Treasury Committee

Oral evidence: Re-appointment of Donald Kohn to the Financial Policy Committee, HC 937

Wednesday 18 April 2018

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Watch the meeting

Members present: Nicky Morgan (Chair); Rushanara Ali; Mr Simon Clarke; Charlie Elphicke; Stephen Hammond; Stewart Hosie; Mr Alister Jack; Alison McGovern; Catherine McKinnell; Wes Streeting.

Questions 1-27

Witness

I: Dr Donald Kohn, External member, Financial Policy Committee, Bank of England.

Written evidence from witnesses:

– Donald Kohn CV

– Donald Kohn questionnaire

Examination of witness

Witnesses: Dr Donald Kohn.

Q1 **Chair:** Dr Kohn, thank you very much for being here this afternoon. For the record and for those watching, could you introduce yourself?

Donald Kohn: My name is Donald Kohn. I am an external member of the Financial Policy Committee.

Q2 **Chair:** Thank you. I was going to start with competitiveness. You will have heard the evidence from Mr Brazier and the question and debate about a low-regulation environment. Have you had any interaction with market participants who hope that regulation is going to be loosened in the UK in the future, either because of Brexit or because more generally the pendulum is going to swing backwards?

Donald Kohn: No, I haven't. I have interacted with market participants. I try to make it a practice when I come to the UK, since I come here quarterly for these meetings, to visit some market participants to get a feel for how the FPC is perceived and how they see the risks in the market, and to help me understand what is going on here. I have had quite a bit of interaction, but I have not been subject to lobbying or pressure to roll back the regulation we have done. I think they understand that it is necessary for financial stability for us to carry out our parliamentary directive, so no, I have not felt that pressure.

Q3 **Chair:** You heard Mr Brazier say at the end that the UK is a world leader in the system that has been set up. You clearly have huge international experience, particularly in the US. In your questionnaire, you say: "I have learned that the UK has an outstanding institutional set up for meeting its financial stability objectives". I wonder if I could draw that out a bit. We have talked about competitiveness. Maybe this is an area in which the UK is competitive and is showing the way worldwide. What are your impressions after your first term on the Committee?

Donald Kohn: The set-up that you, Parliament, have created in the UK is excellent for promoting financial stability. There are a couple of aspects to that. One is that you have put the macroprudential, microprudential and monetary policy committees within the Bank of England, but you have made them separate. There is good communication across those committees and there is a lot of overlap among personnel, but it is inside an institution that is independent from short-term political pressures. It is accountable democratically, but has a degree of independence.

We, the FPC, have been able to draw on the considerable expertise at the Bank of England to support our efforts. We have been able to co-ordinate and co-operate with monetary policy and microprudential policy. Naturally, I like the idea of having external members on these committees. I think our job is to bring an independent view. We are not part of the Bank of

England's structure. We bring different experiences to the process, and we can contribute to making sure that a diversity of views is represented on the Committee.

Other countries have not moved in this direction—at least not to the extent that the UK has. In the US, for example, there is the Financial Stability Oversight Council, but it is made up of a lot of independent agencies, which themselves do not have a financial stability mandate. It is the heads that sit on the committee and it is chaired by the Secretary of the Treasury, which I think complicates the pursuit of particularly countercyclical macroprudential policy—taking away the punch bowl when things get going good. It complicates any interactions between monetary policy and macroprudential policy, because the Secretary of the Treasury is sitting there in the macroprudential seat.

I have given several speeches extolling the virtues of the United Kingdom's set-up, especially relative to the United States. Martin Taylor has cautioned me that I am building us up too well to carry through on this, but I think that we are well positioned, and now we have to execute. We have made a lot of steps in that direction. We have the tools and a process, but time will tell whether we will be as successful as I think we can be.

Q4 **Chair:** It is helpful to have people with international experience on the Committee. Do you get the impression from your conversations with others in the US and elsewhere that they are watching the UK—for example to see how our ecosystem responds when there is a crisis—or do you think others think, "Good luck to them, but we will wait and see; we will do it differently"?

Donald Kohn: No, I think they are watching the UK. My experience, particularly in the United States, is that there is a lot of interest in the Financial Policy Committee and in how we operate the countercyclical capital buffer, which is very different from what they are doing in the United States. Yes, they are watching us carefully.

I have been invited to several places—Beijing, Chile, other places—to give presentations on what I think the attributes of a good macroprudential authority are and I have used the UK as an example, so yes, I think the world's eyes are on us. For a highly developed global financial centre, in an environment in which capital flows freely across borders and across uses in the financial system, making macroprudential policy is really a challenge. I think we have a structure that is up to that, but it is not one that has been used in global financial centres, at least not in recent years, so we are leading the way.

Q5 **Mr Clarke:** As you point out, the success or otherwise of the countercyclical capital buffer will obviously go a long way towards determining the way in which the FPC continues to be viewed into the future. With that in mind, and following on from Mr Brazier's evidence, where did you stand in the recent meeting on the question whether 1% was the right level?

Donald Kohn: My position was that we should give serious consideration over the first half of the year to raising that buffer a little bit. My reasoning was based on a number of factors that I saw in the environment. One that Alex highlighted was a shift in the risk-taking environment in the United Kingdom towards a bit more acceptance of risk. We are in the standard range. We said over a year ago—almost two years ago now—that we were going to 1% because we saw risk moving into the standard range. Since we said that, I think risks have, if anything, moved a little further. You can see this in the mortgage market and to some extent in business credit. It is not a huge move. Credit is not growing tremendously rapidly—it is growing about in line with nominal GDP, maybe a little faster—so there aren't any huge alarm bells going off, but I think the direction of travel is clear.

The second aspect of this was the global system. As was discussed in the last round, the Chinese debt level could threaten to spill over to the United Kingdom, if they have trouble dealing with it. They are taking some constructive steps, but it has yet to be seen whether that will be successful and how that works out. I worry to some extent about the level of corporate debt in the US, and I worry more generally that asset markets are priced to low inflation, low interest rates and good growth, and that people may become complacent everywhere—in the US, in the UK, everywhere—about prospects. That leads to some downside risks as well.

Finally, I looked at Brexit. There is some risk that as a result of Brexit—this may not be what happens; everything could work out fine, and that would be great—assets will need to be repriced, relationships will change and risks will shift. We need to make sure that the banking system is prepared for that, so I thought this was a good time, even though we are in the standard range, to round up on the countercyclical capital buffer, and I will be examining what happens over the next few months, before our June meeting, to see.

Q6 **Mr Clarke:** When you say round up over 1%, what, as an indicator, does that look like—1.25%, 1.5%? I am trying to understand the range within which you would be considering that?

Donald Kohn: I think we are still in the standard range, and we had said that we would be in the region of 1% in the standard range, so I would think 1.25%, perhaps as high as 1.5%, could still be described as in the region of 1%. We will have to have a discussion about that.

Q7 **Mr Clarke:** Just to follow up on the FPC minutes, the Committee also said that it might be possible to look at targeted measures for particular sectors, rather than necessarily an overall increase in the buffer. Were that so, what sectors, in your mind, would you particularly be focused on?

Donald Kohn: One would have to make a judgment whether the risks were moving in a more general way or in particular sectors. We do see a little bit in mortgages, we see a little bit in business credit and we see a little bit in household credit—as we talked about, consumer credit. In my mind, looking across these things, I guess it feels like a general increase in risk taking, but from a cost-benefit perspective, if we saw a particular problem in a particular sector, it is incumbent on us to address that without necessarily touching the other sectors if they are not having a problem. To make the judgment, I think you need to look across a whole array of sectors.

Mr Clarke: Thank you very much indeed.

Q8 **Rushanara Ali:** Good afternoon—back to risks from the world economy. Dr Kohn, you have told us that "a material increase in tariffs and trade barriers among globally active economies would damp global growth and increase price pressures, with consequences for asset prices and financial stability that are difficult to predict." Can you provide some insights into the potential problems?

Donald Kohn: First of all, I am not predicting a material increase in tariffs and trade barriers; I am trying to look at tail risks and possibilities. I think that is a possibility, both with respect to the UK and the EU, and with respect to the US, China and a lot of other places. I am not predicting it will happen. I think if it did, unfortunately it would slow down global growth. The rate of growth of productivity, which is already very slow globally, could be further impaired. I think productivity is increased through competition, and some of that competition happens globally.

Q9 **Rushanara Ali:** What would be the range on growth? Would you be able to say more about how much slow-down you would anticipate, or am I getting too far into prediction territory?

Donald Kohn: I am not prepared to say how much, because I think it would depend importantly on what happened. I am much more confident about the direction than about the amount. Remember, putting up barriers and raising tariffs also increases prices, so this is an adverse supply shock to the global economy that slows growth and increases prices. This is very difficult for monetary policy to work through, and could have effects on financial stability that are very hard to predict. You have a lot of things re-pricing. You have some industries that might be at risk in a less globally free economy—much more at risk than they are now. Other industries might benefit, but there will be a redistribution within a country and within a financial system, as well as a general problem with growth, productivity and inflation.

Q10 **Rushanara Ali:** How concerned should we be about the risks that may arise from the Chinese build-up of debt?

Donald Kohn: I think we should be encouraged by the steps that the Chinese Government have begun to take. They certainly recognise that there is a problem.

Q11 **Rushanara Ali:** Should we be concerned? Mr Brazier obviously set out his response. Are you concerned about it, first of all?

Donald Kohn: Yes. We have yet to see the successes. It is encouraging that they recognise the problem and are taking steps to deal with it. I think we should remain concerned until we see the success of those steps. We have to be alert to the potential that they may not be as successful as they expect, and not so much that things get a bit out of control, but that they suffer some unanticipated slowdowns and difficulties. They are trying to do a very difficult thing, which is to control the growth of credit in ways that are not productive and useful, and slow this down in a very controlled way. They have some ideas about how to go about this, but it will not be easy to execute. We need to be sure that the UK financial system is as resilient to potential tail risks from this as it can be.

Q12 **Rushanara Ali:** How does that sit with the wider issues of the Brexit negotiations and the timings if we do not have a good-enough deal, or have no deal—those sorts of scenarios? Is much work going on around the context of that issue, alongside other risks? Presumably there is.

Donald Kohn: In our stress tests for 2017 and 2018, we have a combination of those things. So we have, from a domestic and Brexit perspective, what I have been thinking of as a messy Brexit. That is one in which the confidence in UK assets—the financial system—is undermined to some extent, so sterling drops and UK property prices fall. That happens—that being a Brexit that does not happen so neatly and so easily—combined with a global financial slowdown and recession. We are trying to combine both of those in our stress test to ensure that the financial system is resilient to everything happening at the same time.

Q13 **Rushanara Ali:** So there could be a perfect storm of a downward spiral, if things go in the wrong direction.

Donald Kohn: Yes—there could be. That is what the stress test is about: taking a set of extreme but not totally improbable events and testing the system. Our job—the job that you have given us—is to ensure that the financial system is resilient to those problems and that it does not contribute to the downward spiral that you mentioned. There may be downward pressure on the UK economy from a variety of channels that you discussed with Alex, but our job is to ensure that the financial system is not part of the problem.

Q14 **Rushanara Ali:** Do you agree with Mr Brazier's statement, which I quoted earlier, that, "Global debt markets are priced for perfection"?

Donald Kohn: I worry, as I think I said before, that a number of asset markets feel like they are priced to continued expansion, continued low inflation and continued low interest rates. Yes, gradual increases in interest rates—but not very far and very fast—may be my central tendency prediction, but our job is to think about the downside risk.

I think it is was important that the stress test that we were just talking about stressed the financial system against an increase in interest rates and very sharp changes in asset prices, partly as a consequence. I worry that there is perhaps a complacency in the financial markets about what might happen in the UK and elsewhere, and that if those things do not happen, some of the asset repricing could be painful. We need to ensure that the UK financial system is resilient to any pain that results from that.

Q15 **Charlie Elphicke:** Dr Kohn, Mr Brazier took us through a detailed discussion of his views on consumer credit and mortgage credit, and the discussions that have been held by the committee in relation to them. Are you in complete agreement with his views on things, or is there variance? If so, where is that variance?

Donald Kohn: I do agree with what Mr Brazier said about consumer credit and mortgage credit. A good way to identify areas to take a close look at is by looking at how fast a credit is growing. We saw rapid growth in consumer credit—10%—when the UK economy was growing by 4% or 5%. That was a dangerous signal that something was going on.

I thought it was very helpful that we could use our stress test results and the returns we got from the banks about how they were looking at consumer credit and how their risk models were looking at and evaluating consumer credit. We could identify that at least some banks seemed to be putting too much emphasis on the recent good performance, and not enough emphasis on the fact that there are downside risks—eight, nine, 10 years ago we went through some very bad downside risks—and we could work with the PRA to address those things. I was concerned about consumer credit and concerned that it was moving in the wrong direction—by "wrong", I mean getting easier and easier.

On mortgage credit, I share the concerns. Partly that is coming from the United States. Certainly, the crisis in the United States was triggered by mortgage credit, but in a different way than we are looking at it in the UK. In the United States, it was the effect of mortgage credit on lenders; the defaults, in particular on sub-prime loans; and the way those loans were distributed around the financial system in a very opaque and difficult way, which meant it was hard to determine where the losses were. In the UK, the problem is more with the borrowers and how heavily indebted borrowers react to adverse shocks in interest rates or their employment. It was a somewhat different focus.

Partly because of my background, my focus is often on the mortgage market and the housing market. The UK has experienced some issues over time with financial difficulties coming out of that mortgage market. It is by far the largest piece of household debt. When, in 2013 and 2014, we could see house prices rising, in particular relative to incomes and to the prices of everything else, you could sense that there was a risk that that debt would build up as people had to go further and further into debt to buy the same sized house. Our insurance policies that we took out on preventing folks—limiting the number of people who could get into problems—from getting over-indebted were justified and useful. I am glad we did it.

Q16 **Charlie Elphicke:** Indeed, you say in your written evidence that, "The long period of economic expansion and low interest rates that has characterized the UK and many other economies in recent years is bound to foster some complacency and risk taking that would be tested in a less benign environment." Are you on top of the complacency?

Donald Kohn: I am trying to be.

Q17 **Charlie Elphicke:** Is there complacency and are you on top of it?

Donald Kohn: There is no complacency in the Financial Policy Committee.

Q18 **Charlie Elphicke:** Mr Brazier talked about the derivatives issue in discussions with the European Union. The Governor of the Bank of England has previously raised this and said that the risk is not on the side of London and the UK, but is of massive loss on the European Union side. Do you think that the UK should be robust in negotiations on derivatives? Were you still at the Fed, and the Europeans were taking this position, what would you have said to them?

Donald Kohn: I don't want to speak to what I might have said at the Fed. Even the UK position on derivatives—in particular non-clear derivatives, unclear derivatives, over-the-counter derivatives—is often between a UK and an EU27—two counterparties. The UK, the UK Treasury and the regulators can take steps to ensure that there is contract continuity from a UK perspective, but we need help from the EU to keep that contract continuity. The derivatives market is especially important. It is large. It is also key to risk management for many financial and non-financial entities. It is so important that people be able to manage the risk and to do so at relatively low cost, and be encouraged to manage risks at relatively low costs.

In the case of derivatives, I do not think that there is any action that the UK can take by itself to make the problem go away. I think that it will take, hopefully, an agreement between the UK and the EU about the transition and the end state, but, if that is not there, these temporary permissions from the UK's perspective. However, we need help from the EU as well.

Q19 **Charlie Elphicke:** Finally, looking slightly at the world economy, the current President of the United States does not always seem to be the biggest advocate of free trade. There are risks in relation to trading relationships between the US and China, and between the US and the European Union, for trading between Britain and the United States—and potentially opportunities. What is your view on the risks of that rhetoric turning into negative reality for free trade? How would that impact on the UK banking system?

Donald Kohn: I think we were talking about that some. That is not my central projection; my hope is that what we see are some bargaining positions and that both parties—or all parties involved, not just China and the US but Mexico, Canada and the US or Europe and the US—see their best interest in keeping these trading relationships as open as possible. There is a risk that things may not turn out that way and that barriers are put in place. That would be adverse for global growth and for global inflation, and could feed back through that to the financial system to the extent that people in the financial system had counterparties here who were adversely affected. There are lots of adverse risks if global trade is damped down and tariffs go up.

Q20 **Wes Streeting:** I am going to pick up where I left off with Alex Brazier by talking about the financial stability indicators. To what extent do you think the current indicators are useful, first to the financial service industry, and secondly to the public?

Donald Kohn: I think they are somewhat useful. The current set of indicators that you see at the back of the financial stability reports, and that we look at going into meetings, were put together several years ago—probably six or seven years ago, when I started on the committee. I look at them myself to see where things are going and to think about the risk environment. I don't think they get much attention from the public. They could be improved.

We need to identify where we might get some more data that would be useful to us and how to get that data, such as by looking outside the banking system. One of the concerns is that our focus so far has been, not entirely but heavily, on the banking system and making it more robust. Are there things we need to look at outside the banking system?

Then there is the project that Mr Brazier was talking about, which is trying to aggregate some of those indicators and think about what he called "GDP at risk" or what it says about the tail risk for the overall economy. That, to me, is a worthy project. It is a research project, but we will see what it brings. Indicators are one area. I don't think the public are particularly focused on those indicators, and maybe there is more we could do with that in our financial stability reports, in how we summarise those reports on the website and things like that.

Q21 **Wes Streeting:** What are the particular financial stability risks that you think ought to be in the public consciousness? What are the key things you would want the Bank to be communicating to the public?

Donald Kohn: Overall, one thing that factors very heavily into the deliberations of the committee is the growth of credit relative to the growth of income, and what that implies for debt loads for the economy. The committee has highlighted that, while household debt relative to household income has come down since the crisis, it is still very high from a historical perspective. Therefore, you could get vulnerabilities if interest rates begin to rise.

The credit will become more burdensome to work through. Looking at some of the things we have been talking about, the terms on which consumer credit and mortgage credit are made tell you something about the risk appetite of the financial system, the household sector and the corporate sector. Looking at the terms and conditions, the willingness of the banks and others to make loans, the overall credit growth for both households and businesses are high-level indicators that we ought to be paying attention to, and the level of house prices relative to income—that sort of thing.

Q22 **Wes Streeting:** Thinking about the development of a new set of indicators, are there particular things you would like to see feature in a new or revised set of indicators?

Donald Kohn: I don't have specific suggestions. One of the projects for this year that the staff is undertaking is a leverage outside the banking system study, particularly looking at derivative markets and the embedded leverage that hedge funds and others get from derivative markets. I would like to see the results of that study and whether there are data that come out of that sort of thing that give us some insight into what is going on outside the banking system.

Q23 **Wes Streeting:** Finally, we have talked about the public, but what is your expectation for how businesses—or indeed the public—ought to use financial stability indicators?

Donald Kohn: One use for them would be to try to predict what we are going to do. It is important that we operate in as predictable a way as possible. That "as possible" was a very deliberate addition to that sentence, because you cannot be entirely predictable—things happen that you do not expect. I think we should act in as systematic a way as possible, given the incoming data.

If the public are looking at those and they see things happening, we should be alerting them, but even if we are not, they should be looking at that and saying, "Gee, those folks on the FPC might be thinking that things are getting a little riskier. Perhaps they will move to do something." Using them to understand what we are doing would be a very helpful way for the public to interact.

Q24 **Stephen Hammond:** Dr Kohn, good afternoon. In response to several colleagues, you made the point that you think assets are priced to low inflation and low interest rate expectations. You said that there is no complacency on the FPC, but it is your job to look at downside risks.

Do you think the scale and the size of the stimulus that has been put into the US economy at this late stage in the business cycle will mean that you will see will interest rates overshoot central expectations and credit markets tighten a bit more, and that that will have any impact on either US financial stability or a reverberation into world monetary markets?

Donald Kohn: I think there is a risk that the fiscal stimulus delivered to the US economy, when that economy is already in the neighbourhood of full employment—maybe a little above or a little below—risks stimulating demand in a way that might end up with the Federal Reserve needing to tighten interest rates more than is currently anticipated by the markets.

Again, I am not sure that this is a central tendency forecast—the market's central tendency forecast might be perfectly sensible—but I think it increases that tail risk: the possibility that interest rates will have to go up faster to contain inflation pressures with stimulus already at full employment. That is something we need to think about as a financial policy committee.

Q25 **Stephen Hammond:** In your written response, you made the point of your background in monetary policy. We are watching the unwinding of loose monetary policy—the unwinding of QE. Could you set out for the committee the risks that you see to financial stability of that, if you see any at all?

Donald Kohn: So far, the US and the Federal Reserve have handled this extremely well. They have behaved in a very predictable way and are unwinding this very gradually. It has had very little effect on markets. I assume that both the MPC and the ECB will behave in a similar way, with very gradual, predictable unwinding, in which case markets should be able to comprehend and build it in with undue stress.

Having said all that, it is certainly the case that we—the global economy—have never been in this situation before. The central banks certainly will be trying, so far successfully, to make the very gradual and predictable unwinding not a story. There is always the risk that an unexplained and unexpected development could reverberate, but that’s not my expectation. Just to repeat, with my friends back in the US, I think the Federal Reserve has done a great job so far in this unwinding, but there is no experience or data to base a prediction on.

Q26 **Stephen Hammond:** Given that you think the US Fed has done a great job, and that your central expectation is that Europe will follow in the same gradual mode, has the FPC had any discussions about what the strategy for unwinding QE should be?

Donald Kohn: No. We have meetings with the MPC on issues of mutual interest, but no, we have not done that.

Q27 **Stephen Hammond:** When you had a joint meeting, there was no discussion about the strategy?

Donald Kohn: No. We have not met on their strategy for unwinding. That is their decision. It is ours to make sure that, whatever their decision is, the UK financial system is resilient.

Stephen Hammond: Thank you.

Chair: Dr Kohn, thank you very much indeed. As you know, we are going to speak to Mr Taylor now, and then we will consider our report. Thank you for your time this afternoon.