



BANK OF ENGLAND

News release

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Donald Kohn – Remarks to British Bankers Association Strategy Group

In remarks to the BBA on 10 September, published on Thursday, Don Kohn, external member of the Bank of England's Financial Policy Committee, explains the role of the FPC and its approach to building resilience in the financial system and enhancing transparency in banking. He also discusses the potential risks to financial stability that may arise as central banks exit from unconventional monetary policy.

Don sees the primary objective of macroprudential policy as reducing financial vulnerabilities, so that the financial and economic systems are more resilient to unexpected events.

“Someone needs to be looking at the whole system to determine its collective vulnerabilities.”

By considering leverage, interconnections and growth of credit in the financial system as a whole, the FPC can identify tail risks and determine what actions are needed to build resilience, Don says.

In order to build resilience against tail risks, firms should expect the FPC to require the following: more capital at every stage of the business cycle; diversified measures of capital adequacy; measures of capital adequacy that vary over types of institutions and over the cycle; constraints and limits on maturity transformation through required liquidity ratios, and narrower measures to target specific problems.

Don outlines three areas in which firms can assist the FPC in the development of policy: first, in identifying risks and vulnerabilities; second, in assessing the effectiveness and potential benefits of policies to deal with vulnerabilities to tail risks, and third, by helping the FPC to gauge the costs of policies against their benefits.

A second priority for the FPC, and one area in which the FPC and Bank of England have a productive relationship with the BBA, is in enhancing the transparency of UK banks so that investors better understand the risks that banks are taking, and their approach to managing those risks.

Here, the FPC has undertaken several actions to help investors assess bank counterparties, such as recommending that leverage ratios be published beside capital ratios based on risk-weighted assets; endorsing the recommendations of the Enhanced Disclosure Task Force and asking that they be implemented by UK banks for their end 2013 reports, and recommending that banks modify their Pillar 3 Basel capital reports to enhance comparability.

“I expect to get an update on progress on these recommendations in the current round of FPC meetings. My preliminary

impression is that significant progress has been made in recent annual reports, and that, importantly, that information is easier to compare and interpret for outsiders,” Don says.

Finally, Don discusses how the FPC can work with banks to manage the risks that could arise as policymakers around the world begin to prepare their exit from unconventional monetary policy.

He explains that exit is likely to be a positive event for the UK economy and financial markets and that the MPC expects that the rise in policy rates will likely be limited and gradual. Some market participants would gain and others would lose, but probably without threatening financial stability.

“But exit is not without its risks and dangers, especially after a long period of very low interest rates and low market volatility,” Don cautions. “The question is whether the long period of low rates and low volatility has led to a mispricing of risks through reaching for yield, herding or other types of behaviours. If it has, the potential for very sharp adjustments would be higher, with possible unanticipated consequences for both borrowers and lenders.”

The FPC has pointed to a number of types of risk that could be mispriced: credit risk; interest rate risk and liquidity risk. One source of concern is the liquidity transformation implied by bond and other mutual funds, as retail investors may be counting on a greater ability to redeem their shares than will be available if a substantial proportion of them attempt to shift direction at the same time.

To conclude, Don says the FPC has been scrutinising these risks and been trying to alert market participants to factor the potential effects of rising rates on asset prices through its FSRs, parliamentary testimony and speeches. In addition, it has incorporated a number of risks into the stress test scenario for banks.

But policymakers have not had experience of the asset price movements associated with an exit from unconventional monetary policy.

“Most likely all will go well; unconventional policies will be unwound with only the sorts of gains and losses that usually accompany policy shifts and don’t threaten financial stability. But this is an unusual challenge for both the authorities – including new macroprudential authorities like the FPC – and the private sector. One that we must get right.”