

## Navigating Volatility: Challenges for Management in Financial Services

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Good morning. It is a pleasure and a privilege to be here today.

A pleasure because it is always good to have the opportunity to stand back and reflect on the major issues of the day amongst peers and those with a great interest in our industry. And, as a banker, it is simply nice to be asked out anywhere.

I have the great privilege to Chair the Board of one of the world's largest banking organisations. I have almost 300,000 colleagues in over 80 countries around the world. There is very little that happens in the world that does not touch HSBC. That gives us a broad perspective.

We are certainly living in interesting times - it is in fact a privilege to be involved in a leadership position at a time in history when so much is changing, being questioned, challenged, re-defined and where long held historic relationships and accepted wisdoms are being overturned. All of this defines the backdrop to, and the complexities of, the challenges that our industry is currently having to address.

Never mind our own industry - one only has to think of all the other shifts in the tectonic plates that are underway: the emergence of economic leadership in faster growing markets led by China; the upheaval amongst long established political leaders in North Africa and the Middle East; the market turmoil this summer around raising the US debt ceiling and; very much closer to home, the challenges inherent in addressing sovereign debt issues within the weaker Eurozone countries.

All these issues have focussed commentators on the challenges within the leadership models - financial, economic and political - the relative success of which will have huge implications for

how the next decade and beyond will play out. So I want to frame my remarks around some of the immediate management challenges particular to the industry I serve.

When times are tough as opposed to benign, it is easier to see both the need for and the qualities of management. And times are certainly tough now, with much at stake both for my industry, financial services, and for the wider economy that banks serve. We are operating in a period of immense uncertainty and complexity; of great risk and possibly opportunity. I doubt, in fact, that there has ever been a more important time in my career for policymakers, regulators and members of the financial services industry to demonstrate collective leadership, as the challenges we face together are immense, the solutions are neither obvious nor without risk.

Without doubt decisions taken by this generation of economic, financial and political leaders will have consequences for many years to come. They will also undoubtedly be analysed critically by future generations, who will of course have the benefit of hindsight.

One only has to think of the massive body of economic and political critical analysis applied retrospectively to the actions taken by the world's leaders in the 1930s to recognise - and perhaps sympathise - with those who have the responsibility to make judgments today on how to move on from the worst financial and economic downturn since the 1930s - this time in a demographically ageing world - and one which is exhibiting lower than expected growth rates. On top of this, with interest rates in the developed world at record lows and with fiscal flexibility, as commonly understood, all but exhausted the armoury to address the challenges is limited.

**Successful leadership is about dealing with the difficult issues**

The great economist JK Galbraith once said “All of the great leaders have had one characteristic in common: it was the willingness to confront unequivocally the major anxiety of the people in their time. This, and not much else, is the essence of leadership.”

The current environment in so many areas highlights the challenge in that statement. The major anxieties are evident; the willingness to confront them less so - the European sovereign debt crisis, indeed the future of the Euro; the constrained fiscal positions and recurring budget deficits in many developed countries as their economies slow; the ticking healthcare and pensions time-bomb as populations age; the balance between austerity and stimulus; the challenge of addressing growing inequalities within and between generations - all require decisive action - leadership - to re-establish confidence in the future.

It is worth observing in passing that there is no model, no proven recipe to recover or improve confidence, which is essential to economic recovery, and without confidence in the future there is no investment, and no-one willing to borrow. And you will have your own views whether our leaders today - whether political, financial or business - inspire confidence about the future through their words and actions. You might also observe that leaders today are often more comfortable delivering strong messages about other people's problems – e.g. Northern EU to the periphery; US to EU; EU to US; UK to Eurozone; regulators to management; management to politicians; and so on.

And inevitably many of the necessary actions to establish confidence about the future are unpopular and so provoke volatility because of recurring perceptions of lack of resolve to see things through, as what is necessary is - for understandable reasons - moderated to what is possible.

Austerity programmes in the most heavily indebted Eurozone countries, for example, have – understandably - limited popular support, and have provoked protests and riots. Governments are having to deal with the social consequences of

austerity measures while trying to maintain the necessary social cohesion needed to deliver support for spending cuts. In the United States, polls point both to the fact that there is strong support for moving to a balanced budget but equally indicate strong resistance to touching Medicare and Medicaid, benefits programmes and the defence budget. This allows both sides of the political debate to claim a mandate from the American people.

In many ways this gets to the heart of the leadership and management challenges. It is easy as a leader or as a manager to take decisions which have limited impact; it is easy to take decisions that simply follow decisions already made by others which are therefore readily defensible and easy to rationalise; it is easy to take decisions that are popular but defer tackling the real underlying issues which thereby become more critical every day they remain untouched.

But none of that is leadership. Too often today, we see people in influential positions following the public mood, being cheerleaders for populist sentiment, rather than trying to lead public opinion to where it needs to go. And the same is, of course, true in the corporate world as management ducks difficult and unpopular issues.

Successful leadership is, however, about dealing with the difficult issues, rather than the easy ones. It is about hard choices, taking decisions you believe to be right, even if they are unpopular, or against a narrow self interest in the short term, and this takes courage. But this is the real challenge of leadership.

As the Chairman of a major banking group, I see this all the time in the constituencies most important to me and where the inherent conflicts include, inter alia, dealing with the following:

- Shareholders. Who are critical as the people who provide the capital that allows us to operate, and who expect to earn a reasonable return on their investment – but there are many conflicting views on timing of returns and how to achieve them.

- Regulators. Who set the rules by which we operate, who want us to hold more than enough capital so that we can survive any foreseeable crisis and who want us to be successful - but not too successful - as it is regulation that builds barriers to new entrants.
- Customers. Who pay our wages, and expect value for money and high quality service – the conflicts here are simple, our customers expect to receive personalised and excellent service - but expect to pay very little for it - and part of our management challenge, particularly in tough times, is to be honest about what it is reasonable to expect at various price points.
- Employees. Who deliver our products and services, and expect to be rewarded fairly and competitively and have a good working environment.
- Society generally. Who give us our licence to operate and expect never to have to worry about soundness of the industry and so are rightly outraged at the management of the industry when that responsibility is not met.

It is worth reflecting for a moment on the current management challenges within our industry for both policy makers and industry leaders.

These challenges are set against a backdrop of huge public anger for all the reasons we know about, and require them to set about the process of reforming the regulatory system, rebuilding lost trust, creating more robust banks and a more secure financial system, without unintended consequences.

It is also worth reflecting at this point on the enormous complexity of the reform agenda facing those charged with leading the process. There are four principal challenges.

### Challenge 1

Rebuilding a regulatory framework after the worst financial crisis of the 1930s which had multiple causes:

- Poor management
- Poor governance
- Poor supervision
- Public policy goals around housing which had unintended consequences
- Excessive liquidity, coupled with low government bond rates, following the dotcom/tech bust and the aftermath of 9/11
- Excessive reliance on modelling versus judgment
- Over-reliance on, and misunderstanding of, ratings.

### Challenge 2

Creating a level playing field as far as possible across countries:

- With different shaped financial systems
- At different stages of economic development
- With differing degrees of central bank/supervisory intervention
- With different growth prospects.

### Challenge 3

Building a new framework that limits the risk of repetition of a crisis but at the same time doesn't excessively hamper economic activity so:

- Building a system that constrains over exuberant credit supply but doesn't choke credit formation to the real economy
- Building a system that promotes good innovation but doesn't allow arbitrage and misaligned structures
- Creating a system with the right incentives.

### Challenge 4

And if it all goes wrong, finding a way to mitigate the impact:

- That deals with cross-border implications
- That avoids contagion
- That recognises that every country is starting from a different place in terms of legal architecture to deal with this.

And to recognise that the reforms are taking shape under intense media and political scrutiny - with many vested interests from within the industry and in individual countries. And where those leading the process are aware of the need to demonstrate - not just that a better framework for the future has been designed - but that a meaningful penalty has been levied on those deemed to have caused or contributed to the crisis.

Balancing the competing priorities of all the various constituencies to deliver a workable solution is one of the greatest management challenges currently facing our industry. That means:

- Political leaders need to balance the populist benefits they will gain from being seen to punish the industry for ‘causing the crisis’ against the long-term economic harm that could be inflicted upon the economy by limiting the capacity and effectiveness of the financial sector in generating and allocating credit supply;
- Regulatory leaders need to balance de-risking or overcapitalising the system so that future extreme stresses can be comfortably accommodated, against the affordability of such protection; and
- Bank leaders need to evidence to society they are focussed on the social value and utility of the services they provide, rather than simply pursuing profit maximisation.

So the greatest challenge in the current environment is being seen to do what is right – not what is popular – to rise above one’s own narrow interests, the short term interests of one’s own institution, and take a balanced view of what is necessary for sustainable economic growth in the long term.

So this is my first message - if the industry, indeed the world economy, is to navigate successfully through this period it will take collective and co-ordinated action by policymakers, regulators and management within the industry to ensure risk management does not become risk aversion and then risk avoidance.

So what does this all mean in practice? How does one address the current challenges?

The first practical responsibility, which rests with the Board, is one of governance – that is to ensure that management has a framework, including incentivisation, capable of promoting the necessary far-reaching decisions – and seeing them through. Second, it is ensuring that management and the Board have a shared vision of the future and that this vision is communicated and embraced by our employees.

At HSBC - like all major banks - we have had our share of difficult environments to face throughout our history. Since being founded in 1865, we’ve survived numerous crises all over the world – from war and occupation to financial crises and nationalisation.

Even in my short career with HSBC of 16 years we have been through multiple Latin American debt crises, the collapse of the hedge fund LTCM, Russia’s debt default, Argentina’s default of its debt and abandoning its fixed exchange rate to the US dollar without compensation, SARS, Avian Flu, Swine Flu, the Asian Financial Crisis, the Dot Com Bubble, the Tech crash, the sub-prime mortgage crisis, the collapse of the structured credit markets, and we are now dealing with the current financial crisis around sovereign debt.

I believe that what distinguished HSBC management from others was their focus on how the firm’s history would judge them when it covered their period of leadership as opposed to how successful they were individually at the time; I believe this is still true today.

So what about current and prospective market conditions and how to navigate through these?

There is no question it is a real challenge given the procyclicality inherent in our regulatory framework.

In the introduction I set a backdrop of considerable geopolitical and macroeconomic uncertainty. So risk is heightened and growing and thereby management actions are predictable but full of challenges and conflicts.

The first thing every good management seeks to do is ensure self determination – that is retaining control over one’s own destiny which means firstly keeping regulators and shareholders onside. And that means holding buffers of both capital and liquidity against unforeseen stress events. But of course if such buffers were not built ahead of the current crisis, options to do so now are limited.

So that means deploying the capital and liquidity already held cautiously and, to the extent possible, avoiding or reducing risk exposures most likely to require augmentation of capital because of increased probability of default and increased severity of loss given default.

So that means identifying first, second and third line risk concentrations and seeking to reduce or mitigate the exposures. It also means strengthening funding where possible, extending duration of liabilities and reducing illiquid assets.

But the problem is that by the time the crisis is upon us, as it is now, many of the desired actions are either impossible or counterproductive. With banks typically trading at less than 50% of book value, raising capital from shareholders is difficult to imagine; and state supported capital injections look challenging for the most needy given the perilous position of the government finances of many of the most challenged banking systems.

And with capital under pressure, augmenting liquidity is equally challenging. Debt providers can see demand coming so supply is limited; pricing is unattractive – look at CDS spreads; and so a process of deleveraging is inescapable which puts pressure on profitability and stock prices fall further. That, in turn, reduces the likelihood of capital raising, and so on.

And a major challenge is judging the balance between mitigating direct exposure through counterparty risk management and precipitating a self fulfilling collapse of confidence in certain banks or industry sectors or geographies as credit capacity is withdrawn. Hence managing communication is vital.

But direct credit exposure is but one part of the management challenge, it also requires:

- Heightened awareness of operational risk;
- More staff training on the importance of reconciliation breaks; late confirmations; settlement delays particularly recurring ones; hugging of intraday settlement limits; bidding up for funding; collateral management integrity; collateral valuation disputes;
- A greater focus on systemic risk within exchanges and central counterparties and clearing systems;
- More regular and severe stress tests on scenarios, geographies, sectors and individual counterparties.

Human resources also have to be taken care of as they are under huge strain and huge workloads – we need to beware of exhaustion. So there is a need to communicate often and transparently and to understand and attempt to moderate the workload of key resources.

For example, risk professionals today are:

- Addressing all the geo-political and macroeconomic risks we have talked about;
- Identifying all the first, second and third line counterparty risks;
- Addressing all the operational risks noted above;
- Looking out for the system architecture risks.

While at the same time:

- Recalibrating RWAs under Basel 2, Basel 2.5 and preparing for Basel 3;
- Producing defined stress tests for many different regulators;
- Preparing models to move from incurred loss accounting to expected loss accounting;
- Building models to move from fair value to prudent value accounting for regulatory purposes;
- Producing more risk information for external and regulatory disclosure;
- Contemplating the impact of ring-fencing under the recent ICB report.

I could probably add a few more but I hope the point is made.

It becomes evident that the ability to calibrate risk – at each of the institutional, prudential and the systemic level – becomes crucial to the functioning of the new system. Risk managers hold the future of our economy in the palms of their hands – or perhaps I should say within the capability of their models to reflect the risks of the real world – particularly if they are able to determine just how much capital is appropriate, at a given point in the cycle, for given levels of prudential and systemic risk.

This is potentially daunting for risk managers, both those working within firms, and those responsible for macro-prudential and micro-prudential oversight.

I believe we will navigate through the current and prospective market conditions but it will take co-ordinated industry, regulatory and policymaker action. It is critical that, together, we distinguish liquidity strains from solvency problems, support the former and deal conclusively with the latter. It is vital we work together to address the broken parts of the system, to prevent contagion spreading to the remainder of the system and ensure there is a sufficient supply of credit to the real economy to match economic growth objectives, and that such credit supply is adequately supported by adequate risk bearing capital. That is the definition of financial stability.

So there is plenty to do.

Thank you.