crisis] in the markets."[5]

There was a massive deterioration in global economic conditions in late 2008. The major advanced economies fell sharply in the December quarter in 2008 as did many of the emerging economies.

According to the International Monetary Fund (IMF) in early 2009 (World Economic Outlook):

> "The continuation of the financial crisis, with government policies failing to dispel uncertainty, has caused asset values to fall sharply across advanced and emerging economies, decreasing household wealth and thereby putting downward pressure on consumer demand."[6]

Risk management experts have described the turbulent times of 2008 and 2009 as having the following features:

- most industries and economies are, or will be, affected by:
  - a tightening of liquidity resulting in a credit squeeze;
  - a decline in asset valuations and increased write-downs;
  - financial innovation which will make it harder to distinguish illiquidity from insolvency;
  - a continuing rise in defaulting loans; and
  - an emergence of new risks.
- an unprecedented number of bankruptcies and takeovers;
- a need for changes to be made in the regulatory framework;
- significant government and central bank intervention, including the preparedness of central banks to assist in the smooth operation of the financial markets;
- extraordinary volatility in global stock markets and world currencies; and
- industry consolidation, including that of many pension funds.

Although banks and other investment organisations have survived many upheavals experts see the recession of 2008/2009 playing out as never before. Previously, when businesses hit rock bottom, owners negotiated with banks or refinanced their loans. Many banks however are no longer holders of the loans that they originally lent to those businesses. From the late 1990s to the present time, banks and investment organisations have increasingly bundled mortgages and on-sold them to investors, insurance companies, pension and hedge funds. These investors and organisations bought loans because they were considered safe securities. Now those investors and organisations are facing losses that could damage the financial system for many years to come.

5 IMF Survey Magazine, 'Global Recession Triggers Slump in World Trade Volumes', dated 28 January 2009. See http://www.imf.org/
6 Ibid.

Policy makers worldwide have realised that the markets have entered a vicious cycle of asset de-leveraging, price declines and investor redemptions. Consequently they are dashing to limit the damage from the global credit squeeze by adjusting (mainly by cutting) interest rates and pumping enormous sums into the banking system.

G20 Communiqué: April 2009 (Global Plan for Recovery)

The London Summit Leaders' Statement from the G20 Communiqué (2 April 2009) covered six basic subjects:

(i) restoring growth and jobs;
(ii) strengthening financial supervision and regulation;
(iii) strengthening global financial institutions to rebuild trust;
(iv) resisting protectionism and promoting global trade and investment;
(v) building a fair and sustainable recovery for all; and
(vi) repairing the financial system to restore lending.

The G20 committed itself to:

> "... a dramatic increase in the funding available to the International Monetary Fund (IMF)."[7]

Under the G20 agreement, funding for the IMF will be increased by $500 billion to $750 billion. The IMF already had about $250 billion at its disposal to lend to countries facing financial difficulty. Other commitments[8] include:

- an unprecedented crackdown on pay and bonuses for bankers;
- at the behest of the G20, the IMF will increase the amount each country has in so-called Special Drawing Rights (SDR) by $250 billion;
- a global agreement on how much various countries would spend on measures to support their economies and fight unemployment;
- the elimination of offshore tax havens;
- a 12-month freeze on introducing any new trade barriers;
- turning the existing Financial Stability Forum (an international group of regulators) into a more pro-active global banking watchdog; and
- the provision of $250 billion in new trade credit guarantees: the guarantees to be offered by the World Bank and other international institutions.

7 London Summit Leaders' Statement from the G20 Communiqué (accessed on 2 April 2009).
8 www.telegraph.co.uk/finance/financetopics/g20-summit (accessed on 3 April 2009) p1-3.

Causes of the crisis: who can we blame?

During the early 2000s a new buzzword emerged – the term was 'leverage' and it is now causing huge economic problems throughout the world.

Leverage was the kingpin on Wall Street – and on Struggle Street – for many years. Leverage meant debt. To the fund managers, leverage was a 'means of accomplishing a purpose, power, influence', which is as the term is defined by the Oxford English Dictionary. [10]

According to former governor of the Reserve Bank of Australia, Ian Macfarlane:

> "... increasing leverage is the easiest way to increase returns in a rising market, and there were incentives to chase these returns and to ignore or downplay the risks. The biggest misdirected incentive was the performance-based pay which awarded massive bonuses to management of financial institutions on the basis of short-term profit results. Annual bonuses in the millions of dollars were not returnable when the short-term profits were lost in subsequent years. ... Highly geared entities ignored or downplayed the risks. It was easy to do so because there appeared to be an unlimited amount of credit available, and it would always be easy to roll over maturing debt. But once doubts emerged about whether a highly leveraged illiquid asset was a going concern, the funding quickly dried up." [11]

One well known Sydney finance writer, Ross Gittins, succinctly put it this way:

> "You can't have bubbles in asset markets without the ready availability of credit. And it's been the long build-up in debt on the balance sheets of households, businesses (via the private equity craze) and financial institutions (hedge funds, investment banks and even commercial banks) that's at the heart of the global crisis and the global recession it's feeding." [12]

Arguably the situation in the US has been exacerbated by the reluctance of banks (or perhaps their inability) to refinance business and housing loans. This has resulted in businesses going broke and homeowners losing their homes. When businesses cannot borrow and banks will not lend the economic crisis worsens. This in turn further reduces existing investments in businesses. Bank shares then fall because of fears of too much exposure to Collateralised Debt Obligations (CDOs).

10 The Concise Oxford Dictionary, Reprinted 1959, Fourth Edition.
11 Ian Macfarlane, 'Look beyond greed – a debt-ridden world of leverage this mess', Sydney Morning Herald, 4 December 2008, p15.
12 Ross Gittins, 'It's not inflation that's done us in, it's all the borrowing', Sydney Morning Herald, 8 December 2008, p19.

The world of financial derivatives

The growth in financial derivatives in the late 1980s through to 2009 can be linked directly with volatility in traditional cash and physical markets. This has created a demand from risk-averse financial institutions for instruments to facilitate the transfer of risks associated with this volatility to those in the financial community that are more willing to hold those exposures. The trouble is that most of the risks have actually been transferred, deliberately or otherwise, to investors with the least capacity to bear loses if and when they eventuate.

In particular, the credit default swaps market significantly outgrew many other derivatives markets in the mid 2000s. Credit default swaps act like insurance, allowing the seller to take on new credit exposure and the buyer to assume the cost of insuring against default. In 2007- 2008 the credit default swaps market was estimated to be worth about US$50 trillion. In 2006 the former Chairman of the US Federal Reserve, Alan Greenspan, even described credit default swaps as:

> "... the most important instrument in Finance ... what credit default swaps did is lay off all the risk of the highly leveraged institutions – and that's what banks are, highly leveraged – on stable American and international institutions." [13]

The fall of various investment banks demonstrated how an intricate web of artificial derivatives had brought the whole financial system to the precipice of collapse.

Ignorance of the risks of derivatives and the extent of the role of derivatives in modern financial markets has been eloquently demonstrated by the ever-widening hole in the balance sheets of major US investment banks and corporations, many of which would have collapsed without a US government rescue package.

As for the hedge funds, given the huge losses run up by many, 'arbitrage' might now look like a fancy word for reckless speculation. Stephen Ross, an economist at the Massachusetts Institute of Technology's Sloan School of Management, argues that:

> "Opportunities for pure arbitrage – defined as no risk of losing money – are very limited. For example, if an investor could borrow at 4% and lend at 5% for the same length of time, in each case dealing with institutions with the same credit risk, he would be very rich. That is why such opportunities are rare. Most of what hedge funds do is 'expectation arbitrage', in which the chances of making a profit simply exceed the chances of making a loss. Most so-called arbitrage has an element of betting....there is no hard line between arbitrage and speculation; it is a continuum." [14]

13 From remarks made by Alan Greenspan on 18 May 2006 to the Bond Market Association in New York, 'The Origins of the Financial Crisis', November 2008, p33. See www.brookings.edu
14 'Turmoil in Financial Markets', The Economist, 17 October 1998, p22.

Although such assurances often come from highly qualified economists is it safe to assume they are correct? After consulting a few fund specialists and checking some economic theories some interesting trends were revealed:

- During the global financial crisis, most of the growth style investments (say, funds with a minimum of 60% in growth assets and a maximum of 40% in defensive assets such as cash and fixed interest) have had negative returns.
- Arguably there is a trend that pension funds have shifted slightly over the past few years to alternative asset classes from listed equities. Alternative asset classes behave differently from shares and bonds and are possibly more resilient during years of sharemarket volatility.
- Prior to the financial crisis, low volatility and strong gains on the Australian sharemarket enabled many Australian equity fund managers to deliver solid returns. In many cases however, these returns were simply in line with the benchmark index, prompting some investors to question why they were paying such high fees.
- The proliferation of private equity and hedge funds using derivative instruments, such as equity swaps, options and contracts-for-difference (which allow investors to bet on rises and falls in shares without actually owning or paying the full value of the shares) have made it increasingly difficult for companies to identify their shareholders.
- During the global financial crisis there have been short stints of government bonds outperforming shares. Apparently this could last for several years.
- Pension fund trustees generally maintain that pension funds are the ultimate long-term investment and it is potentially misleading to pay much attention to short-term performance as it is the long term performance that counts.

Pension funds are not somehow immune from what goes on in the broader economy, either domestic or global. Pension funds invest in assets that can be volatile which means that returns will vary, sometimes sharply, from one period to the next. It is noteworthy that some funds focused on past performance without properly warning investors that there was no guarantee of future returns. Negative returns are, depending on how much and where the pension funds are invested, not only to be expected but inevitable.

A final reminder comes from Bernie Fraser, former Governor of the Reserve Bank of Australia:

> "… remember that markets are inherently volatile; they shoot up further than they should at times and they fall further than they should in terms of fundamentals at other times, and that's what we are going through … But over the long-term, share markets, share prices have proved to be a good investment, better returns than most other asset categories, much higher than the rate of inflation … So from the long-term point of view, and superannuation [pension fund] is a long-term investment, it's a good area to be to have your savings." [33]

The investment policy

Pension funds need to have properly and clearly defined investment strategies and objectives to enable fund members to make better decisions about their choice of pension fund. One fund manager described 2008 as 'the year of investing dangerously'. The year should serve as a reminder to investors to always consider the risks to which they are exposed before they invest.

A pension fund's investment policy should identify:

- the strategic asset allocation (the long-term asset mix over the main investment categories);
- the overall performance objectives of the pension fund; and
- the means of monitoring broad asset allocations and performance objectives in light of changing liabilities and market conditions.

More specifically, the pension fund's policy should include appropriate performance benchmarks, assessment timeframes and address the extent to which deviations from the strategic asset allocation will be tolerated.

As an example, the investment objective of the 'balanced' fund of REST, an Australian pension fund, is a:

> "… good balance of risk and return by investing in approximately equal proportions of growth assets (eg shares and property) and defensive assets (eg bonds and cash)." [34]

The target return of that fund is:

> "CPI [the Consumers' Price Index] + 2%pa over the medium term rolling 4 year periods." [35]

Under Australia's Superannuation Industry Supervisors (SIS) legislation [36], a key responsibility of the pension fund trustee is the formulation and implementation of an investment strategy. Such strategy should have regard to all of the circumstance of the fund and take into account:

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33 From a transcript of an interview between Kerry O'Brien, Bernie Fraser (Former Reserve Bank governor) and Garry Weaven, executive chair of Industry Fund Services dated 14 October 2008; www.abc.net.au/7.30/content/2008/s2391040.htm (accessed on 13 July 2009).

34 See REST Superannuation at www.rest.com.au/Performance-Investments/Investment-Options/Structured-options.aspx#balanced (accessed on 13 July 2009).

35 Ibid.

36 The Insurance & Superannuation Commission, 'The Trustee Guidebook to Superannuation', 1996, p21.

when all they could do was achieve the same return as an index tracker fund. In fact, some active managers even lost against the index as the trustees who invested with them were paying unnecessary fees to achieve a worse than baseline result.

Worse, the best active managers may not have been selected. Many of Australia's pension fund members and other investors would have been better off, on average, if their funds were invested in 'passive' low-fee index funds rather then actively managed funds. Most fund members however will not know about this situation. Their fund will just report an overall investment return number. Perhaps it would be a good idea if pension funds were required to report the costs and returns from actively managed risk as separate items forming the overall return each year.

The investing community will continue to debate the benefits of active versus passive investment management and from time to time one approach will outperform the other. Obviously, the crucial task is to select the active investment manager wisely and ensure he or she is the best person for the job.

One Australian pension fund, AGEST Super, said:

> "We have a simple duty to our members, and we take it very seriously – we set member fees at a level that will cover our costs – no more no less." [41]

In particular, it claimed it not did not have any 'hidden fees' which appears to be a powerful statement to re-assure members that fees must be set at the minimum.

In the pension funds industry expenses and fees fall mainly into two categories:

(i) those fees which are accounted for in the fund return; and

(ii) those which are excluded from the fund return.

Accounted for in fund return	Excluded from fund return*
• Investment costs: for example, fees paid to investment managers, investment consulting fees, custodian costs and internal costs relating to investment management. • Investment-related legal advisory fees. • Member protection costs: costs of protecting members with a small account balance from administrative fees as required by current Australian law. These costs are allocated to members via a reduction in the investment return. • Management fees. • Performance fees. • Brokerage costs.	• Administration fees (which apply to each membership account). • Redemption fees. • Account maintenance fees.

* These charges are deducted from each member's account

The wording and description of those fees and charges need to be properly defined.

41 AGEST Super at www.agest.com.au/pension/low-fees/index.cfm (accessed on 12 July 2009).

Quite often, the term management expense ratio (MER), which is used to compare the costs of various funds, means different things to different people.

The MER is the expenses of a fund (for example, investment, management, trusteeship) expressed as a proportion of the fund's net asset value. This is where confusion could arise since there is no common agreement as to what expenses should be included in the calculation of the MER.

In fact, it is arguable whether MER is a useful way to compare costs amongst various funds because, in addition to the differences between funds in regard to what expenses are included in the MER calculation, MER for an individual fund member will vary depending on the investment strategies in which they are invested and the size of their account balance. In other words, a fund member might be better to calculate the MER for their own investment profile.

Risk management statement

One of the first things a member should try to obtain is a copy of the fund's risk management statement (RMS). At the very least, the RMS should be a road-map for the fund in achieving transparency in relation to the fund's goals and objectives and how it is going about achieving them. Accountability is crucial in achieving effective governance. Also, delegations by the trustee board must be clearly documented.

The RMS should give an indication as to how the fund maintains its risk management framework. The risk management capability of an organization arises from the underlying governance, policies, practices, systems and controls established by the organization for the particular risks to which it may be exposed.

Responsibilities of trustees, and how to fulfil them

Duties of trustees

A complete understanding of the role, responsibilities and powers of the trustee board is vital to the board's effectiveness. This should be formally documented, highlighting the primary duty of the trustee to act in the interests of members. For a trustee board, making maximum efforts to maintain a strong and ethical organisational culture is vital to maintaining a reputation for competency, integrity and impartiality.

Pension fund trustees are fully responsible for the operation of the fund and the board must ensure there is a formalised investment strategy appropriate for implementation.

Trustees must explain their corporate governance policies to members and justify any departures from compliance. It is not enough just to follow a 'box-ticking' approach, where the letter of every governance rule is complied with, but not the substance of those rules. Independent judgement by both executive and non-executive directors, shareholders and auditors must be enabled and facilitated by transparency.

According to the former Auditor-General of Australia, Pat Barrett:

> "The accountability of boards to their shareholders, while perhaps always ultimately sourced in the 'bottom line', is beginning to be framed in less familiar non-financial terms such as 'value and ethics'; 'fair and equitable treatment'; 'access and transparency'; 'the environment'; and 'community welfare'. These elements are becoming important considerations of boards and executives in their business strategies to be seen, and accepted, as good corporate citizens.... An interesting concept is the so-called 'triple bottom line' reporting requiring the disclosure of information about an entity's economic, social and environmental performance". [48]

What a typical corporate governance statement should cover

Responsibilities and functions of the board	• Stakeholders' interests • Strategic plan / investment strategy • Past performance analysis • Scope of delegations • Business continuity plan • External reporting requirements, for example, integrity of reporting systems • Risk management and compliance • Executive review, succession planning and culture • Board performance
Board composition	• Directors possess unquestionable integrity and character • Directors with broad range of expertise • Majority of independent non-executive directors • Appropriate size • Appropriate competencies of directors
Independence of directors	• Regular review of independence • Director must be independent of management and any business or other relationship that could materially interfere with the exercise of unfettered and independent judgement
Appointment and re-election of board members	• Process for appointment of directors • Use of external consultants as appropriate • Election by shareholders
Induction and continuing education	• Orientation program for new directors • Outline fiduciary duties and responsibilities

48 From a paper given at the Institute of Internal Auditors National Annual General Meeting, 'The Internal Auditors: How to maintain their relevance'? Sydney, 18 May 1999, p4.

Board meetings	• Preparation needed prior to each board meeting. For example, ensuring board papers make sense and that board reports have been appropriately and independently 'signed-off' • Timely decision-making based on sound information • Amount of work for board meeting. For example, sufficient time needed to review board papers • Use of external expertise when necessary
Board performance	• Reviews and evaluates the performance of the board with assistance from the nomination committee. This may include completion of a questionnaire regarding the effectiveness of the board and committees' processes
Remuneration of directors	• Nomination committee provides guidance to the board in respect of remuneration • Remuneration in the form of shares for non-executive directors
Remuneration of senior executives	• Short-term and long-term incentives • 'At risk' remuneration also considered
Conflicts of interests	• Directors must avoid any action, position or interest that conflicts with an interest of the organisation, or gives the appearance of a conflict
Access to management	• Board members shall have complete and open access to members of management
Access to independent professional advice	• Board has the authority to conduct or direct any investigation required to fulfil its responsibilities • Each director has the right to seek independent professional advice at the company's expense, subject to the prior approval of the chairperson
Restrictions on share dealings by directors	• Directors are subject to the applicable corporations law on this issue
Board and committee agendas	• Structured to ensure board is able to meet its significant responsibilities, such as the annual signing of statutory accounts
Board committees	• Audit committee • Risk committee • Nomination committee • Compensation committee
Whistleblower protection program	• Established for the confidential reporting of issues of unacceptable or undesirable conduct

The disclosure requirements covering remuneration reporting should include the following information:

- the board's procedures relating to directors' pay, particularly with regard to the role of the remuneration committee;

others are not — it is the role of risk managers to determine the difference. According to one risk manager, during the global financial crisis, the job of a risk manager:

> "has the risk profile of a short option position with unlimited downside and limited upside."[58]

Potential risks in doing business include:[59]

Stakeholder	Data Security	Volatility
Information Technology	Strategic	E-Business
Credit	Market	Liquidity
Interest Rate	Regulatory	Tax
Accounting	Legal	Liquidation
Policy	Process	Human Resources
Cashflows	Unit pricing	Investment
Contract management	Environmental	Hedging
Business entity	Volatility	Value at Risk (VaR)
Longevity	Capacity	Collateral
Gap management	Valuation	Transparency
IT network security	Documentation	Delegations
Systems maintainability	Systems complexity	Settlement
Product	Disclosure	Custody
Operations	Ownership	Training

The above list has been around for many years. Yet, it seems that too many of those key risks identified by the major US banks have not been given much attention! For example, in the 'ownership' risk area too few people were concerned that the issuers of bonds/notes were actually paying the Rating Agencies for ratings.

The question therefore is: who actually owns the ratings assessments? Isn't there a potential conflict of interest in the process?

In the Ernst & Young's 2008 Global Internal Audit Survey[60] which examined the current and evolving state of the Internal Audit function and how Chief Audit Executives are meeting the heightened expectations of stakeholders, it was revealed:

- difficult economic conditions and heightened stakeholder expectations have put pressure on executive management and audit committees to improve risk management and deliver greater value;
- only 17% had rated their risk assessment performance as 'very competent';
- only 20% reported the risk assessment activities conducted across the organisation as 'well aligned', with 19% reporting 'no alignment at all'.

58 'Confessions of a risk manager', The Economist, Australian Financial Review, 14 August 2008, p77.
59 This is only a limited list.
60 The survey covered 348 internal audit executives in 24 countries.

Identifying risks – a new focus is necessary

One of the key tasks in risk management is to identify the whole range of risks that the organisation faces. A good starting point from which to build a picture of the risk management goals is to look back to what has gone wrong in the past.

For example, a five-hour computer system crash which resulted in the inability of financial dealers to carry out arbitrage transactions and caused a large financial loss to an investment bank – if that were to happen again would the organisation have suitable or better controls in place to reduce the risk of losses to nil or at least to an acceptable minimum? A further question would be – what else can go wrong in the future?

Broad areas of risk which have been identified in relation to financial institutions include the need for:

- Greater attention to be paid to long-term vs short-term (risk-adjusted) profitability and (risk-adjusted) rates of return;
- Stronger involvement of boards in the strategic handling of risk management, including strategic risk management;
- More robust risk assessment and control systems and procedures; and
- Less focus on short-term profits. In the past this was reflected, inter alia, in the manner in which some financial institutions accounted for profits, such as recording 100% of up-front fees received as profit in the first year of a 'derivatives swap' transaction rather than spreading the fees received over the life of the transaction. It was also reflected in the incentive packages given to managers.

A renewed focus should include:

1 Operational risk

The issue of operational risk is not new. Operational risk can be defined as the:

> "... risk of loss resulting from inadequate or failed internal processes or systems, human factors or external events. Internal processes include activities relating to accounting, reporting, operations, tax, legal, compliance and personnel management."[61]

61 JP Morgan Chase Annual Report 2000. See www.jpmorganchase.com/ar/mda/operating.htm (accessed on 2 February 2002).

- producing high quality board and management papers for decision-making purposes; and
- improving financial reporting for the benefit of stakeholders.

3 Credit risk

Credit risk is the risk of loss related to a counterparty failure. The credit risks faced by pension funds in their investing activities revolve around the financial strength of the parties with which pension funds deal. Exposures to counterparties should be re-assessed at least daily.

4 Investment risk

Trustees of pension and superannuation funds are required to invest the fund's assets in the best interests of the beneficiaries – that is, its members. The investment strategy should be set after due and careful consideration of the investment risks which will include any:

- failure to ensure investments make sense or are uncomplicated;
- failure to regularly review the investment strategy of the fund;
- failure to manage and monitor the investment risks continuously;
- failure to provide adequate custody over investment and security documents;
- failure to obtain independent and expert advice;
- failure to provide adequate investment management reports to the board, such as investment data and reports which are unclear and difficult to understand; and
- failure to demonstrate transparency of investments, particularly alternative investments.

Derivatives

By the late 1990s risk managers had become comfortable with credit derivatives and accepted them as the financial instrument of the future. Then a new instrument called a 'credit default swap' (CDS) arrived.

A CDS is an agreement between two entities whereby one entity pays the other a fixed coupon over a specified term. The other entity does not pay anything unless a specified credit event such as a default occurs, at which time a payment is made and the swap ends. In other words, the deal allows a lender to transfer the credit risk of a third party to the writer of a CDS. The writer of the CDS undertakes to insure this risk in exchange of periodic payments (insurance premiums).

A CDS is one way an investor can engineer a targeted exposure to credit risk. A CDS, at first view, was a marvellous invention because it enabled the organisation to make bigger profits after off-loading most of the risks to the other organisations and keep the transactions off the balance sheet (and therefore invisible as a risk to observers).

It seemed strange that no one had thought of it before, but with the use of more powerful computer software, dealers were able to do all sorts of financial modelling to come up with such exotic financial instruments. Risk managers became concerned for the organisation since they had never believed that one could get something for nothing. But, too many people were embarrassed to say openly that they had difficulty in understanding the formulae associated with these products. Also, there was a state of constant confrontation between derivatives dealers and risk managers who demanded clarification and regular reporting of risk profiles. The risk profile of a CDS changes constantly. CDSs were the kind of financial instruments that were either unmanaged or unmanageable.

Before the global financial crisis, risk managers had difficulty selling their message. Now, those risk managers may feel vindicated – risk management has become everybody's business. However, it still remains the case that many bankers do not see the value of risk managers in the organisation. In particular, derivatives dealers often regard risk managers as a head-office expense, to be culled in times of economic downturn, or as a breed of spies for a powerful and obstructive risk committee.

The board's risk committee is responsible for the review and oversight of a bank's risk profile, including reviewing management's plans for mitigation of the material risks faced by the bank, so must often rely on risk managers to promote an awareness of a risk-based culture and achieve a balance between risk minimisation and reward for risks accepted. Derivatives dealers, however, can find it difficult to accept the fact that risk managers have a direct reporting line to the board.

In the area of some complex derivatives, monitoring the current position requires highly sophisticated computer systems which are expensive to maintain. In many organisations, they appear to be inadequate or non-existent. There have been numerous methodologies to quantify derivative risk. While progress is being made, there is no wide consensus on a proper approach and the different methodologies are not often explored in the decision-making process.

Value at Risk (VaR)

VaR is primarily a statistical risk measure which estimates the probable loss from adverse market fluctuations in an ordinary market place and provides a consistent business-wide measure of risk profiles and spreads of diversification. VaR is used for comparing risks amongst businesses, monitoring limits and as a variable to economic capital calculations.

Its use is actually being encouraged by the Bank of International Settlements, the US Federal Reserve and the US Securities and Exchange Commission. The use of VaR could be likened to the Chairman of the organisation receiving every afternoon a report showing an estimate of the organisation's total potential losses over the next 24 hours. VaR is about enabling the company to 'aggregate' disparate market positions. For

- local fixed interest bonds or international fixed interest bonds
- active management of the bonds or passive management of the bonds
- index-linked bonds
- listed bonds or unlisted bonds
- hedging of the international fixed interest bonds (if selected)
- granting the funds manager a performance bonus if a certain benchmark of investment return is achieved
- short term or long term investments, and/or
- environmentally-friendly stocks only?

Investor: I didn't realise I would have to make so many choices. I thought you could help me to decide on those matters. All I require is to maximise my investment returns during the global financial crisis.

Fund manager: Before we proceed, I have to remind you about our set investment fee structure which could be very high! Sometimes, it could be as high 10 % pa of the valuation of your investment portfolio plus incidental costs and performance bonus. Our hourly rate is about $800 per hour.

Investor: You must be very good to be able to charge such high fees. I am impressed!

Fund manager: Well, investment management fees are never cheap; it costs a lot of money to train a funds manager. Also, on Wall Street, if I don't charge a high fee, the investors may think I am not that good.

Investor: What happens when the returns are negative? Do you still charge a fee?

Fund manager: Of course we do. In fact you should be pleased that we have decided to take you on as our client as we are very selective in our clientele list. However, you need to sign an investment agreement (as set out by us and which has been passed by our lawyers) immediately as we do have a huge list of potential clients wanting our services and advice.

Investor: Could you let me know your credentials as a funds managers? Including how you propose to increase the value of my investments?

Fund manager: Well, our investment model and methodology has been well-proven world-wide. Of course, you'd understand it is a top secret. We have spent millions in developing the methodology and therefore it cannot be revealed.

Investor: What if I paid you an extra fee, would you reveal the formula of your investing model?

Fund Manager: I don't think so. In any case, our valuation model is so complex that you'd probably need a rocket scientist to understand it!

Investor: OK. Thank you for the opportunity to discuss my investing requirements with you. By the way, please don't call me, I'll call you.

More information

The investors are also demanding that the fund managers provide real transparency in relation to the risks of the financial products the fund managers are providing, and the internal governance and control processes of the fund managers themselves. If you're curious about investments but not sure how to maximise returns, your fund managers should provide clear, simple advice on what they can do with your investments.

In future there will be a great shift in the way fund managers are required to report information and the focus will be on the understanding of market value. Investors will demand more information as to how some products, such as CDOs, could decline in value at such a rapid pace during the global financial crisis. There appeared to be little warning signs when the values of various CDOs took a significant dive.

Less risky products

For fund managers old habits die hard, however the global financial crisis could well be the final wake-up call for them.

Fund managers often live in their own world – it is not uncommon for them to work 60 to 70 hours per week from 7am on every day of the week – they are some of the hardest working people in the world, perhaps leaving little time for reflective thinking or caution.

Until recently, their world revolved around a mindset of two constants:

- No two financial products developed by fund managers should be the same. This means fund managers must be constantly working on unique financial products for the investors; and
- Each fund manager is only as good as the last financial instrument that they designed.
- A fund manager lives and dies by the creativity and profitability of their own self-designed financial instrument. The product is likely to be exotically named, something such as a "COBRA" (Cost Of Borrowings Reduction Agreement). In fact, it is possible fund managers spend about 80% of their time thinking of the most appropriate or fancy names to call their financial products and services. It seems that the more exotic the name, the more investors are willing to pay for them. Forget about the formulae, investment returns or strategies underpinning the product, as long as it sounds relevant and is marketed correctly (in glossy brochures), you may have a winner!

J Bogle, a finance writer recently warned:

> "Beware of financial innovation. Why? Because most of it is designed to enrich the innovators, not investors. Just think of the multiple layers of fees to the sales people, servicers, banks, underwriters and brokers selling mortgaged-backed debt securities. These new products (credit default

(in relation to their benchmark). It is one of the key measures of relative-return risk.

Many portfolios are managed to a benchmark, usually an index. The objectives of some portfolios are to replicate the returns of an index exactly (an index fund). Other portfolios are 'actively managed' meaning the funds manager could deviate a little from the index in order to generate active returns or to lower transaction costs. Tracking error is therefore a function of the level of risk that a portfolio is assuming.

It is notable that tracking restrictions are used (and often misused) widely to try to manage risk in the investment portfolio. At times of changing market conditions tracking errors can be very poor indicators of actual risk levels and this has serious implications for those investors who are heavily reliant on the use of tracking errors for risk-control purposes.

The divergence of the index fund's performance from that of the benchmark is an indication of how effectively the fund has performed its replication. This diversion is referred to as tracking error and can be the result of a number of factors, including the management expense ratio (MER), uninvested cash, or the replication strategy used by the fund.

Absolute return funds

Depending on the investment strategy employed by the fund manager, investors may receive returns in the form of income, capital appreciation, or a combination of both. Absolute return is the return that an asset achieves over a certain period of time. This measure looks at the appreciation or depreciation (expressed as a percentage) that an asset – usually a stock or a pension fund – achieves over a given period of time.

Absolute return differs from relative return because it is concerned with the return of a particular asset and does not compare it to any other measure or benchmark.

Due to the varied types of securities and investing styles 'absolute return funds' are quite different to 'traditional investment management'. The investment return of the 'absolute return fund' is not highly correlated to the performance of traditional assets such as shares, property, of fixed interest. Depending on the investment portfolio and the manager's investment criteria, the risk profile of an 'absolute return fund' can range from very conservative to aggressive. Some of the investment techniques available to 'absolute return fund' include short selling, hedging, arbitrage, derivatives, investing in low liquidity or distressed securities outside the investment mandates of traditional fund managers and leverage.

Comments from the experts

Experts	Comments
Barry C. Melancon President & CEO, AICPA (2002)	Let there be no doubt: hundreds of thousands of members of the CPA profession [auditing profession] say no everyday. 'No' means protecting the public interest by rejecting unsound corporate accounting practices. 'No' means reducing the risk of deceit and fraud. 'No' means ensuring that audited statements are not just accurate, but illuminating. 'No' means questioning and challenging management. When justified, it means rejecting management's accounting decisions. Saying 'no' means saying 'yes' to protect the public interest. Only if auditors are fully prepared to say 'no' will investors be fully prepared to say 'yes'.
Richard Rosen, senior economist and economic adviser, The Federal Reserve bank of Chicago, Chicago Fed Letter, November 2007 No. 244	Thirty years ago, if you got a mortgage from a bank, it was likely that the bank would keep the loan on its balance sheet until the loan was repaid. That is no longer true. Today, the party that you deal with in order to get the loan (the originator) is highly likely to sell the loan to a third party.
Head, Pension Fund, Melbourne	In an efficient market, if you are a sizeable pension fund, you will diversify your manager allocations out which will bring results back towards to the median level. And trustee tolerance will be affected if alpha is not seen to be sufficient.
Treasurer, State of Ohio, US 'Statement of Investment Policy' (2000)	Prohibited Investments and Investment Practices The State is expressly prohibited from the following investments and investment practices. This is not an exclusive list: 1. Short sales (selling a specific security before it has been legally purchased) 2. Investment in complex derivatives such as range notes, dual index notes, inverse floating rate notes and de-leveraged notes, or notes linked to lagging indices or to long-term indices 3. Collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICS) 4. Investing in any security not specifically permitted by this Policy (Author's comments: notice the banning of CMOs)
Robert Monks, Administrator, US. (1985)	I don't think that anybody can make a commercial decision in America today without considering the implications of pension money.
Head, Investment Bank, Sydney	In terms of the way we look at the business, we are just trying to get the assets with the best management in the hands of investors.
Steve Delaney, NBC, USA Reporter, speaking in 1985. 'NBC looks at power of the pension funds'.	There is no greater power in this country than control over the allocation of money. And in the next decade or so, when the funds own most of every stock worth having and most of the country's assets, Congress could decide to use all the money to underwrite the national debt, or to rescue a floundering corporation, or develop an investment priority scale for vital industries. If the funds didn't agree, they could lose their tax exemptions.

In a currency overlay program, investments that are subject to exchange rate movements are highlighted. The various net positions are then assessed and their performances and risks calculated. Continuous monitoring of the effectiveness of the currency overlay program is critical.

When evaluating a currency overlay program, it is necessary to gain insight into the following:

- Do we understand why a currency overlay program (COP) is necessary and what benefits and costs are involved? What is the impact of the overall currency risk management plan?
- When a decision has been made to use a COP, a hedge ratio and respective benchmark (return, risk) should be chosen – have we chosen them yet? Has the investment decision been separated from the currency decision?
- How much money or risk capital should the pension fund allocate?
- How will the fund manage its underlying currency exposure? For example, what types of derivatives should be used? When determining the management process, consider the technical issues and the choice of instruments.
- What is the cash-flow forecast from these strategies? How are cash-flows from maturing hedges being managed?
- How is performance measurement to be carried out? This should include defining the maximum deviation (+/–) from benchmark and determining how often the mandate will be reviewed.
- What are the problems arising (if any) from administration, counterparty, risk and reporting?
- What is the record of the currency specialists? In other words, how many years have they experienced positive returns?
- Is the currency exposure to be managed 'passively' or 'actively' and if so, has the style of management been defined? What is the fund manager's (as opposed to the currency overlay manager's) stance on currency?
- To what extent does the fund undertake foreign exchange (FX) 'roll-over' transactions and what is the fund's policy of FX 'roll-over' contracts?
- Whatever the pension fund's decision on hedging is, it is most important that the fund manager understand precisely what their job requires. It is crucial to provide the fund manager with clear and precise mandates.

There have been cases whereby currency overlay managers have duplicated the efforts or cancelled out the implicit currency bets made by the investment portfolio managers. For example, a portfolio manager may select a specific overseas share portfolio partly for its value in the local currency, but also have the belief that the currency will appreciate. However, the currency overlay manager may have a contrary view on that currency and decide to hedge out the currency risk. The key risk is that it may not become an obvious situation until it is too late and this could be disastrous for the pension fund by potentially costing it millions of dollars.

When a decision has been made to embark on a currency overlay program it is vital that the program be formalized, transparent and properly communicated to all stakeholders. For example, putting the program's objectives onto the pension fund's website.

Excerpts of a Passive Currency Overlay Program

The following example document sets forth the investment policy for a passive currency overlay program that is internally managed. The design of this policy ensures that the currency exposure of the California Public Employees' Retirement System's international equity program is managed with prudence and care. Additionally, use of this policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of international equity.

Passive Currency Overlay Program – Internally managed [80]

Strategic Objectives

The program shall be managed to accomplish the following:

a. Reduce the system's International Equity Program's risk due to currency volatility

b. Consider solely the interest of the system's participants and their beneficiaries in accordance with California State Law.

- *The program shall control risk rather than generate return*
- *The program shall reduce risk vs the volatility of the underlying equity program*
- *Results shall approximate that of the benchmark, within +/– 50 basis points in a 12-month period*
- *The allocation to the Program shall represent a portion of the total Currency Overlay Program. The percentage of assets allocated to the Program shall be determined by considering the following:*

a. Cost vs expected attained risk reduction vs other alternatives

b. Optimal impact to the overall Currency Management Program

c. The impact of cashflow management associated with settlement for the rolling hedge on the rest of the system's investment program and the underlying assets. Generally, longer duration forwards can reduce the volatility of cash settlement and should be considered if it were to be expected that a favorable impact to flow management would result.

- *The target underlying international equity portfolio subject to the program shall be the developed markets portion of the externally managed passive international equity index fund where the currency exposures of the equity portfolio are stable.*

80 Excerpts of 'The California Public Employees' Retirement System – Statement of Investment Policy 2001'.

In terms of exposure, interest rate swaps convert a fixed rate exposure into a floating-rate exposure, or vice versa. As with other swaps, such as cross-currency swaps, interest rate swaps are based on the principle that one party can exchange an advantage it enjoys in one market for an advantage a counter-party enjoys in another market.

During the global financial crisis some large banks and financial corporations were given guarantees by their various governments to stabilize the economy thus enabling them, to a great extent, to maintain their credit ratings (such as AA+ or AAA). Now with that sort of credit rating these organisations would be expected to delve more into interest rate swaps to assist in delivering lower cost of funds to the less well-off counterparties or clients (at a fee, of course).

Need to diversify

If the treasurer of your organisation proposes that it should diversify its hedging activities to include financial derivatives such as futures, options, or currency swaps your immediate response should be to enquire as to:

- Why use derivatives for hedging purposes?
- How are the derivatives to be used?
- Does the organisation have adequate systems of controls in place?
- Does the organisation have the practical expertise to cope with such high risk financial instruments?

The board must evaluate the adequacy of any active derivatives program and how such a program is controlled and independently monitored. The board needs to understand that in order to make informed decisions it is necessary to be familiar with how each derivatives transaction process works and how the characteristics of the various derivatives relate to the organization's objectives, structure and culture.

Hedging

Hedging is the transference of risk from one party to a counter party who either has an opposite exposure to that of the first party or is prepared to accept that position because they believe they can gain by it.

Treasury synthetic products are often used by financial institutions to hedge or offset risks. Hedgers and speculators try to interact as much as possible to render the derivatives market liquid and stable. It would be unrealistic to expect that hedgers' demand for a certain type of derivatives contract (eg swaps) will equal hedgers' supply of contracts for a particular delivery period. It is believed that the first $A swap that occurred in Australia was in August 1983:

> "when the Commonwealth Trading Bank of Australia entered into a 5-year interest rate swap with the Australian Industry Development Corporation for $30 million, whereby the CTB paid AIDC a fixed rate $A." [91]

According to Arvind Sudhani:

> "... a simple rule of thumb can help managers distinguish between hedging and speculation: employ derivatives to transfer risk, but never succumb to the temptation to trade in risk for its own sake. A simple forward contract in currencies will always end predictably. But when you sell an option on a currency that you don't own and look to make a profit, you underwrite risk. If the gamble doesn't work in your favour, you will make headlines. Never underwrite risk. Let the market underwrite it for you." [92]

The growth and complexity of financial derivatives activities and the nature of credit, price and settlement risk they entail should give many people cause for concern.

The concerns in the use of derivatives include credit risk, uncertainty about hedge accounting treatment, taxation issues and legal issues.

My first encounter with some dangerous derivatives was in the mid 1980's on Wall Street. The derivative product in question was an interest rate swap. As derivatives specialists know, an interest rate swap has basically two types of cashflows – one inflow vs one outflow. This particular organisation had hundreds of these interest rate swaps and was having a very difficult time trying to unravel and to account for them. The real problem started when a few dealers decided to liquidate various components of the interest rate swaps with a total disregard to the cashflow consequences (including their maturity profiles) of the other components of the swaps. Various profits had been taken up-front in contravention to proper accounting rules.

This also resulted in a great mismatch of the entire organisations' funding arrangements. Days had to be spent identifying which component of the swap belonged to whom. The system became so complicated that the organisation was truly in danger of losing millions of dollars since it was almost impossible to identify the open positions (including the exposure) of the various interest rate swaps. Furthermore, it appeared that deals had been entered into by the dealers at an interest rate totally different to what had been agreed with an internal counterparty to generate the desired profit.

Making headlines

During the global financial crisis, the US regulators have essentially nationalized their two largest mortgage lenders – Fannie Mae and Freddie Mac.

91 Bill Evans & Mark Hopkinson, 'Swap market for cheaper funds', Financial Review Banking & Finance Survey, 4 November 1985.
92 Harvard Business Review, January / February 1995, p37.

More understanding is required

Irrespective of the investment cycle, managers of hedge funds do not want to be in the headlines. They are fully aware that the community, in particular the pension fund trustees, would prefer them to keep a low profile. The days when Wall Street rich hedge fund investors could afford to bet their entire house are diminishing. Perhaps a new type of hedge fund clientele may evolve, a clientele requiring more transparency in hedge funds investments.

Pension fund trustees want to know whether the hedge fund managers are into investment innovation or investment liquidation when trying to maximize investment returns. Investors would prefer not to see an investment undertaker during the global financial crisis. Time will tell if what the hedge fund managers claim with regard to product innovation is real or rhetorical.

From 1998 to 2009 hedge funds have grown considerably, both in terms of numbers and the amount of capital managed. In 2009, there were approximately 8000 hedge funds[98] (implementing a combination of short-selling, leverage, incentive fees and shared risk) managing more than $US 1.5 trillion. In contrast, it took the pension and mutual funds more than 50 years to become a trillion-dollar industry. In total, the hedge fund industry accounts for less than 5% of the global investment pool yet it is estimated to account for up to 40% the daily brokerage on major exchanges.

When people discuss hedge funds, Long Term Capital Management (LTCM) comes to mind. LTCM was part of a hedge fund that operated from 1993 to its liquidation in 2000. Its difficulties were sparked by the Russian ruble crisis. This fund had excessive borrowings – $US125 billion of trades and $US1 trillion of derivatives exposure supported by just $US4.7 billion of capital[99] – the hedge fund failed spectacularly in the late 1990s and triggered a calamitous chain reaction. The US Federal Reserve put together a consortium of investment banks to bail it out and avert a financial market meltdown.

In a research paper by Barbara Davison (2006), it was held that:

> "The first hedge fund was offered in 1948 and provided investors with favorable returns relative to other alternatives such as bonds and exchange-traded stocks. The fund was a limited partnership and "hedged" against losses by selling certain stocks short to protect against adverse market risk in long stock positions while still earning substantial profits. It increased profits received by partners in the fund by borrowing additional investment capital to leverage returns on the fund's assets. The fund paid large performance bonuses to the general partners who managed the fund, and limited partners participated in returns that were uncorrelated with broader

98 See www.newsvote.bbc.co.uk/mpapps/pagetools/print/news.bbc.co.uk/1/hi/business/4499290.stm
99 'Dubious Rocket Science' – LTCM, SMH, 1 October 1998, p32.

> markets....Hedge funds are actively managed to generate positive absolute returns, regardless of the performance of an index or sector benchmark. Hedge funds often engage in complex trading strategies across different markets to achieve dramatic investment performance. Unlike mutual funds, which make only buy or sell trades, a hedge fund engages in more aggressive strategies and positions, including selling securities short, trading in derivative instruments such as options and futures, and borrowing funds to leverage investment performance. These strategies have frequently generated attractive returns that are uncorrelated with the overall market. The active management of hedge funds makes them particularly attractive alternatives in bear markets, where they often outperform traditional funds because they hold short positions and other hedges against downturns." [100]

In 2006, the US Securities and Exchange Commission (SEC) adopted new regulations that required hedge fund advisers to register as investment advisers under the Investment Adviser's Act of 1940. However, the US Court of Appeals for the District of Columbia Circuit (within about six months) had struck down the rule, determining that the Commission's interpretation of 'client' was arbitrary, rendering the regulation unenforceable. It was a major setback in the regulation of hedge funds.

Fast forward a few years

In early 2007, Kenneth Rogoff, a Harvard Professor, stated as follows:

> "At the moment the most glaring weakness is the so-called yen carry trade. Hedge funds have borrowed hundreds of billions of dollars at ultra-low interest rates in Japan and invested the proceeds in countries such as Brazil and Turkey, where interest rates are high. So long as the yen remains weak, this investment strategy will be a money machine. But if the yen appreciates sharply, as it easily could given Japan's huge current account surplus, some hedge funds will suffer huge capital losses and the yen carry trade will implode....and, while today's main risk is the yen, in a couple of months it could be something completely different. So pressure outside the US and Britain to put hedge fund industry on a tighter regulatory leash is hardly surprising." [101]

The Germans, for example, were trying to force the issue by having hedge funds provide greater details in their reporting. Peer Steinbruck, the German finance minister stated:

> "... regulatory authorities needed to talk to them about how they could be made more transparent." [102]

100 B Davison, 'An Audit View of Hedge Funds', Internal Auditor, December 2006, 75.
101 Kenneth Rogoff, 'The Hedge Fund Hegemon'. See www.project-syndicate.org (accessed on 31 May 2009).
102 See www.guardian.com.uk/business/2007/feb/09

Chapter
8

Comparing traditional investing to hedge fund investing re: AIMA[108] Canada

Characteristic	Traditional Investing	Hedge Fund Investing
1 Return Objective	Relative returns	Absolute returns
2 Benchmark	Constrained by benchmark index	Unconstrained by benchmark index
3 Investment Strategies	Limited investment strategies Take long-only positions Do not use leverage	Flexible investment strategies Take long & short positions May use leverage
4 Market Correlation	High correlation to traditional asset classes	Generally low correlation to traditional asset class
5 Performance	Dependent on market direction	Often independent of market direction
6 Fees	Tied to assets under management, not to performance	Tied primarily to performance
7 Manager's Investment	Manager may or may not co-invest alongside investors	Manager generally co-invests alongside investors
8 Liquidity	Good liquidity	Liquidity restrictions and initial lock-up periods
9 Investment Size	Small minimum investment size (eg. $1,000 minimum)	Usually larger minimum investment size (eg. $25,000 minimum; depends on prospectus exemption)
10 Structure & Documentation; set up as a trust or investment company	Often sold by prospectus	Set up as a private investment, limited partnership or trust Usually sold by offering memorandum
11 Regulation	Highly regulated; restricted use of short selling & leverage	Less regulated; no restrictions on strategies Less mandated disclosure, and limited or no position level and risk exposure transparency Marketing restrictions apply Prospectus exemption

108 www.aima.org (Canada)

Issues for the regulators

Specifically, in relation to hedge funds, there are essentially two issues that regulators need to address. The Governor of the Reserve Bank of Australia, Glenn Stevens, in his speech in Hong Kong on 15th September 2006 to a group of regulators stated:

> "The position of investors who are entrusting their money to these funds. In our view, this is essentially about ensuring there is sufficient disclosure to allow investors to make informed judgments about the risks and returns. In Australia, the regulatory authorities draw no distinction between hedge funds and other investment managers; the regulatory regime is determined by what the entity does, rather than what it is called. This ensures a level playing field.
>
> Ensuring that the activities of investment managers which are not subject to prudential supervision do not threaten the financial viability of firms, such as banks, that are. This approach emphasises to the counterparties of hedge funds and other HLIs [Highly Leveraged Institutions] (that is prime brokers, banks and investment houses) the importance of strong risk management, collateral, knowing their customers and so on. The aim here is to preserve the prudential strength of the core part of the system in the interests of economic financial stability, while allowing the part beyond the prudential net to play its role in taking on risk." [109]

But such an approach, relying a good deal on market discipline, is not getting easier to implement.

Some key concerns over hedge funds

Concerns that regulators may have include:

- Lack of transparency in the level of asset reporting by the underlying funds within the FOHFs;
- Inadequate information provided to the FOHFs on underlying asset holdings;
- Risk of unintentional concentration in a fund of fund portfolios, such as an unwanted concentration in gold;
- Hedge fund managers are reluctant to expose their proprietary nature of the trading strategy used (as this is considered to be its main asset and has a competitive advantage) to scrutiny out of concern that other market participants might copy it, eliminating the original fund's competitive advantage;
- The lack of transparency might benefit funds managers, but it also prevents investors and their auditors from receiving full disclosures about the nature of their investments;

109 Glenn Stevens, 'Risk and the Financial System'. See www.rba.gov.au/speeches/2006/sp_dg_150906htm (accessed on 6 October 2006).

Chapter 8

"The federal securities laws do not create liability for poor business judgment or failed operations." [111]

However, one of the key issues could well be a misrepresentation of the financial products by describing them as 'high quality' when it is materially misleading or false. The board may not have understood how badly they were hurting their banks, but perhaps it can be proved they knew, or should have known, that claims of disciplined and high-quality lending practices were blatantly false.

If there is a witch-hunt for those banking executives who may have been guilty of misrepresentation then it will be necessary to determine how and why things went so horribly wrong. It will also be necessary to determine how those charges can be proven and whether any similar events occurred in the past.

It is worthwhile revisiting some historical cases of corporate collapses to re-learn some lessons and to illustrate the 'red flags' of rogue trading. For example, where some Tyco executives stole from their company and those directors at Enron who issued false financial statements that violated US accounting rules. The WorldCom directors lied about the nature of its spending, and turned losses into profits.

Guidelines

According to the Australian Government's Fraud Control Guidelines – May 2002, fraud is defined as:

'dishonestly obtaining a benefit by deception or other means.' [112]

This definition covers areas such as:

- Theft;
- Obtaining money, property, a financial advantage or any other benefit by deception;
- Making, using or possessing forged or falsified documents;
- Bribery, corruption or abuse of office;
- Deceit, trickery, sharp practice or breach of confidence, by which it is sought to gain some unfair or dishonest advantage;
- An intentional mis-statement of information to obtain financial benefits through improper, unauthorised or illegal actions; and
- The use of false representations to obtain unjust advantage.

Fraud can flourish in an environment of ignorance and neglect. Ignorance of internet

111 Floyd Norris, 'Fury Builds Over Crisis at Banks', www.nytime.com/2002/12/12/business/12norris.html (accessed on 9 March 2009).

112 www.ag.gov.au/www/agd/agd.nsf/page/fraudcontrol_CommonwealthFraudControl Guidelines-May2002#2 (accessed on 12 August 2009).

risk management tools and techniques can expose the whole organisation to undue risk. Fraud risk generally increases when senior management conveys the message that internal control is of minor importance or simply a necessary evil. A major part of any risk management strategy, should be fraud prevention because of the exploitation of administrative, managerial and audit failures by those with fraudulent intent.

Most risk consultants have long contended that the vast majority of security breaches are perpetrated from within the organisation. The ways in which employees are able to exploit or sabotage an organisation's internal control systems continue to multiply rapidly. It is therefore imperative to continually ask whether anyone inside the organisation can subvert internal controls rather than what someone outside the organisation can do.

Management should for example, ensure that employees are not using company information and IT systems to start their own businesses, to take revenge on co-workers, to engage in illegal activities or cause trouble in other ways. It is vital that controls are in place to protect the company from such situations.

As the pace of globalisation increases, the international accounting, auditing and professional standards setters are stepping up their efforts for global convergence. There is also a global push for a stronger legislative regime around anti-money laundering and counter-terrorism financing including the introduction of the Sarbanes-Oxley Act in the US. Control is no longer restricted to national borders.

Talking finance

Tough economic conditions can make people and/or organisations more vulnerable to fraud. There are certain types of fraudsters who may actually use the global financial crisis as an excuse to contact potential victims to talk high finance They then ask people to hand over money, banking details or personal information. The Australian Competition and Consumer Commission (ACCC), warned consumers:

"... to be on the lookout for scammers who might seek to exploit the global financial crisis by luring consumers into providing private financial details or financial payments". [113]

One of the most common types of frauds involves the use of fake emails. The emails are generally aimed at duping customers into logging onto ghost sites that look convincing at 'face value'. They often contain links to pages from real websites, logos from banks and the use of the names of real people. Some of the scams also offer a legitimate reason for contacting you. Some claim system problems and ask customers to re-submit their details, others ask for the re-verification of account following the introduction of an enhanced security system, while others claim phony investigations or irregularities in the accounts.

113 www.scamwatch.gov.au/content/index.phtml/itemID/750949 (accessed on 19 March 2009).

- Are all investments made on an arm's length basis?
- Is there adequate supporting documentation for trustees' valuations of investments?
- Is the reputation of investment managers and their commitment to compliance assessed prior to their appointment?
- Are adequate procedures in place to ensure safe custody of investments?
- Are physical assets, directly held by the fund, regularly reconciled to the fund's accounting records by persons independent of the fund's accounting functions?
- If a custodian is in place, does the custodian regularly reconcile physical assets to their records of the fund's investments?
- Are those records of the custodian reconciled to the fund's accounting records?
- Are procedures in place to ensure that purchases are correctly registered in the name of the fund?
- Are arrangements for control and communication of signatories to investment institutions and banks in place?
- Are there indemnification clauses in relevant investment manager contracts to indemnify the fund from losses arising from fraud within the investment manager?
- Do the trustees obtain and review audit reports and / or auditor's internal control comfort letters in relation to the fund's pooled and managed investments?
- Is banking of investment sale proceeds promptly carried out in appropriate bank accounts?
- Is investment income reviewed on a regular basis for completeness via reconciliations to investment managers' reports?
- Are financial instruments' gross, net and notional positions properly calculated and reviewed?
- Are explanations of variances between forecast and actual income prepared and discussed with the trustees?
- Has the organisation fully complied with the Anti Money Laundering Legislation requirements? For example, submission of the 'Ongoing Customer Due Diligence' report and compliance with the 'Transaction Monitoring & Reporting (TMR) process'? [119].
- Are 'mark-to-market' valuations performed independently?
- Are trades cancellations and amendments properly authorised and reviewed?
- Does senior management and the board understand how the exposure monitoring system work?

119 In Australia, TMR involves having a process in place to identify suspicious matters and report them to AUSTRAC – the regulator – within 3 business days (or within 24 hours if the suspicion relates to terrorism financing.

Possible indications of money laundering

The possible indications of money laundering include:

- Transactions that appear to be inconsistent with a customer's known legitimate business or personal activities or means. The transactions represent unusual deviations from normal account and transaction patterns;
- Situations in which it is difficult to confirm the identity of a person;
- Unauthorised or improperly recorded transactions with inadequate audit trails;
- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services;
- Apparent structuring of currency transactions to avoid regulatory record-keeping and reporting thresholds (such as keeping amounts to less than $10,000 for multiple transactions);
- Business seeking investment management services when the source of funds is difficult to pinpoint or appears inconsistent with the customer's means or expected behaviour;
- Uncharacteristically premature redemption of investment vehicles; particularly with request to remit proceeds to apparently unrelated third parties;
- The purchase of large cash value investments, soon followed by heavy borrowing against them;
- Large lump-sum payments from abroad;
- Insurance policies with values that appear to be inconsistent with the buyer's insurance needs or apparent means;
- Purchases of goods and currency at prices significantly below or above market;
- Forming companies or trusts that appear to have no business purpose [120].

Transparency

One of the most overused and misunderstood terms in the funds industry is transparency. Just mentioning the word to a fund managers could cause much angst as they are often not sure why you even want to raise the subject. It is possible you are implying that there is a need for them to be more transparent in what they are doing.

The following is a typical conversation between an investor and a funds manager:

Investor: Now, how is it possible that you don't have to tell me how you are valuing the complex financial derivatives products, including the entire hedge fund?

120 'The CPA's Role in Fighting Money Laundering', Alan Abel & James Gerson, Journal of Accountancy, June 2001, p5.