How banks and financial markets contribute to companies' competition and countries' growth

Speech by Stephen Green
Group Chairman, HSBC Holdings plc

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Good afternoon.

We've heard a lot today about how banks and financial institutions have not contributed to companies' competition and countries' growth. And certainly in the current climate I can understand the impulse. But I'd like to take a step back and put this in a longer term perspective, to look at the ways in which our world is changing: emerging markets are growing faster than established ones; world trade is outstripping global GDP; and longevity is increasing everywhere. All three have obvious implications, and I think it's in the context of these three trends that we'll see how banks and financial institutions make their impact.

First, the fundamental shift. Most of us here – and, indeed, our companies – came of age when a handful of countries dominated the globe. Though these nations comprised a fraction of the world's population, they created – and kept – the vast majority of global wealth. This economic hegemony, this dominance, has been formidable; but now it is ending.

Fundamental shift

There is a shift in the economic centre of gravity – the world has become progressively multiplex, and the level of integration can only deepen; this is a world where protectionism will not prevail. Financial needs are growing and will become more complex everywhere, and this is the future we're looking to.

So I think the question for us is, how do financial markets and banks contribute to competition and growth under these circumstances?

One of the most fascinating and discussed examples is, of course, China. In the past three decades, she has accelerated from a virtual economic deep-freeze to one of the fastest growing, and one of the most influential, economies on earth. China has experienced massive and rapid urbanisation, both planned and unintended, that doubled between 1980 and 2005 to 44 percent and will climb to 66 percent by 2025. This, of course, has created its own set of issues: pollution, increased energy needs, keeping the population healthy, finding sufficient resources and sustaining the economy.

Overall, looking at China in an economic, demographic and geopolitical context over the past century, it is extraordinary to see what has been accomplished. The China expert Michael Oksenberg put it this way a decade ago: 'the leaders of China reside over an enormous range of very difficult problems, not the least of which remains: how do you feed a vast populus on a narrow agricultural base, how do you keep the economy growing, and how do you deal with the populus continuing to shift from rural to urban areas? Let me summarize it this way: China is in the midst of several major transformations, any one of which would overwhelm most mortal leaders'.

Yet in the face of what would, in Mr Oksenberg's quite accurate assessment, overwhelm most mere mortals, China has managed to establish and sustain growth, both economically and socially. While there are plenty of challenges, I believe this growth will continue for a generation. The re-emergence of China is the most important fact of the first half of this century and it will affect us all.

Now, looking specifically at the financial services role in this development, we begin with the history of China's banking sector in recent decades.

In the old world, the banks were organs of state policy. There was no sense of return on capital, no sense of risk; there was not even a clear central control mechanism, the banks being subject to local government intervention. Banking reforms started with China's opening in the late 1970s, though the financial sector naturally liberalised at a slow pace and with hiccups.

But now, China is making rapid progress: they developed credit-assessment techniques and brought in foreign ownership as a means of strengthening operations. More than 30 Mainland Chinese institutions have received strategic foreign investment, and private sector banks have been allowed to develop. China reduced Non-Performing Loans in bank portfolios, corporatised them, listed them in Shanghai and aggressively recapitalised them – had them audited to IFRS standards, and then listed them on the international market as well – deliberately to strengthen governance and transparency.

Between 2003 and 2005 some $70 billion was injected into the banking sector, while $50 billion in bad loans were written off by the 'big four' banks and $90 billion in non-performing loans were sold to newly created 'AMCs' – i.e. specialised institutions that deal with bad loans.

In the case of my own company, direct investment in 2001 took an 8 per cent shareholding in Bank of Shanghai, the first investment by a foreign bank in a domestic one. In 2004, we bought a 19.9 per cent stake in Bank of Communications, China's fifth largest bank – at the time, the largest foreign investment in a domestic bank. Others followed, then came the big international listings in 05/06; ICBC's Hong Kong/Shanghai listing was the first simultaneous Mainland and offshore listing – at US$19.1 billion it was, at the time, the world's largest ever IPO.

The result of these efforts is that today, most of the major Chinese banks have capital adequacy ratios that meet international standards. All the major banks – both state-owned and private sector banks – are developing broader product ranges, including mortgages, consumer finance and credit cards as well as better business banking. There has also been a marked improvement in overall corporate governance.

In general, the reform of the banking sector has gone very well. But there's still much to do in financial markets, however, and I see three major challenges over the next five to 10 years.

Reform of the banking sector

One is that banks have largely withdrawn from rural areas. In order to become profitable commercial enterprises ahead of public listings, the big banks closed unprofitable branches. This was arguably necessary to help transform China's financial sector, but as this commercial focus has intensified, it's created a retreat from rural areas.

The rural economy has lost standard finance, creating a large underbanked market, which is an issue for all of China. From 1998-2002, the 'big four' closed some 45,000 branches and laid off 250,000 employees. Our research shows that none of the 'big four' banks have rural branches in the entire Northwest province of Qinghai.

We believe there is great potential for the rural market, a population that numbers, conservatively, more than 600 million; hence our keenness to open rural branches. We were the first international bank to enter China's rural market, and we'll continue to expand. We've already received regulatory approval to open a second rural bank in Chongqing.

China is working to meet the challenge. In 2006, the government put a renewed emphasis on rural development, and China's Banking Regulatory Commission dramatically lowered the threshold to enter rural areas and eased access to the rural marketplace.

Challenge number two is the rudimentary nature of the capital markets, both debt and equity.

The bond market has seen movements toward reform, but as corporate bond issuance is highly regulated, these have been very stop-and-start. The China Securities Regulatory Commission gained additional powers in August 2007, including handling issuance for listed firms, although the state planning agency retains authority over non-listed state-owned enterprises. While this is a good start, it has not proven sufficient yet to spur new issuance, and only three firms to date have issued bonds under the new mechanism.

The market for exchange-traded corporate bonds is very small, and something of a catch-22. Banks cannot buy bonds traded on the stock exchange, and insurers cannot buy bonds not guaranteed by banks – yet the banks are barred from issuing such guarantees. The retail investors who can buy exchange-traded debt are far more interested in equities than the low-risk, low-return investment in bonds. Most debt in China is traded on the government debt-dominated interbank market, but that is only short term. So effectively, there is no interest rate curve.

As for the equities market, it has classic emerging markets characteristics: it's volatile, far from fully transparent, dominated by retail, and rules on insider dealing are still evolving.

There have been improvements to China's equity markets – particularly the release of non-tradable state-held shares onto exchanges in 2005-2006. Since about two-thirds of the equity of publicly traded companies had been held by the government or SOEs; unwinding this shareholding did a great deal to broaden the market, though not yet much to deepen it.

A third challenge faced by the markets is the shortage of talent. While China produces a vast number of graduates each year, there is a huge lack of professional experience.

Competition for qualified staff is particularly intense in financial services, exacerbated by the increasing ability of domestic institutions to offer competitive packages. The Financial Times reported that it is becoming common for domestic fund management companies to offer Wall Street-equivalent bonuses of US$1 million or more.

This indicates a broader educational issue, of course, which China is addressing with significant investment in education and training. Education spending increased by 76% last year and the 2008 education budget will raise it an additional 48%. And more private international educational institutions are establishing campuses within China, particularly business schools.

China has taken steps to address each of these three areas – a large underbanked population, the developing of capital markets and the competition for skills. This is encouraging, but reform needs to stay on track. The bottom line is, to support rapid economic growth you need an efficient, competitive, transparent, well-regulated financial services industry; without these, that growth will eventually be hobbled.

So what does this mean to European businesses? There's the obvious answer, that whether you're an importer, exporter or investor, it's in your best interest that this all comes together. An Italian company with a business venture in China wants this to come right, so the business prospers. An Italian importer taking in goods from China wants this to come right to maintain efficient, low-cost production. And an investor wants this to come right because there's no question that emerging markets, and China in particular, will have a major impact on current and future investment flows and opportunities.

And there's the other obvious answer, that this impacts the global economic system, in both direct and indirect ways.

China's increased wealth and economic growth can be seen in its acquisitive moves; think two weeks ago, when Ping An Insurance bought half of Fortis's asset management business, or last year, when China's State Investment Authority invested US$5 billion in Morgan Stanley. Or ICBC's 20 per cent investment in South Africa's Standard Bank – the largest bank in Africa; CCB's acquisition of Bank of America (Asia); or Bank of China's acquisition of Singapore Aircraft Leasing Enterprise.

Opportunities and challenges

But also think about the unintended consequences of increased Chinese wealth. One example Italy knows well: higher pasta prices. Chinese prosperity means more people eating meat, which means more grain to feed livestock, which means higher prices and fewer reserves, which affects the price of pasta.

But there are opportunities as well as challenges.

I was reminded how standards of consumerism have changed when we opened our Premier branch in Chengdu – right next door to a Bentley dealership. Bentley, incidentally, had sold more of its Mulliner 728 limousines – then the world's most expensive car – in Beijing than in any other city in the world. Not surprising, considering there are already over 345,000 millionaires in the country. It's estimated that by 2015, China will be the world's biggest luxury goods market, with 100 million consumers; sales in the sector increased 50 per cent last year, as the Italian luxury goods companies in China well know.

There is no doubt that China will continue to affect all of our lives. But it's important to say that emerging markets as a whole are determining our global economic profile. China is an important example, but it is an example of a more general proposition. I do not mean to say that all emerging markets are identical – each has its own history, demography and geography, and the evolution of their economies and financial systems will be dependent on these and other variables.

But while there are distinctions based on the characteristics of individual markets, some issues they face are universal. The three challenges I outlined for China are shared by many other emerging markets. And their economic rise necessarily impacts our interconnected world economy.

Well, it seems I've spoken for long enough, and I'm interested to hear what the rest of the panel has to say. I look forward to a discussion of the subject and perhaps some lively debate as well.

Thank you and good afternoon.