Australian Ethical® Investment

for Investors, Society and the Environment

Company Procedure Control Sheet

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Procedure Documentation (i.e. document(s) that describe the procedure)	
Name of Document	Location of document
AEI Risk Management Guide (January 2008)	*\\uluru\commonfiles\CorporateData\Compliance and Company Procedures\AEI\Compliance manual\Group wide procedures*
Hardcopies attached (Yes/No):	Yes

Reference Documentation (i.e. document(s) relied upon or referred to in developing the procedure)	
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AS/NZS 4360:2004	*[TBC]*

Modifications		
Authority to approve modifications:	*Compliance and risk committee*	
Date of Modification	Brief description of modification	Approved by
9 April 2008	Update of policy / procedure to bring into standard format.	AEI Board

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Investment + Superannuation

Company Policy / Procedure

Title:	**AEI Risk Management Guide**
Author:	**Compliance Officer**
Date:	**9 April 2008**
Version:	**3.0**

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1. Our aim for risk management

This Guide provides a common framework for managing business risk at Australian Ethical. Different parts of the Australian Ethical Group face different risks and we seek to pool our experience and work together to specify our different exposures, to share our management techniques for treating those risks, and to prioritise risks and their treatment across all parts of Australian Ethical.

The extent and pattern of risks faced by Australian Ethical is significantly influenced by:

- the internal structure of Australian Ethical, major delegations, processes and procedures; and
- the nature and arrangements of tasks outsourced by Australian Ethical, (for example, external custodian, external super administration).

Those arrangements increase some risks and reduce others. Decisions about internal structuring, high level delegations, major outsourcing arrangements and other Board level decisions are covered in the risk registers under the section of "Board – Company wide". Each section's risk register is written based on the current environment. For example, the Board delegates most trust investment risk decisions to the Investment Manager, subject to oversight by the Board's investment committee and Board approved trust investment parameters. The section risk registers do not deal with the differing risks which would ensue from different formulations of that delegation.

Risk management is defined as a process of well-defined steps which, when taken in sequence, support better decision by analysing risks and their impacts. Its aim is to improve the safety, quality and business performance of our Group and thereby promote a sea-change in community-wide practice such that all investment will be undertaken with an ethical purpose as well as in pursuit of competitive return for chosen risk. This Guide is written in the context of Australian Ethical's strategic plan, and it deals with the risks of failure to achieve strategic qua trading company objectives.

2. Areas of intrinsic risk for the Australian Ethical group

As a retail funds manager, there are 4 main areas of intrinsic risk to the Australian Ethical group.

Reputation

As an ethical investment company, our reputation for being ethical is our biggest asset. People are unlikely to invest with us if they don't believe that we are investing their money ethically.

Our reputation will also be affected if treatment of our customers is poor and customer service standards are weak.

Legal

Legal risk relates to the ever changing legal environment and the possibility of doing something that does not significantly negatively affect our investors or our reputation but maybe a breach of regulation or law. It also encompasses the risk of contracts or other arrangements turning out not to be legally enforceable in the way we expect.

Performance

Our investors expect 'adequate' performance from us when they entrust their money with us. If this does not occur, then inflow will reduce, existing investments will be redeemed and clients will complain. At the least, this will impact on our profitability and at the worst could lead to the demise of the company.

Operational

Every day we administer millions of dollars on behalf of thousands of people. Mistakes will inevitably be made, procedures may be flawed and in the worst case there may be fraud.

All of these areas have the intrinsic potential to lead to the demise of the company, and possibly significant negative effects on our investors. Each area is rated as extreme, before our control efforts. All of the intrinsic risks have had considerable effort devoted to them, and most risks in the group are now evaluated at medium or below.

The operational and legal risks occur throughout the group, and all staff and their actions have the potential to impact our reputation. Therefore these intrinsic risks are discussed in a number of sections in the risk register.

Table 1: Intrinsic Risk Areas

	Relevant Area							
Intrinsic Risk	*Invest*	*Super*	*Legal / Compliance*	*Finance*	*Marketing*	*Trust Administration*	*IT*	*Management Services*
Legal			Y		Y			
Investment Performance	Y							
Reputation	Y				Y	Y		
Operational	Y	Y	Y	Y	Y	Y	Y	Y

Note: All areas have some lower possibility of legal and reputation risk.

3. Meeting legal requirements

Managing risk in any corporation must comply with legislative requirements. This is especially so for a retail fund manager. Management of risk involves making decisions that must stand up to scrutiny from regulatory (APRA, ASX, ASIC) and accountability (IFSA, CPA, ASFA) authorities. Decisions, either as directors or officers, are subject to review under the Corporations Act, SIS, and other legislation as well as by the courts and by a range of industry specific statutory and non-statutory processes.

Australian Ethical may be required to defend its business decisions before an authority. Risk management following this guide offers a way in which Australian Ethical's decisions can be documented and supported. From the point of view of the inquiring authority, our risk management process allows any scrutiny under accountability mechanisms to be done readily and openly. It makes our managerial process transparent, as it must be under our Australian Ethical Charter.

4. Aim of this guide and the preparation of risk registers

Risks are events that threaten or enliven the assets or earnings of the Australian Ethical Group, or can disrupt the Group's operations. The company lives with these exposures day-by-day. Managing the risk of something going seriously wrong (or wonderfully right) is part of the job of all Australian Ethical employees. New and emerging risks come in many guises: changing competition, consumer trends, legislative changes, and traumatic events.

The process of preparing and monitoring risk registers as envisaged under this Guide asks:

- has the company (and its directors and officers) identified each major risk?
- have the identified risks been assessed in terms of value at risk and the probability of occurrence?
- is the company controlling the way in which each risk is managed; and
- is the company continuously monitoring its risk management processes and the risk environment?

These questions can be answered in various and in differing ways. The preparation of risk registers are intended to provide a common framework, not to limit management approaches. There may be events or circumstances that do not lend themselves to a standard and that require adaption.

5. What is 'control'?

There is an expectation that the company is 'controlling the way in which each risk is managed'. What is expected is that there is deliberate action directed at that risk. This can take many forms, for which the main categories may be the following so-called TRAP options:

- Terminating the activity giving rise to the risk;
- Reducing the risk by adopting appropriate procedures, controls and strategies;
- Accepting the risk; or
- Passing on the risk to another party.

6. Sources of risk

The scope of this Guide includes:

- Australian Ethical Investment Limited;
- Australian Ethical Superannuation Pty Ltd (as a wholly owned subsidiary trading company of AEI Ltd); and
- the Australian Ethical registered managed investment schemes.

The scope of this Guide does not include Australian Ethical Superannuation Pty Ltd (in its capacity of trustee of the retail superannuation fund) or of the superannuation fund. Risk management for those entities is covered in AES' risk management and compliance strategy and risk management plan.

Our main stakeholders are:

- our shareholders;

- investors in our products;
- staff; and
- the wider society and environment.

Looking more widely we note the various stakeholders in our Group included the SRI community, the NGO community (particularly the Tithe recipients), investee organisations, financial advisers and brokers, our stockbrokers and other financial institutions, our service providers particularly our custodian, regulatory bodies, and the Centre for Australian Ethical Research. Risks can impact on any of these stakeholders.

In the risk registers, we document the main impacts, rather than all impacts, of risks. For example, Human Resources (HR) is a source of many risks, say from lack or loss of resources, key person risk, or lack or loss of appropriate expertise or skills. These risks impact on every section. However, it is the responsibility of Management Services to coordinate resources and to specifically manage risks related to HR. Thus the table below summarises the sources of risk and shows HR under Management Services.

Table 2: Sources of Risk

	Area impacted							
Source of Risk	*Invest*	*Super*	*Legal / Compliance*	*Finance*	*Marketing*	*Funds Administration*	*IT*	*Management Services*
Human Resources								Y
Regulatory		Y	Y					
Natural Events							Y	Y
Communication and Controls	Y	Y	Y	Y	Y	Y	Y	Y
Financial Events				Y				
Investment Events	Y							
Technological /technical issues		Y		Y			Y	
Commercial /Legal/ Outsourcing	Y	Y				Y		
Human Behaviour	Y	Y	Y	Y	Y	Y	Y	Y

This table was developed based on the framework set out in AS/NZ 4360-2004. It was also influenced by banking literature such as ‘Financial Institutions Management A Modern Perspective’ Anthony Saunders 2000.

7. Structure of risk registers

Attachment A provides the template for the recording of risks in the risk register.

Risk documentation is for the current mitigated situation, not the unmitigated situation. The level of residual risk is determined after consideration of the existing controls.

While not all risks need be recorded, the register must record any risk that is at ‘medium’ or above after consideration of risk controls. From industry experience, it is expected that most sections will have up to five risks in that category. It is expected that each section will document and treat lower level risks as well but these do not have to form part of the Australian Ethical risk registers. These are best recorded and documented elsewhere in the section.

8. Consequence and Likelihood ratings

Much of the determination of risk is qualitative. Managers use experience, judgement and intuition to make decisions supported by information that is available.

Consequence to Australian Ethical may be represented by some measure of financial loss. As the leading ethical fund, a major concern for us is our reputation as a socially responsible funds manager. Reputation risk is not always easy to quantify. The figures in Table 3 below have therefore no precise significance but are intended to provide a working indication of areas of possible response.

Table 3: Qualitative measures of consequence or impact

Level	Descriptor	Explanation
1	Insignificant	Less than $20,000 financial loss and or insignificant damage to our reputation
2	Minor	Between $20,000 and $50,000 financial loss and or minor damage to our reputation
3	Moderate	Between $50,000 and $200,000 financial loss and or moderate damage to our reputation
4	Major	Between $200,000 and $1,000,000 financial loss and or major damage to our reputation
5	Catastrophic	More than $1,000,000 financial loss and or catastrophic damage to our reputation

Table 4: Qualitative measures of likelihood

Level	Descriptor	Explanation
A	Almost certain	Is expected to occur in most circumstances, ie expected frequency once a month or more
B	Likely	Is likely to occur in most circumstances, ie expected frequency between once a month and once a year
C	Possible	Is possible to occur, ie expected frequency between once a year and once every 5 years
D	Unlikely	Is unlikely to occur, ie expected frequency more than 5 years but less than 10 years
E	Rare	Occurrence would be rare, expected frequency less than once every 10 years.

Table 5 below cross tabulates the above measures to provide an overall assessment of risk.

Table 5: Qualitative Risk analysis matrix – level of risk

	Consequences				
Likelihood	Insignificant (1)	Minor (2)	Moderate (3)	Major (4)	Catastrophic (5)
(A) Almost certain	Medium	High	High	Extreme	Extreme
(B) Likely	Medium	Medium	High	Extreme	Extreme
(C) Possible	Low	Medium	High	High	Extreme
(D) Unlikely	Low	Low	Medium	High	High
(E) Rare	Low	Low	Medium	Medium	High

Thus a risk noted as ‘insignificant’ but ‘almost certain’ would be assessed as ‘medium’. In contrast, a risk noted ‘major’ but the likelihood as ‘rare’ would also be assessed as ‘medium.

9. Risk evaluation

Using the above analysis, section head and other staff are in a position to evaluate and compare risks. Section managers will need to report on:

- current controls for preventing, detecting or lowering the consequences of potential or unwanted risks or events;

- what is the potential likelihood of the risks happening; and
- what are the potential consequences of the risks if they do occur.

The value of this qualitative analysis is enhanced when the determination of risk is shared across a range of officers with different interests and backgrounds and skills. One person's view may be different from another's and the contribution of many ideas may improve the usefulness of the outcome.

Risks above medium: No new risk can be accepted above 'medium' without specific Board approval. The Risk Officer will draw to the attention of the Board the emergence of any risk at these levels.

For such risks that may be identified above 'medium', treatment plans are to be prepared for submission to the Board. The treatment plans need to be prepared in consultation with the CEO.

Risks at 'medium': Any risk recorded at 'medium' level must be brought to the attention of the CEO.

These requirements are summarised in Table 8. This table sets out the decisions required on the allocation of responsibilities for the treatment of the evaluated levels of risk

Table 8: Management response to the level of risk

Level	Descriptor	Explanation
1	Extreme	Must be signed off by the Board, supported by treatment plans, and managed by the section head and the CEO in accordance with the treatment plan. The treatment plan needs to include specific monitoring and response procedures.
2	High	Must be signed off by the Board, supported by treatment plans, and managed by the section head and the CEO in accordance with the treatment plan.
3	Medium	Must be notified to the CEO. The section head is responsible for appropriate and specific procedures.
4	Low	Manage by routine procedures.
5	Insignificant	Unlikely to require application of resources.

If a revised risk assessment shows a rise in operational risk above 'medium' for a risk currently held, the CEO and Risk Officer must be notified. A treatment plan for the risk must be prepared and presented to the Board. The CEO is similarly required to brief the Risk Officer where some significant negative change in risk is identified.

The outcome from this process is a set of Risk Registers for each section for presentation to, and signoff by, the Board each year. Any significant change in assessment of your Register is to be brought to the attention of Risk Officer with a view to possible further Board presentation.

10. Structure for reporting, monitoring and review

Section heads will report to the Risk Officer in the format determined by the Risk Officer on matters such as any new risk arising, risk breaches, recurring problems and the effectiveness of risk management controls. This includes risks arising from any projects that are being undertaken. Reporting from section managers to the Risk Officer will occur at least on a quarterly basis. The Risk Officer will in turn report to the Board's Compliance and Risk Committee on a quarterly basis.

The Board's Compliance and Risk Committee has the following risk monitoring responsibilities

- to oversee and monitor the implementation of the company's risk management systems;
- to review on a quarterly basis the company's risk registers and recommend to the board any changes to those risk registers.

The Board's Compliance and Risk Committee has the following risk reporting responsibilities to the Board:

- an annual report to the board on the effectiveness of the company's risk management system including recommended changes to those systems.

At least once per year, the Board will review the company's risk registers.

Where a risk management process or control relies on compliance measures that are set out in the Compliance Plan or Compliance Manual and section procedures, those measures may be incorporated by reference to the Plan or Manual or procedure, without the need for duplication in full.

The Risk Officer is responsible for system review and for periodic testing to assess the effectiveness of the existing system/controls, and for establishing appropriate criteria for use by sections in monitoring the adequacy of these controls. The Risk Officer is required to maintain a record of such testing of the system and of any adverse experience or ineffective controls. Reports on the results of any periodic testing will be provided to the Board's Compliance and Risk Committee.

An overall review will be conducted by the Risk Officer each year. Such review with cover:

- does our accepted risk profile remain appropriate?
- are our risk treatments effective in optimising our risks?
- are our risk controls adequate?
- how can improvements be made?

Attachment A – Risk Analysis template

X Risk 1 (Risk X1)

Risk analysis

Description of risk:		Risk Category:	
Pre-control risk rating:	Likelihood:	Consequences:	Rating:
Controls:	▪		
Post-control risk rating:	Likelihood:	Consequences:	Rating:
Treatment of residual risk:	▪		
Responsibility for risk monitoring and oversight:			
Treatment plan for risk (where post control risk rating is high or above)			