

## Impact of regulatory and monetary reform on capital markets and new systemic risks

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Good morning everyone. This is my first speech since taking on my new role as Chief Executive of Global Banking and Markets. But today's subject is a sensitive one, so I hope it will not be my last!

Today, I will ask some key questions about the impact of proposed reforms, what risks they pose, and how these risks could be managed. To do this, I am going to focus on four related themes:

1. Just under one trillion dollars of new Capital will be needed by banks – but where will it come from and what happens if it can't be found?

2. Up to four trillion dollars of new debt issuance is needed for bank Liquidity – who will buy it and will this result in new concentration risk?

3. Market structures are being challenged and changed - will central counterparties create more counterparty and liquidity risk?

4. Monetary reform is being driven by the French G20 presidency - can the transition away from a single reserve currency and pegged currencies be achieved?

These themes are all related. So in closing I will point out that there needs to be some 'macro-glue' to hold everything together.

Let's look first at the need for more Capital.

How much is actually needed?

If the Basel Committee is right, about one trillion dollars more. But we hear this is not enough! Some regulators are demanding far higher capital ratios, far sooner. So the figure could be much higher.

Potential additional capital requirement for "SIFIs" also cloud this issue. In my view, they are unnecessary.

We will return to this later, but the SIFI problem can be solved without this extra cost to the economy. We need early steps to deflate asset bubbles, dynamic regulation, robust bank structures, high quality management, and the creation of sound recovery and resolution plans.

But where will the extra capital come from?

It can only come from equity, contingent capital or retained earnings.

Let us look at each source in turn:

For equity investors, the new higher capital requirements are likely to mean that they will receive a lower return on their investment than in the past. So they are less likely to want to invest.

To tempt investors, some Banks may try to increase returns by taking more credit risk in traditional lending. They may even be encouraged to do this by governments determined to increase credit availability.

On the other hand, where risk intermediation is driven out of banks because of capital and cost constraints, a new risk may emerge as retail investors increasingly become a target for the shadow banking system.

Governments and financial regulators must open their eyes to the growth of shadow banking. Until there is proper regulation of this area, there will never be certainty about the real level of financial risk in the system.

**a uniform global approach to capital requirements is the key**

Some think that Contingent capital, or “COCO”s, may be part of the answer. But investors need certainty on how COCOs will be treated before they will buy them.

For example, insurance companies need to know whether COCOs are treated as debt or equity under Solvency II. Bail-in of senior debt may make this assessment even more complicated.

COCOs are challenging to value and their pricing depends on how likely each bank is to fail. Logically, investor appetite should exist only for instruments issued by the strongest banks.

Weaker banks would need to pay significantly higher risk premiums or be unable to issue at all. This could put pressure, particularly on weaker banks, to increase risk taking to offset the higher costs, perhaps by investing in poorer credits.

The third way of increasing capital in the system is to allow time for retained earnings to grow. The Basel timeframe may be workable. The problem is some governments want action now. So this steady increase of capital may not be acceptable in some countries.

What happens if the banks can't raise enough?

If the capital ratio is increased and capital can't be raised, Risk Weighted Assets will need to be reduced. Simply, this would mean a cut in the amount of credit available to the real economy. Economists argue over the precise effects, but do agree that there would be significantly reduced economic growth.

Is there an answer?

A uniform global approach to capital requirements is the key. If individual states continue to rush ahead increasing capital requirements to safeguard their own systems, it actually undermines global stability.

Even the announcement of change itself can destabilise markets and economies, and can even effectively pre-implement measures. There is no simple way to fix this.

But I believe that we should now pause, ensure a global implementation of what has already been agreed, and review its effects before new reforms are proposed.

Next, I would like to look at Liquidity. More liquidity in the system is certainly critical. To get this liquidity, either banks have to cut back on the credit they provide, or compete for term deposits or issue term debt.

The first question we need to ask is, will banks be able to issue enough debt?

As governments want to be able to allow banks to fail, senior debt investors will become more discriminating. We saw this immediately after the recent EC crisis paper. Spreads widened for banks which were seen to be weaker. So a certain amount of positive selection has already taken place.

In an economic downturn, or if there is a specific loss, this selection may go even further. It may actually stop banks getting funding. So the liquidity requirement may force deleveraging and even accelerate failure. This is a wider issue than just liquidity. As we saw when thinking about capital, weaker banks will have higher funding costs and a need for higher returns may incentivise them to take more risk. The build-up of low grade credit risk in weaker banks is a key risk for the economy going forward.

In the current proposals, the main form of high quality liquidity will need to be sovereign debt. And much more than is held now. So banks will have increasing concentrations of risk toward the sovereign sector.

But it also creates a risk for the sovereigns. In a crisis, it is their debt that has to be sold or refinanced. Also, because some countries have little or no government debt, cross-border sovereign risk concentrations are likely to increase.

The first observation period for the liquidity coverage ratio is underway and there will be a review of the definition of the assets that can be considered most liquid.

In my view, greater stability would be achieved if this list contained a wider range of assets. This could include more assets eligible at the relevant central bank for refinancing, and other liquid assets, such as: corporate bonds, gold, equities and even high quality ABS. I should add, on the other hand, that the knock-on effects of excluding equity and corporate bonds would probably make equity financings and corporate debt placement more costly.

Why does this all matter to the real economy?

Because we all know that an important component of liquidity is market confidence. If a sector with high risk concentration is threatened, confidence can erode quickly. We continue to live and breathe this reality, particularly here in Europe. Observation periods and some time delay have been proposed by Basel. Regulators should seize this opportunity to assess bank capacity to raise debt, and extend the most liquid asset list.

The third subject I want to comment on is Market and Bank structures. The entire structure of the OTC markets is being changed.

Perhaps most importantly, standardised products will have to be cleared through central counterparties (or CCPs). Unfortunately, the changes themselves will introduce new systemic risks.

Three risks in particular give me concern:

One - banks and end users will have very concentrated exposures, as there will only be a few CCPs. To mitigate this, regulators must ask who is standing behind the risk. Not just the default risk, but also who provides liquidity in the last resort.

I believe members must be very well capitalised to support defaults, that CCP capital needs to be higher, and that regulation of CCP risk management must be tightened as they become more heavily leveraged.

Two - there will be an increase of risk in the real economy during the transition to full central clearing and perhaps beyond.

Non-standard risk will be left in bilateral OTC contracts, leaving one-sided risk exposures. Perhaps if clearing was not mandatory, banks could reduce this risk to the economy.

Three - there could be a system wide liquidity drain driven by collateral demands, either in strong market moves or where risk for different products cannot be offset.

This could happen either because of risks being managed in different buckets in a CCP, or because products are cleared with different CCPs and there is no link between them. Having very few CCPs and requiring internal product netting would mitigate this, but CCPs could still turn a counterparty risk crisis into a liquidity crisis.

It is worth noting that the liquidity requirements from mandatory clearing of derivatives is also likely to force pension funds, insurance companies and asset managers to increase their charges, and may even bias their asset allocation.

Finally, let's consider the proposed changes to the monetary system. Financial stability doesn't just depend on improved regulation, it also depends on supportive economic conditions. The flow of credit to the economy is largely provided by banks, particularly in Europe, but as we have already discussed, this flow is also affected by regulation. So regulation and the economic situation are two sides of the same coin.

Last week, the French G20 presidency announced that work would begin both on reconciling global macro economic imbalances and coordinating economic policies, and also on wholesale reform of the international monetary system.

This is bold and important work, because we are not yet in a stable position. We can already see what might happen if this rethink fails. Many of you may even have predicted some of the knock on effects of quantitative easing and measures for domestic stimulus and deficit control in the West - the acceleration of investment flows into higher growth emerging economies and commodity price inflation.

**a new, dynamic approach is needed**

And you may have even anticipated the necessary short term corrective actions by some of these countries, such as Brazil, Indonesia and others, where we are seeing capital controls, increases of tax on foreign investments, increases in loan to value ratios and sector specific investment limits.

What does this mean for capital markets?

It seems clear that these actions and reactions will escalate unless there is structural change. This escalation is a risk to all economies and will impede global capital flows. But as the IMF reminds us, they are just tools. If the causes of the problem are addressed, I think these measures will be gradually withdrawn.

Personally, I am convinced that the deficiencies of the dollar, or any one currency, as the main reserve currency have to be resolved. But there are many unanswered questions as to the precise shape of any new monetary system.

It might go without saying that, after all the discussions, it may be a struggle to convince the US that such radical change is necessary. Transition risk will be at its most extreme as the world migrates to the new order, but it is likely to be a very lengthy process. During the transition, I see the trade ties between China, Brazil and other major Southern economies continuing at speed, possibly bypassing the US and EU.

To conclude, we must be honest with ourselves. On their own, the new global regulatory measures cannot deliver economic stability.

Even though the reforms are right to target undercapitalised risks, they address the affordability of the next crisis, rather than its avoidance. There has been no overall focus on how to ease risk concentration in the wider financial system through deflation of asset bubbles.

The very infrequent resetting of capital ratio levels by the Basel Committee clearly has not been effective. In part because the ratios were not globally applied, but also because adjustments were not sufficiently frequent. They certainly weren't focused on the build-up of risk in the system.

We stand in danger of replacing one set of regulation with another, the difference just based on levels of capital and liquidity.

Is there anything that can be done?

Yes, a new, dynamic approach is needed. A unifying, macro-economic approach which draws the measures together and dynamically sets a level for overall capital in the system. It has to target the balance of risks in each bank relative to the risks in the system.

The ESRB in Europe, the IMF globally, and other local bodies actively collect economic, market and bank data, but none of these bodies yet has a mandate to do much more than issue warnings of impending stresses.

It is therefore time for a clear process to be introduced, driven by macro prudential signals, which instructs the micro-prudential supervisors of changing capital requirements, when the system needs it. This process must set capital constraints for each institution proportionate to their contribution to any swelling bubble.

I believe this is the missing link which can join regulatory and monetary reforms together. If governments, regulators and other stakeholders focus their efforts and attention on this, I believe we will be able to make the capital markets part of the solution, rather than the problem.

The changes to capital requirements, liquidity measures, structures and the wider monetary system are monumental.

Today, I have given you my view of just some of the risks that lie ahead. I am reminded that Albert Einstein once said, "The only reason for time is so that everything doesn't happen at once."

And as we go forward, this seems like a good principle for governments, regulators and for bankers to bear in mind.

Thank you for your time, and I look forward to your questions.