NSW GOVERNMENT | Premier & Cabinet
Division of Local Government

Review of NSW Local Government Investments

April 2013

Premier & Cabinet Division of Local Government	Review of NSW Local Government Investments April 2013

Executive Summary

An independent review of council investments was conducted in early 2008 by Michael Cole (the Cole Report). Since the release of the report, a number of councils across NSW have realised investment losses in respect to their holdings of structured financial products and continue to do so. The current review of local government investments undertaken by the Investigations and Performance Group of the Division of Local Government provides an update on the gains and losses on structured financial products.

1. Key findings

The key findings of the review were:

- Councils have reduced their exposure to structured financial products from approximately $1[1] billion in 2007 to $395 million at 30 June 2012, thereby reducing uncertainty and the potential for further losses;
- Over the past four financial years, councils have realised losses of approximately $192 million, $160 million in CDOs and $32 million in Capital protected products;
- As at 30 June 2012, councils anticipate further (unrealised) losses of $170 million, $155 million in CDOs and $15 million in Capital protected products;
- Total losses (both realised and unrealised) at 30 June 2012 was $362 million[2] from structured financial products (Cole Report estimated a loss/shortfall of $250 million);
- Councils' reserves have been depleted by as much as $50 million over the past four financial years as a result of interest not being received from CDOs and Capital protected products; and
- The largest losses recorded by individual councils were Gosford City Council ($42M), Wingecarribee Shire Council ($19M), Ryde City Council ($15M), Woollahra Municipal Council ($10M) and Moree Plains Shire Council ($9M).

The report has also identified a number Councils at risk of investment defaults, being Broken Hill Council, Yass Valley Council, Singleton Council, Richmond Valley Council, Canterbury Council, Armidale Dumaresq Council and Port Macquarie Hastings Council.

[1] 'Short scale' a billion is 1000 million as used as opposed to 'long scale' a billion is a million million.
[2] ($192 million plus $170 million)

2. Recommendations

The events leading to the significant financial losses to councils from CDOs and related products, the resulting Cole Report and this survey update have highlighted a number of on-going risks associated with council investment practices.

These risks, together with proposed mitigation strategies, are:

Risk 1: Lack of experience and the potential for investment decisions that do not provide an appropriate risk based return

Mitigation strategy: In the medium/long term, consider options for centralising councils' investment and borrowing functions, which is consistent with the Cole Report's initial conclusions. The benefits of centralising the investment and borrowing functions of councils include:

- a body of expertise;
- providing for a better balance between risk and return for councils;
- a governance model overseen by independent experts; and
- the ability to diversify investments managed by qualified and expert investors.

Risk 2: Ongoing inconsistency or lack of clarity of investment information between councils' audited financial information and the information included in councils' monthly investment reports

Mitigation strategy: The Division develops further compliance and monitoring techniques in the areas of financial management for councils. The review found that the Division should maintain greater oversight when reviewing councils' financial statements to ensure consistency and compliance. This can be achieved by integrating the Division's current activities of oversight and compliance with the audit process, making for a more efficient and effective use of resources.

Risk 3: Inconsistency in auditors' assessment of councils' investment information

Mitigation strategy: That in collaboration with Local Government Auditors Association, the NSW Auditor General and the NSW Treasury Corporation, the Division develops a set of strategies to improve the consistency of audits.

1. Introduction

An independent review of council investments was conducted in early 2008 by Michael Cole. The final report (the Cole Report) was completed and issued on 2 April 2008. The NSW Government adopted all of the eight recommendations identified in the Cole Report.

The Cole Report found that NSW councils faced potential losses of $320 million, of which $200 million related to Collateralised Debt Obligations (CDOs). The Cole Report also recommended that investments that did not comply with the updated Ministerial Investment Order could still be held by councils until market conditions improved.[3]

Since the release of the Cole report, a number of councils across NSW have realised investment losses in respect to their holdings of structured financial products and continue to do so. The current review of local government investments undertaken by the Division provides an update on the gains and losses on structured financial products as part of a follow-up to the Cole Report.

1.1 Background

The initial terms of reference for the Cole Report were to identify;

- The total exposure of councils who have invested in structured financial products such as CDOs and the nature of these (such as frequency of trading, specific structured product holdings and terms to maturity);
- The extent to which restricted and unrestricted council funds are being invested in structured products[4];
- The context of total investment practices of NSW councils;
- The extent that unrealised losses from structured investments are threatening the financial position of individuals councils; and
- The options available to remedy the current situation.

In addressing the terms of reference, the Cole Report provided the following table summarising councils' investment losses.

Investment Type	Face Value @ 30-Jun-07 ($m)	Market Value @ 31-Jan-08 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	590	390	200	34%
Capital protected	450	400	50	11%
Managed Funds	2,420	2,350	70	3%
FRNs & Subordinated Debt	600	600	Nil	Nil
Term Deposit, cash, bills	1,630	1,630	Nil	Nil
Total	5,690	5,370	320	5.6%

As a result of the Cole Report, councils can no longer invest in products such as CDOs. The Ministerial Investment Order was amended in 2008, immediately following the release of the Cole Report, and again in 2011, to limit the scope of investment options for councils. All councils are required to report monthly on their investments, including the value of any CDOs they may still hold.

[3] Grandfathered
[4] Restricted and unrestricted funds are those identified as internally restricted, externally restricted and unrestricted in Note 6 to the Financial Statements in each council's annual financial report.

The Division reviews all councils' annual audited financial statements, monitoring the impact of investment losses. These reviews focus on councils' overall financial position including whether councils are holding sufficient cash and investments to cover their reserves.

Councils are required to adhere to a range of frameworks to ensure their funds are managed effectively and responsibly, including the Ministerial Investment Order, the Australian Accounting Standards and the Division's issued Investment Policy Guidelines.

The Cole Report commented that both in Australia and globally the integrity of credit ratings methodologies are under close scrutiny by regulators and investors. In short, the Report found that the credibility of the credit ratings agencies as a key quality filter for investments decisions is being critically questioned. As a result, the NSW government recommended that any further investments of this type should be suspended.

The role of the ratings agencies is important within the financial system in overcoming information asymmetry. It provides an investor with a service, allowing them to concentrate on their operations and not needing to undertake considerable research and ratings reviews.[5]

While clearly the conduct of credit ratings agencies have been called into question[6], their role in providing the best available independent information is important. However, in referring to previous advice provided by the Division in November 2000[7], ratings in no way guarantee the investment or protect an investor against loss. Prescribed ratings should not be misinterpreted by councils as an implicit guarantee of investments or entities that have such ratings.

1.2 Changes to the Investment Order

NSW councils invested in CDO portfolios in the hope of generating higher than normal returns from their long term investments. These investments were aggressively marketed, including by Lehman Brothers, as complying with the Investment Order for NSW councils.[8] Bowrey and Jones found that simple compliance with the Investment Order was a liberal interpretation of fulfilling the requirements and expectations associated with managing public monies, and did little to account for the risk associated with these types of financial instruments.[9]

As a result of the Cole Report, the NSW Government issued a revised Investment Order pursuant to section 625 of the *Local Government Act 1993*. The Order was signed on 31 July 2008 and published in the NSW Government Gazette on Friday 15 August 2008.

The changes to the Order included:

- Including both principal and investment income in the definition of investment instruments.
- Removal of investments with specific credit ratings under items (k) and (l) of the previous Order.

[5] Hunt B and Terry C, 2008, *Financial Institutions and Markets*, 5th Ed, Thomson, p118
[6] Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200
[7] Department of Local Government, Circular to Councils, 'Forms of Investment – Minister's Order', Circular No 00/16, 28/03/00.
[8] Bowrey G and Jones G, 2010, 'Local government investing: a form of gambling?', University of Wollongong Research Online, p8
[9] Bowrey G and Jones G, 2010, 'Local government investing: a form of gambling?', University of Wollongong Research Online, p6

- Removal of item (g) in the previous Order, which identified purchase of land as a form of investment. This removal does not preclude a council from acquiring land for the purpose of exercising any of its functions (s186(1) Local Government Act 1993).
- Streamlining the wording around investing in public funds and securities issued by or guaranteed by the Commonwealth or Territory (part (a)).
- Restricting mortgages over land to first mortgages with a Loan to Value ratio of no greater than 60% (part (c)).
- Excluding subordinated obligations (part (d)).
- Improving the wording for investments and bills of exchange with authorised deposit-taking institutions (part (e)).
- Transitional arrangements regarding existing investments (grandfathering provisions).

The Division issued Investment Policy Guidelines for Consultation on 25 May 2009, aimed at assisting councils in developing a comprehensive investment policy. The guidelines included issues raised in the Cole Report, relating to conflicts of interest, such as product manufacturers and distributors being appointed as investment advisors, and the fiduciary responsibilities of councils and county councils in relation to investment activities. The Division released the final Investment Policy Guidelines in May 2010 after an extensive consultation with stakeholders.

The Ministerial Investment Order was reviewed again in January 2011 and a further revised Order was gazetted on 11 February 2011. The changes to the Order included:

- removing Local Government Financial Services Pty Ltd as a separate item;
- removing the ability to invest in the mortgage of land; and
- adding key considerations in the revised Investment Order that includes a comment that staff responsible for investing funds must do so in accordance with the adopted investment policy of council.

The current Ministerial Investment Order limits councils' ability to diversity their investments. Most, if not all councils, are investing only with Australian banks.

No Australian bank regulated under the *Banking Act 1945* has defaulted on their obligations. A study found last year that a few small institutions failed in the late 1980s and early in 1990s during a period of stress in the banking system. However, it did not result in a loss to deposit holders. The protection of deposit holders is entrenched in Australian law, giving them priority over regular secured and unsecured creditors. The exception being new "covered" bonds from banks.[10] The current Ministerial Investment Order relies on a stable, efficient and competitive banking system in Australia.

[10] Joye C, p29

2. Survey findings

2.1 Methodology

The current review of NSW Local Government investments involved a targeted survey of NSW councils, focusing on councils that had previously indicated holdings of structured financial products.

The information obtained from councils was reconciled back to councils' annual financial statements for the year ended 30 June 2012.

In light of the previous findings into local government investments, in particular that council losses were concentrated in CDOs, capital protected products and managed funds[11], the current review focused on the losses incurred from structured financial products. While councils have incurred losses on managed funds, especially during 2008, improved market conditions have limited further losses. Therefore, managed funds were not a focus of the current review.

The current review of NSW Local Government investments also does not consider the mix of external and internal funds. This is because many councils fund long term liabilities from one large pool of investments, making it an impossible task to accurately assess the extent to which restricted or unrestricted funds are being invested in structured or other products, given the data received by councils.[12]

The initial response to the Division's targeted survey of 78 councils was 60%. Councils were followed up over a number of weeks for their response. Narrabri Council was the only council not able to respond to the Division's targeted survey.

2.2 Balances

In reviewing surveyed councils' information it is clear that councils' exposure to structured financial products has reduced, as a result of changes to the Ministerial Investment Order.

The following graph demonstrates this observation of a significant reduction in councils' exposure to structured financial products from 2008 to 2012. Councils have limited their exposure to further losses through the sales, defaults and maturities of investments and the revaluation of financial assets. Councils' survey results indicate a remaining exposure of $60 million in CDO investments.

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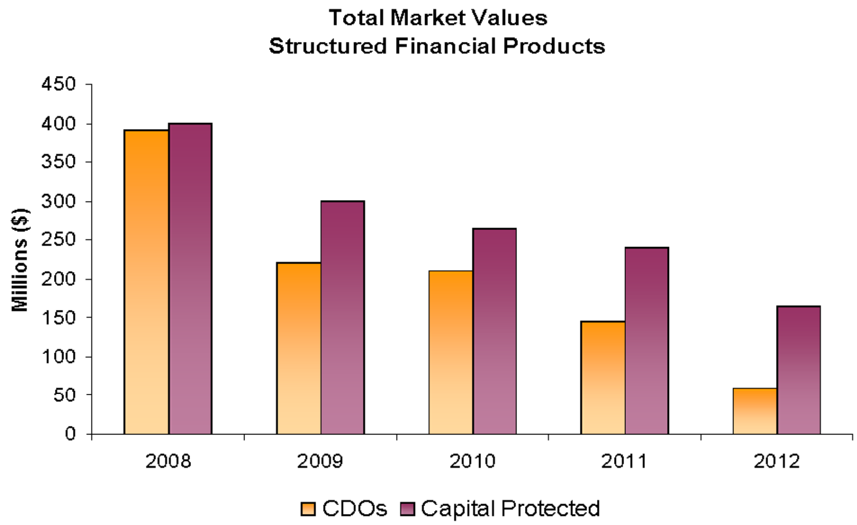
[11] Cole M, p14
[12] Cole M, p19



The following tables show the balances of CDOs and capital protected products at the end of each financial year from 30 June 2009 to 30 June 2012[13].

Investment Type	Face Value @ 30-Jun-07 ($m)	Market Value @ 31-Jan-08 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	590	390	200	34%
Capital protected	450	400	50	11%
Total	1,040	790	250	

Investment Type	Face Value @ 30-Jun-09 ($m)	Market Value @ 30-Jun-09 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	520	220	300	58%
Capital protected	375	300	75	20%
Total	895	520	375	

Investment Type	Face Value @ 30-Jun-10 ($m)	Market Value @ 30-Jun-10 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	455	210	245	54%
Capital protected	310	265	45	15%
Total	765	475	285	

Investment Type	Face Value @ 30-Jun-11 ($m)	Market Value @ 30-Jun-11 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	340	145	195	57%
Capital protected	265	240	25	9%
Total	605	385	220	

[13] The first table is taken from the Review of NSW Local Investments in 2008

Investment Type	Face Value @ 30-Jun-12 ($m)	Market Value @ 30-Jun-12 ($m)	Estimated loss / shortfall ($m)	Estimated loss / shortfall
CDO	215	60	155	72%
Capital protected	180	165	15	8%
Total	395	225	170	

As at 30 June 2012, surveyed councils reduced their exposure to structured financial products from approximately $1.04 billion[14] in 2007 to $395 million in 2012. This reduction in structured financial products was of a consequence of sales, defaults and maturities. As at 30 June 2012, surveyed councils estimated their losses on structured financial products at $155 million in CDOs and $15 million in structured financial investments.

It should be noted that as capital protected products move nearer to their maturity, the market value of the investment moves closer to its face value, until reaching par on maturity.

The market values provided by surveyed councils are estimates which may not necessarily reflect the potential "realisable value" or the actual value if the CDOs were sold in the current market. Market value is typically a combination of interest rates, credit quality and liquidity.

2.3 Settlements

The following tables show losses on settlements for each financial year for CDOs and capital protected products from 1 July 2008 to 30 June 2012. The last table in the series provides a cumulative balance of all settlements.

Investment Type	Reported losses on settlement in 2009 ($m)	Face Value on settlement ($m)	Reported losses on Face Value
CDO	45	80	56%
Capital protected	7	25	28%
Total	52	105	

Investment Type	Reported losses on settlement in 2010 ($m)	Face Value on settlement ($m)	Reported losses on Face Value
CDO	30	65	46%
Capital protected	13	65	20%
Total	43	130	

Investment Type	Reported losses on settlement in 2011 ($m)	Face Value on settlement ($m)	Reported losses on Face Value
CDO	35	110	32%
Capital protected	6	40	15%
Total	41	150	

[14] 'Short scale' a billion is 1000 million as used as opposed to 'long scale' a billion is a million million.

Investment Type	Reported losses on settlement in 2012 ($m)	Face Value on settlement ($m)	Reported losses on Face Value
CDO	50	130	38%
Capital protected	6	80	8%
Total	56	210	

Investment Type	Total reported losses on settlement ($m)	Face Value on settlement ($m)	Total reported losses on Face Value
CDO	160	385	41%
Capital protected	32	210	15%
Total	192	210	

The Cole Report found that only $2 million of CDO losses had actually been realised by councils. Since that time, surveyed councils have reported CDO losses of approximately $160 million.

In addition, a number of councils have sold off their holdings of capital protected products, thus realising actual losses of approximately $32 million, rather than risking future losses as a result of further reductions in the market value of the investment or the potential of suffering greater losses resulting from a default by the counterparty.

Losses were calculated by subtracting the amount received on sale, maturity or default from the cost of the investment. The estimated figure of $160 million understates the extent of total losses incurred by councils in investing in structured financial products as the figure does not include all councils[15] that held structured financial products and also does not include losses from the year ended the 30 June 2008.

However, the figures also do not take into account any payments received by councils via successful litigation.

2.4 Interest

The following tables show the interest received by surveyed councils from 1 July 2008 to 30 June 2012 on CDOs and capital protected investments. The last table shows the cumulative results.

Investment Type	Interest received in 2009 ($m)	Benchmark Amount ($m)	Difference ($m)
CDO	24	25	1
Capital protected	6	18	12
Total	30	43	13

Investment Type	Interest received in 2010 ($m)	Benchmark Amount ($m)	Difference ($m)
CDO	16	18	2
Capital protected	2	12	10
Total	18	30	12

[15] In conducting a reconciliation of council's financial statements, it showed a number of councils with minor exposures to CDOs or other structured financial products that were not included in survey. Narrabri Council did not respond.

Investment Type	Interest received in 2011 ($m)	Benchmark Amount ($m)	Difference ($m)
CDO	13	17	4
Capital protected	3	13	10
Total	16	30	14

Investment Type	Interest received in 2012 ($m)	Benchmark Amount ($m)	Difference ($m)
CDO	5	9	4
Capital protected	1	8	7
Total	6	17	11

Investment Type	Total interest received ($m)	Benchmark Amount ($m)	Difference ($m)
CDO	58	69	11
Capital protected	12	51	39
Total	70	120	50

It is common for only the principal investment amount to be credit rated or bank guaranteed. As a result, the income stream from these investments is not guaranteed or credit rated.[16] Councils' reserves have been depleted by as much as $50 million over the past four financial years resulting from earnings not being received.

For simplicity, the interest calculated above does not include interest received on settled investments during the period.

The benchmark figure is calculated on the balances of councils' investments at the end of year multiplied by the 90 day bank accepted bill rate.[17]

2.5 Individual Council Holdings

The following tables show the largest holders of CDOs and Capital Protected Product Holders as at 30 June 2012.

Summary of Largest CDO Holders by Council 30 June 2012

Council	Market Value ($m)	Total Investments @ 30 June 2012 ($m)	CDOs Proportion of Total Investments
Newcastle	7	184	4%
Parkes	2	43	5%
Moree Plains	2	16	13%
Mid Coast	2	57	4%
Liverpool	2	116	2%
Hurstville	2	28	7%
Eurobodalla	2	57	4%
Wollongong	2	29	7%
Leichhardt	2	45	4%
Lake Macquarie	2	150	1%
Total	25	725	

The table above shows that Newcastle Council ($7M), Parkes Council ($2M) and Moree Plains Council ($2M) are three largest holders of CDOs as at 30 June 2012. Of particular

[16] Cole M, April 2008, Review of Local Government Investments, Final Report, p9
[17] Retrieved on 26 November 2012, http://www.rba.gov.au/statistics/tables/xls/f01dhist.xls?accessed=2012-11-26-14-22-56.

concern is Newcastle Council's survey which does not reconcile with its financial statements, which shows a nil exposure to CDOs investments.

Summary of Largest Capital Protected Product Holders by Council 30 June 2012

Council	Market Value ($m)	Total Investments @ 30 June 2012 ($m)	Capital Products Proportion of Total Investments
Mid Coast	28	57	49%
Bryon	15	59	25%
Sutherland	15	89	17%
Goulburn	10	59	17%
Port Macquarie	9	104	9%
Yass	9	26	35%
Sydney	8	525	2%
Orange	8	106	8%
Canterbury	7	48	15%
Coffs Harbour	6	172	3%
Total	25	1,245	

The table above shows that Mid Coast Water ($28M), Bryon Shire Council ($15M) and Sutherland Shire Council ($15M) are three largest holders of Capital Protected products as at 30 June 2012. The survey results indicate that most of the Capital Protected products are no longer paying interest or a coupon.

2.6 Individual Council Losses

Councils can record gains and losses on revaluation or settlement. A review of the annual financial statements for 2011/12 indicates that councils are largely revaluing their structured financial products at fair value. As part of the revaluation process councils recognise movements such as gains and losses in the value of their investment during or at the end of each financial year.

The following table summarises those councils that have either sold their investment/s and/or the investment/s have defaulted or matured, and their respective losses.

Summary of Largest Losses from Sales, Defaults and Maturities by Council from 1 July 2008 and 30 June 2012

Council	Realised Losses ($m)	Total Investments @ 30 June 2012 ($m)	Losses Proportion of Total Investments
Ryde	15	79	19%
Gosford	12	80	15%
Moree Plains	9	16	56%
Parkes	9	43	21%
Hurstville	9	28	32%
Coffs Harbour	8	172	5%
Willoughby	8	45	17%
Canterbury	7	48	15%
Newcastle	7	184	4%
Liverpool	6	116	5%
Total	90	811	

Councils' total losses realised from the sales, defaults and maturities of investments was $192 million over the past four financial years.

In some cases councils have written down the full value of their investment but have kept the investment on their books. The survey indicates that some councils are leaving investments on their registers in anticipation of receiving a partial recovery of face value on maturity or receiving back capital as a result of successful litigation action.

The councils listed in the following table have been revaluing their investments and writing down their values, recognising gains and losses over the period from 1 July 2008 and 30 June 2012. These investments have not been sold, defaulted or matured.

Summary of Largest Losses from Revaluations by Council from 1 July 2008 and 30 June 2012

Council	Cost minus Valuation @ 30 June 2012 ($m)	Total Investments @ 30 June 2012 ($m)	Proportion of Total Investments
Gosford	30	80	38%
Wingecarribee	19	69	28%
Woollahra	10	35	29%
Parkes	8	43	19%
Newcastle	7	184	4%
Hurstville	6	28	21%
Armidale	6	21	29%
Port Macquarie	5	104	5%
Coffs Harbour	5	172	3%
Shoalhaven	4	109	4%
Mid Coast	4	57	7%
Total	104	901	

Surveyed councils have indicated at 30 June 2012, that if they were to realise their CDOs holdings of $215 million, they would realise only $60 million.

While previous losses are indicative of the future challenges faced by councils, the audited annual financial statements for 30 June 2012 provide for a more meaningful indicator of the ongoing risks to councils.

Based on the information in councils' audited annual financial statements for 30 June 2012 and their unrestricted cash reserves, some councils have been identified as at risk of an investment default.

There is a risk to councils in 'the event of a default' in their holdings of CDOs or Capital Protected products that they will not have sufficient liquidity to pay for unexpected or unforeseeable liabilities.

The following table shows the unrestricted funds of councils and their holdings of CDOs and Capital Protected products.

Councils with liquidity risk

Council	Unrestricted funds ($m)	Total Market Value CDO Investments ($m)	Total Market Value Capital Protected Products ($m)	Unrestricted funds less CDOs and Capital Protected Products ($m)
Broken Hill	0	1	0	(1)
Yass	9	2	7	0
Singleton	9	1	7	1
Richmond Valley	4	1	2	1
Canterbury	18	4[18]	7[19]	7
Armidale	9	2	4	3
Port Macquarie	20	1	9	10

Broken Hill Council is currently being monitored by the Division and there are number of other financial issues for Council to deal with. However, Broken Hill Council's exposure to CDOs investments is one of these concerns.

REFERENCES

Bowrey G and Jones G, 2010, 'Local government investing: a form of gambling?', University of Wollongong Research Online,

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Hunt B and Terry C, 2008, *Financial Institutions and Markets*, 5th Ed, Thomson

Joye C, 2012, "*A deference for deposits*", The Weekend Australian Financial Review, November 10-11

[18] Held to Maturity (Not Fair Value)
[19] Held to Maturity (Not Fair Value)

POLICY NAME:	INVESTMENTS
POLICY REF:	I01
MEETING ADOPTED:	22 March 2012 Resolution No. 220312/23
POLICY HISTORY:	240311/14; 220710/14; 181208/16; 240507/20; 230206/044

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1. OBJECTIVE

1.1 To provide a framework for the investing of Council's funds at the most favourable rate of interest available to it at the time whilst having due consideration of risk and security for that investment type and ensuring that liquidity requirements are being met.

1.2 While exercising the power to invest, consideration is to be given to the preservation of capital, liquidity, and the return of investment.

- Preservation of capital is the principal objective of the investment portfolio. Investments are to be placed in a manner that seeks to ensure security and safeguarding the investment portfolio. This includes managing credit and interest rate risk within identified thresholds and parameters.
- Investments should be allocated to ensure there is sufficient liquidity to meet all reasonably anticipated cash flow requirements, as and when they fall due, without incurring the risk of significant costs due to the unanticipated sale of an investment.
- Investments are expected to achieve a market average rate of return in line with the Council's risk tolerance.

1.3 This policy only deals with Council's investments with financial institutions and does not consider investments Council may wish to make in other forms of capital; such as property.

2. BACKGROUND

- Council has a fiduciary and legislative responsibility to manage public monies in a prudent and diligent manner. The Investment Policy sets the tone and expectations of Council and establishes guidelines and parameters for staff who are required to actually place the investments on a daily basis.

3. DEFINITIONS

Prudent person: A legal maxim restricting the discretion in a client's account to investments that a prudent person seeking reasonable income and preservation of capital might buy for his or her own portfolio. See attachment from the NSW Trustees Act advising matters to which a prudent must have regard when exercising the power of investment

BBSW: The Bank Bill Swap reference rates are independent and transparent rates for the pricing and revaluation of privately negotiated bilateral Australian dollar interest swap transactions. The rates are published daily.

APRA: The Australian Prudential Regulation Authority is a body established by an act of parliament. APRA oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies and most members of the superannuation industry. APRA is funded largely by the industries that it supervises. It was established on 1 July 1998.

ADI: Authorised Deposit-taking Institutions are corporations which are authorised under the *Banking Act 1959*. ADIs include banks, building societies, and credit unions.

3. SCOPE OF POLICY

- This policy applies to Councillors, Committees of Council and Council employees.

4. RELATED DOCUMENTATION

- See section 5 on Legislative Authority for Investments and also Council's delegation policy.

5. LEGISLATIVE AUTHORITY FOR INVESTMENTS

All investments are to comply with the following:
- Local Government Act 1993;
- Local Government (General) Regulations 2005;
- Ministerial Investment Order;
- Local Government Code of Accounting Practice & Financial Reporting;
- Australian Accounting Standards; and
- Division of Local Government Circulars.

6. DELEGATION OF AUTHORITY

Authority for implementation of the Investment Policy is delegated by Council to the General Manager in accordance with the *Local Government Act 1993*.

The General Manager may in turn delegate the day-to-day management of Council's investments to the Responsible Accounting Officer and or the Accountant, subject to regular reviews.

Officers' delegated authority to manage Council's investments shall be recorded and required to acknowledge they have received a copy of this policy and understand their obligations in this role.

The placement of investments requires a minimum of two signatures from officers with delegated authority to invest surplus funds.

7. PRUDENT PERSON STANDARD

The investment will be managed with the care, diligence and skill that a prudent person would exercise. As trustees of public monies, officers are to manage council's investment portfolios to safeguard the portfolio in accordance with the spirit of this Investment Policy. The matters to which a prudent person shall have regard when making an investment on behalf of another are an attachment to this Policy (Section 14C NSW Trustees Act).

It is expected that the skills of officers making investments will include:

- an understanding of the current positioning of the financial markets. ie; what is the current 90 day BBSW rate.
- an understanding of the type of investments in which they are dealing. ie; investment rate offered, term to maturity and the organisation that is receiving and using the funds. Also the underlying conditions of the transaction that impact risk and reward including circumstances in which the user of the funds may default in payment of capital and interest.

- an understanding of the institution that will receive and use the funds including their credit worth. ie; current Standard and Poors rating/are they APRA regulated?
- an understanding of Council's investment policy and associated legislation such that when placing an investment all relevant conditions are considered and weighed.

The role of investing officer will be to:

- avail themselves of current market information and investment options.
- be aware of Council's current liquidity position and the options that best suit Council in terms of length of the investment.
- in most instances the form of investment shall be a term deposit with an ADI and the investing officer shall consider at least three quotes from different ADI's. Typically the investing officer becomes aware of daily rates by phoning the institution or receiving an email.
- phone the preferred institution and advise them that they have been successful, arrange for funds to be transferred as agreed, ensure that the recipient institution provides Council with appropriate acknowledgement and documentation following their receipt of funds, complete Council's investment placement sheet and have verifying officer sign sheet.
- in instances where the form of investment is not a term deposit then the matter shall be discussed between at least two recognised investment officers prior to making a placement.

The investment officer shall maintain an investment register which shall include:

- the source and the amount of money invested
- particulars of the security or form of investment in which the money was invested
- the term of the investment (ie, placement and maturity dates where applicable), and
- If appropriate, the rate of interest to be paid, and the amount of money that the council has earned, in respect of the money invested.

8. ETHICS AND CONFLICT OF INTEREST

Officers shall refrain from personal activities that would conflict with the proper execution and management of Council's investment portfolio. This policy requires officers to disclose any conflict of interest to the General Manager.

Independent advisors are also required to declare that they have no actual or perceived conflicts of interest.

9. APPROVED AND PROHIBITED INVESTMENTS

9.1 Investments are limited to those allowed by the most current Ministerial Investment Order that has been issued by the NSW Minister for Local Government. A copy of the current order is attached to this policy.

9.2 In accordance with the Ministerial Investment Order, this investment policy prohibits but is not limited to any investment carried out for speculative purposes including:

- Derivative based instruments;
- Principal only investments or securities that provide potentially nil or negative cash flow; and
- stand alone securities issued that have underlying futures, options, forwards contracts and swaps of any kind.

This policy also prohibits the use of leveraging (borrowing to invest) of an investment.

10. RISK MANAGEMENT GUIDELINES

Council's primary strategy is to preserve the capital invested by diversifying with different approved financial institutions on the short term (12 months or less) money market.

This minimises the risk in terms of interest rate movement and integrity of individual financial institutions.

Investments obtained are to be considered in light of the following key criteria:

- Preservation of Capital - the requirement for preventing losses in an investment portfolio's total value (considering the time value of money);
- Diversification - setting limits to the amounts invested with a particular financial institution or government authority to reduce credit risk;
- Credit risk - the risk that a council has if an institution fails to pay the interest and or repay the principal of an investment;
- Market Risk - the risk that the fair value or future cash flows of an investment will fluctuate due to changes in market prices;
- Liquidity Risk - the risk an investor is unable to redeem the investment at a fair price within a timely period; and
- Maturity Risk - the risk relating to the length of term to maturity of the investment. The larger the term, the greater the length of exposure and risk to market volatilities.

11. LIQUIDITY RISK PARAMETERS

11.1 All investments are to be placed with institutions regulated by the Australian Prudential Regulation Authority (APRA) in accordance with the Banking Act 1959, ie Authorised Deposit-taking Institutions (ADIs) or the NSW Treasury Corporation, but excluding subordinated debt obligations.

11.2 At least three quotations shall be obtained from qualifying institutions whenever an investment is proposed. The best quote of the day will be successful, providing the investment will not breach any parameters contained within this policy and after allowing for administrative and banking costs.

11.3 Not more than 40% of the portfolio can be placed in investments exceeding 12 months to maturity and not more than 20% in investments exceeding 3 years to maturity.

12. CREDIT RISK PARAMETERS

12.1 Investment portfolio parameters are risk-management tools used to manage credit risk by diversifying the portfolio to avoid a narrow concentration of investments. Investment credit risk parameters are based on credit rating bands as published by the credit rating agencies (eg S & P, Moodys, Fitch).

12.2 Council will use Standard and Poors (S & P) long term credit ratings (or Moodys or Fitch equivalents). The S & P ratings are broadly defined as follows:

AAA	Extremely strong capacity to repay
AA+, AA, AA-	A very strong capacity to repay
A+, A, A-	A strong capacity to repay
BBB+, BBB, BBB-	Adequate protection and adequate capacity to pay
BB+, BB, BB-	Less vulnerable to non payment however adverse economic conditions could lead to inadequate capacity to meet financial obligations
CCC	Vulnerable to non payment and requires positive economic conditions to meet its financial obligations

12.3 The following credit risk parameters apply to the investment portfolio:

Maximum Thresholds - Portfolio Limits		
Credit Rating	**Maximum % of Total Portfolio**	**Exposure to a Single ADI**
A or higher	100%	20% of Portfolio
BBB to -A	60%	10% of Portfolio
Unrated ADI	10%	$1m

13. PERFORMANCE BENCHMARKS

13.1 Investment performance will be measured monthly, in relation to both current month and 12 month rolling returns, against relevant benchmarks.

13.2 The investment portfolio's performance as to interest rate achieved should be compared to the 90 day BBSW, and as to earnings to the approved budget.

14. REPORTING

14.1 The Local Government (General) Regulation 2005 (clause 213) requires a monthly report on investments to be provided to Council.

14.2 The monthly report to Council will include, as a minimum:

- the total value of the portfolio and the balance of the trading bank account
- a complete list of all investments in the portfolio, including the 'Fair Value' of any tradeable investments.
  A break up of the portfolio per institution, showing the rating for each institution.

- a comparison of interest earned to budget for the month and year to date
- a comparison of weighted average interest rate and 90 day BBSW for the month and year to date
- a statement as to whether the investments are in accordance with the Local Government Act, Regulations and Council's investment policy
- a commentary on portfolio performance and other matters of interest

14.3 Documentary evidence must be held for each investment and details thereof maintained in an investment register.

All investments are to be appropriately recorded in Council's financial records and reconciled at least on a monthly basis.

15. POLICY REVIEW

The Investment Policy will be reviewed at least once a year or as required in the event of legislative changes. The Investment policy may also be changed as a result of other amendments that are to the advantage of Council and in the spirit of this policy. Any amendment to the Investment Policy must be by way of Council resolution.

16. THRESHOLD BREACHES

16.1 This policy imposes limits and thresholds in relation to the acquisition and holding of investments. However, due to changes in the amount of Council's investment portfolio over time, situations may occur where these limitations or thresholds are breached.

16.2 Where limitations or thresholds are breached due to a change in the overall size of the total investment portfolio, or a possible change in ratings of the financial institutions, the following process will apply:

- Immediate forced sale of the investments in breach of the limits or thresholds will not be required unless, in the General Manager's or Council's opinion that such sale is necessary to protect the value of the overall investment portfolio

- An immediate freeze on acquisitions of new investments in the relevant category will commence, until the portfolio can be effectively managed back to align with the requirements of this policy

- The objective will be to manage the portfolio back in accordance with the policy limits, within three months from the date the portfolio first exceeds the limit or threshold.

17. GRANDFATHERING OF INVESTMENTS

Transitional Arrangements

17.1 Transitional arrangements contained in the Minister's Order dated 12 January 2011, state that Council investments purchased prior to 31 July 2008, which complied with the previous Minister's Order, are taken to be in compliance with the current Minister's Order. This same 'grandfathering' provision applies to this Investment policy.

17.2 Council will hold investments that fall under the Minister's grandfathering provisions until maturity or until such time as the market price of such investments will allow a sale without financial loss to Council.

SECTION 14C NSW TRUSTEES ACT

14C Matters to which trustee is to have regard when exercising power of investment

(1) Without limiting the matters that a trustee may take into account when exercising a power of investment, a trustee must, so far as they are appropriate to the circumstances of the trust, if any, have regard to the following matters:

(a) the purposes of the trust and the needs and circumstances of the beneficiaries,

(b) the desirability of diversifying trust investments,

(c) the nature of, and the risk associated with, existing trust investments and other trust property,

(d) the need to maintain the real value of the capital or income of the trust,

(e) the risk of capital or income loss or depreciation,

(f) the potential for capital appreciation,

(g) the likely income return and the timing of income return,

(h) the length of the term of the proposed investment,

(i) the probable duration of the trust,

(j) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment,

(k) the aggregate value of the trust estate,

(l) the effect of the proposed investment in relation to the tax liability of the trust,

(m) the likelihood of inflation affecting the value of the proposed investment or other trust property,

(n) the costs (including commissions, fees, charges and duties payable) of making the proposed investment,

(o) the results of a review of existing trust investments in accordance with section 14A (4).

(2) A trustee may, having regard to the size and nature of the trust, do either or both of the following:

(a) obtain and consider independent and impartial advice reasonably required for the investment of trust funds or the management of the investment from a person whom the trustee reasonably believes to be competent to give the advice,

(b) pay out of trust funds the reasonable costs of obtaining the advice.

(3) A trustee is to comply with this section unless expressly forbidden by the instrument (if any) creating the trust.

REVISED MINISTERIAL INVESTMENT ORDER

LOCAL GOVERNMENT ACT 1993 – INVESTMENT ORDER
(Relating to investments by councils)

I, the Hon. Barbara Perry MP, Minister for Local Government, in pursuance of section 625(2) of the *Local Government Act 1993* and with the approval of the Treasurer, do, by this my Order, notify for the purposes of section 625 of that Act that a council or county council may only invest money (on the basis that all investments must be denominated in Australian Dollars) in the following forms of investment:

(a) any public funds or securities issued by or guaranteed by, the Commonwealth, any State of the Commonwealth or a Territory;

(b) any debentures or securities issued by a council (within the meaning of the *Local Government Act* 1993 (NSW));

(c) interest bearing deposits with, or any debentures or bonds issued by, an authorised deposit-taking institution (as defined in the *Banking Act* 1959 (Cwth)), but excluding subordinated debt obligations;

(d) any bill of exchange which has a maturity date of not more than 200 days; and if purchased for value confers on the holder in due course a right of recourse against a bank which has been designated as an authorised deposit-taking institution by the Australian Prudential Regulation Authority;

(e) a deposit with the New South Wales Treasury Corporation or investments in an Hour-Glass investment facility of the New South Wales Treasury Corporation;

All investment instruments (excluding short term discount instruments) referred to above include both principal and investment income.

Transitional Arrangements

(i) Subject to paragraph (ii) nothing in this Order affects any investment made before the date of this Order which was made in compliance with the previous Ministerial Orders, and such investments are taken to be in compliance with this Order.

(ii) Paragraph (i) only applies to those investments made before the date of this Order and does not apply to any restructuring or switching of investments or any re-investment of proceeds received on disposal or maturity of such investments, which for the avoidance of doubt must comply with this Order.

Key Considerations

An investment is not in a form of investment notified by this order unless it also complies with an investment policy of council adopted by a resolution of council.

All councils should by resolution adopt an investment policy that is consistent with this Order and any guidelines issued by the Chief Executive (Local Government), Department of Premier and Cabinet, from time to time.

The General Manager, or any other staff member, with delegated authority by a council to invest funds on behalf of a council must do so in accordance with the council's adopted investment policy.

Councils have a fiduciary responsibility when investing. Councils should exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons.

When exercising the power of investment councils should consider, but not be limited by, the risk of capital or income loss or depreciation, the likely income return and the timing of income return, the length of the term of the proposed investment, the liquidity and marketability of the proposed investment, the likelihood of inflation affecting the value of the proposed investment and the costs (including commissions, fees, charges and duties payable) of making the proposed investment.

Dated this 12th day of January 2011

Hon BARBARA PERRY MP
Minister for Local Government

LOCAL GOVERNMENT ACT 1993 - INVESTMENT ORDER

LOCAL GOVERNMENT ACT 1993 – INVESTMENT ORDER

(Relating to investments by councils)

I, the Hon. Paul Lynch MP, Minister for Local Government, in pursuance of section 625(2) of the *Local Government Act, 1993* and with the approval of the Treasurer, do, by this my Order, notify for the purposes of section 625 of that Act that a council or county council may only invest money (on the basis that all investments must be denominated in Australian Dollars) in the following forms of investment:

(a) any public funds or securities issued by or guaranteed by, the Commonwealth, any State of the Commonwealth or a Territory;

(b) any debentures or securities issued by a council (within the meaning of the *Local Government Act* 1993 (NSW));

(c) mortgage of land in any State or Territory of the Commonwealth (restricted to first mortgages over land with a Loan to Value ratio of no greater than 60%);

(d) interest bearing deposits with, or any debentures or bonds issued by, an authorised deposit-taking institution (as defined in the *Banking Act* 1959 (Cwth)), but excluding subordinated debt obligations;

(e) any bill of exchange which has a maturity date of not more than 200 days; and if purchased for value confers on the holder in due course a right of recourse against a bank which has been designated as an authorised deposit-taking institution by the Australian Prudential Regulation Authority;

(f) a deposit with the Local Government Financial Services Pty Ltd

(g) a deposit with the New South Wales Treasury Corporation or investments in an Hour-Glass investment facility of the New South Wales Treasury Corporation.

All investment instruments (excluding short term discount instruments) referred to above include both principal and investment income.

<u>Transitional Arrangements</u>

(i) Subject to paragraph (ii) nothing in this Order affects any investment made before the date of this Order which was made in compliance with the previous Ministerial Order dated 15 July 2005, and such investments are taken to be in compliance with this Order.

(ii) Paragraph (i) only applies to those investments made before the date of this Order and does not apply to any restructuring or switching of investments or any re-investment of proceeds received on disposal or maturity of such investments, which for the avoidance of doubt must comply with this Order.

Dated this [illegible] day of [illegible] 2008 **Hon PAUL LYNCH MP**
Minister for Local Government