HOUSE OF COMMONS

Treasury Committee

Oral evidence: Appointment of Anil Kashyap to the Financial Policy Committee, HC 730

Tuesday 11 October 2016

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Watch the meeting

Members present: Mr Andrew Tyrie (Chair), Stephen Hammond, George Kerevan and Mr Jacob Rees-Mogg

Questions 1 - 34

Witness

I: Anil Kashyap

Examination of witness

Anil Kashyap

Q1 **Chair:** Thank you very much for coming to give evidence to us this morning. We need to come to a view about your suitability for an interesting job, which is to fill the extra job created under the latest statute for the FPC. Can I begin by asking you, since you have a job in Chicago, how you intend to divide your time between that job and the one that you are intending to fill?

***Anil Kashyap*:** Thank you for having me. The first thing I did before I even applied for this job was to talk to Don Kohn about how he had managed the commute, and he told me that it was reasonably manageable. A lot of the meetings here are compressed into the periods just before the policy meeting, so that makes the physical time on the ground somewhat manageable. It is a little embarrassing to say this, but research faculties at major universities in the United States do not teach that much.

Chair: It is not very onerous out in Chicago; that is what you are telling us. There is plenty of spare time.

***Anil Kashyap*:** I am obliged by my contract to teach three courses during the year, and those three courses are normally bunched into one 10-week period. I have spoken to my dean about taking a reduced teaching load, so I will teach just two courses during 10 weeks, which I will put on one day. I believe I can concentrate all my teaching in one 10-week period on 10 days. It is a good deal if you can get it. That will make it relatively straightforward to attend almost every meeting in person. Right now, for the 2017 calendar there is one meeting that was scheduled that would be a problem, but other than that I think I can be here. I asked the dean, "Are you going to have a problem with me doing this?" There was no concern on their part. In fact, I think they welcome it.

Q2 **Chair:** You are not reducing your teaching commitments in Chicago.

***Anil Kashyap*:** I am going to teach only two sections instead of three, and I also have resigned from a bunch of other advisory positions. I used to be on the Congressional Budget Office advisory panel and the New York Fed's advisory panel. I was a scientific adviser to the Swedish central bank. I have resigned all those posts, which also clears up time.

Q3 **Chair:** The thing we should take from this is that there is some spare capacity out there that could be brought into play across a wide cross-section of the faculty at the Chicago school.

***Anil Kashyap*:** Yes, if you want more Chicago faculty.

Q4 **Chair:** There are plenty of budget savings out there. I want to look at this one meeting that you will not be able to attend. When is that?

***Anil Kashyap*:** Right now there is a scheduled joint FPC and MPC meeting on 5 April and I am going to be teaching in Chicago until 9pm on 4 April. What I will have to do is call into that meeting if it cannot be moved. I do not know when that was set, but the first schedule I saw did not have any conflicts. Don has called in occasionally. All the members occasionally miss a meeting now and again, so I expect that I can call in if need be on times when I cannot be here. I intend to do whatever it takes to make this work.

Q5 **Chair:** I want to clarify this. In principle, what is taking precedence between your teaching commitments and an FPC commitment?

***Anil Kashyap*:** I cannot cancel class. What I can do is set my teaching—

Q6 **Chair:** The answer is that your Chicago commitments are coming before your FPC commitments.

***Anil Kashyap*:** Yes. This is a part-time appointment and that is a full-time appointment.

Q7 **Chair:** One is public service.

***Anil Kashyap*:** Yes, but it is the case that I can slate my teaching pretty much any day I want. Had I known when the meetings were set this year, I could have picked a different day.

Q8 **Chair:** I raise this issue because the most important meetings of the FPC could turn out to be ones arranged at short notice to deal with a crisis.

***Anil Kashyap*:** That is true, in which case I can probably be on the phone. There are only 10 mornings a year where for three hours I am not reachable.

Chair: This is definitely a job to go for and you really need to send us the application forms.

***Anil Kashyap*:** I will send you a link.

Q9 **Mr Rees-Mogg:** I am not clever enough, so I would not be able to apply. Thank you very much for coming in. What I wanted to ask you about was the flash crash in sterling and if you had any thoughts on that, what caused it and whether it matters when things bounce back quite quickly.

***Anil Kashyap*:** It matters for financial stability and the FPC. I would say that short-term volatility like that, especially when it bounces back, probably does not cause any financial stability concerns. For movements in sterling generally, even short run-movements if they are sustained, to my view, the financial stability considerations go first to whether or not there are funding mismatches for any of the large institutions here and whether they have properly or improperly hedged them. That is my first concern, and that would be there regardless of which way the exchange rate moves. I do not think the thing that happened on Friday had any material effect. I do not think, even if sterling was to move substantially, that we would have concerns about the banks, because people have been looking into this question of whether or not their exposures are hedged.

Q10 **Mr Rees-Mogg:** Do people yet understand exactly what caused the flash crash or is it still attributed to computer-generated algorithms?

***Anil Kashyap*:** There have not been any briefings; I have read various commentaries. It is not an accident that it happened at a time that the sterling market was not very thick, but I have not seen anything definitive on this.

Q11 **Mr Rees-Mogg:** Do you think it would have mattered more if it had happened at a time when the UK markets were open or is that a daft question, because liquidity would have been so much greater and it would therefore be much less likely to happen?

***Anil Kashyap*:** I would have guessed if the markets had been open it would have been much less likely to happen, but that does not mean it cannot happen. The United States treasury bond market is the deepest in the world, and there was a flash crash up on a Friday afternoon almost exactly two years ago. That was in the middle of the day, thick trading and all the rest. It can happen, but it is much less likely to have happened.

Q12 **Mr Rees-Mogg:** What are the consequences if it had happened during full market opening hours?

Anil Kashyap: If it had reversed as quickly as it did, I doubt it would have much consequence. If the exchange rate was to move 6% in one day, I think people would be worried, and you would want to go and verify that everybody has their funding in line. If it is a movement in sterling, the Bank, as lender of last resort, can provide liquidity if somebody is caught out. In that sense, I do not think that is a high risk or one that cannot be managed.

Q13 **Mr Rees-Mogg:** Overall, do you think algorithm trading leads to more or less volatility?

Anil Kashyap: It depends in which markets and which times. If you look at equity markets right now, the vast majority of all trades are by algorithms, and those markets are probably the most robust. If you look during the crisis, the equity markets never really cracked despite the fact that the marginal trader is an algorithm. It seems like you can set markets up that can work that way. There is a bigger question as to whether it is socially desirable to have this arms race to be one-10-millionth of a millisecond faster and all of that. In terms of posing systemic risk, I do not think it follows just because algorithms are prominent that that is necessarily that bad.

Q14 **Mr Rees-Mogg:** Thank you. I would add that we hope it does not put fund managers out of business, which is an opportunity for me to make reference to my declaration of interests as a chairman of an investment management company.

Q15 **Chair:** Let us go back to this algorithm question, because that is a key point. Overall, looking at the sterling market, do you think that we are better off having algorithmic trading or not? If we are not, you are going on to a committee called the Financial Policy Committee, whose primary task is to maintain financial stability. If it is not, what policy implications, if any, lie behind that?

Anil Kashyap: I am not sure. I have not studied algorithmic trading in the FX market. The conventional wisdom, as I understand it, is that part of what has gone on in FX markets everywhere is that the banks have devoted less of their balance sheet to being able to intermediate in those markets, and there might not be the depth. It is asserted in some cases that that is partly a consequence of some of the financial stability regulations that have been passed to make the banks safer. We have them less ingrained in certain markets, maybe bid-ask spreads are wider and order flow is smaller.

Sterling is a very deep market. It is third or fourth, I think, in the world in terms of cross with the dollar, so that market is working well. The algorithms are not new. It is not like these started in the last few months or something like that, so I do not think it is a necessary threat, but it is something to watch. Again, I would go to the channels through which sterling instability could threaten the financial system. To me, the first thing in that chain is to watch the funding arrangements: if someone is funding in dollars and suddenly the market moves so that that causes a problem for them. I would be watching that specifically, not just volatility for its own sake.

Q16 **Chair:** When algorithmic trading got going, we were told it would be a force for stability. That is why I am asking this question. Perhaps I will ask a related question, or a dimly related question, which is that, in response to the crisis, we have had the introduction of a heap of new banking rules, both through Basel and in efforts to combat conduct risk. Are those increasing financial stability or reducing it?

***Anil Kashyap*:** There is no doubt that the Basel process broadly has increased stability. Raising capital standards from where we were eight or nine years ago to now has probably been the best single thing that has happened for financial stability around the world. That has been quite good.

Q17 **Chair:** I was pretty confident that we would get that answer, but I needed to put it in for completeness. What about the other half of it: not the prudential side, but the conduct side? We have a $14 billion fine here coming in on Deutsche Bank. That seems to have generated a bit of instability.

***Anil Kashyap*:** Yes. I guess there are two things. The banks ought to be held accountable for misconduct, and there is no alternative but to hold them to those standards and penalise them when they make mistakes. That is a cost of doing business.

Chair: We will come back to that point.

***Anil Kashyap*:** In terms of the magnitudes of these fines and what they are doing, it is true that, if you look around the world, price-to-book ratios for lots of large banks are lower than they were. I should start by saying I do not have any private information about Deutsche here. I am just using the information I read and the way I think about things to say what follows. Broadly speaking, there are two reasons why you could look at a bank that has a very low price-to-book ratio and think that there is a problem. Version one: the bank is insolvent. Basically, it has a hole in its balance sheet, the assets are not worth the liabilities and people are counting on state support to make it good. That is one state of the world.

Another version is that the market values of the assets and liabilities are about the same, but the value of the future franchise, the future profits, has dropped substantially. My reading on Deutsche is that it is probably more in the latter category. It is not that people think that right now it has a big capital gap; it is that people are worried as to whether or not it will be able to make a lot of profits in the future. If the answer to that is that there is not much there, then the price-to-book ratio is going to be low. When we contrast that with what reports are about the Italian system where there are lots of non-performing loans and where people are actually worried that there might be a hole in the balance sheet, that is a very different situation.

The consequences for financial stability are very different in those two cases. If you have a hole in your balance sheet, we kind of know that the performance for the macro-economy is going to be worse, if you let your banks operate as bust. I take that as a lesson from Japan. I wrote a lot about Japan and the effect of the zombie banking there. That is different than just saying that your banking system has become very boring and unprofitable. That can change, because they can change their business models. You can perhaps adjust the regulation. People could reassess whether or not the cost of equities should fall, but those are two very different things.

Q18 **Chair:** Still, I am not quite sure what the answer was to the question, which is: is it generating instability? Is it a source for instability?

Anil Kashyap: You mean fining them or catching them if they are breaking the rules? That has to be good for stability.

Q19 **Chair:** The sheer scale of the size of the fines. The fact that, in the States in particular, there appears to be competition between the regulators in the exercise of conduct risk.

Anil Kashyap: We should enforce the rules. I take the point that it does seem a little bit arbitrary as to how big these fines are and why some firms are being asked to pay this much and others are asked that much. I do not have a great understanding of how this is going to be resolved. Again, just reading, it seems that Deutsche is not going to pay $14 billion.

Q20 **Chair:** This is a question that financial stability policy in the UK is going to have to start thinking about quite a bit. Can I take you back to a point you made earlier, where you said there is no alternative to hitting the firms with fines? There is an alternative and it is to identify the individuals responsible and penalise them. This Committee, and indeed the Parliamentary Commission on Banking Standards, put that as the central challenge and task for regulators. When a sportsman—this is not an exact analogy—behaves badly in a team, it may be that the team needs fining or penalising, but probably the most effective method in most cases is to address the poor behaviour of the individual.

Anil Kashyap: That is fair. I thought I said there was no alternative to enforcing the rules. The rules must be enforced. Everybody must not think there is a shortcut.

Chair: You also said that, but in an earlier part of your answer.

Anil Kashyap: Maybe I misspoke, then, if I said there was no alternative to a fine.

Chair: You did not use the words "no alternative", but you gave that impression.

***Anil Kashyap*:** If you have announced that the rules are that they will be fined if they do this and then you do not fine them, I think that would be a bad situation. I am all for holding the individuals accountable as a first line of defence. You would like the banks to develop their own systems to strengthen that, work on that, get rid of rogue traders.

Q21 **Chair:** We are doing more than "would like". We are seeing this as an absolutely crucial part of the development of greater financial stability in the UK.

***Anil Kashyap*:** I hope that is the case.

Q22 **Stephen Hammond:** Good morning and welcome. Continuing on this theme slightly, obviously you have in your written evidence to us written a lot about the potential contagion from European banks. The Chair is right, is he not, that the problem for European banks with the American regulatory system is that there is a multiplicity of regulators? Even if you think you know what an activity is and who the regulator is, you do not necessarily find yourself complying with those regulations.

There is potential for other European banks to get themselves into the same position as Deutsche Bank. In reality, any analysis of the level of fines that have been exacted by Department of Justice shows that if your name is Deutsche Bank you tend to get a rather bigger fine that if you are perhaps an American bank. That potential financial stability we have to keep very clearly at the forefront of minds, do we not?

***Anil Kashyap*:** Yes, but I do not think that the primary risk of problems in Europe emanates from fines in the US. Let us be clear that, to me, the biggest problems in Europe are the very slow growth and the fact that some of these banks are badly capitalised by all standards. I read something yesterday that said, in the stress test, Deutsche was given credit for a transaction that was not yet consummated when the rules clearly said that should not have been done. That is just terrible for undermining stability.

Q23 **Stephen Hammond:** No one is suggesting it is a major risk, but it is a risk to bear in mind: $14 billion. Although you say your view is that the price-to-book being low reflects poor profitability going forward, there are any number of other articles that have been written suggesting that Deutsche has a fairly major capital gap at the moment as well.

***Anil Kashyap*:** They are thinly capitalised for sure. Having a stress test where the rules say you are not going to do this and then giving them a pass is not the way to deal with it.

Q24 **Stephen Hammond:** Several members of this Committee were in Rome relatively recently and we had some fairly in-depth discussions about the scale of the issue for Italian banks. I wondered about your view, because the popular consensus is that there are about €360 billion of NPLs. They were suggesting that the reality is it is only about €80 billion and it can all be managed.

Anil Kashyap: Can you tell me who said it was €80 billion? Was it one of the regulators or private analysts saying €80 billion? I have not seen that.

Stephen Hammond: It was a government source in Italy that quoted that number at us.

George Kerevan: A senior source.

Stephen Hammond: A very senior source used that number in Italy, suggesting that the world was much too exercised about the scale of the Italian banking crisis.

Anil Kashyap: From what I know from public data and from everything I have seen, Italy has not grown very much for a long time. They have very bad property rights enforcement. They have this whole mess where the bail-in debt was sold to individuals and now they are resisting pulling the trigger on that. It is unfortunate that they have got to this point, but I do not think that the size of the problem is that small, because if it was that small they would have fixed it.

Q25 **Stephen Hammond:** I listened very carefully to your responses to Mr Rees-Mogg about flash crashes. In the UK, we are about to embark next March on a two-year period of Article 50 negotiations. We will then embark on a period of Article 2.13 negotiations. In terms of sterling, I wondered, given its fall of 15% since 23 June, how much likelihood there is of further major depreciation, fluctuations and financial stability risk during the period of Article 50 and then forward.

Anil Kashyap: I will probably have to resign my position at the University of Chicago if I start forecasting asset price movements. We are pretty well known for saying the market sets the exchange rate, and if I was so bright as to know exactly where it was going to go I might be engaged in your firm.

Q26 **Stephen Hammond:** I am not asking you to forecast, but do you think that the market is broadly done on anticipation or do you think we are in for a trickier rollercoaster ride?

Anil Kashyap: I do not think we know, partly because we do not know where these negotiations are going to wind up. Until we see what the arrangements are between the UK and the EU, it is very hard to know where any of this will settle down.

Q27 **Stephen Hammond:** If I were to paraphrase, let us say we went for a hard Brexit, as you know what that effectively implies, how does that impact your thinking?

Anil Kashyap: If we were sure we were going to have hard Brexit, my guess is the exchange rate could weaken a bit more. It will still depend on exactly how this plays out. There is a continuum of possible outcomes between how much the economies and the financial services remain integrated, and what that would mean for the exchange rate. When people say "hard Brexit"—

Chair: Hard Brexit is often, but not always, interpreted to mean a swift exit leading to a fall-back to WTO rules.

***Anil Kashyap*:** What does it say about financial services?

Q28 **Chair:** Clearly those are no longer available to us through passporting or in the equivalence provisions, until they kick in in 2018.

***Anil Kashyap*:** If that is the way we are going to define it, the one point that I have not seen stressed much in this debate is the pure fiscal cost to the budget. If you are going to lose a bunch of financial services jobs that are going to migrate back, the fiscal consequences of that are non-trivial, because those jobs are so high paying and pay so much tax. I looked up some numbers a while ago and something like 3.7% of total UK employment is financial services; 11.5% of fiscal revenue is financial services. You do not have to lose much of that before you cause a hole in the budget that could be meaningful. That would have some knock-on effects for the exchange rate.

George Kerevan: Can I assure you that, afterwards, as a former academic, I will be explaining to the Chair that the formal class contact hours are merely the tip of the iceberg when you are teaching?

Chair: It is always good to see trade unions asserting themselves in the public domain rather than the private.

Q29 **George Kerevan:** I am interested in the relationship between how the Financial Policy Committee works and the MPC. Can you envisage situations where there might be a policy divergence between the two?

***Anil Kashyap*:** Yes, but I do not think that is the natural constellation of affairs. The way I would try to describe this to somebody is to say that the MPC is looking, over the next couple of years, at the central forecast for where things are headed and setting its policy based on that. The FPC is talking a longer view and is worried about the tail risks. Typically, there is no reason why those two things are in conflict. If the FPC is taking tail risk out, that makes it easier for the MPC to do its job. If the MPC has got the economy on a balanced trajectory, the tail risks are going to be lower, so they work together.

Let us take a hypothetical: the low-for-long goes on a long, long time. I do not think we are anywhere near that now, but you could imagine a situation where you start to see the risks of the unintended parts of the very low rates rising and the benefits falling. You could see that the FPC is saying, "We are getting closer to where this is a real problem for us." The out in that case is that the MPC would have to ask itself, "Why are we continuing to pursue this if the benefits are not there?"

Q30 **George Kerevan:** Let me give you an example; that takes me neatly to where I want to go. In the last 12 months, the aggregate deficits on pension funds in the UK, pension funds to which the pension authorities are liable to step in if there is a problem, have doubled in a single year. In the month of August alone, they shot up by 22%. Does that not ring alarm bells? Is that not a tail-end risk suddenly appearing?

Anil Kashyap**:** I am a little bit aware of this, but there are a couple of things. First of all, the pension deficits do not have to be closed over a year. To the extent they are there and they are going to stay for a while, the companies have a long time to work this off. That is a first thing to keep in mind. There is not any reason for there to necessarily be a sharp adjustment. The second thing is, as time proceeds, one would expect that we are going to eventually transit out of this arrangement of very low rates. When we do, we will get some payback on the other side, when rates come back up. If this persists for a long time, that would be one of the channels through which you could start wondering.

You would then have to go and ask a second round question: "What is the financial stability risk that comes from these companies having these pension deficits?" There are clear macro possibilities if you think they are going to cut back on their investment or do something to close the pension deficit that will harm the macro economy.

In terms of destabilising the financial system, taking the remit for the FPC, it is less clear what that could be. Maybe they will start reaching for yield or doing something that would be unfortunate to try to close the gap with some sort of financial engineering, but I do not think that is there. In fact, in this case, I would guess that the risk would be almost as much that the MPC would conclude, "You know what? We are not helping the economy enough to overcome that risk", and eventually they would reverse.

Q31 **George Kerevan:** I will pursue that a little bit further. Do you think that the primary cause of these expanding pension fund deficits is the continuation of the expansion of QE, which is a monetary policy?

Anil Kashyap**:** I would guess no, for a couple of reasons. First of all, the companies are best off if the economy is strong, growing and healthy. The direct effect of the unconventional policy, low rates and all of that is to try to keep the economy on solid footing. That is the first answer. The second answer is that a lot of the interest rates in the world are low. You guys have talked about r* or something like that. I assume that somebody has come before you and given you all the evidence about how interest rates are low everywhere in the world, despite monetary policies that have been very different at times. The Fed is now looking to start thinking about raising rates and yet interest rates are very low on 10-year treasuries too.

The forces that are making interest rates low around the world are to do with much more than just UK monetary policy. I put together the fact that UK monetary policy is trying to help the economy and that this is happening in lots of other places, and I say that they may have just been in for a bad time because of the low rates. There is no reason that the low rates have to stay indefinitely.

Q32 **George Kerevan:** Finally, you mentioned that there is going to be a joint meeting between the two committees. There has been a gentle concern over the years about groupthink emerging. Given the new structures which the Bank has put into place, the different committees, how do you maintain in your mind the different remits? How do we guard against the committees merging into a simple groupthink about where the economy is going?

***Anil Kashyap*:** I do not know fully; I have just seen the calendar and have not participated very much. The one meeting I have been to was a joint meeting of the FPC and MPC last week. There is a lot of structure around the FPC that stops us from losing focus on our remit. First and foremost, the agenda that is set is driven by financial stability first, second and third. The monetary policy spill-over is very small. I suppose the internal members may sometimes bring something, but the primary guarding against that is this Committee calling us to explain what we are doing and making sure that people are sticking to what they are supposed to stick to.

Q33 **Chair:** The FPC, unlike the MPC, operates at the moment by consensus. One of the issues that we have been discussing with the Bank since the FPC's inception is that that consensus should not preclude—indeed, it would be extremely unfortunate if it did preclude—the expression of views and the demonstration of the independence of mind to challenge current orthodoxies. Are you intending to participate in that in public forums?

***Anil Kashyap*:** Yes. The way I think about this, and I put this in my written answers, was that the record needs to be clear enough about how a decision was reached, so that somebody can explain: "The reason I was able to join the consensus was because of this element of the argument that I took to be strongest."

Chair: You would like the minutes to be fuller.

***Anil Kashyap*:** I would like the drafting of the record to be clear enough so that anybody who was trying to figure out why we reached consensus would have no doubt about it. That would then allow a potential member in public to say, "I thought this was the critical bit", and by their silence on the rest you could say maybe they did not care or were not as concerned about the other elements of what was there.

Chair: Which is, as you say, not the case now with the current minutes.

***Anil Kashyap*:** I do not know that. I have not been in the discussions to know how accurately they reflect things. I have been told by the other members that that standard—if we have reached a decision, you have to be able to piece together why—is what they think they are shooting for.

Not having been in the meetings, I do not know if that means there has been stuff that has been suppressed.

Q34 **Chair:** Supressed is too strong; it is summarised. Going back to the question, it was intended to be about making public statements, speeches and setting out your views. Are you intending to do that and to develop a programme of doing so as one of the members of the FPC?

Anil Kashyap: Yes. I have rather the opposite problem to most of the other members of Committee because I am asked to speak all the time at academic conferences. If anything, it is choosing which ones to decline. I am scheduled to go to Manchester in two months to meet with a bank agent and some people in Manchester. I am signed up to speak at two conferences in the next two months. I am more worried about speaking too often, not too little, but I will find a way.

Chair: Good. Thank you very much for coming to see us this morning; we are very grateful to you.