

Industry Response to the New Regulatory Order

Speech by Douglas Flint
Group Chairman, HSBC Holdings plc

City Week, London
7 February 2012

Ladies and Gentlemen

It is a great pleasure to have the opportunity to make a few remarks in the early stages of one of the most interesting and definitely challenging years of recent times, with many of the issues that absorbed our attention last year still very much alive in 2012 and whetting our appetite as to what is to come.

That is certainly true with regard to the new regulatory framework - already three years in the making but still fluid in very many areas.

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 and an interesting one as we observe how different areas of the world have responded to the financial crisis.

Sometimes it doesn't feel like it - but it is in fact a privilege to be involved in a leadership position at a time in history when so much in our industry is changing, being questioned, challenged, re-defined and where long held historic relationships and accepted wisdoms are being overturned.

Let me say at the outset that we - and I believe all in our industry - welcome the steps being taken by the official sector to improve the financial stability and resilience of the industry. Our greatest risks are from within our own industry and the needed rehabilitation of our industry in terms of public trust and confidence can only be earned by demonstrating both that lessons have been learned and that social contribution trumps self interest.

It is worth reminding ourselves for a moment of the immense challenges that were faced - by both policy makers and industry leaders - which were - against a backdrop of huge public anger for all the

reasons we know - 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 were four principal challenges.

Challenge 1

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

- Poor management
- Poor governance
- Poor supervision
- Public policy goals re 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

Create a level playing field so 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

- Build a new framework that limits the risk of repetition of a crisis but at the same time doesn't excessively hamper economic activity.

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

Challenge 4

And if it all goes wrong:

- Find a way to mitigate the impact
- That deals with the 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 recognises that the reforms are taking shape under intense media and political scrutiny - faced by many vested interests from within the industry and in individual countries - 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.

So how well have we done?

Balancing the competing priorities of all the various constituencies to deliver a workable solution - without unintended consequences - has been one of the greatest management challenges our industry has faced and one where strains are now beginning to show as policy design moves towards practical implementation. So what has been achieved?

- We have done a great deal to better calibrate risk, build loss absorption and liquidity and thereby improve the capacity of individual institutions to handle risk.
- We have made progress in defining how systemic risk might be better identified and how through macro-prudential tools that identification could cause the supervisory framework to recalibrate credit supply - but it is very early days in terms of putting this into practice.

- We have done a great deal to discourage that which we don't want to recur - but have done less to define what we want the system to look like once we are finished with reform.
- We are better able to calibrate the consequences of systemic collapse but no more able than before to predict when and for what reason the next crisis will occur.
- Partly as a consequence of being unable to predict the next crisis, we have identified the critical importance of effective cross border resolution - but have made little progress in getting the political buy-in to reforming and conforming national insolvency regimes to facilitate such resolution.
- We are in continuous debate around what is regarded as 'prudent precaution' on one side of the table versus 'unintended consequences' on the other, with both sides prone to exaggerate the risks to the downside - 'better to be safe than sorry'.

But if this sounds a bit grudging it is worth reflecting how much was achieved in 2011:

- In the UK the Independent Commission on Banking ('ICB') delivered its report in September and the Government published its response in December. In the United States greater clarity on the Dodd Frank legislation was delivered through a multitude of notices of proposed new regulation and four financial regulatory agencies in the United States issued proposed uniform regulations that would implement the Volcker Rule which aims to constrain major financial institutions from engaging in proprietary trading and most hedge fund and proprietary investment activities. The Financial Stability Board set out its proposals to identify and increase capital requirements for Systemically Important Banks and most major jurisdictions published their proposals around recovery and resolution planning for major institutions. Europe continued to embed the Basel 3 proposals within a new Capital Requirements Directive and in the UK, HM Treasury published its proposals

for a new approach to financial regulation under the Bank of England.

- However, many areas remain subject to further debate including cross border resolution protocols, the governance and operation of central counterparties, the prospective role of clearing systems and exchanges, the calibration of the proposed new liquidity framework, a fundamental review of the trading book, the harmonisation and peer review of the calculation of the risk weights that drive capital requirements, a re-assessment of the risk free treatment of sovereign debt as well as some 20 plus follow-on work-streams following the UK Government's response to the ICB Report. Oh and on top of this the accounting rules on impairment measurement, hedging, securities valuation as well as further international harmonisation are all under review.

So as we move into 2012, the epicentre of the debate is changing - no longer a debate about whether something should be done - but now about managing transition, timescales for implementation and avoiding unintended consequences. And most importantly addressing the most critical missing piece of the regulatory architecture that of an effective cross border resolution framework.

It is also clear from all the above that the industry will continue to bear a heavy burden of both time commitment and cost as it works with policy makers to finalise the regulatory reforms and address the inconsistencies within and extra-territorial dimensions of national rule-making.

Just like in so many areas of life today there is a real need for leadership to call the point at which we have to stop adding to the reform agenda and observe whether the aggregate of all that has been done has been sufficient to change behaviour so that the system in aggregate is fit for a purpose that is universally understood and accepted.

I make this point because as one stands back and looks at the enormity of what has already been done and what is still being attempted - a number of issues stand out:

- Are there gaps in coverage? Shadow banking?
- Is the aggregate of all the measures both complete and in train duplicative or reinforcing?
- Is there coherence between banking, insurance, pension fund and asset management regulation?
- Does the understandable focus of national fiscal authorities towards limiting their contingent risk to domestic deposit bases risk unwinding many of the elements of globalisation of economic activity?
- Is there too much focus on products, platforms, infrastructure, capital and liquidity because they can be defined and measured as opposed to focusing on behaviour which is much more difficult to pin down objectively?

In relation to the above think about the extraordinary complexity in defining the Volcker rule and distinguishing between proprietary trading and market making; think about the much greater emphasis on long term funding and liquidity in banking regulation yet the greater restrictions on insurance companies holding longer term debt in Solvency 2 Directive and the severe restrictions in the draft Volcker rule that exempts only US Treasuries, Agencies and Municipal debt from proprietary trading restrictions.

Given that the hard wired rules are simply means to an end of getting the system to look and behave as we want it to, the current debate often hinges on hard to prove assertions around what would happen if we took a different policy course or exactly how we want people in the system to behave or indeed what the system should look like if it is to be optimally structured.

It is worth noting that a simple word search in the ICB Report mentions capital 463 times, liquidity 140 times and behaviour 7 times. In the FSA report into the failure of RBS the numbers are 1,389 for capital, 733 for liquidity and 16 for behaviour respectively.

This understandably reflects how difficult it is for the official sector to really get to grips with management intentions, character and behaviour.

And if they can't do that how can they judge the balance between prohibition and permissiveness, reassurance and reliance? Are there greater opportunities to co-operate? Are the industry's beliefs exaggerated or false? Coherent or contradictory? To the hawks, banks are simply self serving whereas bankers believe they are misunderstood. Those in the middle flit between a desire to deter versus reassure and get concerned that undue constraints bring unintended and unknown consequences.

But what is certain is that if we perpetuate a feeling of distrust and hostility we will exaggerate the downside risks to justify our respective position and by preparing for the worst we may well ensure it occurs.

Just because a solution is demanded does not mean there is a soluble problem. Hindsight tends to allow self deception - the number of commentators confidently pointing to the root causes of the last crisis easily outnumbers those pointing to the causes of the next one. Both sides of the debate fuel their self deception by pointing to events that fit easily to their view of the world.

And yet the challenge to deliver reform that meets all the expectations now built up will bring enormous benefits if successful, namely: greater financial stability, alignment of the financial system with economic growth objectives, more sustainable allocation of credit to the real economy, better alignment of investor and market participant rewards, market infrastructure improvements, enhanced competition, greater transparency, more effective supervision and greater linkages between micro and macro-prudential supervision - to name but some.

But we have to be careful not to promise too much:

- One of the main contributors to the situation we now face was promising more than could be delivered - whether it was economic growth without productivity, credit growth beyond our ability to identify misallocation, a step on the housing ladder without any down-payment, higher returns without higher risk or growing social benefit, retirement and healthcare

programs without commensurate and sustainable fiscal support.

- Secondly – there are clear inconsistencies in the multiple policy objectives now mandated:
 1. We want stability as well as growth, we promote economic growth as well as fiscal austerity;
 2. We want banks to lend more and also grow capital both in absolute and ratio terms;
 3. We want the banking system to raise more capital while restricting its activities and restraining dividends;
 4. We want to see more competition in financial services but we don't want to see the higher returns that would attract external private capital;
 5. We want to see fewer interdependencies without losing the benefits of scale;
 6. We continue to incent the banking system to lend ever more to governments and then seek to stress test what happens if the same governments don't/can't pay;
 7. We want the system to respect market signals but then we don't like what ratings agencies say;
 8. We want greater transparency but fret about how immediately markets respond to events not yet understood at a policy level; and finally;
 9. While we need the system to accept responsibility for optimising credit allocation, we want to explore criminalising bank failure.
- Thirdly, what is good and rational for the few may be disastrous for the many - deleveraging an overextended institution or country works when there are those able to take up the slack but doesn't if everyone does it at once, risk-off is fine if it is to bring an outlier back to normality or to adjust risk preference in a single portfolio but is hugely procyclical and destructive if everyone does it at the same time.

It is also worth reflecting on some of the things we learned last year and some of the unintended consequences we now recognise:

- We learned there is no such thing as a risk free asset.

- We learned that imperfect information can precipitate herd like behaviour as the consequences of being wrong far outweigh the benefits of being right - and this is particularly acute when considering cross border activity.
- We learned that models failed us in the last crisis but we still believe we can build better models.
- We learned that economies where investors hold most of the domestic assets are more resilient.
- We wanted greater competition in financial services - that led to multiple trading platforms and greater use of technology so that markets have become ever more correlated - which has led to greater buffers as natural diversification is lower.
- We admired interconnectedness when it facilitated the risk sharing that reduced the probability of a systemic crisis; we loathed the interconnectedness that spread the crisis when it did occur beyond our ability to contain it.
- We learned that market signals can reflect competitive advantage, or mispriced risk, or information asymmetry or maybe all three and given we won't know till afterwards we should exercise caution on relying on such signals.
- We learned about co-dependencies - stable banking systems depend on strong sovereigns and strong sovereigns depend on strong banks - and in times of stress financial systems will force 'home bias' to protect domestic depositors and national fiscs.
- We promoted growth in trade, we delighted in the disinflationary benefits from accessing lower cost goods but couldn't get to grips with the growing and persistent current account imbalances.
- We wanted greater transparency - that, leveraged by technology, has facilitated the high speed trading that accounts for 75% plus of trading across markets today - accentuating trends ahead of possible policy responses.
- We encouraged people to reduce their indebtedness but not stop spending.
- We saw why it was necessary to warn people of the dire consequences of not taking hard decisions in order to build political support for these actions but that made it difficult at the same time to encourage businesses to invest for the future.
- We can see that we have to plan for a less connected world in the future in financial terms - less cross border funding, less foreign currency funding.

2012 is certainly going to be challenging and exciting.

A final thought - if we are to make the most of this reform period we really do need to focus more on what we want the financial system to do in aggregate and less on where there is a need for detailed reform.

Thank you for listening.