Anselmo L S Teng: Risk and compensation management

Opening remarks by Mr Anselmo L S Teng, Chairman of the Monetary Authority of Macao, at the Macau Management Association (MMA) 2008 Annual Management Conference, Macao, 14 June 2008.

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Council Chairman Lau
Distinguished Guests
Dear Delegates
Ladies and Gentlemen,

Good morning!

1. I am honoured to be invited by the Macau Management Association to make an opening remark in this conference, the theme of which, "Navigating Complex Changes through Corporate Strategies", is most timely and relevant, especially when organizations, big and small, are facing a lot of threats and challenges, both internal and external, under a globalised environment nowadays.

   As you are aware, the business definition for corporate strategy is the direction an organization takes with the objective of achieving business success in the long term. I'll use the sub-prime fallout as an example to illustrate two important aspects within corporate strategies, i.e. risk related aspects and human resources related aspects.

2. The turbulence of the international financial markets caused by the subprime fallout will probably linger for another 1-2 years. The rescue actions adopted by central banks of the developed economies have prevented a major financial calamity from happening but the impact on global economy and financial markets will remain for quite a while.

   There is no exact figure for overall subprime losses. The estimates made by financial experts and international institutions range from USD400 billion to USD1 trillion. The losses will be borne by financial institutions and individual investors. The investors who have suffered losses will inevitably cut back investment and perhaps consumption. The losses incurred by financial institutions of the developed economies however have inflicted more serious repercussions. The immediate effect is the overall shrinkage in liquidity in the international financial markets. The most devastating impact is the reduction in lending capacity of financial institutions as the write-off and provision of delinquent loans and/or investments directly eat into the shareholders' fund of a financial institution.

3. After the subprime crisis, financial experts around the world have started to find out the reasons why it happened and proposed ways to prevent similar mistake from happening again. There are a lot of findings but they all boil down to a big topic – "risk management". In the past few years, financial and technological innovations have given rise to a number of subprime related products coming from financial institutions. These included subprime loans, collateralized debt obligations (CDO), structured investment vehicles (SIV) and other exotic financial products. As a matter of fact, a large number of risk management tools such as risk management models, ratings, credit default swaps (CDS) did emerge in the subprime cycle. But unfortunately fallout still occurred which in essence reflected inadequate risk management. Financial post mortem analysis has suggested that financial institutions who have suffered seriously from subprime fallout have failed to mitigate a number of risks, such as market risk, liquidity risk, concentration risk and counter party risk etc. That is to say, the corporate strategy in so far as risk mitigation is concerned was incomplete, untimely and was not commensurate with its business

profile and development. As financial institutions, or organizations with different business nature, offer more sophisticated products and services in order to achieve business success, there will be more associated risks in their on-going risk management framework. This is particularly true as they grow in size and complexity, and their ability to identify, define, measure, manage, and organize to manage their risks; and how to reflect all those elements as appropriate in the corporate strategy is of utmost importance.

4. Besides risk management, however, there is also one aspect which can apply to management of virtually all trades.

The human resources part of corporate strategies relates to the management coherent to an organization's most valued assets – the people working there who individually and collectively contribute to the achievement of the objectives of the business. The goal of human resources management strategy is to help an organization to meet strategic goal by attracting, and maintaining employees and also to manage them effectively. In practice, human resources management incorporates a vast number of issues which include, but not confined to, recruitment, workforce planning, orientation, skill, training and last, but not the least, compensation. We have to admit that compensation, amongst other motivating factors, is the most effective driving force behind a person's desire to perform in the workplace. There have been many papers written on the most appropriate compensation scheme. One of the many schools of thought is the performance related pay which is money paid to someone relating to how well he or she performs. Car salesmen, real estate agents, production line workers, for example, may be paid in this way, or through commission. This compensation scheme is based on the belief that money was the main incentive for increased productivity. This scheme cannot be applied universally as it has its own limitations although it has been widely adopted in a number of fields and proven to be successful. The tool however is a double edged knife and the financial sector has vindicated such a conviction.

5. One of the causes of the subprime bubble is the pay structure adopted by financial institutions in launching subprime products. During the subprime cycle, most financial institutions pursued a compensation scheme which gave incentives to all personnel involved in the subprime products to chase after high income through risky trading, launching risky products that generally provided higher rates of return. Bonus payments for successful and senior investment bankers, including those in the business holding subprime positions, were very substantial. Essentially, bonuses were measured against gross revenue after personnel costs, with no formal account taken of the quality or sustainability of those earnings. We have to admit that greed is part of our human nature. In the face of profit, quality of product and hence the revenue derived therefrom could be compromised. The phenomenon was common among institutions and staff involved in the subprime trade, from top management, originators, agents to traders.

6. All enterprises, not confined to financial institutions, should learn from this lesson that, to maintain the sustainable growth of an entity, all compensation schemes should in future adequately reflect performance in the medium and long term as well. As a matter of fact, the compensation schemes for staff involved in the subprime bubble all had a common feature in that there were enormous rewards for deals but there was also a failure to impose penalty symmetrically when losses occurred. To put it in a nutshell, a viable compensation scheme should be well structured and be geared to the long term corporate target and strategy rather than short term profit.

7. I hope my opening remarks on risk management and compensation management will kick off a series of discussions on management of other facets of business.

Experts and seasoned practitioners from different trades are going to share with us their views, experience and insights to resonate with today's theme "Navigating Complex Challenges through Corporate Strategies". I am sure the conclusions of this Conference will enable the attendees to formulate the correct corporate strategies to navigate through uncharted waters of the contemporary global economy.

Finally, please accept my best wishes for a huge success of this visionary conference.

Thank you.