

Promoting a sustainable financial system

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Good morning ladies and gentlemen. Thank you for that kind introduction and for inviting me to give the keynote speech this morning. There are few more important issues that we need to address as an industry, than how we can promote a sustainable financial system.

In the UK, we have now lived through a record six quarters of recession, caused by a crisis which nearly brought the global financial system to the very brink of collapse. A system which, we have learnt the hard way, was the very antithesis of sustainable.

We are, if you like, in analogous situation to that in which John Maynard Keynes found himself in the 1930's, when he observed:

“The decadent international but individualistic capitalism, in the hands of which we found ourselves after the War, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous - and it doesn't deliver the goods. In short, we dislike it and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed.”

At the time Keynes wrote this passage, the world's economy was in the grip of the Great Depression. As the history books have shown, the policies that our forefathers put in place at that time did not help the global economy to recover. In fact they did the very opposite, deepening and prolonging the pain.

Over seventy-five years later our modern version of capitalism – which once again many have come not just to dislike but to despise – has come under serious question and scrutiny.

Our challenge is surely to put in place economic and regulatory policies which will help us build a better, more stable system. But we need to act now, if we are to be the architects of real and sustainable change.

To do so, we need to:

- understand what was unsustainable in our financial system;
- identify what worked - and put the lessons we have learned from the crisis into action;
- and address some key outstanding challenges if we are to build a truly sustainable financial system for future generations.

Let's start then by identifying the aspects of our system which were not sustainable.

Casino capitalism reached its zenith just before the crisis. It was Susan Strange, Professor of International Relations at the London School of Economics who first coined the phrase, 'casino capitalism'. She warned in the 1980s how the speed at which markets work, combined with their near-universal reach, could result in levels of global volatility that had never been seen before.

In a world where the vast bulk of market trading has no direct relation to any specific business requirement, what concerned her was how the instability of active markets could lead to the collapse of national and regional economies. Nearly thirty years on, we have seen exactly how, at their worst, financial markets can be engines of unprecedented destructive excess.

We had become obsessed with growth projections and persuaded ourselves that the good times would keep on rolling forever. This misguided belief allowed consumption to grow faster than income and asset bubbles to froth, underpinned by ephemeral trading and financial instruments, much of which in the end served no real economic purpose.

“individualistic capitalism”

And underlying all of this were the growing global imbalances in the macroeconomy; the cheap money following the dotcom bubble and 9/11; the search for yield without incremental risk; and the market efficiency hypothesis which told us there would always be a price for anything and that market arbitrage would ensure the price would always reflect value. It depended upon what you might call the ‘guaranteed liquidity hypothesis’ – which of course derived its plausibility from the very financial imbalances that were being created by the real economy in the first place.

These bubbles fuelled huge levels of Western consumption in the years up to the crisis. At the same time, savings levels in the East accelerated.

We’re all broadly speaking familiar with the statistics. Household mortgage debt outstanding in the US rose from 5.3 trillion dollars at the end of 2001 to 10.5 trillion dollars at the end of 2007. In the UK, the average household’s financial liabilities doubled in a decade from 23,000 pounds in 1996 to over 56,000 pounds by 2006, and so on.

Meanwhile, across the five main Asian economies the aggregate savings rate rose from 31 per cent to an astonishing 45 per cent between 2000 and 2008. This was partly a result of households accumulating ‘precautionary savings’ in the absence of social safety nets, leading to a corresponding drop in private consumption. It was also, partly, the result of uncompetitive banking systems which created distorting incentives for businesses to save in order to invest and grow.

Put simply, consumers in the West *spent* too much and saved too little, while economies in Asia *saved* too much and spent too little.

There are obvious and painful lessons to be learned from all this – for markets, for individual institutions, for investors, for individuals, and for the political domain. But we all know that there is no alternative to taking action and moving forwards. We cannot turn the clock back.

Second we therefore need to identify what worked within the financial system and build on this.

While there was much which was wrong, there was also much right with our financial markets and we must be careful not to throw the baby out with

the bathwater. It may be unfashionable for me to say so, but one of those elements was and is securitisation.

Guy Hands famously described securitisation as the “*crack cocaine of the financial services industry*” and that was long before the financial crisis. There is no question that some parts of the securitisation market subsequently became overly complex and opaque, and that as people had stopped asking the right questions, things got out of hand. The need for reform became clear and undeniable, and some parts of the asset-backed securities market are probably gone for good.

But at its best, securitisation helps to allocate capital and risk efficiently through the market on a global basis. If we go back to the 1970s, it began with structured financing of mortgage pools, meeting the demands of consumers for housing credit which could not have been met fully by traditional depository institutions. Securitisation has since become an integral and fundamental part of the financial system – as natural a part of a globalised capital market as the public debt market is.

We need to ensure that the securitisation markets operate effectively and transparently. It would simply not be desirable to regulate securitisation - or the innovation that flows from it - out of existence.

Even more fundamentally – and we must be careful not to overlook this amid the understandable backlash to the crisis – the financial system has brought real value to global economic development.

In particular, financial markets have made an important contribution to the remarkable changes in countries like China and India. Market-led development unleashed in both these countries, in different ways, from the early 1990s has led to an enormous increase in opportunity and reduction in hardship since then, as a growing middle class has emerged and hundreds of millions have been lifted out of poverty. Both have a long way to go, but the achievement so far is nothing short of historic.

Anyone who knew Shanghai or Bangalore even ten or twenty years ago knows only too well how huge the transformation has been since. Similarly, today, rural China and India still have a long journey to make towards prosperity. And of course,

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this is about more than China and India. UNICEF estimates that every day 25,000 children die due to poverty and they die “quietly, in some of the poorest villages on earth, far removed from scrutiny and the conscience of the world.”

We should not see this as just a philanthropic challenge: it is the reminder of what is ultimately at stake when we address the challenge of repairing the markets. For perhaps the first time, the world has the resources and the technology it needs to wipe out poverty, perhaps even in a generation. But some great global redistribution will never be a realistic objective. Rather, one of the stark lessons of the twentieth century is that there is no acceptable alternative to a market-based approach to development.

Nowhere will this be more important than in emerging markets. As hundreds of millions of people start to benefit from a regular income, they will need access to financial services – whether microfinance or small business lending, or personal savings and wealth management services. Companies will need access to capital and banking services. Absolutely the wrong lesson to take from the crisis would be that the developing world does not need more sophisticated capital markets – China knows this and is continuing to reform its capital markets to support its rapid economic development.

In one very important sense, we clearly have learnt from this crisis. When the history books record their verdict on the events of the last three years I believe they will conclude that, thanks to an unprecedented level of co-ordinated action by governments around the world, we successfully avoided the mistakes of our forefathers in the 1930s. Fears that we would rapidly retreat into some past world of closed markets have proved unfounded.

The G20 has emerged as the primary discussion forum for international economic affairs. The financial crisis was the catalyst to creating a global architecture which reflects the world’s economic and demographic reality. The G7 and G8 have been marginalised. In order to build a sustainable financial system, the world’s leaders must now deliver on their commitment to co-ordinated action. Co-ordination will be just as vital in the years ahead, as it was at the height of the crisis.

I now want to turn to three particular challenges we must address in order to build a truly sustainable financial system.

Getting regulation right will be critical for learning from our mistakes. The litmus test for sustainable regulation is not just whether it makes individual firms more stable, but: does it contribute to a sustainable financial system, will it support economic growth, and can it be applied internationally? In particular, we must consider the impact of regulation on the wider economy. Our forefathers made some serious mistakes in the 1930s: if we are to succeed we must be careful not to repeat them or make analogous mistakes at this critical stage of recovery.

The debate is intense: higher capital ratios and liquidity requirements, leverage ratios, narrow versus broad banking, “too big to fail” and “living wills” are all included. Policymakers need to pay close attention to the timetable for formulation and implementation, however.

The cumulative impact of various measures currently under discussion for the enhancement of capital ratios, at the wrong stage of the economic cycle, could easily withdraw credit from the economy, and drive a new credit crunch.

This, in turn, would sabotage economic recovery. We need an approach to implementation which is properly calibrated and phased, and one which is co-ordinated across a wide range of jurisdictions, as we seek to turn fragile green shoots into sustainable recovery.

An important debate is also taking place about the size of individual systemically important financial organisations. This has been given the shorthand “too big to fail”, which is really a rather unhelpful term since all banks are too big to fail in the strict sense, and in any case there was no common denominator of size or structure amongst the institutions which collapsed as a result of the crisis. Indeed, less diversification by geography and business line could lead to more individual failures, with a corresponding adverse impact on economic and market confidence.

Calls for a return to some earlier age of “narrow banking” also miss the point that both markets and their customers are now global, with complex and multiple financial needs. It would not only be unrealistic, but also highly inefficient, to demand

implementation must be properly phased

that business customers, for instance, use a range of institutions for these services. Nor would it, in practice, reduce risk to the system.

It is impractical and undesirable to prescribe some ‘ideal’ structure or size for a bank. It is right and proper, however, that we give consideration to how they can be dealt with in the event of a crisis. Certain organisational structures may provide greater protection if the worst happens. A model based upon separately capitalised local subsidiaries, for example, enhances security for depositors, regulators, and investors.

Recovery and resolution is also a complex area. The concept of the living will - the idea that institutions and their regulators should be able to produce discrete and actionable plans which set out how the bank will be reorganised or wound down if the worst happens – certainly deserves closer consideration. But, as ever, the devil is in the detail. There is a real danger that a simple concept which is in the public interest, could become a complex and bureaucratic process, which certainly would not be. Any approach to recovery and resolution planning needs to be developed with a large dose of common-sense. The focus has to be on corporate structure simplification and on viable high-level recovery planning – but it should primarily be on liquidity management, capital adequacy, and macroprudential supervision, and above all cross-border co-ordination.

This brings me on to one final point before leaving the subject of regulation. The debate on regulatory reform at the institutional level must not distract us from the need to create a wider macroprudential framework which delivers systemic stability.

I have believed for some time that policy-makers need to evolve a new macroeconomic tool that will influence the supply of credit as well as the cost of credit in the economy. Inflation targets, to be clear, are absolutely necessary, but they proved an insufficient armoury against a tide of cross-border flows driven by global imbalances, and an addiction to leverage driven by the search for yield. We need an additional tool to smooth the credit cycle. It was therefore encouraging to see the Bank of England’s thoughtful and open-minded

contribution to the debate through its discussion paper last week.

A key element of all of this, I believe, involves adopting a counter-cyclical approach to capital ratios, which is more alert to systemic stresses and which is more closely aligned with key macro indicators in the real economy than has hitherto been the case. This could help us to balance stability in the financial system with the requirements for economic growth. During the good times, banks would be required gradually to increase the amount of capital they hold against assets, across the board or in key sectors, to discourage excess and to build up their reserves before leaner times. It does also mean that during the bad times, capital ratios could be managed to help offset a dangerous drop in lending to a suffering economy.

The point is that no amount of work to improve stability within individual firms will deliver a sustainable financial system if gaps in the framework for macroeconomic management are not plugged as well. Working out how to do this is a primary challenge for policy makers and regulators. The discussion is underway, but there is much work to be done at both the national and the international level.

On this, and on all aspects of the regulation regime, the need for reform is clear. But this is not the stuff of easy headlines: in order to deliver a stable, effective and sustainable system we need to have a clear-headed, thorough and unemotional debate. It is in the collective interest - that of the public, the industry and its supervisors – that we get it right or else we will eventually end up in the midst of another crisis. And it is more important to get it right than to implement hasty solutions.

As important as regulation is, we also need to focus more on sustainable value maximisation. For some, in lead up to the financial crisis, there was only one business imperative: chasing short-term profits at all costs, regardless of the long-term consequences. This fostered a ‘who cares’ culture, or as *The Economist* recently put it “... I-B-G-Y-B-G ... ‘I’ll be gone, you’ll be gone’”.

It is as if the attitude had become: if you have a contract and a product and it is legal, you don’t need to ask any further questions.

**a culture of
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The risk of short-term thinking has not gone away. The practice of focusing obsessively on quarterly results can lead us to lose sight of the longer-term. Shareholders have an important role to play in fostering a longer-term outlook, as do Boards. We need to reject short-term approaches to value maximisation, by getting back to the real task of sustainable value maximisation.

Let's be clear on this. The primary objective of any business must be to deliver a sustainable profit to its shareholders.

But sustainable business also requires the nurturing of customer relationships and providing a consistent, high quality service. This, in turn, depends on engaged employees, who are respected as 'ends' and not just treated as a 'means'. Furthermore, consciousness of the broader impact of a business on society and the environment is growing both for customers and employees. This means that the way we interact with the wider world must be a fundamental to how we think about - and do - business. Those who care about sustainable value maximisation, and the long-term health of thriving business investments, are led inexorably to focus on sustainability in the broadest sense of the business model.

Over the last twenty years we have seen the development of socially responsible investment products - or SRIs. Today, these remain a small but nonetheless important part of the overall fund industry.

However, today's value-based investors need increasingly to assess the health of *every* investment in *every* company, using a range of sustainability measures, including environmental, social and corporate governance because it is essential to sustainably successful business models and therefore to sustainable returns.

Following the crisis, this trend is only accelerating. In a recent McKinsey survey, 72 per cent of global executives said that the public's expectations of business have increased as a result. Drilling down into the detail gives some clues as to what this means for business strategy: two thirds believe that the crisis has accelerated demand for more ethically produced products, and even more think that it has led to greater demand for investment in developing countries.

Yet there remains a major gap between expectation and delivery. A recent UN study shows that three quarters of senior executives believe that new skills are required to respond to challenges such as climate change; but fewer than 8 per cent believe that their company is currently developing these skills. Creating a glossy corporate sustainability report is not enough. Ultimately companies which talk of action but don't take it, will lose their competitive advantage.

Which all leads me to a final thought: I believe the single greatest opportunity for markets in the generation ahead will be to prove the contribution they can make to the fight against climate change. Effective market mechanisms to encourage - and to finance - the shift to low-carbon economic growth will be essential. Carbon has to be priced properly; technological development has to be funded; investments have to be financed, if this greatest of human challenges is to be met. There is no way we can do it without the help of the financial market.

In conclusion, over seventy five years ago John Maynard Keynes talked about a "*decadent, international but individualistic capitalism*" and said "*when we wonder what to put in its place we are extremely perplexed.*"

Today, thankfully we are not perplexed - indeed what we need to do is very clear.

We have identified the elements of our financial system which were not sustainable and we know that we cannot return to that way of thinking - or indeed investing.

Instead, we must now build on what is right and good today, in order to drive sustainable growth tomorrow. By focusing on regulatory reform, sustainable value maximisation, and an investment culture which focuses on the longer-term - we can ensure investors receive the *greatest sustainable returns*, from the *most sustainable companies*, operating in a *truly sustainable financial system*.

Thank you for listening.

CHECK AGAINST DELIVERY

**getting back to the
real task of
sustainable value
maximisation**