

The City UK Debate 2012

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The City UK Debate
London, 12 June 2012

Ladies and gentlemen

I have but ten minutes to speak to the opportunities and challenges around the future of the European economy so let me waste no time.

Some of the key factors we all understand better now are the interdependencies and co-dependencies between sovereign nations and their financial systems, particularly in Europe. So my remarks will concentrate on the necessary underpinning of the financial system to support European economies.

It is clear the challenges we are facing today 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.

So it is incumbent upon all of us in the financial industry to support and work constructively with those who have the responsibility to make judgments today on how to move on from within some of the most challenging financial and economic conditions since the 1930s – this time in a demographically ageing world – and one which is exhibiting lower than expected growth rates.

We all understand the 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.

The challenge is to restore confidence – 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.

In light of this backdrop, the importance of the world's policymakers coming together and evidencing their

commitment to take decisive and coordinated action to address the sovereign debt challenges, to bolster economic growth, and to promote balanced and supportive financial regulation as part of restoring confidence is clear. And there are some recent positives – the publication of the EU's crisis resolution framework, the recapitalisation proposals for troubled Spanish banks – and - as we look towards the future, recent thoughts around a banking union and a common bank deposit insurance scheme are all positive initiatives worthy of further urgent consideration.

As we rebuild the regulatory system we need to be wary of two traps – firstly we should also be wary of using 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. Secondly we have to avoid being over-prescriptive as we cannot foresee every possible scenario.

These traps are seductive, pandering to the basic human desire for there to be meaning in life, for there to be some kind of order to show that fate is not capricious – ie - 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 would make this observation about the eurozone today. If only it were as simple as moving a toggle switch between 'Austerity' and 'Growth'.

And there are many such conflicts challenging the restoration of growth:

We want stability as well as growth, we promote economic growth as well as fiscal austerity;

We want banks to lend more and also grow capital both in absolute and ratio terms;

We want the banking system to have access to private capital at the same time as we debate the future shape and capitalization of its activities and restrain dividends;

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;

We want to see fewer interdependencies without losing the benefits of scale;

We continue to incent the banking system to lend ever more to governments and then agonise what happens if the same governments don't/can't pay;

We want the system to respect market signals but then we don't like what ratings agencies say;

We want greater transparency but fret about how immediately markets react to events not yet able to be responded to a policy level;

And finally, while we have made great strides in defining what we don't want the system to do we have made less progress in determining what we want the system to look like when we are finished. And we continue to pose important questions which underpin many of the challenges in getting the financial system back to business as usual.

For example; 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, is there too much focus on products, platforms, infrastructure, capital and liquidity because they can be defined and measured as opposed to focussing on behaviour which is much more difficult to pin down objectively?

So, in closing, let me to turn briefly to offer some thoughts on the subject of financial regulation and make three points on coordination, on deleveraging and on resolution based on current conditions.

Firstly, the current uncertainty over the eurozone is leading to risk management and regulatory actions that are leading to 'home bias' and concerted reductions in cross border financing. To a large extent banking systems are becoming more national, less global. The result is rising fragmentation and balkanisation of the global financial system.

Secondly, in a world of reduced returns, heightened uncertainty and most banks trading in Europe well below book value, equity capital raising in the private markets is infeasible for all but a few; this is prompting substantial deleveraging across the banking system, inconsistent with restoring growth.

Thirdly, one of the most important lessons of the financial crisis was that banks must be able to take risks, must be able to fail, and therefore must be capable of being resolved upon failure – via an orderly, internationally co-ordinated process to resolve their insolvency or illiquidity without creating destabilizing systemic shocks or requiring public intervention to facilitate this. Delivering this remains a key challenge for both the industry and policy makers

To end on a more positive note we ought not to forget that in a time of uncertainty the financial system has a key role to play in providing finance and risk management services and in building on changes in global trade and investment flows of which today the obvious opportunity is the growing internationalization of the RMB.

So in closing, looking at both the opportunities and the challenges prompts a reflection that this is perhaps an opportune moment to reflect whether there should be a pause in adding further to the aggregate of regulatory reform already in place and in train.

Maybe it is even timely to review the procyclicality of many of the current requirements and determine if this remains appropriate in the current environment.

Monetary policy has delivered an incredibly favourable cost structure for investment which ought to be stimulating activity – the question for our industry and its policy makers is how do we restore the confidence necessary to reduce the enormous premium demanded today between the risk free rate and return demanded by equity markets? If we can do that the firepower available to restore growth is I believe immense.