

Good Value in Banking

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Good morning ladies and gentlemen. I'd like to thank the conference organisers for their kind invitation to participate in this conference. For me, it is always a great pleasure to be in Germany.

I hardly need to say that the financial industry, and the world economy, have come through a major crisis. A year ago, America's mortgage agencies had just been bailed out by the government; its largest insurer was about to follow suit. Then came the cataclysmic event – the demise of Lehman Brothers, a year ago next weekend.

The world's financial system had already been weakened by a year of ever-increasing instability and distrust. When Lehman's failed, we truly looked into the abyss.

Trust in banks by the public, and between banks themselves, evaporated completely. A savage credit squeeze took hold. And economies worldwide went into freefall. In a matter of months, the world economy exchanged growth for recession, and people across the world faced financial hardship from falling asset prices, a squeeze on credit, and rising unemployment.

Today, we are probably past the worst of the crisis, thanks to the unprecedented interventions by governments worldwide, both to support the financial system and to stimulate economic growth. The financial system has stabilised, and some countries are beginning to show signs of recovery – not least Europe's two largest economies, here in Germany, and in France.

Although I don't believe we are out of the woods yet, these are encouraging signs. And with the immediate crisis behind us, but still fresh in our minds, now is a good time to take stock of what has happened and what it might mean for the future.

The crisis has been a major setback for banks, and for market capitalism as a whole.

The public views our industry, understandably, even if somewhat simplistically, as architects of the

worst synchronised economic downturn since the Great Depression. While the taxpayer has been forced to step in to rescue ailing banks, credit has become much harder to obtain, exacerbating the already severe economic climate.

Moreover, the rapid return of remuneration and bonuses for bankers that are many times the compensation of the average worker is, quite understandably, further fuelling public anger. It calls to mind the words of Brecht: "*What is robbing a bank compared with founding a bank?*"¹ With the public standing of bankers at one of its lowest levels for decades, it is no wonder that the public is asking, is there good value in banking?

It's not only the reputation of banks and bankers that has suffered in the last two years. The breadth and depth of the crisis have called into question the market system itself, or, as some have characterised it, the 'Casino capitalism' of the last two decades.

At a time when ordinary people are suffering extraordinarily from the destructive excess of the last few years, it is not surprising that markets generally, and banks specifically, are in the dock. What is their contribution to the common good?

For at their worst, it is plain that markets are unjust, abusive, destructive and crisis-prone – a glance through the history of world finance could be told as a succession of crises: from the Italian bank failures of the 14th century; to the Dutch tulip mania of the 17th century; to the dot com bubble at the turn of the millennium; to the present global crisis – to name but a few. And it is also clear that the belief that markets are inherently self-stabilising has been dealt a fatal blow.

The so-called Washington consensus – with its theoretical underpinning in the "efficient market hypothesis" – will not survive the present crisis.

Yet at its best, the market is a highly efficient allocator of capital, and has been the catalyst for

**banks and
markets
in the dock**

¹ *The Threepenny Opera*, 1928

the fastest growth in human prosperity and development ever known. Capitalism is not so much an ideology, but the default mode of human social and commercial interaction. Or, in the words of Adam Smith, the natural result of man's "*propensity to truck, barter, and exchange one thing for another*". Churchill famously defended democracy as "*the worst form of government – except for all those other forms that have been tried from time to time*". This applies equally to well to the market, which is the worst engine of economic and social development – except for all those others that have been tried from time to time. That is the harsh lesson of the 20th century, after all.

Banks are an intrinsic part of this flawed but powerful market system. They are the market economy's "*bloodstream, taking resources from people who do not need them or cannot use them and supplying them to people who do need ... and can use them*".²

At their best, financial markets are at the heart of every successful economy, lubricating the engine of economic growth and prosperity. In the midst of the crisis, it is too easy to forget the real contribution our industry can make.

At our best, what we do allows businesses to supply products and services that customers need; allows individuals to own homes and cars; to save for a rainy day and for retirement; and to protect themselves and their businesses against the unpredictable. If we care about human freedom and human well-being, we cannot do without these functions.

But at their worst, financial markets can be engines of destructive excess. In recent years, banks have chased short term profits by introducing complex products of no real use to humanity. It is clear that very many innovations introduced by the financial markets have been socially useful, and indeed are critical to economic and social development – to our prosperity, in short.

But it is equally clear that some parts of our industry had become overblown, and that certain products and services failed the tests of usefulness, suitability and transparency.

² Martin Wolf, *Why Globalization Works*

If we are to regain the position of trust and confidence that is a fundamentally important mark of social and economic health, the financial industry will need to learn the lessons of a crisis that has shocked and frightened the world.

The lessons are many and varied, and not every factor exacerbating the crisis was within the control of banks. Global imbalances, low interest rates, and loose monetary policy all contributed to the build up of loose credit and asset bubbles. But our industry played its part too – in some cases with foolhardy enthusiasm.

The catalogue of errors is long. It includes the appetite for higher leverage... the creation of products whose complexity outstripped their usefulness ... the over-reliance on wholesale funding ... over-confidence in risk modelling techniques... and, sadly ... the misalignment of incentives, especially in the question of compensation.

There is a common underlying theme here. All these errors have their origin in a greedy focus on the short-term – the maximisation of short-term returns without any concern for the sustainability of these practices over the long-term.

Good value in banking will only return when banks have relearned the lessons of sustainability in all their business practices. Let me elaborate.

In recent years, 'corporate sustainability' has begun to replace the term 'corporate social responsibility' in the business lexicon. Both expressions are a reminder of the broader responsibilities that businesses need to accept. But it is also true that there has been a tendency to compartmentalise so-called CSR activities as an adjunct to the mainstream business – charitable donations and community involvement are often the principle functions of the CSR department.

Valuable though these activities unquestionably are, there is an overriding need to extend the understanding of corporate sustainability to include responsibility for building the business as a whole in a way which enhances the common good. Corporate sustainability is not an adjunct to the company's business, it is about the *raison d'être* of the company itself.

You will all be familiar with the long-running debate about the relative merits of the Anglo-Saxon and continental European styles of

**financial markets
essential to growth
and prosperity**

capitalism, with the former supposedly ruthless in pursuit of shareholder value, and the latter more plural in its aims, serving a range of stakeholders, including shareholders, employees and the local community. The suggestion is that, under the Anglo-Saxon model, the pursuit of shareholder value maximization is incompatible with a broader, socially valuable role.

My own view is that the economically important job of maximising shareholder value only conflicts with the common good when it is interpreted with a short-term focus.

But it is not, and never should have been, part of the responsibility of company Boards to focus on the short term. There is no question but that the markets – in the form of investors and traders – have often put pressure on Boards and managements to pursue short-term strategies and profits. The results of that pressure are now plain to see in the broken businesses and weakened economies around the world. This was the basic failure of corporate governance.

We must reject that short term approach to value maximisation, and get back to the real task of sustainable value maximisation.

As I see it, this has four key components.

First, there is of course the direct and basic responsibility to earn as good a return as is sustainably possible on the capital entrusted to the company by its shareholders. No broader understanding of business responsibility can be an excuse for fuzzy and unrealistic strategic objectives, poor competitive positioning or operational inefficiency. Shareholder-value creation is the hallmark of business well done.

This is not a new concept. As the renowned management writer, Peter Drucker, observed: *"Profit is not the explanation, cause or rationale of business behaviour and business decisions, but rather the test of their validity."*

And business well done inevitably means that businesses need to nurture their customer relationships and provide a consistent, high quality service. And as consumer consciousness of the wider impact of a business on the social and ecological environment is growing, good customer relationships increasingly depend on their perceptions of the contribution your business

makes to society and to the environment as a whole.

A third element of value maximisation is the way a business engages its own employees. I have argued, since long before the crisis, and with renewed vigour since, that the vast majority of my colleagues want to be seen to be making a contribution to society through the work they do and the business they are in. This inevitably leads you back into the territory of social responsibility and community engagement.

By setting the company on a course that contributes to social and economic development, and by providing opportunities to really get involved in community programmes, you can achieve a real sense of engagement among your colleagues. I met a colleague recently at a business processing centre in Hyderabad, in India, who had recently returned from a two-week project on Lake Baikal in Russia. He had been helping the charity Earthwatch, through an HSBC partnership, catalogue the fauna and flora of the world's largest fresh water lake. His enthusiasm was infectious, exhilarating and energising – for me personally, and for his colleagues.

Thus, the fourth element of sustainable value maximisation is the way in which a business engages with the communities in which it operates, which, as I have said, motivates customers and colleagues alike.

In short, businesses must ask, and be able to answer, the question: 'how do we contribute to the common good?' Not enough thought has been given to this question over the last decade or so. But now, the economic crisis has created a new imperative: Boards and senior management must answer this question; they must help employees understand how they participate in the contribution the company makes overall. Our colleagues should be able to look at themselves in the mirror each morning and feel confident that what they do at work contributes to the common good.

These four elements, in my view, feed into the question of sustainability and are mutually reinforcing. Good customer relationships and engaged employees are essential to profit growth. Community commitment nurtures customer relationships and people development. Sustainable profits underpin investment in people and

**maximising
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community. Sustainable profits and corporate social responsibility are not simply not in conflict, they are in fact interdependent.

It is clear then, that capitalism generally, and banking specifically, needs to reaffirm its commitment to contributing to social and economic development.

And while I certainly believe that the financial services industry has much to answer for in the last few years, I am also convinced that it is an activity that is essential to sustainable economic development. Our economies need strong, efficient, well-supervised banks with a drive to innovate. Banks that provide suitable, profitable services, staffed by people with integrity and commitment, are a *sine qua non* of effective market economies and modern social development. We have a significant contribution to make to a more prosperous future.

But first we must work hard to restore the trust and confidence that have been the casualties of the crisis, and that are so vitally important to our industry. It is worth remembering that the word for credit derives from the Latin word *credere*, meaning 'to believe'.

And to restore trust and confidence, we will need to recognise the moral dimension of what has happened, and to restore a proper sense of values in our corporate lives.

It is as if we have grown increasingly to accept the idea that the value of what we do is fully delineated by the market, by regulatory compliance and the law of contract. If the market will bear it, if the law allows it, if there is a contract, then no other test of rightness need apply.

Yet we do not live our private lives this way, and it is surely no more acceptable in business.

There will, of course, be enhanced regulation, better risk management, clearer codification of directors' responsibilities in law. And all of these things have been sadly proved necessary. But regulation and legislation is not and cannot be sufficient without a culture of values in our industry – and in capitalism as a whole.

Nowhere is this more true than in the question of pay and bonuses, which has been such an emotive subject throughout the crisis, and where it has been clear that incentives have focused far too heavily on the short-term at the expense of the long-term interests of the company and its owners. The market has been distorted: it has lacked transparency; there have been obvious excesses.

As we look ahead to a more stable – and I hope sustainable – future, we must not waste the opportunity this crisis presents us with.

That opportunity is not only to refine the rules, but to review the values of the market system to ensure they better serve social and economic development. To reassess the contribution of our companies, and ourselves as individuals. To reestablish our industry as a major contributor to human prosperity and development. And to ensure there is, truly, 'Good value in banking'.

And if this crisis leads to a genuine reassessment of the role of business and banking in market economies, it may come to rank as one of the great turning points in history of the modern world.

restoring trust and confidence