

The Treasury

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
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- [3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Vote Serious Fraud

Four-year Budget Plan

Version [3]

10 February 2011

Submitted by:

Serious Fraud Office

Section 1: New Baseline and Summary of Changes

Direction of Change

The SFO is not proposing any material change of direction. Rather, through improved operational efficiency and performance, it is looking to ensure that it can remain viable in order to deliver on the Government's priority of economic growth and safe communities.

At the strategic level, the SFO is seeking to make a material difference in reducing financial crime. It has been restructured with a view to re-defining its role more widely in fighting major financial crimes; and establishing the capability necessary to ensure it is the country's centre of excellence for fraud-related forensic accounting and investigations. In this regard, the SFO can offer greater efficiencies to Government by providing its specialised expertise to all Government agencies whether by way of assuming responsibility for major financial crimes or by way of some form of contracted service.

Six months on from its restructuring, the operational performance of the SFO has lifted significantly, and compares very favourably with its most obvious international benchmark, the UK SFO. It has cleared a backlog of cases, with approximately 50% referred to prosecution (including Bridgecorp and Five Star Finance). It has commenced investigations and prosecutions, and secured convictions, into major cases of public interest involving enormous losses.

SFO currently has 24 investigations at hand (22 from the current financial year) which include:

- Hanover Finance (\$400+M losses)
- Dominion Finance (\$200M losses)
- South Canterbury Finance (\$400+M losses)
- Capital + Merchant Finance (\$167M)
- Aorangi Securities/Hubbard Management Funds (\$40+M losses)
- Lane Walker Rudkin (\$100M losses)
- B'On Financial Service (\$15M losses)
- Belgrave Finance (\$15M losses)
- Kiwi Finance (\$2M losses)

It also currently has 30 prosecutions at hand (8 from the current financial year), including:

- National Finance (one guilty plea already entered)
- Bridgecorp
- Five Star Finance (two guilty pleas already entered)

Overall Impact

While there is no single "typical" case, recent improvements to the analysis of case costs and resource requirements show that the approximate length of a case is 9 months with an average cost of \$300,000-400,000. On the current appropriation this

equates to 20 cases. On any analysis, and given the rise and sophistication of economic crime, the current budgeted volume of cases (and related funding) means SFO cannot properly address serious financial crime, and has significant challenges to be viable at the lower volume of investigations. Consequently, it either requires funding to a level of “critical mass”, or consideration of other options.

The table below summarises the financial position required in order to achieve greater cost efficiency in the investigation of serious financial crime across the public sector; ensure that SFO as an agency has sufficient critical mass; and more properly address the incidences of serious financial crime.

Of the \$8m required, it has been identified that Police could provide investigation resource through seconded staff arrangements. In addition, the SFO considers there could be fiscally neutral transfers between Votes if the SFO were to assume responsibility for parallel investigations being conducted elsewhere. This could include financial crimes investigations currently investigated and prosecuted by other departments and Crown entities, but which arguably better fit within the remit of the Serious Fraud Office Act 1990.

Operating	Impact (\$000s)				
	2010/11	2011/12	2012/13	2013/14	2014/15
Current Baseline	7,470	7,470	7,470	7,470	7,470
OBU – technical adjustment*	2,813	(2,627)	0	0	0
Cost of new/increased activities	780	8,000	0	0	0
Amount reprioritised	0	(500)	0	0	0
New baseline	11,063	12,343	7,470	7,470	7,470

***Note** that at OBU 2010, a technical adjustment (with no cash requirement of the onerous lease provision) recognising \$2.720m of an onerous lease was approved for 2010/11. This lease will in-turn be sublet in 2011/12 which reverses the technical adjustment made. There is also an adjustment for recognition of rental revenue. Though this has an appropriation impact, the cash requirement would remain at \$7.470m in 2010/11 and 2011/12 as well as any new funding approved.

In 2011/12, a review of investigative and prosecution functions across other public sector agencies which deal with some aspects of financial crime will be conducted. It will consider options for determining the optimal way of delivering these services with regard to economic crime. This review should provide the Government with savings in 2012/13 and outyears determine whether there is any duplication of Serious Fraud activities in other Votes.

Capital

The SFO does not require any additional capital funding. This has been provided for in prior years and has not yet been fully spent. The balance of significant expenditure is planned for 2010/11.

Section 2: Vote Priorities and Pressures

Intended achievements over the next four years

Over the next four years the SFO is seeking to achieve through its strategy for detecting, investigating and prosecuting serious financial crime:

- A reduction in the very significant public costs of fraud (estimated at \$1.8 – 5.4 billion)¹;
- Minimise investor losses from fraud through earlier detection and intervention, and thereby increase investor confidence in the integrity of our financial markets; and
- Ensure there is public confidence in the justice system, and in the public sector, through the SFO's work on bribery and corruption issues.

Last year, the SFO underwent a major review which resulted in significant organisational and case management improvements. The future focus of the SFO is on:

- **Greater operational sophistication:** To enable earlier intervention in major financial crimes, the SFO needs to continually develop its skills and tools. This will both mitigate the effects of such crimes (on investors and the wider public) and increase the prospect of success in prosecuting them.
- **Whole of Government response:** The SFO's current budget for fighting white collar crime is less than 0.15% of the Justice Sector resources. In order to maximise its results, it is seeking to achieve a better coordinated law enforcement response across Government which improves both the efficiency (i.e. the time and cost) and the effectiveness (i.e. successful investigations) of economic crime investigations.
- **Awareness of the costs of economic crime:** The SFO aims to ensure that the lessons of major investigations and prosecutions are understood by those who can help prevent recurrences of them by: (i) better fraud prevention at an operational level; and (ii) promoting legislative responses where there are demonstrable weaknesses in the existing framework.

The SFO is now managing investigations in significantly shorter times than before, with a 70% reduction in the average investigation. It has commenced investigations into numerous failed finance companies, with charges laid and convictions obtained in respect to several of them. Further charges are imminent. The SFO is also dealing with a host of other financial crimes including major banking frauds, large embezzlements involving lawyers and other professional advisers, as well as several bribery and corruption cases. The totality of alleged offending involves over \$1 billion of losses and affects 30,000+ investors.

¹ Based on University of Portsmouth "*The Financial Cost of Public Sector Fraud*"; Refer: <http://www.macintyreHUDSON.co.uk/sites/www.macintyreHUDSON.co.uk/files/The%20Financial%20Cost%20of%20UK%20Public%20Sector%20Fraud%20-%20-%20Report.pdf>

How these achievements link to the Government's priorities.

The coming four years provides a unique opportunity for the SFO to make progress in an area of law enforcement that addresses two important Government priorities – law and order, and economic development. The scope and scale of recent economic crimes has created general public concerns regarding the integrity of the justice system and its ability to hold white collar criminals to account. The finance company collapses have also undermined domestic and international investor confidence in the integrity of our financial markets.

Cost of financial crime to the economy

Though in New Zealand there has been little policy or economic analysis about the impact of economic crime on the New Zealand economy, internationally there has been a growing awareness both as to the scale of the problem, and the tangible economic benefits to be gained from effectively targeted funding of financial crime investigations.

A 2003 Treasury paper² estimated that fraud represented 13% of the total cost of crime in New Zealand, or approximately \$1.1b (at that date). Internationally, the more academically robust studies suggest this figure is considerably understated. The UK National Fraud Authority estimates³ the cost of fraud in the UK at NZ\$123b. On a pure population based comparison, this would equate to NZ\$8.9b in New Zealand.

Comprehensive and authoritative research on fraud and financial crime was recently undertaken by the University of Portsmouth in 2010.⁴ Based on worldwide research, it concluded that “...*the latest global data is unequivocal...*” and that fraud consistently accounts for 3-9% of public expenditure with 4.57% being the international average. Even at the lowest level, this would equate to approximately \$1.8b in New Zealand, or \$2.7b using the international average.

Whatever the true figure, there is little doubt that financial crime in New Zealand is: (a) prevalent; (b) a significant impediment to economic growth; and (c) the costs which are incurred from effective law enforcement are modest compared with the scale of the economic benefits which flow from effective prevention, detection and prosecution.

The major pressures facing the Vote over the forecast period

The improvements and efficiencies made over the past 9 months have only been possible by the SFO reducing its caseload to numbers which are in line with its present funding (\$7.47M or 0.15% of the total Justice sector budget). However, the SFO is now faced with having to take on several large investigations (including Aorangi Securities; South Canterbury Finance; and Hanover Finance) and it has approximately twice the number of new investigations than were planned for the first half of the financial year. As noted earlier, this caseload level is not sustainable on the current funding levels.

² http://www.treasury.govt.nz/publications/research-policy/wp/2006/06-04/02.htm#_TocT1

³ <http://www.attorneygeneral.gov.uk/NewsCentre/Pages/NationalFraudAuthority.aspx>

⁴ Refer footnote 1.

The drivers of costs in the Vote

Table 1: UK SFO & NZ SFO - comparative funding and resources

	UK SFO ⁵			NZ SFO ⁶		
	1997	2010	Variance (%)	197	2010	Variance (%)
Staff	154	307	+99	38	28	-26
Budget (NZ\$M)	34.2	85.7	+250	4.7	7.5	+59
Investigations	64	55	-15	38	24	-37
Prosecutions	18	9	-50	16	31	+93
Staff/investigation	2.4	5.5	+190	1.0	1.2	+20
Budget/investigation (NZ\$000)	534	1,558	+190	123	339	+175
Losses (NZ\$M) / case	unknown	5.2	-	4	35	+775

The SFO is endeavouring to service a caseload which is both meaningful in terms of having a positive impact on financial crime in New Zealand and also aims to offer greater cost-efficiency across Government by providing adequate forensic investigative and accounting assistance to related agencies, such as the Securities Commission, MED, Police etc. The cost factors which arise from this are:

- ***Additional staff:*** SFO staff numbers are demonstrably lower than comparable international standards.⁷ Even allowing for economies of scale (i.e. proportionally fewer staff can handle a greater workload due to less “lumpiness” in the case workload), if the SFO is to handle an “appropriate” workload the SFO would require a 50-100% increase in current FTE’s.⁸
- ***Adequate provision for external legal costs:*** The practice of early engagement of external prosecution counsel has been widely endorsed for speedier; better-focused and more successful investigations. This comes with cost implications (with legal costs for the year expected to be 200% higher than previous years), but is off-set by better focused (i.e. faster) investigations, which have improved prospects of successful prosecution.

⁵ These numbers are based on their year end annual reports.

⁶ These numbers are based on the 1996/97 annual report and current statistics (October 2010) respectively.

⁷ Refer Table 1.

⁸ SFO has had budgeted staff number of 40 FTE’s since inception. However, due to salary and other cost increases, it currently has 28 FTE’s, 26 of whom are considered “front-line” staff. Current staff numbers can serve approximately 20 investigation cases p.a.

- Adequate provision for specialist technical expertise: Even with a pool of experienced forensic accountants and lawyers, the nature of the SFO's work is such that external expert advisers and witnesses (including forensic IT providers, valuers and professional directors) are occasionally required for the more complex investigations. Recent internal improvements to financial reporting on a case by case basis indicate that the costs for this kind of advice are up to \$100k/case, or \$500k – \$1M/year.⁹ Previous SFO management made no allowance for this.
- Additional computer forensic tools: SFO evidence is now quantified in terms of terabytes of data and tens of millions of emails and electronic documents. The SFO has attempted to manage this in a cost-effective manner by a shared services arrangement with Customs for cloning equipment. This arrangement is valuable, but does not address the need for on-site analytical tools. Investment in industry-standard hardware and software of this kind is essential to improving both the speed with which evidence can be searched and the integrity underlying the discovery of evidence material to a charging decision. The capital cost of approximately \$100,000 (cloning hardware), together with ongoing operational costs of approximately \$50,000 (software licences and training).

The measures being put in place to manage these pressures within the Vote

As part of Budget 2010, the SFO introduced a comprehensive set of performance measures to manage the pressures within the Vote, which it is meeting. However, it does not have the scale of operation or the diversity of functions to off-set one priority with another. It also has negligible corporate service costs. Consequently, the only mechanism to manage cost pressures is to reduce case numbers. This would require prematurely closing major investigations and/or refusing to take on new, major investigations. While possible, this is considered publicly unacceptable, and a failure on the SFO's part to carry out its statutory function.

Moreover, even if it were to prematurely terminate investigations, most of the SFO's costs are fixed; i.e. staff; IT and premises. Consequently, the corollary of terminating investigations would be to reduce staff numbers which could only occur by way of redundancies. This would have severe repercussions for the future of the SFO.

⁹ Assuming approximately half of the cases investigated require specialist expertise.

Section 3: Proposed Changes for Budget 2011 (Reprioritisation)

What will be new or increased?

With a single measurable output (successful investigations and prosecutions), the SFO's fiscal pressures are simply determined by the interrelationship between caseload, resources and timeframes. If caseload increases, then timeframes and/or resources must increase.

In past years, the SFO has maintained a high (relative to other considerations) caseload of 45-60 cases p.a. As a consequence, timeliness has suffered significantly,¹⁰ with individual cases having to be juggled relative to the commitments of different investigation staff. In addition, the quality of cases had been reduced (i.e. a focus on relatively minor frauds such as low value employee embezzlement or mortgage funding frauds) to avoid the need to apply significant internal resources to any one case and/or incur the cost of external expertise.

The positive results delivered over the last 6 months have demonstrated the success of this strategy in a short time frame. However, the SFO is still seeking to deliver further improvements to these results – particularly in regard to cost-effectiveness.

The table below outlines the additional costs for SFO if it is to maintain current performance levels in investigating and prosecuting major financial crimes which reflects the current level of activity and the impact of doubling this caseload to reflect a long term viable and efficient agency.

	Investigations	Prosecutions	Additional funding (\$M)	Total funding ¹¹ (\$M)
Current 2010/11 budget	20	15	-	7.47
Projected 2010/11	25+	20+	0.780	8.50
Projected 2011/12	40-50	20-30	7.50	14.97
2012/13 & Outyears	40-50	20-30	To be determined	To be determined

¹⁰ Until the current year, the SFO has not met its timeliness measure (80% of cases completed inside 12 months) in 8 of the past 10 years.

¹¹ Excludes an onerous lease technical accounting adjustment of \$2.72m to the appropriation for 2010/11, which reverses in 2011/12, and recognition of rental revenue and expense.

Alternatives to additional funding

Given the links between case numbers; costs/resources; and timeframes, there are three broad options available to manage the current pressures:

- push investigation timeframes back out to 18+ months;
- decline new cases and/or close current cases;
- increase current resources and/or transfer additional resources from other agencies and/or transfer cases to alternative resources.

1. Transfer other agency resources to SFO

It has been identified that Police could provide some investigation resource through a long term (1-2 year) seconded staff arrangements.

2. Transfer fiscally neutral funding (and responsibilities) from other agencies

A significant proportion of SFO cases are also investigated, and often prosecuted, by other agencies. Recent examples of this include:

- [8]

- [9]

[3]

Properly resourced and focused, it is suggested that the two agencies can provide complementary, rather than competitive, roles. The Securities Commission/FMA's skills lie in wide regulatory powers in the (relatively) narrow field of financial markets, while the SFO skills lie in the very specialised criminal powers being brought to bear against all types of serious financial crimes which include the financial markets, but include many more general forms of fraud, as well as bribery and corruption.

It is considered that there could be further work undertaken across other government agencies to identify duplicated costs involving investigation and prosecutions of fraud which could conceivably be transferred to the SFO, with consequential cost savings elsewhere.

3. Transfer SFO cases to other agencies

Referring cases to another agency is an appropriate option, *but only where that agency is the appropriate one in terms of jurisdiction skills and resources*. The SFO already refers the bulk of its (more minor) complaints to other agencies. Examples of this are:

- Minor frauds are referred to the relevant Police district;
- Bribery matters which are resource intensive but do not have significant financial complexity are also referred to the Police;

- Financial markets cases which have marginal evidential sufficiency for the Crimes Act charges are referred to the Securities Commission or MED for investigation under the Securities or Companies Acts.

If a matter is a genuine case of complex and serious fraud then it should be investigated by the SFO for three reasons:

- SFO is the only agency which can exercise the powers under the SFO which are critical to a major fraud being properly investigated;
- SFO is the only agency with a fully complement of forensic accounting and computer resources to investigate a major financial crime; and
- There would not be any cost saving to the public sector by simply transferring such costs to another agency. Indeed, because most of these agencies lack their own forensic accounting or computer resources, the cost of their investigation is typically outsourced at a much high cost.

4. Cease to take new investigations

The SFO does not have a legal obligation to investigate a major financial crime. However, it would be difficult to argue that the Director was properly discharging his duties if a matter was referred to SFO which met its statutory threshold; was appropriate to the SFO's jurisdiction; and had sufficient prima facie evidence to warrant inquiry.

Section 4: Summary of Financial Movements

This section details the changes to appropriations (including new appropriations) which are required to implement all of the proposed changes in section 3.

Departments should generate this report from CFISnet.