Interview with David Hodgkinson, group chief operating officer for HSBC

FST interviewed David at the Sibos 2008 show in Vienna about risk management practices, the financial turmoil affecting the industry and what he sees as the potential consequences moving forward. Selected excerpts follow:

Q. How long have you been in the industry? How does the present crisis compare to previous downturns you've been through?

A: I've been in the industry for just under 40 years. I've spent a lot of that time in Asia, where I've seen some big property crashes and the impact it can have – seen it in Honk Kong and in Singapore in the mid-80s. Of course I also saw the 1987 market crash; I was responsible for our securities business in Singapore at the time, when the equity markets tumbled 40 per cent in two days. I remember at the end of the Tuesday evening, after 14 hours in the office, thinking 'well, if it carries on like this, by the end of the week everything in the world is going to worth absolutely nothing'. But, as it was, the market bounced back; it was very scary, but educational. I see this present situation as broader and more complex and it goes right to the heart of the FS industry. This is in a way bigger and it is now beginning to affect the wider economy and the behaviour of businesses.

The investment banking industry is going to have to slim down and, of course, those that are in the mortgage industry in a big way are going to suffer as well because we're seeing asset values decline. Those that have relied on wholesale funding in particular, rather then retail customer deposits, will suffer [for example, Northern Rock]. Many have stretched the envelope in recent years, and that's got to stop.

Q. The global nature of this crisis has been very interesting and the fact that regulators have not followed the supra-national trend perhaps highlights a weakness in the system?

A: Well, Basel II is clearly a global initiative and it has the intention of catching up with the innovations and developments in our industry over the last few years. It's one thing to have the framework though; you also need specific standards as well, otherwise people will arbitrage one against the other. The other thing regulators need to do at the moment is ensure any interventions they make are well co-ordinated – what they do in one market may well have an impact on another, so they need to watch this. The impressively co-ordinated international moves to put liquidity into the markets have been welcome.

Q. Are improved capital adequacy rules needed to ensure more money is stored away during the good times – a Basel III in effect?

A: Clearly, in the light of recent experiences, some changes will need to be made, but perhaps more of a Basel 2.5 is required. In all honesty though, many changes need to be made post-crunch. The role of ratings agencies needs re-examination, for instance. The reliance on quantitative models has also been shown to be faulty; you need a broader understanding than simply modelling something.

The next area to address is transparency. Markets have seized up because people are not confident in counterparty risk. I'd refer you to the Counterparty Risk Management Policy Group (CRMPG), which is lead by Mr Gerald Corrigan, ex-MD of Goldman Sachs, and HSBC's own group finance director, Douglas Flint, which produced a report in August entitled *Containing Systemic Risk: The Road to Reform*, often called CRMPGIII as the first report came out in 1999 and this is the latest, which contains a number of recommendations about how to deal with the systemic risk that's out there (see the link for more info: http://www. crmpolicygroup.org/docs/CRMPG-III.pdf).The CRMPGIII report sets out how to mitigate some of the risks we're facing.

Regulators clearly need to take a lead [in cleaning up this mess] – for example, the settlement of previously over-the-counter (OTC) incidents, such as credit default swaps (CDSs), needs a centralised clearing mechanism that people can rely on and that needs institutional guidance from countries; we can't just rely on two or three of the major players getting together and doing it. The figure that's widely quoted is that there is $62 trillion worth of gross, face-value, CDSs out there. Even if just five per cent of that position is net in the current straightened environment, then that's a lot of money. People will wonder 'how am I'm going to get settled'?

Editor's Note: US regulators have since got together and signed a memo to guide the development of such a central counterparty clearing arrangement for the CDS market. In a statement released in November the President's Working Group on Financial Markets, said this was its "top, near-term OTC derivatives priority". The Working Group, which is chaired by the Treasury and includes the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission, says it is reviewing proposals from several potential providers of counterparty services, such as NYSE-Euronext, Eurex, and CME. It anticipates that one or more CDS central counterparties will commence operations before the end of 2008. In Europe, the EC has set a year-end deadline for financial market participants to draw up a blueprint for the clearing of credit default swaps on this side of the Atlantic.

Q. What about the human element involved in creating systemic risks. Could more automated systems help here and restore calm to the markets?

A: Absolutely. We need to get to T+0 trading. There are markets where we've already got quite sophisticated settlement mechanisms in place, where you can even get intra-day settlement – in Saudi Arabia, for example, they have an equity market that is T+0. That has to be the ultimate objective for all markets, such as CDSs, and so on. That way, you won't have anybody failing with a whole load of outstanding trades, creating further destabilisation.

Q. How long do you think the post-crunch recovery process will take?

A: It's hard to tell how long it'll take. There will be a bottom though and things will bounce back; I don't think the world has ended. You need to look at the pre-requisites for a recovery. One is that asset prices have to reach a stage of some stability so that people believe that assets are worth buying again – I'm not just talking about property in the US either, but investments too. Secondly, these very complex leverage instruments, which have been the cause of so many problems, clearly have to be worked through. People will have to get back to a simpler securitisation world, where you know what you're getting and you know that it hasn't got toxic elements in it. Thirdly, the balance sheets of the major market players have to be repaired; they need to get to a sustainable position where their capital ratios are no longer under such strain.

Editor's Note: The recapitalisation plans announced after the Sibos show will at least help to address this latter point, very presciently made by David.

try to speed up its 50 per cent cost reduction programme for large scale users, first unveiled last year, so that it delivers ahead of schedule by the end of 2009, no doubt after recognising the potential for competition from possible rivals, such as PayPal.

An agreement with the global insurance standards organisation, ACORD, reinsurance companies Swiss Re and Munich Re, plus the reinsurance brokers Aon, Benfield and Willis, was also unveiled. SWIFT will partner with them to produce a central platform for electronic data transmission, eliminating paper-based processes and improving industry-wide efficiency. The pilot will launch in spring 09 and be under review for a year.

Away from the internal issues concerning SWIFT, the fast-changing payments landscape was also under discussion in Vienna, with many people interested to check up on the progress towards achieving a single euro payments area (SEPA), especially with the major Direct Debit aspect of the scheme due to launch in November next year. According to the fourth annual *World Payments Report* from RBS and the Capgemini consultancy, the transposition of the Payments Service Directive, which will outline the legal basis for SEPA in each participating European country, still needs a lot of work to ensure consistency. The report also concentrated on the growing cards market, with non-cash payment transactions set to reach 233 billion in 2006. More growth and revenue is available as China increasingly adopts cards, while contactless card adoption rates will rise in developed countries.

Another hot topic was the changing clearing and settlement landscape in Europe post-MiFID, under transformational pressures such as the EU's Code of Conduct, vertical integration models, T2S, and Euroclear's Single Platform and CCI drives. Everything was overshadowed by the banking crisis facing the industry during the Sibos week however, with much speculation as to what financial institution would be affected next. It was certainly one of the more momentous gatherings of the industry's financial and technological professionals and not one to be forgotten in a hurry. Little did delegates know, of course, that the waltz was only just beginning and the music would only build to a crescendo in October when financial meltdown was only narrowly avoided after mammoth government bail-out schemes and recapitalisation plans were unveiled around the world.

Bank announcements

As ever at Sibos, there were a number of bank and technology announcements. *FST* provides an overview of some of them here:

From the banks, **Citi** announced an agreement with Banque Atlantique group, which has operations in seven West African countries, to act as its global payments partner, facilitating workers remittances into Africa with the QuikRemit service. India's Andhra Bank will white label the same customisable service to provide its customers with an easy remittance tool. Citi's Global Transaction Services department also unveiled a new mandate from Erste Group. The Vienna-based bank, which serves more than 16 million clients in central and eastern Europe, signed up to the bank's Citi Execution to Custody service ensuring a single counterparty to execute, settle and provide custody in all its major execution markets worldwide, reducing the risks associated with dealing with multiple providers. The Bank of China (Hong Kong) Ltd also gave a contract to Citi at Sibos to act as its Continuous Linked Settlement (CLS) Nostro Agent for US dollars.

Royal Bank of Scotland unveiled that it is to handle the cash management business of BT Global Services' in North America, expanding the European service it already provides. The bank's Access Direct host-to-host channel will cater for liquidity management, domestic cash management, and handle electronic and paper-based payments and receipts. RBS also unveiled a SWIFT Service Bureau to deliver data to and from corporate clients, along with back-up, disaster recovery, systems maintenance, infrastructure upgrades and support services. In addition, it signed an agreement with **VocaLink** at the show to provide a liquidity bridge from VocaLink's Euro Clearing & Settlement Mechanism to the EBA's STEP2, creating interoperability across its payments operation and extending its SEPA reach across the EU. The troubled **Dexia Belgium** bank also signed an agreement with VocaLink to join its EuroCSM to support the payments processing needs of its customers.

ING Investment Management is using Microsoft's BizTalk Server 2006 to enable SWIFT connectivity into the **Bank of New York Mellon**, the settlement counterparty ING has appointed to look after its back-office operations. The project will go live by the end of the year. **JP Morgan Treasury Services**, a provider of trade finance, cash management and treasury solutions, announced that it is to invest more than $1 billion into its technology offering, establishing a global client platform, as it expands its geographic footprint around the world.

The Central Bank of Bahrain granted a license to **Credit Suisse** at Sibos to open a branch in the kingdom. Authorised as an investment business firm (category 2), Credit Suisse Bahrain will provide high-net worth individuals in the region with a full range of investment and private banking products and services.

• For more technology announcements please see our website – www.fstech.co.uk.