Institute of International Finance

Speech by Douglas Flint
Group Chairman, HSBC Holdings plc

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Good evening.

Can I start by saying how fascinating it has been to listen to today's proceedings – the challenges described are those faced the whole world over so it is good that many minds are addressing the solutions.

I thought I would use this opportunity to offer some broad reflections on how the global financial system is being reshaped partly by regulatory reform and partly by changing economic conditions.

The Chinese character for danger is also the character for opportunity which is a reminder that every crisis provides a catalyst for reflection, for learning, for changing direction and for stress testing human character. The key point is 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.

We should 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.

It's tempting of course make such a claim - 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.

Let's start by reflecting 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

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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, political and societal scrutiny with all sorts of conflicts and vested interests to consider

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 the following were accepted as 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
- 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.

It is also instructive to reflect on what else we have learned from the crisis: let me take just a few:

- We learned there is no such thing as a risk free asset
- We learned that risk models are not great predictors of the future
- We learned that economies where investors hold most of the domestic assets are more resilient
- We learned that the multiple trading platforms and greater use of technology that we wanted to improve competition also made markets more correlated
- We admired interconnectedness when it facilitated the risk sharing that reduced the probability of a systemic crisis; we loathed the same interconnectedness when it spread

the crisis which 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 taxpayers. So economies dependent on cross border financing are inherently risky

- We promoted growth in trade, we delighted in the disinflationary benefits from accessing lower cost goods but we still can't get to grips with growing and persistent current account imbalances

- The greater transparency we sought facilitated the high speed trading that accounts for 75% plus of trading across markets today – accentuating trends ahead of possible policy responses

- We wanted people to reduce their indebtedness but not stop spending

And so on.

Many question why these facts were not appreciated at the time.

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.

As the debate continues as to what needs to be done everyone can support their argument by selectively pointing to events that fit easily to their view of the world. So for some it's all about so called 'casino banking', some point to industry structure and promote separation of certain activities, for others its all about compensation, others point to exuberant monetary policies, asset bubbles, misguided housing policies and incentives - everyone agrees that management, governance and supervision were all defective but disagree on relativities, and so on.

There is also an element of justification of each position by exaggerating the downside –'ok we may have gone too far but far better to overestimate the risk than underestimate it' prompting the industry cry that '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 a once in a generation opportunity.

But as we reform we can see the many inconsistencies in the multiple policy objectives now mandated:

- we want stability as well as growth

- we demand economic growth at the same time 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 raise more private capital while restricting its activities and restraining 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 seek to stress test 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 respond to events not yet understood at a policy level
- and finally while we need the system to accept responsibility for optimising credit allocation, we want to explore criminalising bank failure

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 the 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 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 huge amount has already been delivered which will bring enormous benefits including better alignment of the financial system with economic growth objectives and a more sustainable allocation of credit to the real economy.

So as we move towards the end of 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.

And this is where the Institute on behalf of all of us raises the following challenges:

- Are there gaps in coverage? Shadow banking? All the way from money market funds to payment mechanisms such as M-Pesa.
- 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 versus Africa and so on? 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?
- 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 focussing on behaviour which is much more difficult to pin down objectively

One has to understand 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?

But - if it were possible to get to grips with management intentions character and behaviour surely there would be greater opportunities to co-operate? If it were possible to prove lessons have been learned would we still need to prescribe actions to constrain a tendency to get off the reservation?

The essential point here is to recognise that banking, indeed all of financial services 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 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.

I truly believe we deceive ourselves if we believe that it is possible to 'engineer' a system that eliminates failure and unintended consequences.

But if we are ever to place more reliance 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.

So part of our collective mission is to 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 more than anything else.

So we need to seek to refocus examination of our industry to 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.

If we can do that it will demonstrate we have re-established trust and created the public-private partnership essential to sustainable economic development which is the goal we all share.

Thank you for listening.