relatively "young" committee, having been established less than five years ago, whereas the MPC was formed almost 20 years ago when the Bank of England was granted independence on setting interest rates by the then Chancellor Gordon Brown . This was widely discussed during the recent Conference the Bank organised on the topic of "Bank Independence – 20 Years on".

The remit of the FPC and its decisions might at first glance appear to be more difficult to understand and of less direct relevance to the broader public than a change in interest rates. The FPC has a far more complex set of tools, a wide set of indicators and generally its decisions have an indirect effect which is harder for the broader public to understand.

Having said that the FPC can have a direct impact on the public by using some of its tools (such as on housing) and I believe it is therefore important that the public broadly understand why the FPC is doing what it is doing and that it trusts the FPC to be competent. This makes it important that the FPC is accountable to, and can be held to account by, the public. In my view, accountability to the public implies a duty of making sure actions and objectives are understood by the public.

In my view important outreach initiatives, such as the Open Forum at Liverpool a few months ago and the attempt to make the Financial Stability Report more accessible to a broader audience have increased the knowledge of the broader public.

I believe there is more work to be done and I would very much hope to play a role in improving the understanding of the FPC's purpose and the decisions it takes.