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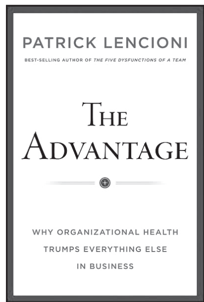

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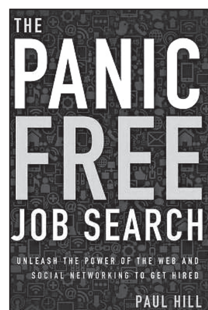

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Risk managers distracted by esoteric calculations

Wan Lixin
wanlixin@shanghaidaily.com

THE latest issue of the Century Weekly magazine carries an article about China Construction Bank's (CCB) ill-fated extension of huge loans to Zhongjiang Group, now bankrupt and being liquidated.

One senior bank source called this the biggest risk management scandal in the history of CCB.

According to the report, some local Zhejiang CCB branches had lent nearly 3 billion yuan (US$470 million) to the Group while aware the Group was floundering and its cash flow, drying up.

The owner of the group, Yu Zhongjiang, now in custody, started as a taxi driver, and made his first pile about 10 years ago by operating a car rental service.

As a typically successful Chinese business person, he then diversified into real estate, but atypically, he met his Waterloo while trying to turn an unfinished building into Wyndham Grand Plaza Royale Hangzhou, a luxury hotel by the West Lake.

In analyzing Yu's fiasco, a bank insider cited his "blind diversification into real estate."

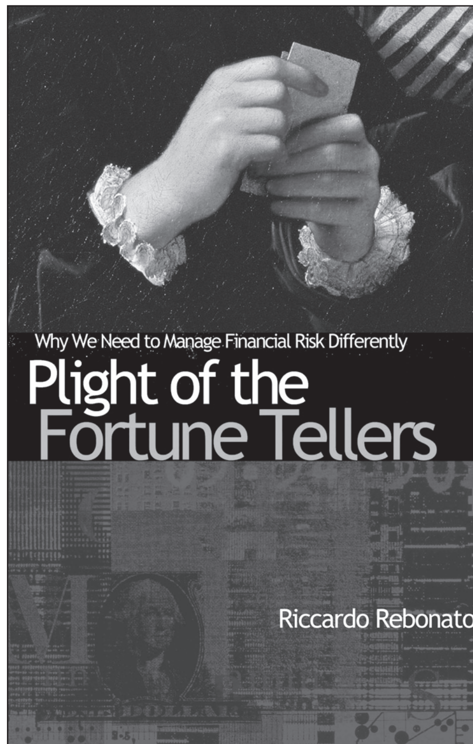
So when the state took steps to cool the sector by restricting its access to credit, the group's cash flow dried up. As a last resort, a desperate Yu turned to loan sharks to finance his property developments.

Facile analysts can draw any number of morals in terms of risk control today, that is, in hindsight of the disaster.

But could the risks be identified before the insolvency?

Regarding the diversification charge: What is a taxi driver's proper line of business?

Recent history did suggest one truth:



There is no rational explanation or prediction of when the state would impose, and then relax, curbs on property sales.

When it comes to China's sky-high property market, a fearless taxi driver guided by his native optimism should have more chances to succeed than a risk control expert trained in supply-demand economics.

Whether for private entrepreneurs or banks, one of the secret to their success has always been their willingness to take risks, without which there can be no returns.

According to "Plight of the Fortune Tellers: Why We Need to Manage Financial Risk Differently" by Riccardo Rebonato, a dangerous confusion prevails in the financial markets: The apparent success of risk management is illusory.

As Rebonato states, his book is "about the quantitative use of statistical data to manage financial risk."

The author believes the extrapolation of statistical methods from the natural sciences to finance has been too bold.

Risk control experts believe they can estimate risk with extreme precision, and make the right decisions on the basis of exact, quantitative metrics.

"The magic of modern financial engineering truly becomes apparent in the way risk, not just money, is parceled, repackaged and distributed to different players in the economy," the book observes.

The belief in quantitative risk management has created a demand for risk managers, many of whom have backgrounds in physics or mathematics.

Cognitive dimension

These "quants" understand what they understand quite well, but as the financial meltdown in 2008 has proved, they are also ignorant experts who fail to see the obvious.

In their eagerness to create neat statistical formulas they fail to pay attention to the cognitive dimension of economic decision making.

As Rebonato observes, financial risk managers and regulators emphasize areas of risk and probability where humans are not good evaluators.

The emphasis on fine calculations of very remote-probability events actually magnifies the chances of risk management errors instead of reducing them.

Risk management can be illusory because of the simple truth that no return occurs without risk, so eliminating risk is the same as eliminating returns.

"If return is a compensation for risk, by investing in risk management and dampening volatility, senior management are also giving up some expected return," Rebonato concludes.

When it comes to risk assessment, off-the-cuff assessments, habitual heuristics and time-honored precepts often make more sense than esoteric mathematical formulas.

"Unfortunately, elegant theories tend to have a hold on human minds that, at times, goes beyond what a hard-nosed critique would recommend," the author says.

This is an interesting book for managers or regulators whose responsibilities include oversight of finance.

Call for carbon emissions trading scheme

Liao Zhenliang

AS China's GDP soars (despite a current slowdown due to reduced orders), its energy consumption as well as the emissions of carbon dioxide are increasing rapidly.

Simply relying on traditional administrative controls can no longer fulfill the promise to reduce emissions. So we must find some new, efficient reduction methods.

Carbon emissions trading has been acknowledged as a good option.

Compared with other methods, this scheme is a market method, which can reduce the marginal costs and fees of greenhouse gas emissions by a wide margin.

Carbon emissions trading treats carbon credits as merchandise that can be bought and sold. Surplus or shortage of credits can be adjusted through transactions in the carbon credit market.

Since it's a market, there will be a main body of transaction. From 2012-15, the National Development and Reform Commission approved Shanghai and seven provinces to carry out pilot projects, which would then be expanded to the whole country.

Our country is still engaged in production and manufacturing. The level of energy consumption of these producing industries is much higher than in developed countries.

But the carbon dioxide emissions per capita from living consumption is far below the level of developed countries. And the carbon emissions from daily living have a wide range of sources, which makes it difficult to include in a carbon trading scheme.

Moreover, it's hard to consider the construction industry, a secondary industry, and the transport industry, a tertiary industry, as part of a trading scheme because both are closely related with people's livelihood, and also with a wide range of carbon emissions.

Currently, China joins the international carbon market mostly through CDM (Clean Development Mechanism) trade, that is to say developed countries invest in clean energy projects in developing countries, to get a carbon reduction credit.

However, because of our own lack of a trading mechanism and platform, China always remains at the low end of the international carbon trading chain, without pricing power, hence, international traders can easily force down prices.

It is imperative for China to establish a national carbon emissions trading market and then to join the international efforts.

The author is an associate professor at the UNEP-Tongji Institute of Eivronment for Sustainable Development, Tongji University.