REVIEW OF NSW LOCAL GOVERNMENT INVESTMENTS

FINAL REPORT

MICHAEL COLE APRIL 2008

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Section 1: Terms of Reference

TERMS OF REFERENCE - REVIEW OF LOCAL GOVERNMENT INVESTMENTS

1.1. Confirm the total exposure of Councils who have invested in structured financial products such as collateralised debt obligations (CDOs) and the nature of these (such as frequency of trading, specific structured product holdings and terms to maturity);

1.2. Assess the extent to which restricted and unrestricted council funds are being invested in structured products[1]; and

1.3. Assess, in the context of total investment practices of NSW Councils, the extent that unrealised losses from structured investments are threatening the financial position of individual Councils and consider options to remedy this.

[1] 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.

Key Discussion Points Addressing Each of the Terms of Reference

1.4. Relevant table addressing the first point of the Terms of Reference:

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%
Funds intended for medium term investment horizon[2]	1,640	1,390	250	15.2%

1.5. See sections 5.2 and 5.3 for detailed commentary on the first point of the Terms of Reference.

1.6. Relevant table addressing the second point of the Terms of Reference:

	Restriction							
	Externally Restricted	Internally Restricted	Mixed	No Response	Other	Restricted	Unrestricted	Total
Capital Protected Note	38.1	3.6	28.1	157.0	29.5	113.6	79.3	449.2
Collateralised Debt Obligation	39.4	16.5	68.0	131.7	37.7	155.4	137.5	586.3
Floating Rate Note	1.0	5.7	20.1	25.5	19.0	56.4	29.9	157.7
Managed Fund (A rated)	47.9	32.4	224.6	430.4	116.5	517.7	407.8	1,777.3
Managed Fund (AAA & AA rated)	10.1	8.9	127.0	159.8	37.4	136.2	174.4	653.8
Other	13.9	0.5	10.6	18.0	6.3	20.6	7.6	77.5
Short-dated Deposits	46.6	84.2	213.9	363.9	148.2	310.9	373.2	1,541.0
Subordinated Debt	22.3	8.1	45.6	84.6	8.0	184.4	66.0	418.9
Total	219.4	160.0	737.8	1,370.9	402.8	1,495.1	1,275.6	5,661.6

1.7. See sections 5.20 and 5.21 for detailed commentary on the second point of the Terms of Reference.

[2] Excluding estimated working capital (i.e. cash, term deposits, bills and managed funds)

1.8. Relevant table addressing the third point of the Terms of Reference:

Council	Estimated Mark to Market Potential Losses ($m)	Face Value of CDOs & Capital Protected Note Holdings 30-June-07 ($m)	Total Investments ($m)	Estimated Mark to Market Losses as a Percentage of Total Investments
Gosford	23.0	74	135.5	17%
Newcastle	12.6	39	138.4	9%
Hastings	10.7	45	82.3	13%
Wingecarribee	10.4	32	58.8	18%
Sutherland	9.1	55	123.0	7%
Parkes	8.6	26	41.2	21%
Coffs Harbour	8.0	39	144.3	6%
MidCoast County	7.9	54	58.7	13%
Hurstville	7.0	23	29.7	23%
Byron	6.9	44	60.3	11%
Total	104.3	430	872	12%

1.9. See sections 4.26 and 5.7 for detailed commentary on the third point of the Terms of Reference.

Section 2: Recommendations Summary

2.1. Recommendation 1: All investment instruments (debentures, securities, stocks and deposits, but excluding discount instruments such as bills of exchange) in the Investment Order be defined to include both principal and investment income.

2.2. Recommendation 2: All existing investments by NSW Councils that may be excluded by any proposed changes to the Investment Order are to be grandfathered. For the avoidance of doubt, existing securities that become ultra vires under the proposed amendments to the Investment Order can continue to be held to maturity, redeemed or sold, but new investments must comply with the amended Investment Order. Note that investment portfolio restructurings / switches currently being offered by product manufacturers or advisors are specifically excluded from consideration if the switch investments are outside the amended Investment Order. If the proposed switch investment is within the amended Investment Order all transactions must be on a market value basis. Book value transactions are explicitly prohibited.

2.3. Recommendation 3: Product manufacturers / distributors should be excluded from being appointed investment advisors to Councils.

2.4. Recommendation 4: Investments specified in k) and l) of the Investment Order be suspended for the period to 31/12/2009 and be subject to a further review after this period to determine the relevance of using a credit ratings based approach to determining authorised investments, particularly in light of the current CDO credit experience. It should consider whether to restore the current investment powers under k) and l). Any such review should have specific regard to the trade-off between the cost of Government monitoring and Council compliance which would be required, and the prospective incremental investment return.

2.5. Recommendation 5: It is recommended that the current partial deregulation model operating in New South Wales be retained with the modifications suggested in Points 4.13, 4.15, 4.18 and 4.30 of this report, as well as the minor modifications set out in Points 4.39 and 4.41. Consistent with the existing Investment Order, interest income and capital growth investment options will continue to be available through the TCorp Hour-Glass Investment Facilities. This outcome provides a number of the advantages highlighted in the centralised model in section 6.19.

2.6. Recommendation 6: It is most important that the Councils' fiduciary responsibility in relation to investment activities under the *Local Government Act 1993*, should be reinforced strongly. All participants should be made explicitly aware of the obligations under the *Trustee Act 1925 (NSW),* and be requested to sign to acknowledge the same. Inclusion of the relevant sections of the Trustee Act in the Investment Order may also assist in this regard. In particular, it is important that long term assets including Section 94 funds are invested in a manner consistent with meeting future liabilities, on the basis that the nominal return sought is consistent with an acceptable level of investment risk.

2.7. Recommendation 7: With regards to the Investment Order section (m), permitted investments in securities should explicitly exclude subordinated obligations. The permitted investments under (m) must rank pari passu with deposits of the same group entities; under (f) mortgages over land should be restricted to first mortgages with a Loan to Value ratio of no greater than 60%, and under (g), permitted land investments are to explicitly exclude ASX listed property trust investments.

2.8. Recommendation 8: The NSW Department of Local Government should give consideration to releasing a document, similar in content to the Western Australian Department of Local Government and Regional Development, Investment Policy – Local Government Operational Guidelines- Number 19, February 2008 (refer Appendix C). Further as noted in this document, there are deemed to be significant benefits from external monitoring: "a well constructed investment policy with clear objectives will facilitate an external review. The review should act as an intermediary to confirm that the investments explicitly align with the investment policy."(7-3/92).

Section 3: Background to the Review

The New South Wales Local Government Act and Investment Order

3.1. The permitted forms of investment for Local Government are outlined by order from the Minister for Local Government (with the Treasurer's concurrence) under section 625 of the *Local Government Act 1993 (*a copy of the latest Ministerial Order is included in Appendix A).

3.2. Unlike the framework adopted within other areas of the NSW public sector, operational guidance is not provided by Government to Councils. For example, within the general government / PTE sectors, the Treasury Management Policy is produced by the Department of Treasury in support of Investment PAFA approvals / Investment Orders.

3.3. Operational guidance supporting the Ministerial Order has been developed for Councils by the NSW Local Government Association – Finance and Professionals Special Interest Group. This document provides guidance on a range of issues and is widely used by Councils.

US sub-prime

3.4. Buoyant credit conditions in the United States in recent years have led to an expansion of investments into new sectors. One such avenue is the sub-prime mortgage market. Sub-prime mortgages are residential loans to borrowers with low credit quality that do not conform to the criteria for prime mortgages and so have higher interest rates and lower probability of full repayment.

Structured products and CDOs linked to sub-prime

3.5. Recently there has been a strong shock to the USA sub-prime mortgage market. This has been referred to in popular media as a credit crisis. This "credit crisis" has been caused not so much by the expansion of US sub-prime originations and their subsequent default, but more as a result of the securitisation of sub-prime mortgages into Mortgage Backed Securities (MBS). As a result, credit risk has been spread across a large number of investors worldwide and has created uncertainty about the underlying exposure to sub-prime due to their complex structures.

3.6. CDOs are a type of structured Asset Backed Security (ABS) that gain exposure to the credit of a portfolio of fixed income assets and divides the credit risk among different tranches, each with a different level of risk and return: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). The collateral for CDOs includes MBS, ABS, leveraged loans and corporate bonds. By combining low rated sub-prime MBS with high rated collateral, originators were able to create highly rated CDOs that could be widely distributed to traditionally conservative investors such as commercial banks, insurance companies and pension funds.

NSW Councils investing in products with sub-prime links

3.7. Some NSW Councils have invested in collateralised debt obligations (CDOs); particularly in recent times. To the extent that these investments are linked to asset backed securities and potentially the sub-prime mortgage market in the US, this has created potential exposure to movements in the secondary market valuations of CDO holdings for some NSW Councils. As a result, the NSW Treasurer initiated a review of NSW Council investments, with Michael Cole appointed to undertake this review.

Methodology

3.8. The review involved two main components:

3.9. a survey of all 152 NSW Councils asking each to report all their investments, short and long term including cash, categorised by type of investment; and

3.10. a series of informal interviews with key stakeholders in the sector including product providers, advisers, ratings agencies and Councils from which anecdotal evidence could be drawn upon.

3.11. Despite tight deadlines, compliance from Councils with the survey return was very good with over 85% of returns received by the due date. In time, 100% of data sought was collected. The data was of high quality, able to be reconciled to audited annual account figures, and formed the basis of a robust database used to analyse investment holdings of the Local Government sector.

Section 4: Report on the Review and Recommendations

4.1. The form of investments currently permitted by Councils in New South Wales (NSW) is set out in the Investment Order under s625 of the *Local Government Act 1993 (NSW)* (Refer Appendix A).

4.2. From an investment professional's perspective, the Regulator's intent would appear to be to limit such investments to interest paying deposits or securities issued by entities of high quality credit status. Mortgages secured over land (f), whilst conceptually a different security, have the same interest income characteristics as interest paying deposits / securities.

4.3. The only asset class in the Investment Order, which explicitly contemplates a capital gain, is the purchase of land (g). In addition, investments in the TCorp Hour-Glass investment facility (o) can include growth asset portfolios such as shares, and hence include capital gains in the prospective investment returns.

4.4. All investments entail some risk. Generally the higher the expected rate of return of an investment, the higher the risk and variability of returns. In each of the 3 years to 30/6/2007, the ASX 300 Accumulation Index increased in excess of 20% per annum; nearly doubling over the period.

4.5. The excess return of shares over the risk free rate was over 15% per annum and twice the theoretical equity risk premium based on longer term trends. It was a permissive investment environment where increased risk was seemingly well rewarded with enhanced returns. The warning of an inevitable severe adjustment was clear when Alan Greenspan, Chairman of the U.S. Federal Reserve said in 2005: “History has not dealt kindly with the aftermath of low risk premiums”

4.6. In this equities bull market, the attraction to NSW Councils of higher prospective returns offered by new investments different from the traditional suite of fixed interest products was an enticing proposition. At 30/06/2007, investments held by NSW Councils totalled $5.64 billion. Council investment funds fall broadly into two categories: the shorter term working capital balances, which account for approximately 70% of the total, and the residual 30% are the longer term funds, including S94 balances for deferred capital expenditure commitments.

4.7. Councils have continued to invest their short-term cash balances in the traditional fixed interest manner with a high level of security.

4.8. In relation to the longer term investment portfolio, the nominal rate of return required by Councils should preferably be sufficient to accommodate inflation in respect of future capital works. The nominal returns required could probably have been achieved by investment in traditional fixed interest securities. However, Councils appear to have invested these longer term assets to seek out the highest return available, so long as investments were consistent with the restrictions imposed by the Investment Order.

4.9. A new range of longer term investments were specifically financially engineered to accommodate the requirements of (k) and (l) of the Investment Order. These investments fell into two broad categories:

4.10. Highly structured credit products, the most common being Collateralized Debt Obligations (CDOs). At 30/06/2007 the book value of these investments was $590 million; and

4.11. Capital Guaranteed Products, with some exposure to high risk non-prescribed investments such as shares. At 30/06/2007 the book value of these investments was $450 million.

4.12. In both categories but particularly 4.11, 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. This is a liberal interpretation of the Investment Order as it is incorrect to simply gauge the riskiness of an investment by the likelihood of capital loss as this ignores the contribution of interest income to overall return on the investment portfolio. This ambiguity needs to be removed by amendment in relation to new investments.

4.13. Recommendation 1: All investment instruments (debentures, securities, stocks and deposits, but excluding discount instruments such as bills of exchange) in the Investment Order be defined to include both principal and investment income.

4.14. Any investments that are no longer permitted because of amendments to the existing Investment Order may continue to be held to maturity or redemption.

4.15. Recommendation 2: All existing investments by NSW Councils that may be excluded by any proposed changes to the Investment Order are to be grandfathered. For the avoidance of doubt, existing securities that become ultra vires under the proposed amendments to the Investment Order can continue to be held to maturity, redeemed or sold, but new investments must comply with the amended Investment Order. Note that investment portfolio restructurings / switches currently being offered by product manufacturers or advisors are specifically excluded from consideration if the switch investments are outside the amended Investment Order. If the proposed switch investment is within the amended Investment Order all transactions must be on a market value basis. Book value transactions are explicitly prohibited.

4.16. It is unclear whether the new suite of investment products offered to NSW Councils was initially 'demand driven' or 'supply pushed' but it was most likely a combination. However, it is clear that once the market was identified, the product suppliers aggressively sold these complex investment products as complying with the Investment Order. This compliance was a necessary, but not a sufficient, condition for NSW Councils to invest, as they are also governed by their fiduciary responsibility as trustees for the prudent investment of public funds.

4.17. The manufacturers of these new investment products promoted them directly to Councils. A limited number of distributors both promoted products as well as acted as advisers to the Councils. In one case, the participant acted as product promoter, adviser and investment manager. A party performing more than a single function has a responsibility to deal with the conflict of interest in a transparent manner. There is anecdotal evidence this was not the case.

4.18. Recommendation 3: Product manufacturers / distributors should be excluded from being appointed investment advisors to Councils.

4.19. The challenge facing product promoters offering complex investment products to NSW Council investors with limited broad investment experience was to thoroughly explain all the product risks. The difficulty of this task is highlighted by a current court case between a NSW Council investor and a product provider that misleading representations were made in relation to the security underlying the Federation CDO.

4.20. This period of buoyant share markets has been characterised by excess liquidity and very aggressive pricing of credit risk by historical standards. Since mid 2007, liquidity in global markets has tightened dramatically; share markets have adjusted downward by over 20% globally and are now technically in a bear market. It is now clear there was significant mispricing of the liquidity and credit risk embedded in these highly structured investment products.

4.21. The sub-prime securities issued in the US, and the associated global credit crisis, has resulted in securities write-downs by major financial institutions approaching $US 180 billion. This has adversely affected all CDO credit spreads, but the impact on sub-prime CDO issues has been most pronounced. However, the dramatic deterioration in CDO prices was not matched by a negative adjustment in credit ratings. Initially, credit rating agencies continued to defend their unaltered ratings against dramatic secondary market price reductions in CDO securities by explaining the negative price movement as being caused by a loss of market liquidity rather than a change in the underlying credit quality.

4.22. CDO investments by New South Wales Councils backed by corporate credits have typically declined by approximately 25-35% in the secondary market trading. The market value of the aggregate CDO portfolio of NSW Councils is now 34% less than the book value. However, the Federation CDO, backed by sub-prime mortgages is currently priced at around 15% of the issue price. That is an 85% decline in value. S&P initially reduced the Federation CDO rating from AAA to AA then to AA negative credit watch, still above the investment grade minimum qualification under the existing Investment Order. The Federation CDO rating was only downgraded to CCC- in late February, 2008.

4.23. Prior to the downgrade, the Federation CDO highlighted the serious difference in opinion between the market view of the CDO securities intrinsic value and the credit rating agencies forecast probability of default and loss. The market was strongly of the view that the credit rating was far too optimistic and it would significantly deteriorate in the period ahead. In the end S&P was left to play rating catch-up by downgrading too late and to the investor's disadvantage.

4.24. The market value of the investments held by NSW Councils is currently $5.37 billion, a fall of $320 million from the book value. It represents a decline of 5.6% of the total investments and a fall of 15.2% of the longer term funds. It must be emphasised these are market valuations and hence unrealised estimates of potential market losses. To date, only $2 million of CDO securities losses have actually been realised by a Council selling its holding of the Federation CDO.

4.25. These unrealised losses are significant in absolute terms but are not considered to pose a threat to the financial viability of the NSW Local Government Sector. As noted earlier the pursuit of a higher rate of return entails the acceptance of higher risk and variability in returns. The main criticism of the NSW Councils investment strategy is the poor risk /return trade-off. The upside return was capped at a couple of per cent over the risk free rate but, in one instance, the downside risk exposure has been recorded at 85% of the capital investment.

4.26. A number of NSW Councils have been identified as holding in excess of 45% of their total investments in CDOs and/or Capital Protected Notes. As these instruments represent the greatest risk of potential loss, further analysis should be undertaken by the NSW Department of Local Government to identify any potential negative impact on the financial viability of individual Councils. By comparison with 34% deterioration in the market value of aggregate NSW Council CDO portfolio, the market value of aggregate NSW Council holdings of Capital Protected Notes have deteriorated by 11%. It is noted that Councils have typically diversified their holdings within each investment category and do not appear to be materially exposed to any single investment.

4.27. US SEC Chairman Christopher Cox, whose agency gained oversight over the credit agencies eight months ago, told US Congress recently:

4.28. "Critics have faulted rating agencies for initially assigning ratings that were too high, for failing to adjust those ratings as the performance of the underlying assets deteriorated, and for not maintaining appropriate independence from issuers and underwriters for those securities. Now …… some market participants have lost faith in the ratings."

4.29. Mr. Cox said that he expected to receive a preliminary report on whether ratings agencies failed to impartially rate billions of dollars of mortgage backed securities. Both in Australia and globally the integrity of credit ratings methodologies are under close scrutiny by Regulators and investors. In short, the credibility of the credit ratings agencies as a key quality filter for investment decisions is being critically questioned. Until this issue is satisfactorily resolved any further investments of this type should be suspended.

4.30. Recommendation 4: Investments specified in k) and l) of the Investment Order be suspended for the period to 31/12/2009 and be subject to a further review after this period to determine the relevance of using a credit ratings based approach to determining authorised investments, particularly in light of the current CDO credit experience. It should consider whether to restore the current investment powers under k) and l). Any such review should have specific regard to the trade-off between the cost of Government monitoring and Council compliance which would be required, and the prospective incremental investment return.

4.31. A full appreciation of the risk of investing is obtained by monitoring the variation in the book value and market value of the investment portfolio. This is an important component of calculating the rate of return of the investment portfolio. The relevant accounting standards are AASB 132 – Financial Instruments: Disclosure and Presentation, AASB 7 – Financial Instruments: Disclosures, AASB 139 – Financial Instruments; Recognition and Measurement and AASB 136 – Impairment of Assets. In addition to ensuring that the value of the investments is adequately disclosed in the financial statements, attention needs to be given to a consistent definition of investments between current assets and longer term maturities. Discussions with NSW Councils suggested there was some ambiguity on this point.

4.32. Given the current negative investment climate for credit based products, this proposed new investment restriction is not anticipated to practically impact on current Council investment activity in CDOs or Capital Protected Notes. However, NSW Councils have over $2.42 billion invested in Managed Funds rated A or higher. This is considered a responsible investment strategy and the diminution in market value has been around 3%. This investment option for new funds will no longer be available but a number of the same managers maybe be used by TCorp as external managers of their Hour Glass products.

4.33. Following the above proposed amendment to the Order, all residual investments will now be limited to deposits / securities of entities which are directly regulated by either Commonwealth or State Government entities. The exception is investments in land and mortgages, where clear fiduciary guidelines already exist.

4.34. NSW Councils wishing to invest in higher risk, higher return securities further along the 'efficient frontier', will be able to do so by investing in the TCorp Hour-Glass Investment Facilities. These investments are liquid, cost-effective and transparent in terms of their underlying security and secondary market pricing. TCorp uses selected "best of breed" external managers to achieve an optimal risk return across a broad range of investment strategies focusing on both interest income and capital growth. Finally, TCorp's existing governance framework provides oversight to ensure that investment decisions and portfolio allocations are consistent and aligned with the risk management requirements and objectives of individual clients. Currently, TCorp holds $33 million on behalf of Councils invested across a range of Hour-Glass products.

4.35. A review of investment regulation methodologies including the centralised and decentralised models as well as a highly regulated and deregulated approach is discussed in section 6. It is contended that the fully deregulated model is most effective when policed by a strong regulator. For example, the successful investment performance of the $1 trillion Australian superannuation industry with full deregulation of investment powers is in part due to the strong supervisory activities at APRA.

4.36. In relation to NSW Councils the deregulated model was considered as an option but rejected in large part because of the estimated high cost of establishing and maintaining an independent regulator of over $1 million per annum or an impost of $10,000 per NSW Council. Further, in the short term, the investment activities of NSW Councils would be restricted to low risk investments until competency was established to the satisfaction of the Regulator. Another factor supporting rejection of the deregulated model is that investment activities are a relatively minor component of Local Government activities, unlike the superannuation sector where it is the dominant activity. Accordingly, it is unrealistic to expect that NSW Councils will achieve the same level of investment expertise as the superannuation sector.

4.37. Recommendation 5: It is recommended that the current partial deregulation model operating in New South Wales be retained with the modifications suggested in Points 4.13, 4.15, 4.18 and 4.30 of this report, as well as the minor modifications set out in Points 4.39 and 4.41. Consistent with the existing Investment Order, interest income and capital growth investment options will continue to be available through the TCorp Hour-Glass Investment Facilities. This outcome provides a number of the advantages highlighted in the centralised model in section 6.19.

4.38. A further factor in the success of the Australian superannuation regime in Australia is the clear fiduciary responsibility of the Trustees in undertaking investment activities and administration of the funds.

4.39. Recommendation 6: It is most important that the Councils' fiduciary responsibility in relation to investment activities under the *Local Government Act 1993*, should be reinforced strongly. All participants should be made explicitly aware of the obligations under the NSW *Trustee Act 1925,* and be requested to sign to acknowledge the same. Inclusion of the relevant sections of the Trustee Act in the Investment Order may also assist in this regard. In particular, it is important that long term assets including Section 94 funds are invested in a manner consistent with meeting future liabilities, on the basis that the nominal return sought is consistent with an acceptable level of investment risk.

4.40. Two additional amendments are suggested to the Investment Order to reduce potential investment risk exposures to Councils.

4.41. Recommendation 7: With regards to the Investment Order section (m), permitted investments in securities should explicitly exclude subordinated obligations. The permitted investments under (m) must rank pari passu with deposits of the same group entities; under (f) mortgages over land should be restricted to first mortgages with a Loan to Value ratio of no greater than 60%, and under (g), permitted land investments are to explicitly exclude ASX listed property trust investments.

4.42. To assist NSW Councils to develop a consistent approach to investing, a standard reference document could be issued by the NSW Department of Local Government. The recently released Western Australian Council Investment guidelines would provide an excellent starting point. Technical input from the NSW Local Government Finance Professionals Group would assist in formulating the template and assist in lifting its credibility with NSW Councils. Finally, external monitoring of performance to the guideline may assist in improving standards of compliance.

4.43. Recommendation 8: The NSW Department of Local Government should give consideration to releasing a document, similar in content to the Western Australian Department of Local Government and Regional Development, Investment Policy – Local Government Operational Guidelines- Number 19, February 2008 (refer Appendix C). Further as noted in this document, there are deemed to be significant benefits from external monitoring: "a well constructed investment policy with clear objectives will facilitate an external review. The review should act as an intermediary to confirm that the investments explicitly align with the investment policy."(7-3/92).

Section 5: Findings from the Survey Responses

Review of council investments

5.1. The total face value of financial assets held by Councils at 30 June 2007 was $5.6 billion. Investments can be classified into five broad categories as outlined in Table 1 below, ranging from interest bearing deposits with banks, Structured Debt Products such as CDOs to longer term capital guaranteed products with performance linked to longer term equity market indices.

Table 1: Summary of Council Investments by Product

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%
Funds Intended for Long Term Investments[3]	1,640	1,390	250	15.2%

5.2. As at 31 January 2008, it is estimated that Councils have suffered mark-to-market losses of approximately $320 million on their investment portfolios. This loss represents around 5.6% of total investments. Attempting to remove working capital from consideration and concentrate only on those funds intended to be long term "growth" investments results in an estimated loss of 15.2%.

5.3. Losses have been concentrated in the CDO, capital protected and managed funds products, with write-downs of $200 million, $50 million and $70 million respectively. As a percentage of the funds invested in those products, the losses represent write-downs of 34%, 11% and 2.9%. All three products remain exposed to further deterioration in economic and market conditions. No material market valuation losses were identified on other investment products.

[3] Excluding estimated working capital (i.e. cash, term deposits, bills and managed funds)

5.4. The largest holders of each of type of investment that has suffered potential losses are summarised in the following three tables ordered by largest face value investment in each product type. The estimated losses give a theoretical indication of the Councils which may be most affected by potential losses from their holdings of each type of investment.

Table 2: Summary of Largest CDO Holders by Council

Council	Face Value 30-June-07 ($m)	Total Investments ($m)	CDOs Proportion of Total Investments	Estimated Loss[4] ($m)
Gosford	65	136	48%	22
Newcastle	36	138	26%	12
Wingecarribee	30	59	52%	10
Port Macquarie Hastings	25	82	30%	9
Parkes	25	41	60%	9
Hurstville	20	30	66%	7
Coffs Harbour	16	144	11%	5
Sutherland	13	123	11%	4
Ryde	13	66	20%	4
Lake Macquarie	13	101	13%	4
Total	256	920	28%	87

Table 3: Summary of Largest Capital Protected Note Holders by Council

Council	Face Value @ 30-Jun-07 ($m)	Total Investments ($m)	Capital Protected Notes Proportion of Total Investments	Estimated Loss[5] ($m)
Mid Coast County	45	59	77%	5
Sutherland	42	123	34%	5
Byron	35	60	58%	4
Coffs Harbour	23	144	16%	3
Port Macquarie Hastings	20	82	25%	2
Canterbury	19	60	31%	2
Rockdale	19	47	39%	2
Goulburn Mulwarre	17	36	48%	2
Waverley	15	50	30%	2
Warrumbungle	11	14	76%	1
Total	245	677	36%	27

[4] Assuming 34% loss from Table 1 above. It should be noted these estimates are theoretical calculations only and will depend upon the specific investments held by Councils. Actual losses if holdings were sold at market would differ significantly.
[5] Assuming 11% loss from Table 1 above. It should be noted these estimates are theoretical calculations only and will depend upon the specific investments held by Councils. Actual losses if holdings were sold at market would differ significantly.

Table 4: Summary of Largest Managed Funds Exposure by Council

Council	Face Value @ 30-Jun-07 ($m)	Total Investments ($m)	Mgd Funds as a % of Total Investments
Sydney	277	420	66%
Blacktown	186	200	93%
Wyong	100	109	92%
Clarence Valley	91	100	91%
Tweed	83	129	65%
Liverpool	83	113	73%
Parramatta	76	88	86%
Fairfield	71	75	95%
Tamworth Regional	70	110	64%
Bankstown	67	83	80%
Total	1,104	1,427	77%

5.5. Managed funds holdings are likely to include a high proportion of working capital meaning high proportions of managed fund holdings compared to total investments are not in any way necessarily indicative of imprudent investment behaviours.

The following table summarises the largest combined holders of capital protected notes and CDOs combined. These two product types are those suffering the highest potential losses.

Table 5: Summary of Largest Exposure to Capital Protected Note and CDO Investments combined by Estimated Mark to Market Loss

Council	Estimated Mark to Market Potential Losses ($m)	Face Value of CDOs & Capital Protected Note Holdings 30-June-07 ($m)	Total Investments ($m)	Estimated Mark to Market Losses as a Percentage of Total Investments
Gosford	23.0	74	135.5	17%
Newcastle	12.6	39	138.4	9%
Hastings	10.7	45	82.3	13%
Wingecarribee	10.4	32	58.8	18%
Sutherland	9.1	55	123.0	7%
Parkes	8.6	26	41.2	21%
Coffs Harbour	8.0	39	144.3	6%
MidCoast County	7.9	54	58.7	13%
Hurstville	7.0	23	29.7	23%
Byron	6.9	44	60.3	11%
Total	104.3	430	872	12%

5.7. Table 5 shows that $104 million of the estimated $250 million of potential losses in the CDO and capital protected note product types are being held by the largest holders of these products. The remainder of the estimated potential losses are spread across Councils with face value holdings of $20 million or less. None of these Councils are holding estimated individual potential losses of more than $4 million.

5.8. The following table summarises the largest holders of the Federation CDO by face value at June 2007. Federation is directly linked to sub-prime mortgages and is exposed to potentially the greatest losses of the CDO products. At last check Federation was estimated at 15c in the dollar – 85% less than face value.

Table 6: Summary of Largest 'Federation' Exposure by Council

Council	Volume June '07 ($m)	Issuer	Restrictions
Gosford	5.0	SPRC (Federation)	Unrestricted
Wingecarribee	3.0	TBD SPRC Federation	Restricted
Newcastle	2.5	TBD -(Federation)	Restricted
Parkes Shire	1.0	Lehman Brothers - Federation	Mixed
Woollahra	0.5	SPRC (Federation')	No response
Armidale Dumaresq	0.5	SPRC	No response
Eurobodalla	0.5	Lehman Brothers Treasury Co. B.V Federation	Unrestricted
Manly	0.5	Lehman Brothers Treasury Co	Unrestricted
Oberon	0.5	Lehman Brothers Treasury Co.B.V. Federation	Unrestricted
Tamworth	0.5	SPRC (Federation)	Other
Total	14.5		

5.9. Fourteen other Councils have holdings of Federation with June 2007 face values of between $200,000 and $400,000.

Future Performance of Investments – Key Risk Factors

5.10. At the time of writing, only a small number of the investments held by Councils have been downgraded by the credit rating agencies.

5.11. The credit ratings on 38 of the 50 CDO transactions held by Councils were reviewed in February 2008. Of those, 24 ratings remained unchanged whilst 14 have been downgraded or placed on "credit-watch". Of those downgraded, 3 have been reduced to CCC- which is a level indicating vulnerability to default. Those 3 are Federation, Helium Capital Ltd series 69 and Helium Capital Ltd series 70. Data collected from Councils indicate a total of $15.2 million invested in the two Helium series.

5.12. In late February, 2008, S&P downgraded 240 securities including the Federation CDO and the Helium Capital bonds. The timing of this response suggests that the rating agencies may be somewhat slow to react to changes in underlying creditworthiness as reflected in secondary market pricing.

5.13. It does not appear that any of the credit ratings on the capital guaranteed products have been downgraded.

5.14. The credit ratings on other products appear to be unchanged.

Investment Purpose – Restricted and Unrestricted

5.15. Councils' investments attempt to fulfil a range of investment objectives; from short term and long term, cash management, to matching of investments to specific non-current exposures (e.g. section 94 developer contributions).

5.16. Funds held for investment by Councils are classified as restricted or unrestricted as to their end use. Furthermore, restricted funds may be subject to external restrictions (e.g. s.94 developer contributions, environmental levies) or internal restrictions (e.g. leave entitlements, facility reserves).

5.17. From the data provided by Councils, it is clear that while Councils account and report on these various investment objectives individually, actual investment funds are usually pooled together with returns reinvested into the same large pool of funds. There appears to be little partitioning of investments into specific funds or products to meet identified liabilities.

5.18. Therefore it is difficult to precisely comment on any one component of Councils' investment funds by the liability intended to be met. It is likely that a portion of non-current externally restricted funds shown in Table 7 below are comprised of section 94 developer contributions aimed at meeting long term infrastructure obligations, for example.

Table 7: Summary of Council Liabilities – by Classification

Classification	Current	Non-Current	Total
Externally Restricted	2,323	598	2,922
Internally Restricted	1,726	206	1,932
Unrestricted	736	25	761
	4,785	829	5,615

Source: Local Government data, 31 December 2007.

5.19. Table 8 is intended to be used to identify how developer contributions, to continue the example above, may be invested into a particular product type. Councils reported that the liabilities are represented by financial assets as set out in the table below.

Table 8: Summary of Council Financial Assets – by Product Type

	Restriction							
	Externally Restricted	Internally Restricted	Mixed	No Response	Other	Restricted	Unrestricted	Total
Capital Protected Note	38.1	3.6	28.1	157.0	29.5	113.6	79.3	449.2
Collateralised Debt Obligation	39.4	16.5	68.0	131.7	37.7	155.4	137.5	586.3
Floating Rate Note	1.0	5.7	20.1	25.5	19.0	56.4	29.9	157.7
Managed Fund (A rated)	47.9	32.4	224.6	430.4	116.5	517.7	407.8	1,777.3
Managed Fund (AAA & AA rated)	10.1	8.9	127.0	159.8	37.4	136.2	174.4	653.8
Other	13.9	0.5	10.6	18.0	6.3	20.6	7.6	77.5
Short-dated Deposits	46.6	84.2	213.9	363.9	148.2	310.9	373.2	1,541.0
Subordinated Debt	22.3	8.1	45.6	84.6	8.0	184.4	66.0	418.9
Total	219.4	160.0	737.8	1,370.9	402.8	1,495.1	1,275.6	5,661.6

Source: Local Government Review survey data, November 2007

5.20. The data in Table 8 gives an indication of the variety of responses from Councils (including a significant proportion of “no response” or “mixed” returns). This data is not useful in making specific comments on Councils’ use of investment types to meet particular liabilities.

5.21. The way many Councils appear to fund long term liabilities is from one large pool of investments, irrespective of whether those funds are associated with a liability or long term restriction which must be met in future, 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.

Section 6: Key Observations, Matters of Discussion and Findings from Interviews with Market Participants

6.1. The following section outlines a summary of issues that were discussed and the conclusions reached during the informal interview sessions with various market participants.

6.2. The parties interviewed by Michael Cole as part of the Review included: Longreach Capital, ANZ Bank, Grove Advisory Services, Oakvale Capital, Moody's Ratings Agency, Fitch International Ratings, Grange Securities, Westpac Bank, Deutsche Bank, Commonwealth Bank, BlackRock Investments, National Australia Bank, PIMCO and APRA, plus representatives from various local Councils and the NSW Local Government Finance Professionals Group.

Discussion topic 1 – Choice of Fiduciary Model – prescriptive or non-prescriptive

6.3. Finding: There is no evidence to suggest that a non-prescriptive model results in significantly different outcomes than a prescriptive model.

Interstate Comparison of Fiduciary Models

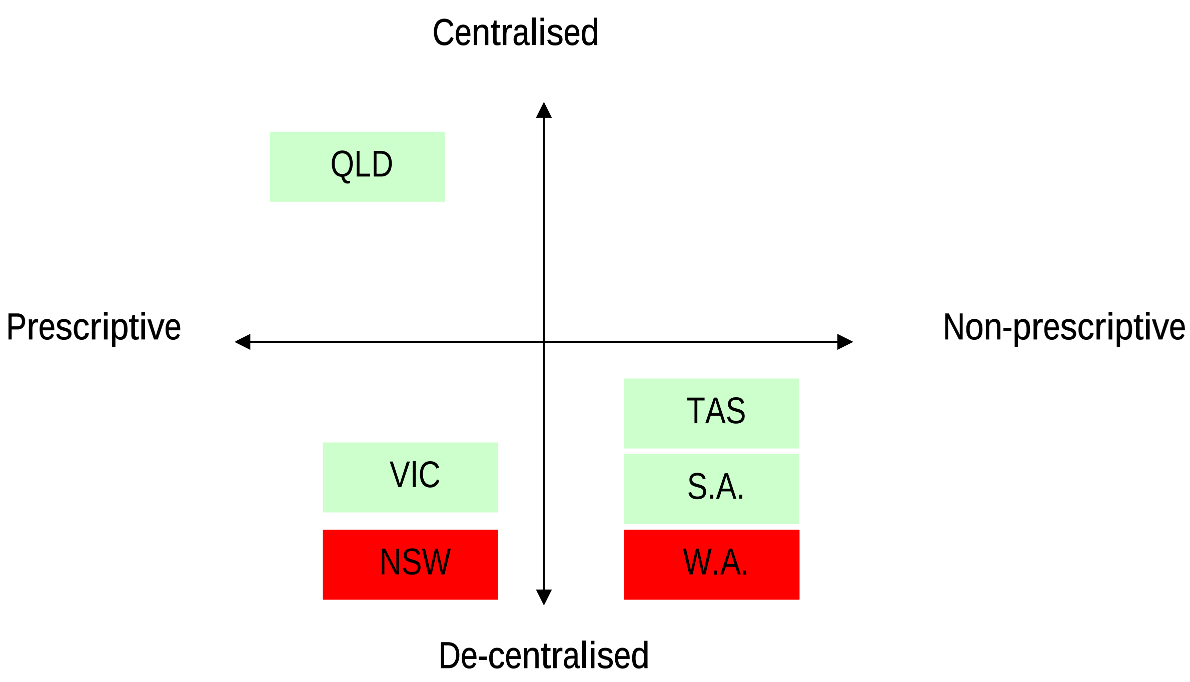
6.4. Across Australia, there are two main methods by which the State Governments limit council investments:

6.5. Restrictions on the types of products which Councils can invest in by prescribing permitted forms of investment either through legislation, regulation or Ministerial Order; and

6.6. Requiring that Councils invest through a Central Government authority for some or all investments.

6.7. These two measures create a mixture by which State Governments regulate council investments. This is illustrated in the following matrix which maps states to the fiduciary framework they have in place.

Figure 1 – Comparison of States by Fiduciary Model



6.8. Figure 1 ascribes a position to a state based on the degree of centralisation (measured along the Y axis) and whether a prescriptive order is used to limit permitted investments (indicated on the X axis).

6.9. Looking at centralisation (the difference between the Northern and Southern hemisphere on the matrix) reveals that Queensland is currently the only state which requires local Councils to invest through a central authority. Queensland Councils must invest through either the Queensland Investment Corporation (QIC) or Queensland Treasury Corporation.

6.10. Turning to prescription (the difference between the Eastern and Western hemispheres of the matrix) reveals that the six states are evenly divided between those that generate a list prescribing types of products Councils may invest in, and those which allow Councils to invest in products as they see fit.

6.11. Queensland, Victoria and New South Wales all use a prescriptive approach, while Tasmania, South Australia and Western Australia allow Councils to invest in any products they deem appropriate.

6.12. The relative exposure to negative impacts as a result of the sub-prime fallout is indicated by the colours for each state. New South Wales and Western Australia are the two states with comparatively high exposure to losses from sub-prime– these two states have been marked in red. All other states have had relatively little exposure to sub-prime and are marked green.

6.13. Broadly speaking, the experience of other States indicates that the use of a prescriptive list was not a significant mechanism in protecting Councils from losses as a result of the sub-prime fallout.

Discussion topic 2 – Choice of Fiduciary Model – centralised or de-centralised

6.14. Finding: There is no evidence to suggest that a centralised model results in significantly different outcomes than a decentralised model.

6.15. Figure 1 shows that Queensland, the only state to use a centralised fiduciary model, has insulated Councils effectively from the sub-prime fallout. Though this cannot necessarily be interpreted as meaning that a centralised fiduciary model is necessarily more effective than a decentralised model, it provides some confidence that centralisation assists in ameliorating the risk of exposure of local Councils to high risk investments.

6.16. However, comparing the results in Queensland with those of Victoria, a decentralised state, reveals that Councils in both states have no serious exposure.

6.17. While there may not be any evidence to suggest any significant difference in the outcomes of either a centralised or decentralised fiduciary model, each model clearly has its own advantages and disadvantages, which can lead to a certain model being preferred over another.

6.18. These advantages and disadvantages are presented below.

The Centralised Approach

6.19. A centralised system implies that investments are managed on a consolidated basis by Central Government or an established entity. The management framework requires that the central management authority is suitably qualified in investment management and has appropriate skills, expertise, systems and governance to reliably fulfil this role.

6.20. Advantages of the centralised system:

- Provides the strongest controls with the associated lowest risk of unfavourable outcomes;
- Can be monitored externally by a board and external audit control procedures;
- Transactions costs are minimised as work is performed at the wholesale level. Under a decentralised system, Councils make transactions at retail margins; and
- Allows for the concentration of expertise and knowledge which is made available to all individual entities.

6.21. Disadvantages of the centralised system:

- Increased cost to the incumbent management authority (either central agency or public financial institution) which must facilitate the additional account activities of Councils;
- Loss of flexibility at the individual entity level;
- Centralised policy and political accountability; and

The Decentralised Approach

6.22. A decentralised system means Councils independently manage their investment transactions at the individual entity level. Where a council has a large or complex investment portfolio, the management framework must be more sophisticated than when dealing with small, simple portfolios.

6.23. Advantages of the decentralised system:

- Flexibility that allows for the precise matching of actual investment strategies with optimal strategies at the individual entity level;
- Direct accountability at the entity level where investment decisions are made. Particularly given the additional incentive of being responsible to the Local Government electorate;
- Allows for innovation; and

6.24. Disadvantages of the decentralised system:

- Requires high levels of skill at the individual entity level;
- Transactions conducted at retail margins, negatively impacting on value-for-money across the sector; and
- Maintenance cost as there is a requirement for ongoing supervision where incentive structures do not guarantee optimal outcomes.

Discussion topic 3 – Behaviour of market participants in NSW

6.25. Finding: The current decentralised NSW framework has led to examples of behaviour by market participants which differs from that found in other sectors.

6.26. It appears that the separating of advisory roles from product manufacturing and distribution is not always practiced across the sector. Anecdotal evidence to suggest this includes:

i. Feedback suggesting that at least one major market participant's governance model and compliance monitoring framework was weak; and

ii. The fact that some market participants offer purely advisory services while others offer a mixture of advisory and product distribution services.

Discussion topic 4 – Separation between advice and product manufacture and distribution

6.27. Finding: The requirement for complete separation of product advice from product distribution needs to be better understood by the sector.

6.28. Compared to NSW Councils, market investor participants who are subject to strong regulatory supervision (e.g. the superannuation market under APRA's supervision) demonstrate a greater understanding of:

i. The requirement to clearly separate the advisory role from product distribution role; and

ii. The risks to reputation associated with selling products that are not fully understood by the client or are inconsistent with the prudent objectives of the client.

Discussion topic 5 – Investment management objectives

6.29. Finding: There is a need for better quality investment advice to guide council investment strategies.

6.30. There is evidence of two key drivers influencing the investment patterns of NSW Councils:

i. Contraction in interest rates leading to increased holdings of higher yielding but more complex securities; and

ii. A trend toward higher growth; higher return strategies pursued through riskier investments.

6.31. There is anecdotal evidence that the relationship between the investment time horizon and the risk-return trade off is not well understood by investment managers across the sector. This is further compounded by the fact that the use of independent advice, common in the superannuation sector, is not widely accessed by the NSW Local Government sector.

6.32. There is quantitative evidence to support this. For example, some Councils have a significant proportion of their total investments allocated to CDOs or Capital Protected Notes. This practice is inconsistent with prudent investment strategies, exposing these Councils to the risks that would not be present in a lower risk or less concentrated portfolio. It would be a surprise if this pattern were consistent in a sector that regularly sought and followed independent investment advice.

Discussion topic 6 – Prescribed investments list in the Ministerial Investment Order

6.33. Finding: Evidence to suggest that a much tighter monitoring of investment products and consistency with intended objectives of investments is required. There are potential benefits to greater control at the Central Government level.

6.34. The Ministerial Investment Order, which restricted Councils to investing in products with a credit rating of at least A (among other controls), was intended to restrict investment options to the least complex products in the market. The evolution of the market now allows Councils to invest at a higher risk / return point, while still complying with the Order. There is potential to improve aggregate returns to the sector by moving toward less complex products.

6.35. There is anecdotal evidence to suggest a lack of accountability to monitor, interpret and update the existing prescribed list. Neither the Department of Local Government nor Treasury actively administer the Order. Councils have sought legal interpretations of the Order in lieu of State Government interpretation.

6.36. The current operational guidance developed for Councils supporting the Ministerial Order has been developed by the NSW Local Government Finance Professionals Group. This document provides guidance on a range of issues, and the guide seems to be widely used by Councils.

6.37. There are a number of improvements that could be made to the existing best practice guide provided to councils:

i. The Guide is not produced or reviewed by the Department of Local Government. In comparison, the NSW Treasury produces and regularly updates a Treasury Management Policy framework guide;

ii. CDOs are commonly referenced within the Guide without reference to the different nature of these sorts of structured products when compared with, for example, traditional bank floating rate notes;

iii. Limiting the use of derivatives to purely hedging purposes is acknowledged within the guide. However, the document supports the use of products such as CDOs (CDOs are classified as a security, however the security generally represents the combination of a traditional bond with a derivative);

iv. The absence of risk-adjusted benchmarks for investment performance analysis potentially enables relative investment performance to be overstated or gives a misleading impression of returns, as the risks associated with achieving these returns are not highlighted;

v. Potential for inconsistency between investments prescribed under Part 3 of *Public Authorities (Financial Arrangements) Act* and those instruments outlined in Guide; and

vi. Unlike the Treasury Management Policy framework, individual Councils are not required to renew their investment objectives, exposures and performance with shareholder departments on a regular basis (for example, by way of an annual Statement of Intent).

6.38. There is potential to further develop the use of best practice guidelines to improve investment management practices and procedures and, correspondingly, investment outcomes (one of has recently been released by the Western Australian Government, see Appendix C).

Discussion topic 7 – Accounting valuation issues

6.39. Finding: There is a need to improve consistency in accounting for investments across the sector.

6.40. Inconsistent accounting policies across the sector impede transparency in reporting of some investment products. Under existing treatment, some products with credit risk can be accounted for on an accrual basis, masking liquidity risk. In particular, products with some form of capital guarantee on maturity appear to be accounted for in this way. This ignores the risk that the product may have to be liquidated at market prior to maturity.

6.41. The lack of consistency in accounting policy impedes central agency policy implementation also. Inconsistency restricts the ability for valid comparisons across the sector, making it difficult to develop targeted policy and implications are less predictable. Market participants should advocate the use of market valuations across the sector.

6.42. It appears that some Councils may be seeking to restructure their existing investments without triggering market value or accounting losses. The restructuring of investments to specifically meet accounting outcomes requires further investigation.

Section 7: Disclosures

7.1. The review was undertaken by Mr Michael Cole, supported by a representative from the Department of Local Government, Department of Treasury, Department of Premier & Cabinet and NSW Treasury Corporation.

7.2. Mr Cole's interests include being Chairman of IMB Limited, Chairman of Platinum Asset Management Limited, Director Ascalon Capital Management and a member of the Board of NSW Treasury Corporation.

Section 8: Appendices

8.1. APPENDIX A

LOCAL GOVERNMENT ACT 1993 – INVESTMENT ORDER

(Relating to investments by councils)

I, David Campbell, MP, Acting 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 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 Government stock or Government securities of the Commonwealth or any State of the Commonwealth;

(b) any debentures or securities guaranteed by the Government of New South Wales;

(c) any debentures or securities, issued by a public or local authority, or a statutory body representing the Crown, constituted by or under any law of the Commonwealth, of any State of the Commonwealth or of the Northern Territory or of the Australian Capital Territory and guaranteed by the Commonwealth, any State of the Commonwealth or a Territory;

(d) any debentures or securities issued by a Territory and guaranteed by the Commonwealth;

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

(f) mortgage of land in any State or Territory of the Commonwealth;

(g) purchase of land (including any lot within the meaning of the Strata Schemes Management Act 1996) in any State or Territory of the Commonwealth;

(h) interest bearing deposits in a bank authorised to carry on the business of banking under any law of the Commonwealth or of a State or Territory of the Commonwealth;

(i) interest bearing deposits with a building society or credit union.

(j) 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, building society or credit union as the acceptor or endorser of the bill for an amount equal to the face value of the bill;

(k) any securities which are issued by a body or company (or controlled parent entity either immediate or ultimate) with a Moody's Investors Service, Inc. credit rating of ``Aaa", ``Aa1", ``Aa2", ``Aa3", "A1" or "A2" or a Standard & Poor's Investors Service, Inc credit rating of ``AAA", ``AA+", ``AA", ``AA-"; "A+", or "A" or a Fitch Rating credit rating of "AAA", "AA+", "AA", "AA-", "A+" or "A";

(l) any securities which are given a Moody's Investors Service Inc credit rating of ``Aaa", ``Aa1", ``Aa2", ``Aa3","A1"; "A2" or ``Prime-1" or a Standard and Poor's Investors Service, Inc credit rating of "AAA", "AA+", "AA", "AA-", "A+"; "A"; "A1+" or "A1" or a Fitch Rating credit rating of "AAA", "AA+", "AA", "AA-", "A+" or "A";

(m) any debentures or securities issued by a bank, building society or credit union;

(n) a deposit with the Local Government Investment Service Pty Ltd;

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

Dated this 15TH day of JULY 2005

Hon DAVID CAMPBELL MP
Acting Minister for Local Government

8.2. APPENDIX B

Further details on analysing product types

CDOs

- Valuations were obtained on 65% of the assets.
- Those valuations indicated an average write-down of 34%.
- Extrapolating across all CDOs produces a write-down of $200 million.
- Most valuations were provided by the promoters or distributors of the product and therefore may represent the optimistic end of a valuation range.
- A small number of CDOs are listed on the ASX and the last observed trade was used for valuation purposes.
- CDOs are highly illiquid and the valuation typically represents an *estimate* of the market price rather than the actual level at which the bond could be sold.
- Given the structure of the CDOs, the write-down incurred to date represents (with a few notable exceptions) the *increased risk* of loss rather than a realised loss. CDOs are highly leveraged to the creditworthiness of a pool of corporate borrowers. To date, very few borrowers have actually defaulted, however the bonds have been marked-down on the expectation that there is a higher likelihood that they might. The final value of the bonds potentially ranges between zero (many defaults) and 100% (no defaults).

Capital Protected

- Valuations were obtained on 70% of the bonds.
- Those valuations indicated an average write-down of 11%.
- Extrapolating across all capital protected products produces a write-down of $50 million.
- A number of capital protected bonds offer the prospect of capital gain at maturity. That is, the council receives not only interest and principal but also an additional amount on maturity dependent upon the performance of the underlying investments. For the purpose of this exercise, we have capped the valuations at 100 cents in the dollar.
- Most valuations were provided by the promoters or distributors however the structure of the notes suggests that the valuations are likely to be relatively accurate.
- The capital guarantee on these products means that the value should not fall below approximately 70 cents in the dollar and will trend toward 100 cents in the dollar as the bond approaches maturity.

Managed Funds

- Valuations were obtained on 70% of the funds.
- Those valuations indicated an average write-down of 2.9%.
- Extrapolating across all managed funds produces a total write-down of $70 million.
- Valuations are sourced from the relevant fund manager but are calculated daily and generally based on independent valuations of the underlying assets. They are considered accurate.
- Further losses are possible in the event of deterioration in corporate creditworthiness or significant market disruption.

Other investment types

- Modest market value losses may have been suffered on other investment types (perhaps 1% - 2% on individual assets) however in aggregate these losses are not considered material when weighed against the losses noted above.
- The major risk for these assets lies in a significant deterioration in the creditworthiness of Australian financial institutions (banks, credit unions and building societies).

8.3. APPENDIX C

Western Australian Local Government Guideline no. 19 – Financial Investments

A copy of this appendix can be found at:
http://www.dlgrd.wa.gov.au/LocalGovt/SupportDev/Guidelines.asp?Return=True