

## Restoring Governance and Trust

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We are almost two years into a financial and economic crisis which is still far from over. We cannot even say that we are past the worst or that the way out of the woods is clear. I am not going to dwell on its causes. We all know that these are complex; be they global macroeconomic imbalances; loose credit conditions; dangerous over-trading in parts of the financial sector; over-clever risk management; pro-cyclical capital regimes and accounting standards; and compensation structures which have all too often been greedy and short-termist.

The result of all this is not only the worst recession for 70 years, but a massive breakdown of trust: trust in the financial system, trust within the financial system; trust in bankers, trust in business, trust in politicians, trust in the whole process of globalisation even. All have been severely damaged, in rich and in poor countries alike.

So there is no question more important for us today than how do we go about restoring that trust? It's a question for all the actors in this drama. There are questions about the way forward for the supervisory regime, of course. There are vitally important issues about the sustainable structure of an industry which is so critical to the overall economic health and stability of an economy, that failures within it are a matter of national interest. There are issues about how supervisors should regulate and control risk within institutions to limit the danger to the public purse. There are also issues about the architecture and the co-ordination of supervision itself – at national level, at the EU level, and at the global level in response to the G20 demand for a new international order to cope with the challenges of globalised markets.

I am not going to dwell on these issues, other than to underline the importance of evolving an approach which confirms London's reputation as

the leading international financial centre because that is something very important to the UK.

There are questions too for the accounting profession. There is a real debate to be had about some highly complex issues – about the effect of mark-to-market accounting when there is a total breakdown of market liquidity, for example; and about such important technical matters as whether there should be an available-for-sale category of accounting alongside mark-to-market and accrual accounting.

Other issues are not complex. Some aspects of IFRS can only be described as bizarre – the requirement to take movements in the fair value of your own debt through the profit and loss account is my favourite example, though not the only one.

Again, I am not going to dwell on these issues. I would only make the plea for a process of deliberation, which seems cumbersome even for straightforward questions, to be speeded up. Sometimes it seems as if

the undoubtedly important convergence agenda of the IASB and the FASB is getting in the way of straightening out obvious – and in some cases dangerous – nonsenses.

But what I want to focus on today are not the things which are the responsibility of other institutions and domains but the areas where the banks themselves must be at the forefront of the campaign to rebuild public trust.

In the public mind, banks have been at the epicentre of a storm of rage, of which the BBA sometimes bears the brunt. The public standing of bankers is now at one of its lowest levels for decades. The perception that some have taken pay and bonuses in vast multiples of the remuneration of ordinary hard-working and socially valuable people – for indulging in an alchemy which has blown up in their faces and required huge bailouts at prodigious cost to the taxpayer – has ignited fury around the world.

**how do we  
restore trust?**

And then, as economies turn down, businesses fail, unemployment rises, and banks – including those that have been rescued by those same bailouts – are seen to be tugging the rug from under people’s livelihoods, causing pain and further anger. Even if the truth is more complex than the headlines, re-establishing confidence in and respect for the banking sector will be a journey up a steep mountain. That journey has to be undertaken. In virtually any human endeavour – and certainly in the financial services which are the bloodstream of any modern economy, trust is essential. Trust has three core components and I will reflect on each of them this morning:

- first, relationships, because the outcomes of relationships affect human beings and require human beings to deal with each other;
- second, confidence, because it is confidence which enables us to risk entering into relationships; and
- third, values, because they are essential to making those relationships constructive and sustainable.

Rebuilding trust is partly a matter of effective rules and guidance – and those are now quite properly under review in the public domain. So far as external oversight is concerned, I for one warmly welcome the Turner Review, and believe it has played a key role in shaping the debate about the way forward in effective regulatory oversight. I also look forward to the report by David Walker on internal oversight – Board governance of banks – due on July 16, because I am confident it will also help take forward the rebuilding of trust.

But we would all agree, I think, that the rules and guidelines can never be more than a necessary condition. They cannot in themselves be sufficient. True governance is always about more than just following the rules. Indeed, we have in recent years seen far too much of the attitude which says, in effect, “if there’s a market, if it’s legal and if I have a contract, then I don’t need to ask any further questions.”

Yet unless we think more widely about our responsibilities, we will not have sustainable business models and indeed we risk losing sight of the very *raison d’être* of banking. This has, indeed, been too much in evidence in recent years and the effect on public trust has been devastating.

Let’s be clear what the *raison d’être* of banking is: it is to provide financial services on a sustainably profitable basis to our customers.

All parts of that sentence are important, but first those all-important customer relationships. Financial services does not just mean loans and deposits. In this age of markets which are interconnected across both geography and products, it is a fantasy to believe that “narrow banking” is the way to predictability and stability.

Customers need a wide, and indeed increasingly wide, range of services. To force them to go to different types of institution for different services – according to some resurrected Glass-Steagall model if you will – would be totally unrealistic, as anyone will appreciate who thinks through the detail of what it would mean in the era of derivatives.

It is unrealistic to believe that the industry can be reconstituted and reconstructed such that individual institutions are not too big to fail. Quite small and simple banks are too big to fail in the strict sense – as the pervasive presence of course deposit insurance reminds us. And the Northern Rock debacle clearly demonstrated the need for Special Resolution Regimes to deal with failing banks. You can’t just put them into receivership. The notion that the failure of a bank can be “contained” by the conventional legal and administrative processes for handling business failures is nonsense. And it would still be nonsense even if the institution was wholly involved in the wholesale markets, had no direct retail presence, and did not have the benefit of any deposit guarantees. This is precisely the lesson of the Lehman experience.

The fact is that financial institutions are systemically important in a way that other businesses are not, and we have to face that fact head on. There is no alternative to effective oversight by regulators and – as the central locus of accountability – by Boards.

To go back to my one-sentence definition of the *raison d’être* of banking, it is the job of Boards (and indeed their senior management) – it is the corporate and social responsibility of those Boards – to oversee the provision of financial services, not just on a profitable basis but on a *sustainably profitable* basis.

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And it is delivering on this, over time, that is the secret of rebuilding trust. Because it means focusing on long-term customer relationships, not just the next transaction. Because it implies ensuring responsibility in trading, ensuring that management tests the suitability and transparency of products that are sold or transactions undertaken, not just their profitability. Because it entails accepting that the risk in all parts of trading activities must be properly measured, controlled and truly proportional to the business capital at risk. Adair Turner is certainly right when he says that major changes are needed to trading book capital. While there is room for debate on the specifics, the need for a significant increase in the capital required for key parts of trading books is clear.

The next component of trust is confidence. Above all, none of us needs reminding of the way the subject of compensation lights the blue touch paper in the public mind. Nothing is more important for the rebuilding of public confidence than demonstrable, consistent and sustained evidence of greater responsibility by employers in regard to compensation. Perceived excesses were bad enough in earlier years of this decade when the economy as a whole was riding high and there was a widespread feel-good atmosphere. Things are very different now, with recession and rising unemployment. And when you read some of the things that have been seen of late – the eye-watering golden hellos in particular – frankly, your heart sinks.

There is an emerging regulatory consensus on what responsible compensation should look like. Appropriate deferrals, appropriate clawbacks, conditionally structured to align the individual's interest with the long-term interest of the shareholder (and therefore with the public interest too). And this should be welcomed by any responsible institution.

There is little appetite thus far to interfere with the market in setting quanta. And, so far, little sign of any focus on golden hellos. Generally, I believe that in a world of markets it is correct to focus on ensuring there is transparency and that there are no distortions, hence the need for deferrals and conditionality to allow for the risk that remains after a transaction is done. Beyond that, neither

institutions nor regulators can go against the grain of the market very far.

But none of us can be completely comfortable about where this all may lead. We should be prepared to argue steadfastly for bonuses as a legitimate element of compensation, against the voices that have sometimes questioned the ethics or efficacy of any bonuses. Yet Boards must be sensitive to the wider social context. Public trust depends on a responsible, measured attitude to compensation. No public company in this industry can afford to treat compensation as solely a matter between the employer and the employee. At present, I have to say that it is not clear that the seriousness of this issue is widely enough appreciated.

There are other challenges, of course, in rebuilding confidence too. In particular, in a time of great economic difficulty, there is a need to ensure that we remain able to respond appropriately to customer needs for finance. We need to accept as a matter of reality that many will feel – whether they are in business, in politics or in the media – that banks are not doing enough. We all know what the dilemmas and risks are in providing financial services in a recessionary environment. And we all know that the withdrawal of foreign participants from this market has indeed led to a significant shrinkage in credit supply, particularly in certain sectors.

This isn't the occasion, I think, to get into detailed analysis of patterns of credit in the UK economy in order to determine the relative weight of supply and demand effects – plainly both of them are in evidence. I just want to make three observations on this topic:

- Firstly, one of the positive outcomes from the crisis has been a much more serious, constructive and fact-based dialogue on the flow of credit between the industry and the authorities than was ever the case before. I sincerely hope this will continue after this recession is over, since it is part of what is required for the long-term health and balance of the economy.
- Secondly, sound economics in the provision of financial services are in the interests of sustainable profitability and are therefore in the

**focusing on long-term customer relationships**

public interest. This in turn depends on transparency, proper capital ratios and tough-minded independent risk management.

- And thirdly, as an industry we need to communicate as openly as possible about the true cost of finance, and explain why we take the actions we do. We need to look our customers in the eye and explain clearly and transparently why the economy needs sound economics in finance.

We need to explain why a return to the excesses and false economics of two years ago or more is unsustainable – unsustainable both for customers and for the banks. And we need to explain that, if sense and economics are allowed to prevail, we can avoid in the future the extreme fluctuations in risk appetite and lending capacity that we have witnessed in recent years. It also, of course, means eliminating various structured and complex products that had no real economic value.

And how do boards ensure that this is all delivered, and confidence restored? Not, of course, by micro-managing their companies. Their role in governance is oversight. Oversight which takes the long-term view, which seeks sustainable profitability. Oversight which, therefore, takes clear account of the public interest and which is closely aligned in so many ways with the regulatory oversight task.

This means that any business which values its brand, and understands how the brand represents, or should represent, the essence of the company's self-understanding and *raison d'être*, has to be able to ask, and give a satisfactory answer to, the question: how does the business we do contribute to the common good? Boards and senior management need to be able to answer this question themselves and explain the answer convincingly to their own people. It is, if you will, a question of understanding and sharing common values. It is not just a matter for strap lines and sales manuals: it should be a central task of training and development programmes to help employees understand how their roles make this contribution.

For the record, I believe that, whilst banking has had much to answer for in recent years, it is an activity which is essential to sustainable economic development, in rich countries and in poor. Strong, efficient, well-supervised banks – with a drive to innovate and to provide suitable, profitable

services, and staffed by people with integrity and commitment – are a *sine qua non* of effective market economies and modern social development, the relief of poverty, and indeed our future as a low-carbon economy.

Nurturing a company's ethics and values can never be an exact science of course, but it is one of the most important tasks for any Board as part of its duties of good governance. Indeed, it should be the subject of explicit and regular Board discussion, at any major company actually, not just banks. How the corporate culture has evolved; how it is contributing to shareholder value; how it can be nurtured for the good of future generations. There is no more seriously important topic of conversation within a Board.

Of course, values are not something which can be prescribed by edict from the centre. They have to run much deeper than that, and are bound up in the DNA of any organisation. But what management can and must do is to ensure that they are articulated and understood throughout the organisation, and that they are supported by policies and standards that encourage the appropriate thinking and the appropriate behaviour that we aspire to, but that our industry has in so many ways failed to deliver recently.

In summary, ladies and gentlemen, restoring trust requires persistence and hard work. The standing of the banking industry is at a very low level, and despite some recent improvements in the economic environment, we are a long way short of an upturn and a return to normal growth. Full and constructive debate on the future of the regulatory landscape must and will continue, and we can and should and must play our part in that discussion. But in the end, much of the responsibility to restore trust rests on each of us, as organisations and as individuals. We must lead change from within. Doing that successfully demands moving beyond the rulebook, for true governance is about much more than following the rules. It means investing in long-term relationships, it requires working with all our stakeholders to restore confidence, and of course it means living and breathing the values.

In conclusion, restoring trust means getting back to the *raison d'être* of banking. Thank you.

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common good**