

# Hindsight of a crisis: An opportunity to improve or deceive?

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Good evening.

It is both a pleasure and a privilege to be here tonight as a guest of the Institute of Chartered Accountants of Scotland.

A pleasure, because in very many ways I owe my career to what I learned training as a CA in the offices of Peat Marwick Mitchell & Co in 135 Buchanan Street Glasgow and then practising as a Chartered Accountant, having been brought up from my earliest memories to understand the essence of what a profession meant: as some of you will know my father, who was and is a great influence in my life, taught generations of accountants in Scotland the difference between a profession and a job, instilling in everyone the responsibility, as well as the privilege, of being in a profession. He used to make much of the fact that it was the Institute of Chartered Accountants of Scotland as opposed to The Institute of Chartered Accountants in England and Wales, to illustrate the point that one's duty as a professional was first and foremost to oneself and one's profession; it did not change depending on one's role or one's location.

Before I get too nostalgic I have to say my father didn't get everything right — in his days in professional practice he once took on as an articled clerk — and so set him also on a career in accounting — a fellow by the name of David Tweedie and has had to live with that accountability ever since.

It is also a privilege to be invited to give an address in memory of Aileen Beattie whom I knew and respected greatly and who also embodied the essence of the profession.

The title of tonight's address 'Hindsight of a crisis: An opportunity to improve or deceive' was crafted partly to intrigue people enough to attend - but also to make the point that a crisis gets people's attention - and therefore is a great opportunity to move things forward to learn lessons, fix things that need fixing and so avoid repeating mistakes - but it is also an opportunity to take advantage of people's fear of repetition to offer seductively attractive remedies that only address symptoms rather than causes.

We should therefore always be wary of the phrase 'never again' – if we learn anything from history it is that we are destined to repeat mistakes whenever we believe that we have solved definitively the cause of the most recent crisis.

Much of this reflects a most basic human desire for there to be meaning in life, that there is some kind of order, that fate is not capricious – i.e. somehow we all get what we deserve. Indeed it is a core objective of both political and economic systems to promote a comforting perception of predictability. Ever more today, society does not want to acknowledge unpredictability, particularly around economic outcomes – we want to believe an unwelcome outcome is the cause of failings that need both to be compensated and cause revisions to be made to the system to reinforce predictability and so restore confidence in the future.

This leads us to seek out definitive solutions to identified problems. But just because a solution is demanded of course does not mean there is a soluble problem. Many commentators make this observation about the Eurozone today. If only it were as simple as moving a toggle switch between 'Austerity' and 'Growth'.

As you would expect I shall concentrate my observations on the current economic turmoil and the financial crisis that preceded and contributed to it, but the observations are equally true in any crisis where society feels let down by others and where its established predictions of the future have been destroyed.



In 2003 I had the opportunity to contribute to a number of reports on 'restoring confidence in financial reporting' in the aftermath of the Enron and other accounting scandals of the day – as I reflect on these reports there are many parallels with where we sit today – public and political outrage on breach of trust, demands for scrutiny of corporate governance, of skewed reward systems (it was share options then) and for clawback of extravagant pay demonstrably not related to performance, greater regulation of accounting and financial reporting which led to the Sarbanes Oxley Act and the establishment of the PCAOB to name but a few. Today of course it's Vickers, Dodd Frank, Volcker, Basel 3 and CRD IV.

It is also worth reflecting at this point on the enormous complexity of the reform agenda facing those charged with leading the process — and perhaps even feeling some sympathy for them as they address the four principal challenges.

# Challenge 1

Rebuilding a regulatory framework after the worst financial crisis since the 1930s 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 recognise 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.



And there is no doubt that the reason these challenges and the broader challenges facing society today are so deeply problematic politically is because they expose the harsh truth that many of the pillars that were supporting society's confident expectations of the future were built on shaky foundations

Simply put, we believed that which was comforting to believe and we believed those in authority whether political, financial or economic when they confirmed that our aspirations were realistic – and we gave them credit when they claimed this was in fact in large part due to their guiding of the economy, their unlocking barriers to growth, their financial skill in seeking out superior returns or their sound economic forecasting abilities.

So in many parts of the world it was accepted that the following were achievable;

- elevated economic growth without productivity improvement,
- credit growth which exceeded underlying economic growth without risking a misallocation of resources,
- a step on the housing ladder without the need for any down-payment,
- enjoying sustainable house price inflation well beyond wage growth,
- delivery of higher returns without higher risk,
- or growth in social benefit, retirement and healthcare programs without commensurate and sustainable fiscal support.

And these beliefs with hindsight were wrong – and ex-post rationalisation reveals just how implausible they were – and so we rally to the banners of those who, while in a minority at the time, foresaw things that only became obvious to the rest of us after the event. And the band of those who claim they saw the impending wreck grows daily.

To steal from a fellow Scottish accountant - as Sir Angus Grossart so eloquently wrote in his Chairman's Statement in 2010;

'Everyone seems to have assumed the mantle of retrospective omniscience in explaining the

financial collapse and the recession. Seldom can so many people, from so many backgrounds, have been so sure, and so clear, after the event, what really went wrong and what were the causes.'

Angus goes on to observe;

'All that energy, adopted clarity, and sense of blame begs the question, why so few were not equally perceptive, or sure, ahead of events, that a major collapse was brewing. The answer, of course, is that they did not see it, at the time, and they misread the prospects in much the same way as those they now blame.'

He goes on;

'An unfair comparison? Can we test the legions of recently qualified expertise, by asking them to bring the same measure of retrospective clarity to their current assessment of future prospects? Few seem willing to do so, or are able to be certain, and the honest recognise that it is remarkably difficult.'

A good parallel might be that we are very skilled today in understanding the cause of earthquakes, how to calibrate their impact and in building infrastructure and buildings better able to withstand the shocks but we still cannot predict where and how severe the next earthquake will be.

It is however an imperative - politically, socially and economically - to understand the causes of each and every crisis so that lessons can be learned, barriers built to prevent or mitigate the impact of recurrence, infrastructure reinforced to withstand the aftershocks and confidence restored so that the future can be faced with a higher degree of predictability once again.

That word – confidence – is important, and 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 – as without confidence in the future there is no investment, 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.

And if we are to inspire confidence then that requires trust in one's leaders, trust in their motives and trust in the data which is presented to support the actions they are taking or wish us to take - which is why so many policy makers currently are so focussed on the accounting profession – because they need there to be a solid and trusted foundation of reliable financial information on which to take decisions and on which markets can function.

This is understandable as many of the necessary actions to establish confidence about the future are immensely challenging, as the enormity and interrelatedness of the challenges facing us all are better understood, while the ability and timetable in confront them remain which shrouded uncertainty - the European sovereign debt crisis and its impact on the Euro; the constrained fiscal positions and recurring budget deficits in many developed countries; the ticking healthcare and pensions time-bombs as populations age; the balance between austerity and stimulus; the challenge of addressing growing inequalities within and between generations – all require near term decisive action and leadership to re-establish confidence in the future.

And in large part because there is no way of gauging our proximity to the next financial crisis, the political/regulatory/ industry response seems currently to have got deeply into a world of 'line of least regret'.

Hindsight allows self-deception on both sides – we convince ourselves we really knew what caused the problem so that we can justify a full slate of measures to avoid repetition or justify limited actions because lessons have been learned.

We fuel that self-deception by selectively pointing to events that fit easily to our view of the world. So for some it's all about so called 'casino banking', for others its mis-aligned, badly structured or excessive compensation, others point to exuberant monetary easing creating asset bubbles, others point to misguided housing policies and incentives - everyone agrees management and governance and supervision were all defective but disagree on relativities, and so on.

Each side then justifies its respective position by exaggerating the downside – 'ok we may have gone too far but far better to overestimate the risk than underestimate it' and on the other hand 'the actions proposed will seriously damage the real economy'

Two possible futures that neither side can contemplate:

- Why did you do nothing to prevent another crisis?
- Why did you turn the system upside down at huge cost to address an event that did not occur or was less damaging than predicted?

# For example:

- Y2K
- Repeat of 9/11
- Climate change/global warming
- Nuclear proliferation
- The next financial crisis

This in no way undermines the importance of improving – and demonstrably improving - the financial stability and resilience of the financial industry. This is clearly necessary and the recent crisis has provided a once in a generation opportunity to take a fresh look at one of the most important and critical pieces of infrastructure to any successful economy and indeed the global economy – its financial system.

But as well as addressing all of the most urgent fixes highlighted in the recent crisis we must now also focus on what we want the wider financial system and banks in particular to do – recognising that rehabilitation of the industry in terms of public trust and confidence will only be earned by demonstrating both that lessons have been learned and that social contribution trumps self-interest.

Balancing the competing priorities of all the various constituencies to deliver a workable solution – without unintended consequences – remains one of the greatest challenges the industry and its regulators have faced and one where strains

are now beginning to show as policy design moves towards practical implementation. Creating a robust, resilient and sustainable platform across which our clients can move money safely, protect and retain access to their savings, manage their borrowing and funding needs and hedge their risks is essential to economic prosperity.

So how well have we done so far?

- 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 good progress in defining how systemic risk might be better identified and how through the macro-prudential tools now available to the Financial Policy Committee of the Bank of England that identification could cause the supervisory framework to recalibrate credit supply.
- 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 are in the early stages of 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 true to say that a lot has already been delivered – establishing a framework for the industry in the future which

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 macroprudential supervision – to name but some.

So as we move through 2012, the epicentre of the debate has changed – no longer a debate about whether something should be done – but now about managing transition, timescales for implementation and avoiding unintended consequences.

But 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? Who is responsible for ensuring this?
- Is there coherence between banking, insurance, pension fund and asset management regulation? Again whose responsibility is it to check this?
- Is there market capacity for the capital raising and funding assumptions being made?
- 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?

- If fiscal authorities don't want the contingent risk of the banking system does anyone else and at what price?
- If a consequence is to unwind globalisation to some degree and establish a 'home market' bias does this impact the availability and cost of financial services delivered to multinational groups? Does this change the competitive landscape between companies domiciled in Europe versus the US versus Asia? Does this matter?
- Does the public policy concern over systemically important institutions create a greater probability of stability because of their higher capital requirements and supervision or does it further concentrate activity into these institutions because of their elevated status; current experience suggests that in times of great uncertainty customers prefer the largest institutions.
- Does prospective bail-in of creditors change positively the probability of a future bank failure because of greater market led discipline or does it simply reallocate systemic losses away from the future income of society (through taxation) towards society's current and future savings (via insurance and pension funds) and if so have we deceived ourselves that we have achieved very much?

# And finally the critical point:

• 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.

Given that market infrastructure and hard wired regulation are simply a 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.

In the accounting world it's called principles versus rules – in the banking world it's about the extent to which we regulate by defining the desired outcomes or go to the extent of mandating in detail how to achieve the desired outcomes.

This understandably reflects how difficult it is for the official sector to really get to grips with management intentions, character and behaviour. How can these be measured, how can they be assessed, how can a regulatory body demonstrate it adequately monitored values and behaviour, how can there be comparability across jurisdictions with different cultures? And if the official sector can't do that how can they judge the balance between prohibition and permissiveness, reassurance and reliance? How can they accept accountability if there is no objective framework of measurement against which to judge performance?

But if it were possible to get to grips with management intentions character and behaviour surely there would be greater opportunities to cooperate? To determine if the industry's beliefs were exaggerated or false? Coherent or contradictory? If it were possible to believe lessons have been learned would we still need to prescribe actions to constrain a tendency to get off the reservation?

To many in Society, 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.

The essential point here is to recognise that banking, indeed all of financial services, just like accounting and other professions is subject to societal expectations that are constantly changing and evolving. We cannot change this and indeed must accept that if we do not fit into a role acceptable to society then it will reject us and replace us with a model suited to its requirements.

We have to recognise that what was once deemed acceptable may no longer be so; we have to accept that societal expectations may swing too far towards what is impractical or unrealistic; we may then need through trial and error and advocacy to

convince society what its reasonable expectations ought to be - but if we are to do that we need to restore trust and credibility.

And what is certain is that if we continue to engender a feeling of distrust and hostility we will on both sides of the argument exaggerate the downside risks to justify our respective positions and by preparing for the worst we may well ensure it occurs.

So returning to the question I posed at the outset 'Hindsight of a crisis: An opportunity to improve or deceive?' my assertion is that we deceive ourselves if we believe that it is possible to engineer a system that eliminates failure and unintended consequences.

Regulators and public policy makers on behalf of society clearly have a duty to respond to failures highlighted in a crisis. They have the ability to modify and recalibrate the framework under which we operate but with this privilege goes the responsibility to do so only if it is proportionate and in the long term interests of society.

Just like accounting standards cannot deal explicitly with every circumstance to which they need to apply, neither can financial sector regulations. And if we train a future generation of bankers to follow an immensely detailed rulebook, not only will complexity ensure unintended breaches, but we risk intelligent minds identifying numerous unintended consequences rationalising non-compliance structuring or solutions which are form over substance or which arbitrage local variations. And of course – just as in accounting - rationalising arbitrage and structured solutions to mitigate unintended consequences inevitably leads to more and more aggressive behaviour. A mindset is created around it being okay to get around rules if they don't make sense.

Once again we come back to that word 'behaviour'. It is worth noting that a simple word search in the Independent Commission on Banking Report mentions capital 463 times, liquidity 140 times and behaviour 7 times. In the FSA's report into the failure of RBS, the numbers are 1389 for capital, 733 for liquidity and 16 for behaviour respectively.

Simplistic - but all the same interesting. If we are to learn the lessons of the crisis, improve the sustainability of the financial system and demonstrate its overwhelming social value it will be because we have changed behaviour.

Capital, liquidity and infrastructure enhancement will also play a role as will better governance and supervision but the greatest opportunity for improvement will come from defining, teaching, reinforcing, rewarding and enforcing values in terms of behaviour.

And if we are ever to rely on behavioural values it has to be based on trusting organisations to deliver them and organisations trusting their people to deliver – and that trust has to be built over time and evidenced by experience. And we need to find a way to build assurance into the system that trust has been earned.

In this context I will share with you of one of my earliest recollections of my early career as an accountant having moved down to London in 1979. Peat Marwick Mitchell & Co in London was the market leader in bank audits which represented its largest industry group then so it was inevitable I would end up involved in that sector - and I remember vividly the first job I ever was in charge of – an investment banking subsidiary of one of the largest US money centre banks - the partner in charge was one of the most senior partners in the firm, he led the banking practice which he had largely built from scratch and had the reputation of being unreasonably demanding and intolerant - in those days a requirement for partnership it seemed to those of us at the bottom - and to cap it all he had the reputation of making or breaking careers based on early experiences of juniors work - so it was with some trepidation I entered his office carrying the audit files I had carefully prepared.

After the obligatory 15 minutes sitting in silence while he finished reading the FT he gazed over his half moon horn rimmed glasses and declared - somewhat surprisingly to me as he had been the partner on this client for a considerable number of years – you'd better tell me what this bank does as I don't really understand their business. So I set off as best I could explaining what I had learned – after about ten minutes or so he stopped me and



asked to see the detailed profit and loss account and pointed to stationery expenses which had risen by about 60% from about £10,000 to £16,000 from memory – trivial in relation to the bank's business and asked me to explain why.

I replied that I didn't know but would find out and report back. With that he handed me back the files declared the review over and went back to reading the paper.

That experience has stayed with me all my careernot great on mentoring maybe but very powerful in many other ways – in two questions he determined to his satisfaction two things – firstly did I understand the business and what I was supposed to be auditing and secondly would I lie and make up an answer to a question I was most unlikely to know the answer to – and by passing those two tests he concluded he could trust me and therefore no need to probe further.

I don't think this would work today in a much more compliance and documentation driven world, but the essence of what he sought to achieve – that was bringing into his team people he trusted and on whom he could rely to tell him the truth, has stayed with me vividly some 30 years later as a great example of the need of every successful leader to attract good people around him, by giving them responsibility and demonstrating they are trusted. And if people earn trust my experience is they live up to what is expected of them.

This is not the same as light touch regulation – in my view it is far more onerous to live up to other people's expectations of behaviour than demonstrate compliance with a checklist of rules.

So I would encourage the regulatory and public policy bodies to think more deeply about how they can get to understand and if necessary shape the character and culture of the organisations critical to the financial system. It is the aggregate of behaviour evidenced within the system and in particular how it has changed that will change society's perception of banks rather than thousands of pages of worthy new regulations designed to work in theory.

So rather than obsess about whether organisation can break down exposures by the hour, by product, by customer, by industry classification, by business line, by country, by region - care more about tone from the top, how individuals are screened for behavioural characteristics when recruited or promoted, how ethics and values are taught and reinforced, how values are enforced and rewarded and how an organisation looks for and adapts to changing expectations within the communities it serves.

This is why HSBC is - independent of all regulatory requirements - refreshing and reinforcing 'Values' training for all our staff around the themes of 'leading with courageous integrity' and being 'Dependable, Open and Connected' in our actions.

The core of the programme is summed up as follows:

'HSBC has a long, proud history of doing the right thing: by our people, our customers and our shareholders. With unprecedented levels of scrutiny within our industry, standing firm for what is right – regardless of pressure to act differently – is more important than ever. Our values and principles provide a framework to help us make the right commercial decisions and mitigate the risk of doing the wrong thing, in order to drive long-term, sustainable gains for our organisation.'

In other words those within our industry need to embrace the essence of what the Scottish Institute has always stood for, what Aileen Beattie personified, what the rigour of a professional training seeks to deliver – independence of thought, character, judgment, accountability, responsibility, a duty that goes beyond one's own self-interest or the narrow interest of one's employer to one's underlying principles and integrity. Simply put to demonstrate the values and integrity of a profession.

Thank you for listening.