An Overview of International Banking

Speech by Sir John Bond
Group Chairman, HSBC Holdings plc

8 May 2005

Good evening ladies and gentlemen. I'd like to start by thanking you for inviting me to speak at this, the inaugural meeting of Greek and Turkish Bank CEOs.

I have a great personal affection and admiration for both Greece and Turkey. Both countries with a great history and bright future. I studied Greek throughout my school days, so I have long admired Greece, the birthplace of much of Western civilisation. And although my acquaintance with Turkey is more recent – since HSBC established a major subsidiary in the country – Turkey has captured my spirit in an immense way. Its talented and courageous people, and unique geographic location will surely make it a place of great opportunity in the 21st century.

I also have a strong professional interest in both your countries. HSBC has operations in both Greece and Turkey. We view both banking markets as ones with great growth potential, particularly for personal financial services.

renewed interest in international banking

You will have forgotten more than I will ever know about banking in Greece and Turkey, so I would not presume to talk to you tonight about your domestic markets. Instead, I have chosen as my theme today the international banking scene.

I would like to start by paying tribute to the Mediterranean as the cradle of modern banking. It was the birthplace of many banking and trade finance techniques; in particular, the importance of trade and shipping in the development of finance and insurance should not be underestimated. For example, bottomry loans, used to finance trading voyages in Periclean Athens in the fifth century BC, were the earliest form of insurance.

I'm afraid HSBC does not have quite such a long lineage, although we are proud to be celebrating our 140th anniversary this year. We were founded in an emerging market in 1865, and within a year of our formation were operating in 12 countries, so throughout our history, we have been international. Eight of the fourteen members of our founding committee were from outside Britain, and today our Board continues to reflect our international character. Today, we serve 110 million customers in 77 countries and territories. Therefore, tonight's theme also reflects both the origins of HSBC as well as the reality of the company today.

At HSBC we start from the precept that banks are fundamentally a leveraged play on the economies they operate in, they cannot materially outperform their host economies for long. HSBC's strategy, therefore, is a simple one: to pick the right economies to be in, then to pick the most valuable clients within those economies.

We conduct this policy against a broadbrush scenario of what the world might look like in 25 to 50 years' time. We believe that in the next 25 years, we will see a fundamental rebalancing of the world economy, so that the distribution of the world's economic wealth will be much more in line with the distribution of population. Consequently, we believe that developing markets will provide much of the growth. This is why we have invested in China, Brazil, Mexico, India and Turkey in recent years.

As a company that has been resolutely international throughout its history, we follow the development of international banking with great interest. We think it is true to say that the international endeavours of banks have a mixed record; more banks have failed in their international ambitions than have succeeded. Indeed, it was the imprudent expansion of the UK's Midland Bank into the US, through the acquisition of Crocker, that eventually weakened Midland to the point that HSBC was able to acquire the bank in 1992.

Other bad decisions leading to unhappy experiences have forced banks to retreat from the international arena in recent decades, but we appear to be entering a period where banks are thinking of going international again.

This renewed interest is, in my judgement, caused by a remarkable confluence of trends in the world today. When things get tough at home, banks inexorably think of international expansion.

There are powerful forces at work that are literally changing the way we, our customers and financial systems function.

The first of these is the unprecedented degree to which the world has become interconnected, personally, commercially and financially.

As individuals, our world has got a whole lot smaller. There are few places in the world that are not accessible to people wishing to visit them, people travel to and experience other countries and cultures to an extent that would have been unthinkable a generation ago. For example, the third largest Greek city in the world is several thousand miles from here; Melbourne, Australia, with a Greek community numbering some 600,000 people. Los Angeles is sometimes referred to as the fifth largest Canadian city, due to its Canadian expat community, also 600,000-strong.

What is true of individuals is also true of the commercial world. Barriers to international trade have been coming down; one result has been to make many companies less dependent on the economic health of their home economy. For example, over half of the assets of the world's top 40 multinationals reside abroad. This means that companies' sales, costs and performance are influenced by economic trends a long way from home.

Finally, and of particular interest to ourselves, is the extent to which the world is interconnected financially. We can see this for example in the ownership of HSBC, which has some 200,000 shareholders in over 100 countries. And we can see it reflected more widely in financial markets, where surplus savings in Asia and the Middle East are being recycled to Western economies, mainly America. In our view Asia and the Middle East will develop international financial centres which will challenge New York and London. Money moves around the world in a way that was inconceivable 50 years ago.

clients, shareholders and capital are international

Work is also becoming increasingly international. High value jobs will be performed in the countries and cities where the executives want to live. Modern technology means that work that was previously tied to a particular location can be done anywhere in the world. In this, the service sector is following the trend set by the manufacturing industry, dispersing work to where it can be done most efficiently. At HSBC, for example, 38 per cent of all systems development work now takes place outside the country where it is used. And at the end of last year we employed some 12,500 people, around five per cent of our workforce, in global service centres to serve customers in other countries, a figure that is set to rise to 18,000 by the end of 2005.

These factors mean that most domestic banks, and their clients, are influenced by what happens internationally, whether they are aware of it or not. Most of our clients are international. Many of our shareholders are international. Capital is international. The capacity to do work is international. It would be imprudent for banks not to understand this pattern of internationalisation.

Other trends which will affect our industry profoundly are also at work. Demographic changes – the well-publicised falling birth rates in many Western industrialised nations and increased longevity – will reshape societies in the West. We all know economic growth comes essentially from an increase in the working population or an increase in productivity. In many Western countries both these engines of growth are going into reverse.

The only way to pay pension commitments in many developed countries will be by investing in the emerging economies, so we expect to see a substantial increase in international investment flows. There's nothing new here: it was what Britain did at the height of empire.

Shrinking workforces in mature markets will restrain their growth potential, although the increase in longevity will create opportunities for banks in the funding of retirement by way of long-term savings, retirement planning, estate management and trust services, health care support and insurance.

At the same time, in the world's fast developing markets, such as China, India, Brazil and Mexico, demand for financial services is in its infancy, and is set to grow strongly, as these countries assume a greater share of the world's GDP. In Mexico, to take just one example, only one in five people has a bank account. We anticipate huge demand for auto-loans, mortgages and credit cards as living standards rise.

So companies wanting to produce a reasonable return for their shareholders may need to look outside their domestic markets for future growth opportunities.

The final major trend is the effect on our business of the internet, it is a truly transforming technology. It is empowering individuals as never before. From a virtual standing start seven years ago, HSBC now has 19 million online customers – almost 20 per cent of our customers – who can transact their business with us, 24 7, without any human intervention at all.

The implications for our business are profound and varied. There are potentially serious consequences for employment; banking is likely to become a more capital intensive and less labour intensive business in the future.

The internet also puts power firmly in the hands of the consumer, who can compare the prices of goods and services at the touch of a button. On the other side of the coin, we are able to reach customers all over the world. Our offshore banking division in Jersey has online ex-patriate customers resident in 192 countries, more than the member states of the UN.

These three trends transcend national barriers, so there can be few financial institutions who are not considering some form of strategic response; for many this will pose the question: should I remain domestic or expand internationally?

The question is all the more pertinent when you consider that on top of the lower growth prospects in mature Western markets, some larger institutions are nudging up against regulatory limits to their domestic market share.

If we compare the shape of the financial services industry today with that of 20 years ago, we can see that it has already changed significantly.

changing shape of financial services

On the one hand, in some major developed economies the number of commercial banks and their share of the financial system has been in linear decline for several decades. In the US, for example, the number of banking institutions has fallen from 15,400 in 1990 to just over 9,000. Banks' share of total financial assets in the US has also declined, from around 50 per cent in 1983 to between 25 and 30 per cent. In the EU, consolidation has followed a similar path. Between 1997 and 2003, the number of credit institutions in the EU fell from 9,600 to 7,400, although there are still wide differences between countries. In both the USA and the EU there is surplus capacity for conventional banking.

On the other hand, the size of the industry has grown and is forecast to grow further; hitherto this has been accommodated by larger institutions. A recent report by Mercer Oliver Wyman suggests that the financial services industry will account for ten per cent of global GDP by 2020, up from six per cent today. But if the industry is primed for overall growth, the future for individual companies is uncertain. How should they respond?

The temptation to expand into new markets is strong and understandable; but international success is not assured in a world where banking markets remain divided along national lines. I can only speak from my own experience of working at one company, but there are a number of foundation stones that are necessary for international success.

- In my experience, successful international banks usually start from a strong domestic base, using surplus profits from the domestic base as a springboard to fund expansion overseas. HSBC is perhaps an unusual case, having been founded in an emerging market, and used the capital from an emerging market to fund expansion in developed markets. Now we are reversing the process, and using capital from our mature markets to fund further expansion in developing markets.

- The entering bank must add value to the host country, either by the branch it establishes or bank it acquires. It needs to know precisely who its customers will be. Value only comes from adding revenues or subtracting expenses. Clearly, the bank will also have to be competitive locally in order to survive.

- You also need to be honest about your strengths as the entrant or acquiring company; why should a customer want to deal with you rather than a domestic bank?

- Perhaps <u>the</u> critical factor for success in my judgement is the internationalism of your management cadre and Board. Managing internationally is very different from managing domestically.

- At HSBC, for example, our Board includes directors of five different nationalities who have, collectively, worked in 33 countries; I have worked in six. We make strenuous attempts to ensure that colleagues, especially those destined for senior roles, gain the cross cultural experience that we consider essential to success. Our most recent intake of 25 international graduate recruits, for example, included young people of 12 nationalities.

These may be simple concepts, but they are rarely easy to implement, and we have not been immune from mistakes although we have always taken care to learn from them. Our expansion into Argentina, for example, proved an appalling, and hopefully rare, mistake.

The international option is one of the major strategic challenges banks face today.

As if we didn't have enough causes of grey hair, there are other trends which may present major challenges to banks in the future. I can see several areas of frailty in the system today.

First, is the possibility of a credit crisis. Financial institutions are mis-pricing credit in many markets. Low interest rates, low volatility and low credit losses have engendered too much confidence in the market; indeed, it has become a self-reinforcing dynamic, with past stability creating confidence in future stability. This is a heady cocktail when combined with the high liquidity that characterises today's markets. These have combined to bring risk premia down, encouraging additional borrowing by consumers who, in many developed countries, are now highly geared. The risk of a credit crunch will be heightened if America's current account deficit is not managed carefully. A sharp spike in interest rates or a sharp fall in the dollar could precipitate such a crisis.

The second issue that may have difficult consequences is the structure of the banking system today, which could make a crisis more difficult to manage and therefore more damaging. The rapid growth in dispersal of risk through both hedge funds and instruments for risk transfer, such as credit default swaps, has created large risk exposures in complex products, which are difficult to model and assess. And while these instruments have clear risk-reducing benefits for institutions and the system, we only have limited knowledge of how they will perform under stress in a bear market.

Ladies and gentlemen, to summarise, this is a period of unprecedented change in financial services. Indeed, I don't believe I have witnessed a period of more rapid change in financial services in my 44-year career, than today. It certainly makes for a fascinating job for someone like me. Undoubtedly, in the international arena winners and losers will emerge. The ability of institutions to both make the right strategic choices and to respond to extreme events will ultimately determine who wins and who loses.