

NSW Local Government Investment in CDOs: A Corporate Governance Perspective

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By

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Dedication

For my wonderful wife Hazel;

In recognition of her generous love, support and encouragement (and
forbearance).

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Statement of Authentication

The work presented in this thesis is, to the best of my knowledge and belief, original except as acknowledged in the text. I hereby declare that I have not submitted this material, either in full or in part, for a degree at this or any other institution.

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Abstract

This research was motivated by the losses that New South Wales (NSW) Local Government Authorities sustained by investing in Collateralised Debt Obligations (CDOs). The extent of the losses was identified in the Cole Report (2008) which highlighted that NSW councils had lost \$200 million from investments in CDOs. Councils are charged with managing public funds and losses such as were reported suggested that there were problems in the way investments were being managed. This research has focused on the decision-making processes that led to investments in what were eventually termed toxic products.

There are two main components of this project. The first related to the policies governing investments by NSW local councils. These policies were used as a method of governing the investment practices of councils. The types of products that NSW council were allowed to invest in were stipulated by the Minister for Local Government via the Minister's investment orders. These orders in the late 1990s became more liberal and began allowing investment in rated products. This change also coincided with the removal of reference to the *1925 Trustees Act* from the Minister's orders and the associated requirement to protect capital. This leeway opened the door on more aggressive investment practices by local councils. The Minister's orders were a governance tool to control aggressive investment behaviour but when rated products became allowed investments the governance of investments resided in the validity and security of the ratings bestowed by the rating agencies.

The second component of this research investigated how investment decisions were made in practice. This process was investigated through a multiple case study approach. Interviews were conducted with three coherent multi-sited ethnographic groups of participants. First, individuals external to councils who had specific knowledge of the investment decision process and background of councils. The second and third groups were individuals within councils involved in the decision making process. The second group were council officers from councils who chose not to invest in CDOs and the third group were council officers from council which invested in CDOs.

Both components of this research were analysed through the lens of Bourdieu's (1977) *Theory of Practice* framework. Using this lens the factors that influenced decision making were segregated into fields, capital and habitus to determine which factors were most significant.

The results indicated that investment policies issued by the Minister were complied with. Therefore as a governance mechanism the Minister's orders are successful. The difference lay in how those policies were applied and how willing the individual councils were to take on risk products. That willingness was governed by the habitus of the organisation and by the positive and negative investment experiences of each. The decision process was also influenced by a variety of other factors, including advice from investment professionals, the nature of the general manager and finance manager, communication with other finance professionals and whether those making the decisions believe capital protection or investment returns were a priority.

Financial investment decisions within the local government community were made within a multi-faceted environment. Those responsible for making the decisions were faced with abiding with the Minister's orders, the investment policy and habitus of their respective councils, advice from a variety of sources including investment investors and the expectations of the community. At the same time they needed to have the skills to understand complex investment products and what and how ratings were applied to them. This complex mash of information and requirements meant that investment decisions were made, while simultaneously evaluating a diverse range of factors.

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Abbreviations

Australian National Audit Office.....	ANAO
Australian Stock Exchange.....	ASX
Australian Public Services Commission.....	APSC
Bank Bill Swap.....	BBSW
Collateralised Debt Obligations	CDOs
Department of Local Government.....	DLG
Finance Professionals Association.....	FPA
Global Financial Crisis.....	GFC
Local Government Authorities (including councils and municipalities).....	LGA
Local Government Shires Association.....	LGSA
Investment Managed Portfolios.....	IMP
New South Wales.....	NSW
Queensland Treasury Corporation	QTC
Reserve Bank Australia.....	RBA
South Australia.....	SA
Standards and Poor's	S&P

Within this thesis, the expressions of Local Government Authority (LGA), and Local Council are used synonymously. However, other commonly used expressions, including the shortening of these terms, are employed and will appear throughout the thesis. Other expressions include local bodies, councils, local government, local authority, municipality and parish. Reference to the Minister is to the Minister for Local Government and the Minister's Orders are the investment orders issued by the Minister for Local Government.

Key Terms

Accountability: Seen as an essential component of good management and practice with an essential requirement which ought to be that one party must be obliged to provide a full account of events to another party

Capital: Can refer to both the tangible and intangible resources which enable individuals to further their aspirations and achieve success (or what is perceived as success) within their field. Bourdieu (1977; 1990b; 1996) put forward the proposition that there are four main forms of capital (or power) being;

- *institutionalized relationships* of mutual acquaintance and recognition
- Economic (financial, property and resources controlled)
- Cultural (including knowledge, cultural goods, education, competencies, skills, and qualifications)
- Social (or connections), which he elaborated as being the “sum of the resources, actual or virtual, that accrue to an individual or a group by virtue of possessing *a durable network of more or less* (Bourdieu & Wacquant 1992, p. 119).

CDO: Collateralised Debt Obligations: highly complex financial tools that repackage individual loans into a product that can be sold on the secondary market. They are special purpose vehicles that acquire a range of portfolios and issue securities which are primarily backed by the cash flows expected from the acquired assets.

Corporate Governance: Mechanism for providing assurance and demonstrating adequate oversight within an organisation.

Epistemology: How individuals perceive knowledge is created (Gaffikin 2008).

Fields: Bourdieu (1990a) “networks of social relationships, structured systems of social positions, within which struggles or manoeuvres take place over resources, stakes and access” (p. 52)

Habitus: “The relationship between two stages of the social, that is, between the history objectified in things, in the form of institutions, and the history incarnated in

bodies, in the form of that system of enduring dispositions” (Bourdieu 1990a, p. 190).

Minister’s Orders: The Minister’s investment orders stipulated the types of products in which councils were permitted to invest.

Ontology: The “nature of being or reality” (Dillard 1991, p. 11)

Rating Agencies: Provide a rating of the credit worthiness of products and institutions as a market mechanism.

Chapter 1: Motivation and Type of Research

1.1 Motivation

The recent global financial crisis and resultant write down of many balance sheet investments has centred attention on the investment practices of a large number of organisations. The catalyst for this research has been the reported financial losses suffered by New South Wales (NSW) Local Government Associations (LGAs) after investing in collateralised debt obligations (CDOs) (Cole 2008; Gold 2008). NSW LGAs were permitted under the investment guidelines issued by the NSW State Government (Appendix 1) to invest in a range of financial products, which include credit rated products such as CDOs. As a result of the collapse of the underlying value of the assets backing these financial derivative products, NSW LGAs have written down their financial investments to the tune of hundreds of millions of dollars (Barton 2005; Cole 2008, p. 124).

While the Securities Commission were aware as early as 2007 that NSW LGAs were investing in CDOs, and even earlier during 2005 the Reserve Bank Australia (RBA) had identified that potentially they were a high risk product (Black & Rai 2005), there was little done to prevent investment in them. The ministerial investment guidelines allowed investment in financial products, which incorporated AA and AAA, rated products (these included CDOs). However, ultimately the decision to invest in CDOs, or not to invest, was in the hands of individual LGAs. Local Councils were able to adopt a more conservative approach if they wished and could have chosen to invest only in low risk, capital secured products.

1.2 Research Questions

This research will discuss the following questions:

What were the factors that influenced some LGA to invest in collateralised debt obligations (CDO) while others operating under the same investment guidelines did not?

To what extent do the corporate governance policies and practices of LGAs in NSW provide adequate safeguards to all stakeholders?

These questions have been developed from an extensive review of the literature. The literature will be discussed in later sections.

1.3 Method of Enquiry

The initial part of this research was conducted by using analysis of the NSW ministerial investment policies for LGAs. The Minister of Local Government, through the Department of Local Government (DLG), as a mechanism to provide guidance to councils when they are making investment decisions, issues these. The ministerial policies form one part of the guidance, the second element of this guidance takes the form of circulars to councils. The investment policies are also a tool with which to provide a method of governance of the investment practices of LGAs. This is done by stipulating the boundaries for financial investment, which therefore constrain the types of products in which LGAs are allowed to invest.

The second part of this research investigates how council financial investment decisions were made. This will be done by conducting multiple coherent case studies from three ethnographic groups and interviewing individuals, within the councils, who were involved in the decision making process at the time when the decisions were being made to invest (or not) in CDOs. The focus of this research is on NSW metropolitan councils. This group of councils represent the largest proportion of the NSW population. They were equally likely, when compared to their regional counterparts, to have made the decision to invest (or not) in CDOs.

1.4 Reason for Focus on NSW

This research focuses on Local Councils in the State of NSW for five main reasons.

First, NSW is the Australian State with the largest population.

Second, there are 152 LGAs in NSW of which 43 (28%) are classified as metropolitan and 109 (72%) as regional, which creates a diverse range of councils. These councils have a disparate range of sizes, both in terms of populations and

geographic area. In terms of population, these range from large metropolitan councils with high population density, to small remote LGAs who have low populations. While in terms of the area serviced, remote LGAs cover significantly larger areas than their metropolitan counterparts.

Third, both metropolitan and regional LGAs in NSW are faced with a disparate range of funding requirements, availability of resources and ability to generate revenue, which created a diverse group of potential participants.

Fourth, NSW investment policy differed substantially from other states, in that NSW had adopted a hybrid model, which allowed prescriptive investments in a specific range of financial products (Gold, 2008).

Fifth, and most importantly, of all the LGAs within Australian States, NSW councils were the largest investors in CDO products and suffered the greatest losses when the value of CDOs declined (Cole 2008; Collins 2007; Gold 2008).

LGAs in Australia are empowered by their respective state governments to make investments in a range of financial instruments. The types of investment vary from state to state, with LGAs in each required to comply with the relevant statutory state investment provisions. A variety of different investment models are employed by each state and these range across a spectrum which encompass at one extreme, highly prescriptive centralised control to an almost total freedom to invest in whatever product may be available. In some states the investment by LGAs in 'at risk' products was minimal or even non-existent, while in others there were substantial losses of capital experienced. As will be discussed later, the decision not to invest in CDOs was not always necessarily due to the respective states restrictive investment policies; however, the capacity to invest in CDOs was provided by these policies. A brief explanation of the different state investment policies has been provided in Appendix 2.

The types of investment in which NSW LGAs are allowed to invest in have been stipulated by the State Treasury Department (DLG 2006; 2009a). There has been a significant departure from 2000 onwards from the types of investment products,

which were permitted prior to the introduction of the *1993 Local Government Act*, and also from the types of investment products, which some other Australian States have sanctioned. Additionally, the NSW Treasury authorisation also provided the opportunity for discretionary investment decisions and actions by individual LGAs, provided they stayed within the range of products permitted under the ministerial order. The list of products in which LGAs were permitted to invest was required to be approved by the Treasurer and included, from 2000 through to after the advent of Global Financial Crisis (GFC) in 2008, the use of minimum credit ratings as a tool to measure if the investment is permitted. Appendix 1 shows the ministerial investment order in place in 2005, which was effectively the order governing investment decision making prior to the GFC. These ratings were what Treasury and NSW LGAs were using as guidance for making their investment decisions during that period. This was a significant modification to the type of investments that could have been made prior to changes to the *1993 Local Government Act*. At that point, LGAs were only permitted to invest in capital secured products, such as government bonds, so that their initial investment was secure. The alteration to the investment order meant that NSW LGAs, provided they continued to meet the requirements of the *1993 Local Government Act*, were able to invest in products that may not be capital secured (meaning that the initial capital investment was not protected from loss) thereby increasing the risk of losing their initial investment. It also meant that LGAs were able to take on investments that gave higher returns, often because the returns from the products also incorporated the investor taking on increased risk. While the *1993 Local Government Act* did provide advice for LGAs recommending that they be conservative in their portfolio selection, at the same time the investment rules specifically allowed investment in credit rated products provided they comply with the allowed ratings from the *1993 Local Government Act* investment order (Appendix 1). However, the credit agencies have not suggested that their ratings provide a guide to credit worthiness, but propose that they should be considered as recommendations and an indication of investment values (Gold 2008).

LGAs in NSW had been advised, via the ministerial orders, that they were able to use credit ratings as an appropriate method of judging investments. Conversely, the credit rating agencies present ratings only as recommendations and an indication of

investment values where the investor is required to weigh up the associated risk (Gold 2008; Moody's 2012). It would thus appear that the use of ratings may be an improper method of judging and assessing what are prudent investments, particularly if capital protection was considered to be a priority. This therefore suggests that the corporate governance policies and ministerial guidelines related to investments by NSW LGAs may be fundamentally flawed. Alternatively, it can be argued that states such as South Australia reside at the liberal end of the scale of investment policies, with the ability to invest in almost anything, yet they did not invest in CDOs. While having an almost laissez-faire investment policy, in practice South Australian LGAs have acted as some of the most conservative in the country. They run an investment scheme where they filtered funds through the Local Government Finance Authority of South Australia. They combine their funds to get better returns, buy low risk investments, develop loans between LGAs as needed and buy guarantees from the SA State Government to provide an instrument of protection (Chaplin 2009).

One possible reason for the LGAs in NSW being interested in investing in higher risk products was the desire, and even perhaps a perceived need due to constrained resources, to achieve high yields from their investments as a mechanism to supplement their revenue streams (Cole 2008; Dollery, Fletcher & Rao 1998; Dollery, Marshall & Sorensen 2007; Gold 2008). Another reason for the willingness of councils to accept increased risk to their investments, may have been that they were under financial stress and seeking to maximise revenue from all sources to meet current spending requirements. The NSW Government was aware as early as the beginning of 2007 that NSW LGAs were failing to comply with the rules around financial investments (Collins 2007) and had placed the capital at risk of loss.

A review by Michael Cole (2008), of NSW LGA investments, was launched after the sub-prime mortgage problems emerged in the United States and it became apparent that a number of derivative type products would be significantly impacted. The review was implemented by the Minister for Local government after a number of NSW LGAs admitted to having losses due to exposure to investments with suspect valuations (Collins 2007; Gray & Barrett 2007). The magnitude of the problem was demonstrated in the results of the Cole Report (2008) which highlighted the extent of

the exposure of NSW LGAs to CDOs. This report reviewed the level of financial exposure of LGAs in New South Wales to structured financial products such as collateralised debt obligations (CDOs). The combined book value of the local LGAs' investments in CDOs at the end of the 2006-07 financial year was \$590 million dollars. Six months later in January 2008, the market value of these investments had dropped \$200 million to \$390 million (Cole 2008).

Of the 152 LGAs in NSW, approximately half made the decision to invest in CDOs. The decline in the values of CDOs represented a significant reduction in the value of NSW LGA investments and was detailed in the Cole Report (2008). The Cole Report was commissioned by the NSW government to evaluate LGAs exposure and losses as a result of the GFC. The following Table 1.1 shows the results of that report.

Table 1.1: Value of NSW Local Government Investment Losses

Investment Type	Face Value @ 30/6/07 (\$m)	Market Value @ 31/1/08 (\$m)	Estimated Loss (\$m)	Estimated Loss (%)
CDOs	590	390	200	34%
Capital protected	450	400	50	11%
Managed Funds	2,420	2,350	70	3%
Subordinated debt	600	600	Nil	Nil
Term Deposit, cash, bills	1,630	1,630	Nil	Nil
Total	5,690	5,370	320	5.6%

(Cole 2008, p. 14)

Since 2008 the value of the financial investment market for CDOs has reduced significantly further with LGAs losing many more millions of dollars, primarily due to organisations such as Lehman Brothers, who filed for bankruptcy in September

2008, managing their investments (Gold 2008). The Cole Report found that while LGAs had acted within the parameters of the *1993 Local Government Act* and the relevant ministerial investment guidelines, they had also embraced a policy which pursued a high return investment strategy which had included a resultant exposure to high risk of capital loss (Cole 2008). Nevertheless, even though the Cole Report identified the losses by councils and the practices of taking on risk, it failed to identify the reasons for particular LGAs may have had for investing in these products. Gold (2008) has proposed that when LGAs undertook these investments, it demonstrated that financial investment governance practices were inadequate, and that stakeholders are being exposed to “imprudent investment decisions and economically sub-optimal outcomes” (Gold 2008 p. 51).

Even before the credit market crisis was apparent, the NSW Department of Local Government had provided information to LGAs reminding them of their fiduciary duties and responsibilities in respect to financial investments (DLG 2006). This communication highlighted to councils that it was their responsibility to ensure that investments were made in accordance with the Act with the “onus for investments...to be on preservation of capital rather than the rate of return” (DLG 2006. p. 1). The Cole Report also identified a number of ‘at risk’ LGAs within NSW. They were LGAs who had substantial losses as a result of the write down of their investments and who would as a result have difficulty in meeting their future financial obligations. This demonstrated that the impact of these decisions was likely to have a long-term detrimental effect on the financial position of those councils and their communities. LGAs in New South Wales have the authority, under section 625 of the *1993 Local Government Act*, to invest ratepayers’ money that is not currently required for any other purpose by the LGA. However, for the purpose of this research there was a need to identify the types of funds that were being invested. Were they funds preserved for future infrastructure, were they funds set aside for future liabilities such as employee entitlements, or were they ‘free’ funds? One of the reasons for investing in CDOs may be the financial distress that LGAs were under and the need to supplement their revenue. The following section details factors, which may show why LGAs experience financial distress and feel the need to pursue investments, which are able to provide additional revenue. If the LGAs is

experiencing financial distress then the incentive to take on risk, even at the expense of placing capital at risk, would be enhanced.

1.5 Local Government Authority Distress

A number of other researchers have also focused on identifying factors that would indicate that the LGAs are in distress (Dollery 2006; Jones & Walker 2007; Modell 2004). Gold (2008, p. 36), reinforced the concept that LGAs were suffering financial stress and apportioned blame by proposing that the

Multi-million portfolio losses reported imply poor investment governance; these outcomes are symptomatic of the financial stress affecting the local government sector. This phenomenon has intensified as the Commonwealth and State Government tiers have devolved responsibility for provision of community services, engaged in cost shifting, and imposed increased accountability and compliance, all without providing commensurate financial compensation to the sector.

Alternative suggestions on how to identify and evaluate LGAs' distress levels have been provided by (Dollery 2006; Dollery & Manley 2007). They propose that there are a number of measures for financial distress, which need consideration. These measures should include the ability of LGAs to continue to provide basic services at the existing level, or their capacity to upgrade existing facilities to an acceptable level (Dollery 2006; Jones & Walker 2007). However, this only provides the ability to meet existing needs without considering whether the requirements of the LGAs have, or are likely to change, or if more funds are needed to provide additional services that may be required by the community. Gold (2008, p36), has suggested, "LGAs have faced difficulties increasing own-source revenues from existing rating bases and fees and charges" resulting in the desire to create revenue from other sources. Therefore, as LGAs have engaged in the search for high return income streams they have been described as "yield pigs" (Gray & Barrett 2007, p. 44). While the report by Cole (2008) identified the significant investment risk which was being confronted by NSW LGAs, it only focuses on one area of risk; being their exposure to CDOs.

As LGAs manage public monies they have a fiduciary responsibility to protect public money and assets (NSW Trustees Act 1925; 1993 Local Government Act) as well as to manage those funds for the benefit of all stakeholders. However, as the federal government, under the power granted in the constitution (Commonwealth of Australia Constitution Act 1900), possesses most of the revenue raising powers, and state and local governments are tasked with carrying out functions requiring expenditure, this has created a reliance on funding of LGAs from both the state and federal levels, often through a variety of grants. While there is a substantial amount of research into the nexus between state and federal finances, there is very little research into the local government grant process (Dollery, Fletcher et al. 1998) or on how LGAs ought to manage their financial activities. This research is intended in part to address the general lack of research in the area of local government financial investment and consider the impact of changes in local government investment policies within NSW that have caused large exposure to high risk investments, which have since proved to be toxic investments.

1.6 Thesis Outline

This section provides an overview of the structure of the research outlining the flow and provides a short description of the contents of each chapter.

1.6.1 Chapter 2

This chapter provides an explanation of the theoretical framework and research philosophy, detailing how the researchers' ontological and epistemological viewpoint informs the investigation. The researcher has taken a subjective approach to the project. This chapter also presents an explanation of the methodology and theoretical framework used to analyse the data collected. Decision Theory at the base of this research, but the primary focus is on the use of Bourdieu's (1977) *Theory of Practice* as a tool to explain how LGAs made their financial investment decisions. Bourdieu proposed three categories; fields, capital and habitus as the framework to describe how individuals function in practice. This chapter provides an explanation of those categories and detail how they are applied in the research.

1.6.2 Chapter 3

This chapter discusses the research method and design. The research includes document analysis of the investment guidelines, which informed investment decisions. However, the primary focus of this research was concerned with how the investment decisions were made within the local council itself. This was investigated by undertaking case studies and interviewing individuals who were involved in the investment decision making process. This chapter details the method of interview analysis and the limitations of this research.

1.6.3 Chapter 4

Chapter 4 provides an overview of the historical framework within which NSW local councils operate. The purpose of this is to demonstrate the environment and influences that impact behaviour and actions of NSW LGAs. Local councils were established for the purpose of providing service to their community. Over time that has evolved from the core activities of roads, water and waste to a more encompassing role and much wider range of services. The purpose of this chapter is to explain the background to the way councils have functioned and how as the role of councils has changed. The changes to the role of local councils have resulted in different expectations from a range of stakeholders, specifically in relation to how they provide governance and accountability.

1.6.4 Chapter 5

Chapter 5 provides an explanation of the nature of CDOs, describes how they were created as financial market derivatives and were rated by the credit rating agencies. This means the CDOs were able to meet the normally restrictive investment governance guidelines provided by the Minister. The Minister's investment orders had previously limited investment in rated market products such as CDOs. This chapter analyses the changes to the Minister's orders and investment policy guidelines, both prior to and subsequent to the GFC.

1.6.5 Chapter 6

Chapter 6 provides an analysis of the interviews with financial managers of NSW local councils and others involved in council investment decisions. The interviews were with three groups of participants, first with individuals external to councils able to provide insights into the history and investment decision process. The second and third groups were council officers involved in investment decision making. The second group worked for councils who invested in CDOs and the third group for councils who did not invest in CDOs. Analysis was conducted through the lens of a Bourdieuan perspective within the categories of fields, capital and habitus, to explain how investment decisions were made.

1.6.6 Chapter 7

This chapter discussed the findings from the interviews. It explained how the factors influencing decision making were identified from the three groups of interviews and grouped according to Bourdieu's *Theory of Practice*. Capital did not exist on its own, as capital relates to the field. These findings demonstrated the inter-relationships between the factors influencing the practice of investment decision making.

1.6.7 Chapter 8

The final chapter described how investment decisions were made within NSW councils. This was done within a Bourdieuan framework and explains how investment decisions were influenced by a diverse range of factors and that decision making required analysis of all factors in parallel. Emphasis was placed on the importance of the Minister's orders as a governance mechanism for financial investments by local councils. It also demonstrated how even unsatisfactory investment policies could be adequate when the controls within the individual councils were more stringent. The habitus and capital within each council (field) were sufficient to exert governance over investment practices.

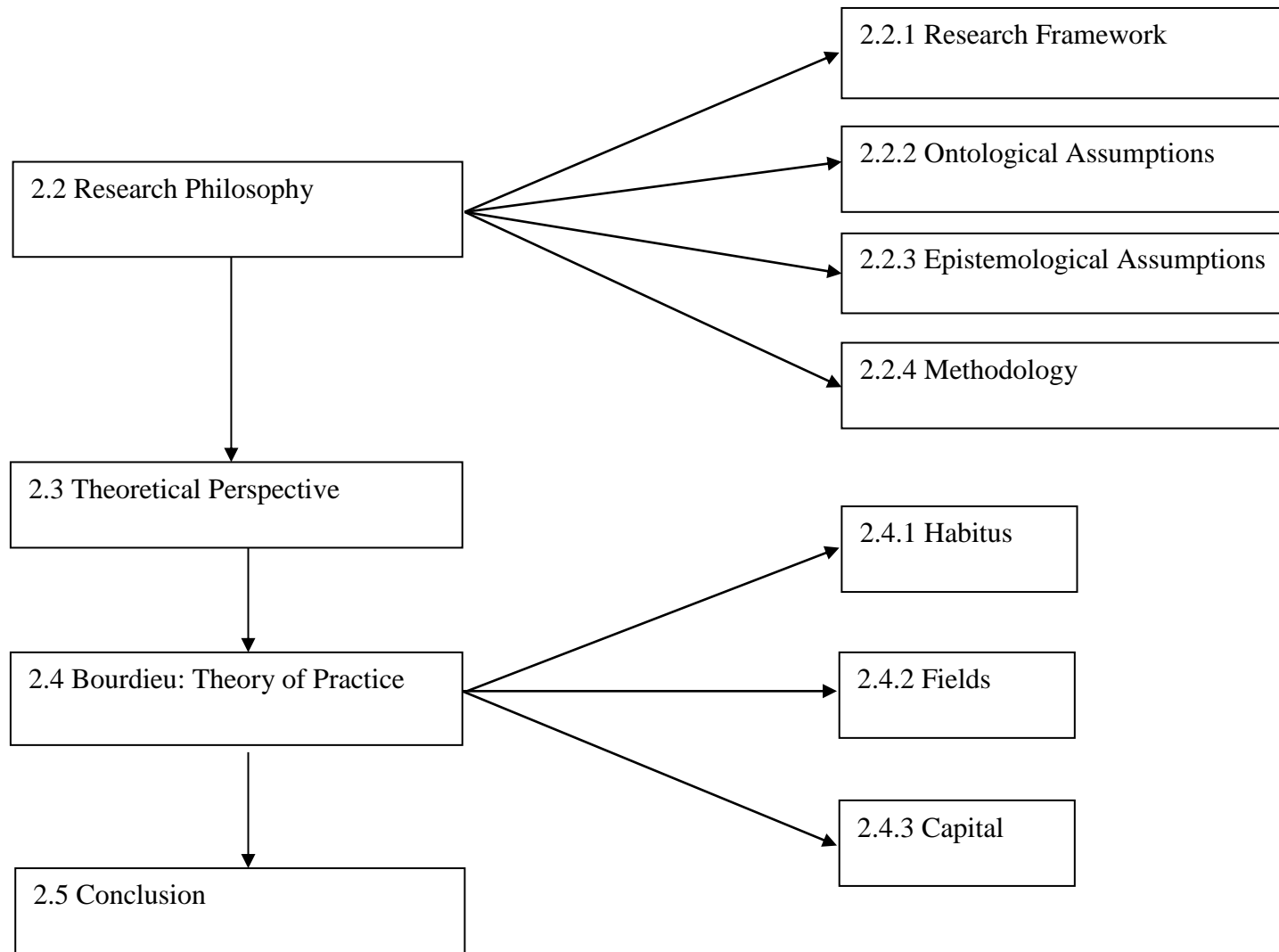
Chapter 2: Theoretical Framework

2.1 Introduction

There have been a number of theories, which have been used to describe and explain how organisations make decisions, develop practices and procedures, and carry out their activities. These include the use of institutional, legitimacy and stakeholder theories and, in prior research, these theories have been used to explain the actions and practices of LGAs. These theories have been rejected as inappropriate for use in this thesis. A short description and the reasons for the rejection of these theories are provided in Appendix 3.

The first part of this chapter outlines the research philosophy and framework for this thesis and explains the perspective from which the researcher has approached the research topic. It also includes the methodological assumptions associated with the research framework, which in turn leads to an explanation of the research design in the following chapter. The second section of this chapter then describes how the theoretical tools developed from Bourdieu's work (Bourdieu 1984; 1987; 1990b; 1996), and particularly Bourdieu's (1977) *Theory of Practice*, coupled with decision theory, will be used to examine and explain the data and develop an additional depth of understanding to the financial decision making processes of NSW LGAs. The following Figure 2.1 presents the chapter outline.

Figure 2.1: Chapter 2 Outline



2.2 Research Philosophy

Method and methodology are terms which often failed to be differentiated, and are often incorrectly used interchangeably (Hussey & Hussey 1997). Writers who do this use methodology as the descriptor for both the theoretical approach as well as the method by which data is collected. This is highlighted by Kemp (1970, p. 57) who states that “accountants often use the same term to describe different things and different terms to describe the same thing”. Therefore defining these terms provides an opportunity to clarify how they are differentiated within this research and allows the separation of the concept of methodological strategy from the method used (Mason 2002, p. 30).

Methodology refers to the manner in which the research is conducted (Dillard 1991), that provides the framework for gaining knowledge (Gaffikin 2008), and hence, relates to an established group of tools or procedures that may be used to address different problems by providing systems to interpret or solve a problem. Methodology therefore cannot be viewed as a rigid principle or rule but rather as a broad set of practices, from which methods or principles are derived to interpret or solve problems. Methodological assumptions will therefore designate the methods that might be used to conduct the research. Methods relate to the specific tools and techniques used to accumulate, evaluate and describe the data (Neuman 2006).

Choosing a suitable methodological approach is dependent on the researchers’ ontological and epistemological assumptions (Chua 1986; Gaffikin 2008). Researchers whose ontological and epistemological assumptions represent an objectivist perspective intend to create law like generalisations (Gaffikin 2008; Neuman 2006). This research is sometimes referred to as “nomothetic” (Gaffikin 2008, p. 150) or scientific research (Tomkins & Groves 1983). This type of research is primarily of a quantitative nature and is based on a realist ontology, which allows the researcher to use systematic quantitative techniques and scientific testing which are also then able to be replicated.

At the alternate end of the spectrum, researchers whose ontological and epistemological assumptions represent a subjectivist approach are often referred to as “ideographic” researchers. This indicates that they take a focus on the cultural and

historical aspects of the research, which is also sometimes referred to as critical theory (Gaffikin 2008). This type of research is primarily of a qualitative nature requiring the researcher to explain the research in terms of their own subjective interpretations, with reference to the associated cultural and historic position of the research (Chua 1986; Dillard 1991; Gaffikin 2008). For this type of research (sometimes referred to as ‘naturalistic’ (Tomkins & Groves 1983)), there is a need to obtain intimate firsthand knowledge of the subject, often through the use of case studies, and as a result this type of research may be subject specific and therefore unable to be generalised.

NSW LGAs appear to function in a predominately-subjective manner, as entities in their own right, able to determine their own structure, direction and policies, albeit within the framework provided by the NSW state government. While they are dependent on state and federal funding, and require the authority of state governments to exist, they also appear to have limited accountability to those bodies with a focus on quality assurance rather than compliance. Therefore, this research has taken a subjectivist approach to evaluate the cultural and historical aspects, which influence LGA behaviour.

The following section discusses the research framework. Initially it will explain and identify the ontological and epistemological assumptions upon which the research will be based. These assumptions then lead to an explanation of how the research framework has been structured.

2.2.1 Research Framework

In order to postulate a research framework, the reasons for choosing a particular research methodology need to be identified. Essentially this research is of a qualitative nature which therefore has required the researcher at the outset to identify the ontological assumptions as they lay “prior to and governs subsequent epistemological and methodological assumptions” (Chua 1986, p. 604). The methods used for this research have been defined by the methodology chosen, the methodology determined by the epistemology embraced, which in turn was determined by the ontological assumptions (Gaffikin 2008, p. 7-8). Therefore,

initially I need to identify my ontological assumptions as my perceptions of reality will influence the research methodologies, shape, and direct how the research questions will be explored.

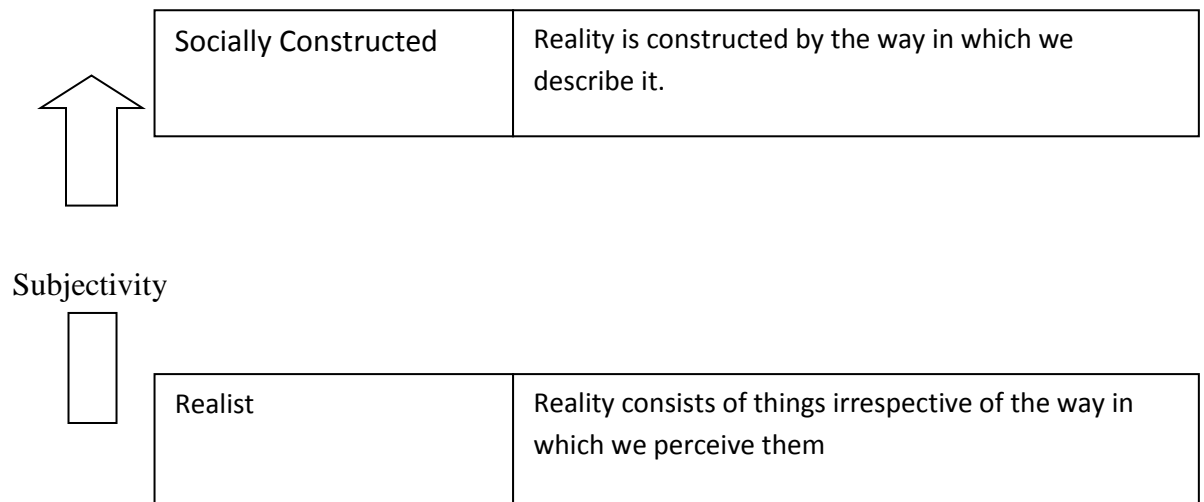
Each step of the framework will be developed progressively, relying on information developed from the previous step, therefore it is essential to initially explain and construct the first step and from there gradually step up through the structure and develop the research framework. The end result will identify the research methods to be used which have been developed from the preceding processes.

2.2.2 Ontological Assumptions

Ontology refers to the “nature of being or reality” (Dillard 1991, p. 11) and individuals with different ontological assumptions will view the research questions from a different knowledge base, undertake different methodologies and direct the research questions in diverse directions (Morgan & Smircich 1980; Tomkins & Groves 1983). The fundamental question should therefore be whether or not reality is external to me, or a product of my ontological assumptions.

Ontological assumptions are particular to the individual and relate to the individuals perception of reality. A simplistic model has been proposed by Burrell and Morgan which suggests that ontological assumptions are either founded in reality which exists independent of the researcher (Realism) or reality is constructed through artificial means of describing, naming and explaining the world to make sense of it (Nominalism). A similar explanation has been provided by Gaffikin (2008), except he uses the terms realist and social constructionist to describe the extremes of the ontological viewpoints. See Figure 2.2 following.

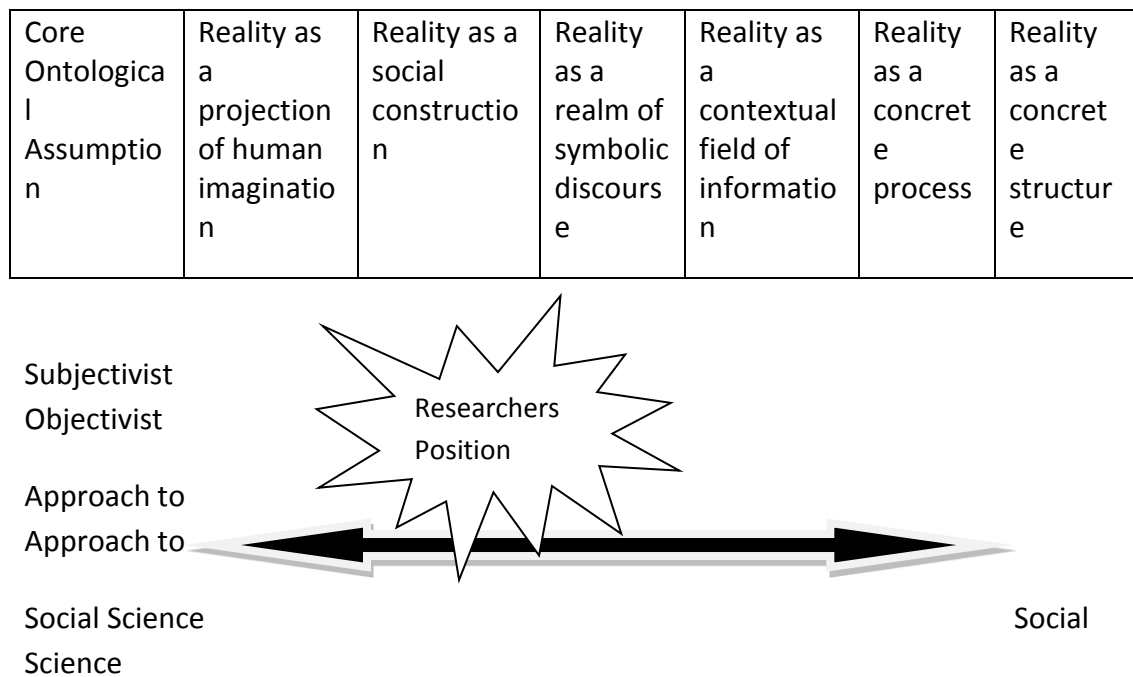
Figure 2.2: Simple Model of Ontological Assumptions



(Adapted from Gaffikin 2008)

A more detailed explanation of ontology suggests that ontological assumptions range from the perception of reality as being totally external to the researcher (distinct and well-defined), to the perception of reality as being completely internal to the researcher (a projection of their imagination). Morgan and Smircich (1980) present this as a continuum, suggesting that an individual's ontology may lie anywhere within the gamut of these perceptions. The continuum of assumptions is presented in Figure 2.3 below.

Figure 2.3: Core Ontological Assumption Continuum



(Adapted from Morgan & Smircich 1980, p. 492)

At the objectivist (realist) end of the spectrum lies the belief that there is a world of material things which exist irrespective of whether anyone is aware of them at all (Gaffikin 1988; Gaffikin 2008; Morgan & Smircich 1980), and that they subsist unchanged while affecting all around them. The idea of social construction presents the concept that reality is constructed by the decisions and actions of the players who construct, maintain and reproduce social reality over and over again (Hines 1988). Similarly, Lukka (1990, p. 245) proposed that the world is regarded as existing objectively in the physical sense, but has been subjectively created by humans in respect to the social existence. This therefore contends that social construction of reality is a continuous process, which is subjectively created by humans through the use of instruments of language, actions, routines, relationships and developed meanings (Morgan & Smircich 1980).

Considering the prior discussion I recognise that my ontological assumptions are at the subjective end of the Morgan and Smircich (1980) model and that I perceive reality as being somewhere within the continuum between socially constructed, and a

result of the symbolic discourse. I contend that “human knowledge is a social artefact”, and “is about people and their social environment” (Chua 1986, p. 603). This thesis considers through the lens of a socially constructed practice, how the use of a variety of influences has affected the behaviour and actions of those within NSW LGAs responsible for making investment decisions.

In respect of NSW LGAs, my underlying ontology has led me to consider that financial investment decisions are made within the prevailing social framework. Within that social framework, there is potential for the established culture of the respective LGAs to either restrain or liberate actions by the finance managers, and that the history of the organisation has a fundamental influence on future actions. Likewise, due to the power and dominance of particular individuals within the organisation, their individual views and experience has the capacity to affect how decisions are made. Power and dominance of particular individuals may either come from the position that individuals hold within the organisation or may be a result of their education, experience, knowledge or even their personal characteristics. The following subsection of the research framework identifies and discusses the epistemological assumptions on which this research has been based.

2.2.3 Epistemological Assumptions

Epistemology refers to how individuals perceive knowledge is created (Gaffikin 2008). Similarly, Dillard (1991, p. 10) describes epistemology as the “means or process of knowing”. Identification of the researcher’s epistemological assumptions assumes significantly more importance when considered from the perspective that it is the researcher who decides what to regard as an acceptable truth, through the process of denoting both the criteria and process for assessing claims of truth (Chua 1986). In relation to this thesis the researcher assumes that knowledge has been created through human interaction and experiences and is dependent on the environment in which individuals operate.

As previously identified, my ontological assumptions are based on reality being within the Morgan and Smircich (1980) range of a social construction, and a result of symbolic discourse. These two ontological assumptions have comparable elements

yet have differing epistemological stances. The ontological assumption of reality as a social construction leads to an epistemology of trying to understand how the social reality was constructed by analysing, and comprehending how the processes within the organisation have led to the construction and creation of social reality (Morgan & Smircich 1980, p. 492). This proposes that humans attempt to understand the world in which they function by creating a shared reality which is dependent on individuals sustaining the shared construction.

When considering the ontological assumption of reality as a realm of social discourse, it leads to an epistemological stance of attempting to understand the patterns of symbolic discourse which in turn guides the development of understanding how language, labels and routines contribute to how humans interpret and modify their actions in response to the social discourse (Morgan & Smircich 1980). It provides a description of how “social order is fashioned by humans in ways that are meaningful to them” (Morgan & Smircich 1980, p. 496) and provides explanations of how individuals through negotiation with each other develop similar symbolic understanding of definitions, meanings and situations (Tomkins & Groves 1983).

Epistemologies that view reality as a product of social construction, lead the research to emphasise the types of methods which will generate insights into how individuals make sense of their situation, and are thereby able to create and maintain an agreed social order (Morgan & Smircich 1980, p. 297). This therefore presents the concept that in order to understand the world, individuals rely on their own judgement (Dillard 1991). An understanding of how this occurs depends on the social context in which it occurs, as within a social constructionist ontology a thing only exists insofar as it has a social context (Gaffikin 2008 p. 8). Therefore, the focus of these epistemologies is on how reality is created by individuals’ internal understanding and interpretations as events occur within the individuals’ social context.

NSW LGAs will therefore be examined through the lens of how individuals interact with the environment, what aspects of investment decision making were a result of the environment in which they were made, and which aspects stemmed from the individuals beliefs and experience. The following section outlines how the selection

of epistemological assumptions will be used to inform the methodology upon which this research will be conducted.

2.2.4 Methodology

Taking the position that my ontological assumptions are primarily of a subjective nature, and therefore my epistemological stance is from the social constructionist perspective, the methodology adopted may be described as ideographic or critical accounting. The methods adopted will be based on my methodological assumptions (Chua 1986) and research orientation (Morgan & Smircich 1980).

This type of research relies fundamentally on qualitative methods. This study will build on the concept that social reality is subjectively created, emerges from the environment in which it is located and is objectified via the interaction of humans (Burrell & Morgan 1979; Chua 1986; Gaffikin 2008; Morgan & Smircich 1980). Therefore, to understand the behaviours and actions of the various participants it has also been necessary to consider the social environment in which the events have occurred. The reasons behind this are that the environment, organisational history, power of participants and social context, are from a social constructionist perspective, able to have an influence on events. Qualitative research requires the researcher to describe and then interpret practices for the purpose of explaining events. In interpreting events there is also a need to understand the context in which they occur, in order to make sense of the behaviour, actions and the meanings that participants have applied to the issues from the perspective of their everyday environment and social context (Burrell & Morgan 1979; Chua 1986; Gaffikin 1988; Lukka 1990; Tomkins & Groves 1983). This type of research is able to provide rich meaning to the events by explaining within the social context the behaviour and actions of participants (Sikka & Willmott 1997).

The preceding sections have described the various ontological assumptions and epistemological stances that could be used. It has then identified the researchers' present ontological assumptions and epistemological stance upon which this research will be based. Identification of these has been essential in order to develop and explain the methodological position of the researcher.

2.3 Theoretical Perspective

Prior research (Alvesson & Kärreman 2011; Barrett 2002; Burritt & Welch 1997; Dollery 2006; Dollery & Manley 2007; Dollery, Wallis & Allan 2006; Jarvinen 2009) has focused on a number of theories about how LGAs function and achieve their stated purpose. The theories used for that research have predominately been institutional, legitimacy, and stakeholder theories. The researcher believes that while these theories have applications to practice, a different approach will be a more effective mechanism for the purposes of this research. Appendix 3 provides a brief outline of those theories in relation to LGA governance, investments and financial reporting, and expands on why they were not used in this research.

Considering the ontological and epistemological position of the researcher, detailed in the previous section, the researchers' belief is that the theories used in prior research are inadequate to explain the decision making process for LGAs investment decisions. It is proposed that a more appropriate theoretical perspective with which to evaluate the decision making of LGAs in NSW is to view the decision making practices through the lens of the tools provided in Bourdieu's *Theory of Practice* (1977). The intent to couple Decision Theory with those tools to develop an appropriate mechanism with which to examine the behaviour of the individuals involved in LGAs' investment decision-making process. This will provide an instrument with the capability to identify the factors that influenced decision making, develop an understanding of the decision-making processes, and evaluate how financial investment decisions were made within LGAs in NSW.

While Bourdieu's *Theory of Practice* (1977) will provide the tools to analyse the data, it will be coupled with Decision Theory. Decision Theory focuses on how decisions are made, with the classical view of decision-making within an organisation being that rational choices will be made based on the expectations about the consequences of alternative actions. There are two main types of decision theories (Simon 1997). Normative Decision Theory prescribes how decisions should be made (in order to be rational) and Descriptive Theory explains how decisions are actually made (Zeleny 1982 p. 85). While in principle normative decision-making is likely to produce improved decision making, in practice decisions are influenced by

the individuals making the decisions and therefore incorporate humanistic limitations and behaviours. Therefore, the course of action undertaken is likely to conform to the decision-makers beliefs and values. Descriptive Theory tries to explain why particular decisions were made even when they were not the rational choice, by describing and explaining how “individuals link their decisions to their beliefs and values” (Slavic, Fischhoff & Lichtenstein 1977 p. 1).

The starting point for discussion of problem solving generally comes from Dewey (1910, p. 68-78) who proposed that there are five consecutive stages:

- A felt difficulty

- Definition of the character of that difficulty

- Suggestion of possible solutions

- Evaluation of the suggestion

- Further observation and experiment leading to acceptance or rejection of the suggestion

Simon (1960, p. 2) modified and adapted Dewey’s work to contextualise decision making in the organisational context proposing three principle phases

- Finding occasions for making decisions

- Finding possible courses of action

- Choosing among the courses of action

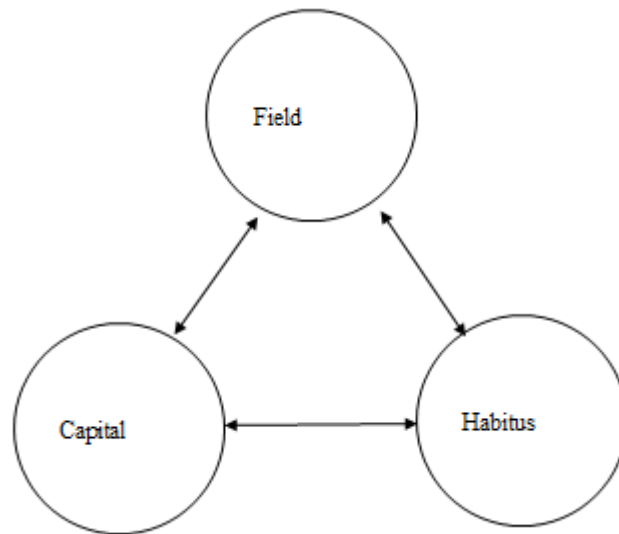
This, and later works, have focused on human choice and administrative decision-making to concrete organisational problems (Simon 1960; 1997). However, these works have proposed that decisions are made in a sequential manner, and follow a logical process, with each step building on the previous information developed. Alternatively, Witte (1972, p. 180) rejected the idea that decisions are made sequentially and proposed that the decision making stages are performed in parallel, believing that “human beings cannot gather information without in some way simultaneously developing alternatives”. Therefore, a more comprehensive model would view the decision making process in its entirety and seek to evaluate the factors that influence behaviour at all parts of the process. Consequently, the purpose of this research model is to develop better decision techniques that incorporate tools

to aid decisions that do not necessarily conform to a rational decision-making process.

Therefore, in order to focus on a framework which provides the necessary epistemological stance this research uses Bourdieu's '*Theory of Practice*' (1977) to develop an understanding of the organisational structure and spheres of influence which had some bearing on the way in which financial investment decisions were made. While Bourdieu (1977) has labelled this as a "theory of practice", he also states that it is not a theory and in reality he has provided a framework and set of tools with which to analyse and understand how individuals practice and functions within a social environment. Bourdieu's work (Bourdieu 1977; Bourdieu 1990a; b; Bourdieu & Wacquant 1992) can be used to develop understanding of the relationships the structure of the organisation and the actions of the agents. He uses the methodological and theoretical concepts of habitus, field and capital to move away from the paradoxical subjective-objective views to create an epistemology based on uniting social experience within a framework of structure patterns and interrelationships.

The following Figure 2.4 shows how Bourdieu has depicted his framework, illustrating that the tools he uses to describe social and practice interactions are interconnected and dependent on each other. When one element dominates there is a resultant effect on the remaining elements in the framework.

Figure 2.4: Bourdieu's Framework



(Adapted from Bourdieu 1977; Bourdieu 1990b)

This interconnectedness of the field, habitus and capital is primary to Bourdieu's *Theory of Practice*. By describing, and explaining how these relationships work and influence behaviour of the participants (actors), understanding can be developed of why and how particular decisions are made, even when they are contrary to the actor's fundamental beliefs.

2.4 Bourdieu: Theory of Practice

Bourdieu is a social theorist who was one of the founders of what is now described as practice theory. For Bourdieu (1977), practice is based upon the inherent pre-existing dispositions of the actors. He proposed that the actors seek to improvise and pursue strategic goals and interests, while also acting within their societal and situational environments, which also have existing strong internal norms. Bourdieu (cited in Wacquant 2004) sought to show that social agents develop strategies which are adapted to the area which they inhabit and that these strategies are unconscious results of prior learning and social expectations. Bourdieu wanted to analyse actors in the practical arena, while considering their performance, and their meaning as part of a social product which was linked to their cultural and symbolic actions (Breiger 2000, p. 109). Bourdieu's concepts are highly interdependent and the way in which

he uses them is intended to guide research and elicit research questions in a variety of social environments while looking at the interrelationships that exist (Hurtado 2010, p. 54; Neu, Cooper & Everett 2001).

Bourdieu sought to connect empirical research with his theoretical ideas and offer insights into “how objective and subjective factors are interrelated” (Berard 2005, p. 205). His work was grounded in the way everyday life operated and focussed on the culture or as he posited, a “theory of practice” (Bourdieu 1977; Webb, Schirato & Danaher 2002). Bourdieu argued that both quantitative and qualitative methodologies contribute and identify different elements of social practice (Wadham 2003). He was adamant about the inseparability of the structure, subjectivity and the pre-reflectivity character of practice. Bourdieu (1977) proposed that social order is produced through relations of domination, where the power to make groups and instil them with authority is a representation of symbolic power (Bourdieu 1987), and then agents develop ways of comprehending the world through developing dispositions or inclinations that support the patterns, purposes and principles of the social context in which they operate. The main terms he used to describe his theory of practice were habitus, field and capital. Later, Bourdieu (1977; 1984; 1990b) further divided capital into a range of categories such as social capital, cultural capital and symbolic capital. These terms will be further explained in section 2.4.3.

2.4.1 Habitus

Bourdieu sees power as something that is created through culture and symbolism, which is then re-legitimised through interactions between the agent and the organisational structure. The primary way in which he viewed this occurring is through what he labelled ‘habitus’. Habitus is essential to Bourdieu’s theory (Berard 2005, p. 201) and is described (Bourdieu 1977; 1996) as a socially constructed set of dispositions. It captures the cultural unconscious that shapes action through encapsulating the dialect between structure and agency. Habitus is the residue of past actions, knowledge, knowhow, behaviour and responses that now function in the present and influence behaviour (Bourdieu 1984). Habitus is therefore the social norms or tendencies that guide behaviour, actions and thinking (Webb, Schirato et al. 2002). According to Jenkins (1982, p. 272) habitus and culture are interchangeable

and are the “product of those objective structures which constitute the basic framework of life”. Bourdieu (1990a) perceived that agents do not act according to rational and economic criteria but rather according to their implicit practical logic, which has been developed from lasting acquired systems of perception, thought and action. He proposed that social agents act according to their “feel for the game” with the “feel” broadly speaking related to the habitus and the “game” being the field in which they are situated (Bourdieu 1977).

Bourdieu (1977) described habitus as being created through social processes, which then lead to patterns of behaviour that are both enduring and transferable from one context to another. He also proposed (cited in Webb, Schirato et al. 2002) that habitus is shaped by past events and structure, that it shapes current practices and structures, and that it conditions our perceptions of those structures and practices. Bourdieu (1984, p. 170) proposed that habitus is a result of the interplay between freewill and structure, that it is shaped by past events and structures, shapes current practice and structures, and is very influential in shaping perceptions of current practice and structures. He stressed that the capacity of actors to engage with the structure and impose their freewill was essential to the reproduction of social structures (Bourdieu 1984, p. 170). Bourdieu (1990a) has defined habitus as;

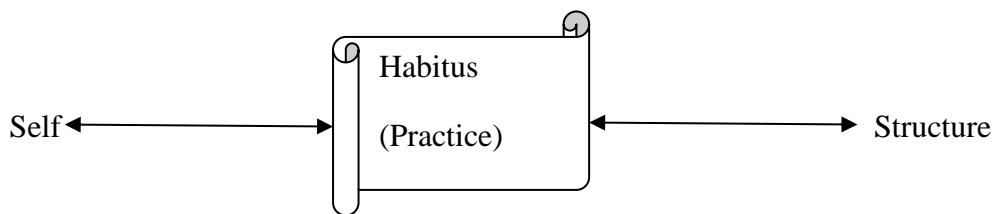
the relationship between two stages of the social, that is, between the history objectified in things, in the form of institutions, and the history incarnated in bodies, in the form of that system of enduring dispositions which I call habitus (p. 190)

Hurtado (2010) provided support for this and stated that Bourdieu claimed “in stable societies, social structures are reproduced by social practices. Mediating practices and structures is the habitus” (p 54). Similarly, Wacquant defined habitus as the “way society becomes deposited in persons in the form of lasting dispositions, or trained capacities and structured propensities to think, feel and act in determinant ways, which then guide them” (Wacquant 2004, p. 316). Habitus in this sense is created and reproduced without conscious pursuit, it is neither fixed nor permanent,

it is able to change as a result of an unexpected event, situation or to evolve over a long period of time.

For Bourdieu, each individual develops their dispositions as a result of the conditions which they have experienced and encountered. Bourdieu proposes that individuals subjectively inculcate their social structures. Once having absorbed the social structure, individuals then link them to their personal set of dispositions, after which the individuals' actions should be commensurate with the objectives of the social field in which they operate, hence creating a doxic relationship. The following Figure 2.5 demonstrates that the relationship between self and the structure of the organisation is dependent on the habitus of both the individual and the field in which they function.

Figure 2.5: Influence of Habitus



When the existing beliefs and habitus become unassailable, individuals no longer question or try to change practice leading to a doxic environment. Doxa refers to the deep founded unconscious beliefs and values that are taken as self-evident opinions. These are then used to inform the actions of an individual within a particular field. The existing social arrangement of the field is flavoured by the existing doxa, leading to replication of the current power and domination of certain positions and roles. The existing power relationships and dominance by certain positions are taken as self-evident and fundamentally desirable. In a doxic environment, the social world within a particular field is viewed as natural and logical. Therefore, improbable actions and practices are seen as undesirable, leading to submissive acceptance of the existing doxa and belief in the inevitability of conforming to the social norms.

Local Government Habitus

Habitus in LGAs is vested within the organisation itself, and within the individuals working in the organisation. From the perspective of the LGAs, prior experiences,

both good and bad, develop a habitus, which is capable of influencing future behaviour. From a financial investment perspective, the types of experiences that could influence the habitus of LGAs cover a range of possibilities. They could include failed investments in the past leading to a reluctance to invest in risky products; reaction of stakeholders, such as ratepayers, to previous investments, or alternatively success in the past may heighten interest in seeking greater returns creating a habitus more accepting of risk. Organisations and individuals, who have not having previously experienced investment failure, enable the creation of a habitus where the idea that financial investment may contain risk is not considered (Goddard 2004). This may be reinforced by the banking situation in Australia, where bank deposits are government guaranteed, therefore creating the habitus of expecting all investments with major banking institutions to have a similar protection. Another element that could influence the habitus could be how the LGAs view the money that they hold. If they view it as theirs, for the use of the LGA, albeit to provide community services, then they may have a different habitus to another LGA who view it as public money which should be protected and preserved for the benefit of the community and future generations.

Equally, the influence of those in authority, and in particular their habitus, is able to permeate throughout the organisation. Individuals' personal experience and knowledge will influence their habitus, and depending on their capacity to influence organisational behaviour, the habitus of the organisation. This research looks at the existing habitus of NSW LGAs, the past events that have helped to shape the organisations and where those events have created a doxa, which influences financial investment decisions. Likewise, the habitus of individuals involved may have influenced investment decisions. Therefore, this research delves into what events may have influenced individuals' perceptions and actions.

The combined treatment by Bourdieu of habitus (structuring disposition) and fields (social structure) (Berard 2005, p. 201) is the core to how he analyses organisational structures and the practices of the actors within. Habitus and fields are inter-related and therefore should be considered together to truly understand how they interact.

2.4.2 Fields

Bourdieu (1977) proposed that habitus and fields exist only in a two way relationship with each other. He divides the social world into a number of interlocking fields, with fields being a metaphor for the space in which it is possible to identify elements such as the institution, agents, practice, discourse and values (Webb, Schirato et al. 2002, p. 86). Those fields could relate to institutions such as government or family, whereas others may relate to sub-parts such as local government where there is a set of embedded rules defining the function of the organisation. Each field exists through the participation of individuals (through actions and thought) within it, thereby imbuing their habitus on the field, effectively creating the field and giving it meaning. Bourdieu (1990b) defined fields as “networks of social relationships, structured systems of social positions, within which struggles or manoeuvres take place over resources, stakes and access” (p. 52-56). He perceives fields as being autonomous, where the dynamics and structure of fields are determined by the actions of the individuals within them. Those individuals are trying to position themselves in dominant roles within each field; however their ultimate behaviour is conditioned by their position within the field. He also proposes that individuals may occupy different levels of power and dominance in different fields. Power in these fields is both internal, through the ability to influence behaviours within the field, and external via the capacity to influence other fields

Individuals, according to Bourdieu, are not only defined by where they reside within their social class. He proposed that individuals occupy a position within a social space (field) that is multidimensional and that an individual’s position is determined by the various types of capital that the individual can command within individual fields. For this reason the capital controlled by individuals needs to be considered when evaluating their position in the field.

Local Government Fields

Within the local government arena there are a number of different players, forces and factors which have the potential to influence the investment making decisions of LGA. Bourdieu (1977; 1990b; 1996) has provided the framework for analysing the

inter-relationships between these various elements. Bourdieu describes government, which he terms the 'state' and the bureaucratic mechanisms of the state only in general terms. From a variety of sources (Bourdieu 1990b; 1996; Webb, Schirato et al. 2002) it emerged that he considered the state as both a cultural field and a field of power. The following section explains the fields and capital evident in the local government arena.

Cultural fields are made up of a range of "rules, rituals, conventions, categories, designations, appointments and titles which constitute an objective hierarchy" (Webb, Schirato et al. 2002, p. 21), and lead to the production and authorisations of particular discourse and activities. LGAs are cultural fields with their own rules, policies and structures designed to lead to certain activities.

Fields of power differ to cultural fields in that they are not the actual site of influence but a metaphor for the way in which the fields 'act'. Power is the mechanism by which the state is able to manage the community, which means that the "government is not the field of power, but is one of the sites in which power operates" (Webb, Schirato et al. 2002, p. 86). While LGAs are able to manage their own operations, their power to operate, raise revenue and provide services is vested in the authority stemming from the state government.

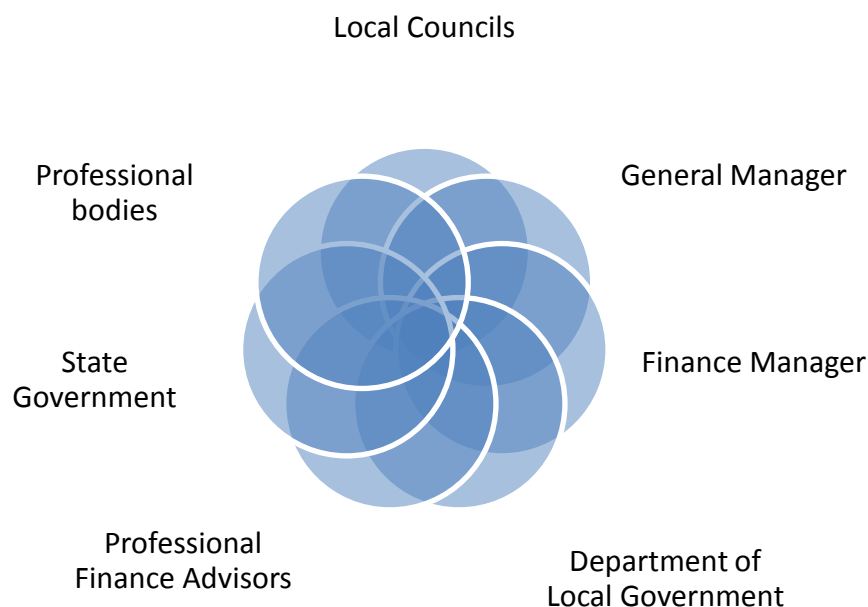
Finance managers working in NSW local governments function in a variety of fields which are interwoven. While some of these fields are highly regulated and prescriptive others are less rigid and are potentially adaptable to the power exerted by individuals or other fields.

From the perspective of the finance managers, an example of highly regulated fields are the restrictions imposed by the state government through ministerial investment policy guidelines, which detail the types of products that LGAs are able to invest in. Similarly finance managers are governed by the investment policies of their individual LGA (which also have to comply with the State investment guidelines), thereby creating firm boundaries within which they have to function.

An example of where the field within which finance managers practice is less restrictive and where influence may be exerted, is the local government finance

managers groups, where they meet and discuss issues faced by their members. This field has the potential to exert influence on the perceptions and actions of the finance managers and then, through the actions of finance managers in other fields, to be extended beyond that original field. Bourdieu recognised that if the conditions in a field changed significantly, then the habitus would still generate the conditions previously expected and would no longer meet the objectives of the field (Hurtado 2010). He suggested that this would cause the individuals within a field to be more reflective, consider their practices and may then lead to modifications of those practices. Therefore, influences on a field have the capacity to shape the existing habitus and the practices of those functioning within the field. The following Figure 2.6 highlights the fields of influence, which operate in the local government investment arena.

Figure 2.6: Fields in the Local Government Arena.



This figure has emphasised that there are a wide variety of fields, all of which have the capacity to influence the decision making process of the individuals who are responsible for making financial investment decisions. This is by no means an exhaustive set of fields; other fields which could impact would include the general economy, ratepayers, environmental groups, developers to highlight just a selection.

2.4.3 Capital

Bourdieu describes the concepts of field and capital as being the structural context in which action occurs. Struggles over various resources that actors decide are worth expending effort on, define the stakes that are valued by the actors. Action is shaped by the recognition of those stakes and by the resources (capital) available to the agents and by the resources that are sought. While the traditional concept of capital (Emirbayer & Johnston 2008) has typically related to money or financial resources (economic capital), the more modern approach has been to other types of capital such as human and social capital. Hence, capital can refer to both the tangible and intangible resources which enable individuals to further their aspirations and achieve success (or what is perceived as success) within their field. The quantity and type of capital that agents are able to control are thereby a reflection of their social position within any given field and as highlighted by Bourdieu and Wacquant (1992, p. 110) “capital does not exist and function except in relationship to a field” and an individual’s capital may be substantially different in different fields. The capital that is vested in a non-economic resource relies on how it is perceived. Lash (1993, p. 195) explains that “the value of a symbolic good depends on the value assigned to it by the relevant consumer community”.

Bourdieu (1977; 1990b; 1996) put forward the proposition that there are four main forms of capital (or power) being;

- Economic (financial, property and resources controlled)
- Cultural (including knowledge, cultural goods, education, competencies, skills, and qualifications)
- Social (or connections), which he elaborated as being the “sum of the resources, actual or virtual, that accrue to an individual or a group by virtue of possessing *a durable network of more or less institutionalized relationships* of mutual acquaintance and recognition (Bourdieu & Wacquant 1992, p. 119).

- Symbolic (being the power of legitimation or recognised value e.g. prestige, honour, attention). Symbolic power can be anything, which is socially perceived as valued.

(Adapted from Bourdieu 1977; Wacquant 2004; Wadham 2003; Webb, Schirato et al. 2002)

Hence, it can be seen that the field and capital are interwoven with the habitus. As agents operate and become involved within a particular field, the habitus is shaped, which in turn shapes actions, which are able then to act to reproduce the field. The capital controlled by agents defines their position within the field, the position allows possibilities for action and hence the capacity to influence the habitus. Applying this logic to local governments, habitus is constructed by the social context in which it operates (the field), and actions that shape the nature of the organisation.

Local Government Capital

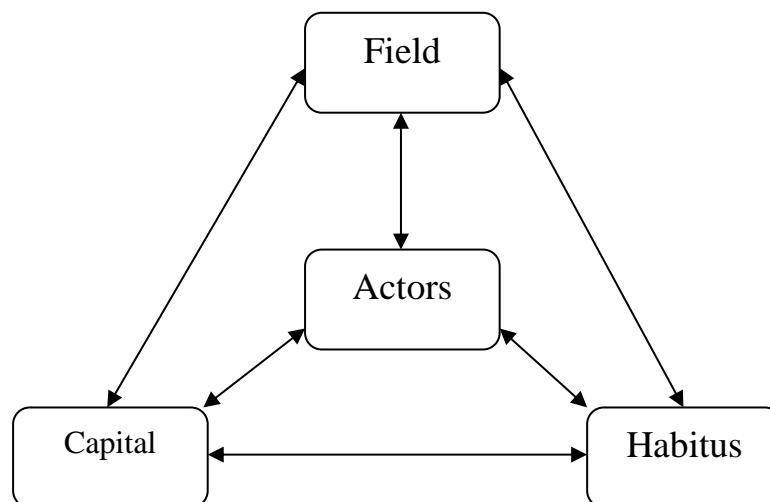
Within the local government environment in NSW, there is a range of different types of capital that may exist. Within the LGA, there is a hierarchical structure that creates capital due to each individual's position in that social structure. The elected LGA councillors may have the role of guiding the policy and direction of the LGA and therefore the capital in respect of policy, however it is the general manager that runs the day to day operations and hence the 'capital' to influence practice. Individuals such as the finance manager may have capital due to expert knowledge, qualifications and experience, which could be used to influence policies and decisions. Other capital may be vested in the education qualifications, practical experience, capacity to influence policy, or links to community or business of other individuals. Professional associations or groups such as the Finance Professionals Group (FPG) make up a field with their own capital. The interaction of the members and different experiences, or duplication of experiences, when shared throughout the group, has the capacity to influence decisions and actions of the members when they return to their respective organisations. This was highlighted by Bourdieu (1987; 1990b; 1996) who suggested that, individuals within society, in positions of authority, try to hang onto their existing power. Individuals attempt this through not

only controlling physical action but also by dominating the social discourse. He also noted that what is not discussed, or the social silence, is crucial in understanding how individuals, or sectors, have been able to maintain power within a particular arena. The silence around the risk associated with CDOs was a classic example of how silence allows power to be maintained. This has been highlighted by Tett (2009a) who proposed that;

the “iceberg” pattern that developed in finance over the last decade is a classic case of an elite hanging onto power in a manner that proved extraordinarily effective—at least until the bubble burst.

The following Figure 2.7 depicts the relationships between the terms Bourdieu uses to describe the tools for his theory of practice. While he only uses the terms of habitus, field and capital to describe the factors that influence practice, the actors themselves are essential to the process as without them there is no need for the other elements. The inter-relationship of the actors with the prevailing fields, habitus and capital has the capacity to influence each of them.

Figure 2.7: Incorporation of Actors into Bourdieu’s Theory of Practice



(Adapted from Bourdieu 1977; Bourdieu 1996; Webb, Schirato et al. 2002)

2.5 Conclusion

This chapter has provided an explanation of the research philosophy and presented the theoretical perspective used for this thesis. The rationale for the use of Bourdieu's framework of a theory of practice has been provided to demonstrate why it is an appropriate tool to investigate and describe the financial investment decision-making process of local councils. Bourdieu's framework includes fields to describe the interactions of groups and institutions, capital to demonstrate the power relationships allied to position, authority, knowledge, skills and networks, and habitus to account for the factors that influence practice within a particular field. The following chapter outlines the research method and describes the types of research used in this thesis, the analysis methods employed, ethical considerations and the limitations of this research.

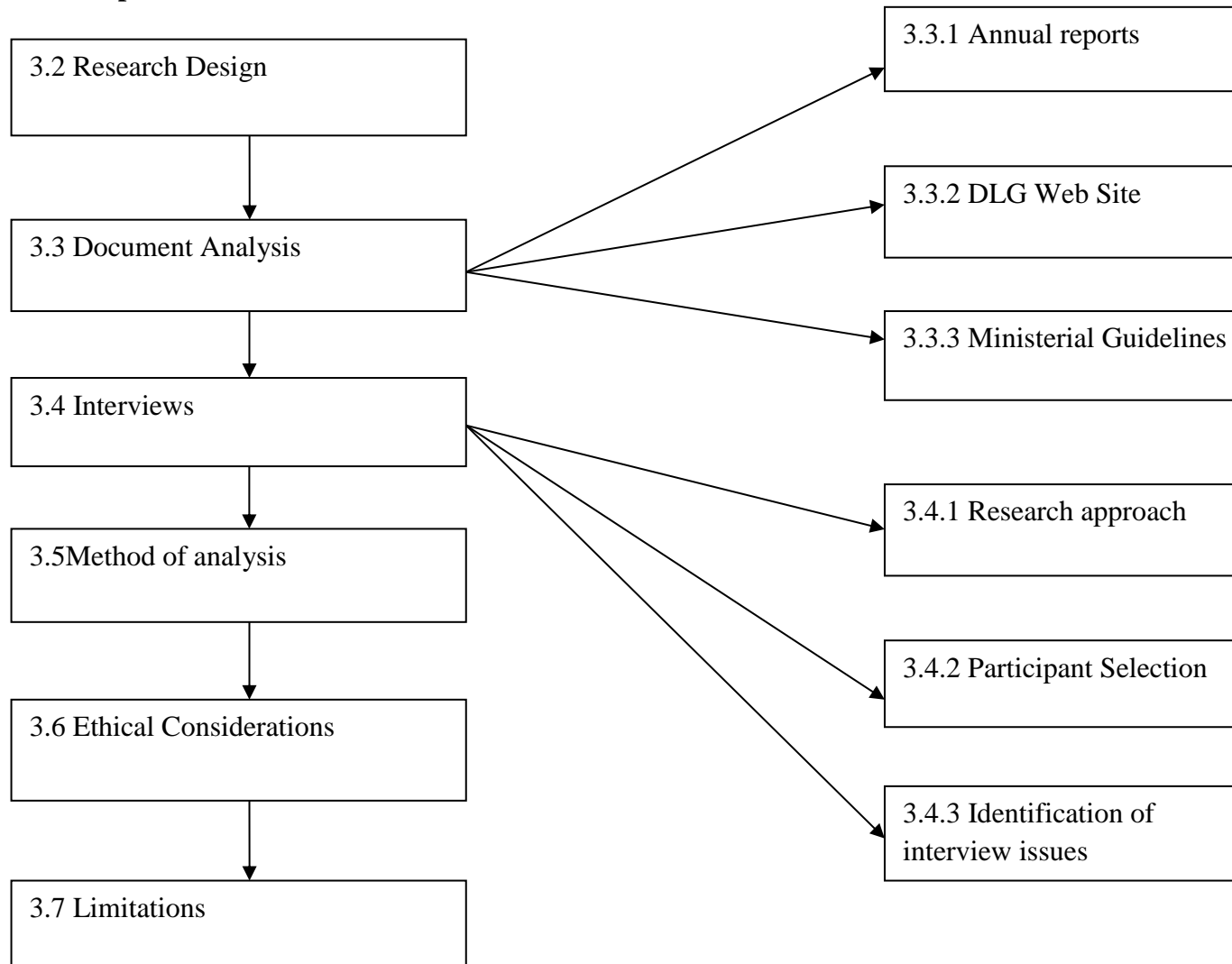
Chapter 3: Research Method

3.1 Introduction

The previous chapter has provided an overview of the research philosophy of the researcher. Primarily the researcher has taken a subjective perspective believing that reality is socially constructed and influenced by both the environment and common communal beliefs. Additionally, that an individual when making decisions will interact with their environment and be influenced by the professional, business and social norms of their environment.

The following chapter will outline the design of the research, which takes a case study approach to look at three ethnographic groups involved in investment decisions by NSW councils. Initially the documents such as annual reports, ministerial financial investment policies and guidelines will be evaluated to determine how they have changed over the last decade. An explanation of the interview process of participants and how they were selected for this research and how they will be analysed will be provided. This chapter will conclude with an explanation of the ethical considerations and the limitations of the research. Figure 3.1 shows the outline of this chapter.

Figure 3.1: Chapter 3 Outline



3.2 Design

The thesis research design is based on “a desire to know something currently inaccessible and the belief that systematic reading of potential available texts could provide answers” (Krippendorff 2004, p. 342). This research takes a qualitative approach and methodology, while using some quantitative data primarily for the purpose of identification of which local LGAs did or did not invest in CDOs.

This involved the use of some secondary data, which is information and material that is not originated by the researcher, but collected from other records developed by someone other than the researcher. Use of secondary data relies on the researcher being confident of the accuracy and validity of the material used. Secondary data can also be used as a tool to develop and understand how the accounting information was utilised (Christensen 2003; Napier 2001; Previts, Parker & Coffman 1990). Secondary data sources used in this research include the annual reports, and financial reports, of NSW LGAs. The researcher is confident of the accuracy and validity of this data, particularly as these are audited reports and are prepared as part of the reporting requirements councils supply to parliament. These are publically available documents, sourced online from LGA websites, the DLG, and from the LGAs directly. Other secondary material used included the ministerial investment guidelines, obtained from the DLG and from an professional investment advisor for NSW LGAs.

3.3 Document Analysis

Publically available information was gathered from three main sources. The first of these was from the web sites of each of the councils in NSW. The information from this source included financial and annual reports and was gathered for the purpose of developing data about which councils had invested in CDOs and their investment policies. The second source was from the DLG website. This included information about the types and quality of information that was being disseminated to councils, primarily through circulars to councils. The third source was also principally through the DLG website but focused on the Minister’s orders with respect to investment policies. The following sections detail this process further.

3.3.1 Annual Reports

Quantitative information was gathered from LGAs financial reports from 2005 through to 2010 inclusive. LGAs are required to make these reports publically available and the majority of them were accessible online. Those that were not accessible online were either available through the DLG or directly from the individual LGAs by attending the individual LGA office. All bar one of the 2010 reports were available on-line as a result of recent requirements of the DLG requiring LGAs to provide on-line access to annual and financial reports (DLG 2010a).

The financial reports were subjected to a longitudinal analysis covering the period from 2005 to 2010, to determine which of the LGAs in NSW invested in 'at risk' financial instruments, such as CDOs, and what types of funds (such as employee benefits or funds held for capital projects) were held in those investments. Revenue streams were scrutinised to determine levels of revenue, the reliance on property rates to fund current and future operations, and the need to generate revenue from other sources to meet cash flow requirements. Additionally, analysis of the contingent liabilities was conducted to determine if they were suffering financial stress or cash flow problems. This was used to establish if there were patterns or factors that influenced LGAs to decide to invest or not to invest in these products. Once the LGAs who invested or did not invest in 'at risk' financial instruments were identified, they were further divided into two sub categories. The categories used were metropolitan and regional LGAs. After they had been grouped into metropolitan and regional LGAs they were further analysed to determine what, if any, relationships existed between the category of LGAs and their financial investment activities.

3.3.2 Department of Local Government (DLG) Website

Qualitative data was also collected through the DLG web site (publically available) by reviewing the circulars to LGAs issued from 1997-2011. The circulars focussed on were those relating to Minister's orders, guidelines and policies issued for investments as well as any other guidelines or issues identified by the DLG in respect to forms of investments. These were supported by the records of investment

guidelines, issued by the DLG, which had been kept and made available from a local government investment advisor. This data enabled the analysis of ministerial and DLG guidelines related to the initial recognition of issues linked to financial investments and further highlights how the Ministry and DLG have acted prior to the global financial crisis and subsequently responded to events.

The annual and financial reports for the period 2005 through to 2010 were accessed and analysed to collect both quantitative and qualitative information. This time frame was chosen as it covered the years prior to the public identification of issues related to the GFC particularly in related to the valuations of CDOs, the period immediately after the Cole Report (Cole 2008), which identified the exposure of LGAs in NSW to CDOs and highlighted the extent of losses experienced by NSW LGAs. It then encompasses the years subsequent to the Cole Report, in order to highlight how LGAs have reported and adapted their investments in response to the collapse of the market for CDOs and the resultant write down of those investments.

Initial identification of NSW LGAs who did and did not invest in CDOs was made via accessing the financial reports of all LGAs. LGAs detailed their investments in their financial statements and the notes to the financial reports. Subsequent to the identification of LGAs who invested or did not invest in CDOs, an evaluation of the various aspects that may have influenced how and why particular investment decisions were made differently by LGAs faced with the same ministerial guidelines on investments was conducted (DLG 2006; 2009a).

3.3.3 Analysis of Ministerial Guidelines

Analysis of the ministerial guidelines and how they have changed over time was conducted to develop an understanding of the way they changed over the period before and after the global financial crisis, and if or how they changed to reflect the prevailing financial investment environments. As the central component of this research is qualitative, it differs from quantitative research in that it is a reflection of the approach to the research rather than making use of a particular set of techniques (Morgan & Smircich 1980). The approach taken is therefore influenced by the researchers' ontological and epistemological assumptions which have been detailed

in the previous chapter. This notion is supported by the statement that “with qualitative methodology goes an acknowledgement that the field is itself not just part of the empirical world but is shaped by the theoretical interests of the researcher” (Aherns & Chapman 2006, p. 820).

The ministerial guidelines were examined using content analysis techniques. Quantitative content analysis of selected text can be conducted via the use of statistical techniques that collect and measure elements of the text. While this is the traditional approach, the use of content analysis has evolved to incorporate qualitative analysis which of necessity, due to the interpretations placed on the data, may be influenced by the researcher imposing boundaries around qualitative information. Using qualitative content analysis involves examining all of the material and then the researcher deciding how it ‘best fits’ (Schreier 2012). This is a necessary component of examining text as after all “ultimately all reading of texts is qualitative, even when certain characteristics of a text are later converted into numbers” (Krippendorff 2004, p. 342).

The core of content analysis requires that the characteristics of the data are evaluated and then coded into categories by the researcher. This is supported by Hackston and Milne (1996, p. 82) who propose that the “identification and coding of characteristics ... of text are key components of content analysis”. The ultimate interpretation of the data to extract useful information is done by the researcher and therefore has the capacity to be influenced by the researcher’s expectations and beliefs. Clearly, “documents never speak for themselves – interpretations are always made by intelligent readers. And texts inevitably have several meanings” (Krippendorff 2004, p. 342). The meaning may be influenced by the context, the interpretation of the participant, or even the researcher. This method only allows the researcher to describe the material in terms which the researcher has specified (Schreier 2012) and is primarily used as a method to describe the material being examined. Therefore, ultimately the researcher has to endeavour to not unduly influence the results through interpretation and to try and let the text speak for itself where it can, while at the same time being aware of the contextual environment within which events have occurred.

Analysis of content has been described as “a class of methods at the intersection of the qualitative and quantitative traditions” (Duriau, Reger & Pfarrer 2007, p. 5) which will therefore facilitate the “rigorous examination of often important but difficult to study issues” (Duriau, Reger et al. 2007, p. 5). This is consistent with the suggestions from Harwood and Garry (2003) who propose that content analysis is not a stand-alone method but should be used as a complimentary method. This approach to content analysis is consistent with the suggestion that content analysis has moved from the traditional concept of being an element more commonly related to the realist (objective) ontological assumption based on quantitative analysis of the text, to analysing content in a qualitative manner, based on the concept of drawing inferences from both the language and phrasing used (Krippendorff 2004).

3.4 Interviews

This research will develop primary data from interviews with a range of individuals involved in the financial investment decision-making process of NSW LGAs. Interviews were planned with finance managers involved in making the decisions to invest in CDOs and other individuals who were aware of the CDO investments and who may have influenced behaviour. These include an auditor of NSW LGAs, a former town clerk (to provide an historical perspective), and an investment advisor for NSW LGAs. This is primary data, as it is information and material generated by the researcher. This type of material allows the researcher to evaluate the way that accounting information was recorded and the manner in which it was developed (Copeland & Ingram 1982; Fleischman, Mills & Tyson 1996). The researcher is then able to evaluate how the financial investment decisions were made and in what context.

Interviews are a form of qualitative research and are likened to learning the “native’s point of view” (Hannabuss 1996) by developing an understanding of how the ‘actors’ (the people within the organisation) do particular tasks. This type of research stresses developing an understanding of the way in which the actors make sense of, and create meanings of, the way they live and function within their environment, while also interacting and adapting the structure of that environment (Dilley 2004). They enable the researcher to see the social world through the eyes of the participants, and

then to evaluate and develop an understanding of the ways in which decisions and actions have been made (Foucault 1981).

The primary purpose of using interviews is to allow the “respondents’ own perspective to emerge....get insights into particular experiences, find out motives behind decisions, get a view of informal procedures, consider apparent contradictions between attitudes and behaviours” (Hannabuss 1996, p. 23). Likewise Seidman (1998) described interviewing as providing “access to the context of people’s behaviour and thereby provides a way for researchers to understand the meaning of that behaviour”, and therefore “allows us to put behaviour in context and provides access to understanding their action” (cited in Dilley 2004, p. 128).

One of the advantages of interviews is that it sees each individual as being unique, able to provide a depth of information rather than a broad overview. As noted by Cohen, Manion and Morrison (2000, p. 267) “..the interview is not simply concerned with collecting data about life: it is part of life itself, its human embeddedness is inescapable”. This type of research requires the researcher to play an active role in the data collection and may mean that the findings cannot be generalised over larger groups due to the small scale or unrepresentative nature of the samples.

Smith (2011, p. 127-128) noted that there are a variety of interview formats with the three most common being:

- The structured interview; where interview bias is restricted through asking the same questions in the same order. The disadvantage of this method is the lack of flexibility and richness of response.
- The semi-structured interview; where a series of questions are asked in no specific order. Additional questions are then asked to pursue areas of interests or to deepen understanding and examine issues raised
- The unstructured interview; which starts with a series of topics rather than specific questions and then the researcher allows the interview to ‘freewheel’ while remaining on topic

This research has used the semi-structured interview format with specific questions (see Appendix 4) being the focus of the interview while at the same time structuring the questions into themes and sub questions, which were open ended to enable richer responses from the participants. Equally this allowed the researcher to “draw questions from unplanned encounters” (David & Sutton 2004, p. 87) and provide greater depth of understanding than could be achieved through a structured interview process (Denzin & Lincoln 2005). As a result the researcher was able to allow the interview to continue unfettered if the participant was willing to provide additional information or explanation of experiences. This type of interview structure allowed the interviewer to respond depending on how the interview developed (Breakwell, Hammond & Fife-Schaw 1995). As a result, the interview could pursue areas, relevant to the topic, brought up by the participants that had not been previously anticipated. This was done to enable the interviewer to develop richness of information that would not have been possible under a more structured regime.

3.4.1 Research Approach: Ethnographic Multiple Case Study

This research abides by the concepts that direct research in an organisational setting (Mintzberg 1979), to develop understanding of social phenomena, can be achieved through a case study approach (Bryman & Bell 2007; Yin 2009). While the research strategy takes a case study approach the data is developed from three coherent multi-sited ethnographic groups (Yin 1981). A case study approach is relevant and pertinent where the research question investigates how or why something occurred (Shavelson & Townes 2002; Yin 2009), and particularly where there is a need to develop an in depth and first hand understanding of events (Yin 2009). The variety of LGAs used in this research potentially may be of particular use when conducting analysis (Stake 1994) across the cases and determining what differences existed between the cases. This ethnography observes the decision making process of the finance managers within NSW local councils from their perspective and analyses the environment through the lens of Bourdieu’s (1977) *Theory of Practice*. The resulting case studies reflect the systems of meaning within this group (Geertz 1973, Geertz 1994) selecting individuals knowledgeable about the investment practices of NSW local councils.

Case study research does not mean that the research is limited to one source or type of data. The intent of this research is to triangulate information from a number of sources, from three ethnographic groups, and determine where there is convergence of information. Ideally the information gathered will all point to the same 'set of facts', however this is an unlikely event and the expectation is that the data gathered will provide pointers to the events and the processes that were followed in making investment decisions.

Multiple Cases

There are a number of reasons for using a multiple case study approach. Similarly to a scientific approach which could undertake a series of experiments, multiple case studies is not done to produce a sample of all cases, or as a means to be able to extend the results and generalise to a wide population, but rather as a means to develop understanding and theorise about a larger collection of cases (Stake 1994). Multiple case studies are used to pursue a logical framework of inquiry (Yin 2009), investigating phenomenon within a real life context where the boundaries between the phenomenon and the context are not clearly understood (Yin 2009, p. 14-16).

Interviews with LGA officers involved in the financial investment decision-making process were conducted. Particular attention was given to trying to select LGAs who still had the same personnel in the finance roles, as when the initial decisions to invest (or not) in CDOs were made. The purpose of this was to gather information about how financial investment decisions were made prior to the GFC and how or if the decision-making process had changed. It provided an opportunity to develop an understanding of what corporate governance structures existed prior to the collapse of the CDO market and how they may have changed. How the financial investment policies were determined and how they may have changed. This process also served to clarify what characteristics of the organisation and personnel may have influenced the decision-making either way and to illuminate if there were any individuals or groups that were able to influence, or capture the financial investment decision-making process.

As the interviews would later be analysed through the lens of a Bourdieuan 'Theory of practice' perspective (Bourdieu 1977; 1996; Wadham 2003; Webb, Schirato et al. 2002) it was necessary for the interviewer to have a good understanding of the framework and implications associated with this perspective. While Bourdieu has been discussed in the previous chapter, it is noteworthy to mention that the lens through which that the interviews would later be viewed influenced the research method. This required the interviewer to consider the responses and subsequent questions while keeping Bourdieu's theory of practice in mind. Bourdieu (Bourdieu 1977; 1996; Webb, Schirato et al. 2002) suggests that agents operating within their environment will develop dispositions or inclinations that support the patterns, purposes and principles predominate in the context in which they operate. He also refers to habitus as the 'cultural unconscious' that shapes actions. Habitus is the result of past actions and knowledge that function in the present and influence behaviour. Therefore in conducting the interviews there was a responsibility to keep in mind how the interviewees' responses fitted into the Bourdieu framework in order to allow the interviewer to delve deeper when particular areas of interest arose.

Bourdieu (1996) highlighted that the interview process is different to most other ordinary exchanges due to its objective of 'pure knowledge', while still being a social relationship and hence having the capacity to affect the results. He emphasised that in any interview relationship there is an element of intrusion and that the effects of that intrusion need to be considered both during and after conducting the interview. He also suggested that developing a relationship before the interview can be useful in reducing the perceived threat to the respondent as this may lead to a more open and frank discussion that is less likely to be influenced by the interviewees' concerns of being judged or criticised (p. 18-22). This was particularly relevant when considered in relationship to this research where the interviewees may have made, in retrospect, poor investment decisions.

Therefore, the decision was made to seek, where possible, introductions to potential respondents from individuals they trusted or through networks of friends and co-workers. The purpose of this was to reduce any perceived threats and to attempt to make potential respondents more comfortable with taking part in the interview

process. For similar reasons respondents were provided with an outline of the types of questions which would be asked so that they could develop an understanding of the purpose of the research and allow them to feel more secure.

After establishing which of the local LGAs invested in 'at risk' financial instruments, particularly those who were impacted by the GFC and which had an ensuing write down of their investment portfolios, interviews were arranged at a number of those LGAs. See Appendix 5. Interviews were also arranged with LGAs who had not invested in CDOs to establish what it was about their decision-making process that varied from those who did invest. Predominately they were conducted with the finance managers although on some occasions other staff members involved in the decision making process were also involved. There were potentially a wide range of reasons for the different choices made by the LGA officers, and the purpose of the interviews was to draw out the reasons behind why particular decisions were made.

3.4.2 Selection of Interview Participants

Overview

At the outset it was anticipated that LGAs would be identified from reviewing the councils' financial reports, to determine which had and had not invested in CDOs and then interview participants (finance managers), who were likely to be representative of each group. Identification of the finance managers was initially made through publically available information which was available on the individual LGA websites. The DLG website provided a list of all NSW LGAs which included a range of contact information and websites of individual LGAs (DLG 2010a).

Primarily, it was necessary to determine if there were any differences between regional and metropolitan decisions to invest in CDOs. It was expected that regional LGAs may have been more likely to have invested in CDOs due to having reduced availability of revenue, particularly from rates (due to lower land values and smaller populations), and with higher proportional costs associated with providing services to often vastly larger areas which were required to be serviced. It was therefore anticipated that they may have been more likely to be suffering from financial stress

and consequently have felt the need to take advantage of the higher returns promised from investing in CDOs, as a mechanism to supplement their constrained revenue streams.

Analysis Determining Differences Between Metropolitan and Regional Councils.

Initial analysis of NSW LGAs who did and did not become involved in investing in CDOs was conducted. This revealed that there was an almost even spread of LGAs in NSW who did and didn't sign on to CDO products. Of the 152 councils there were 78 (51.3%) councils who invested in CDOs and 74 (48.7%) who chose not to invest in this product. These councils were then segregated into two discrete groups made up of metropolitan or regional authorities. The purpose of this was to test if it was evident from the data that there was any difference between regional LGAs and their metropolitan counterparts when it came to engaging in the practice of investment in CDOs.

While the total number of LGAs who invested in CDOs was much higher for regional LGAs than metropolitan LGAs, that was a reflection of the relative proportions of regional and metropolitan LGAs in NSW. A more appropriate measure was obtained by looking at the proportion of each type (metropolitan or regional) of council who were investing in CDOs. The following Table 3.1 breaks down these figures and shows the results of this analysis.

Table 3.1: Summary of Types of Local Government Authorities and if they Invested in CDOs

	Total number of LGAs	% of total LGAs	Regional LGAs	Metropolitan LGAs	Proportion of regional	Proportion of metropolitan
Invested in CDOs	78	51.3 %	54	24	49.5%	55.8%
Did not invest in CDOs	74	48.7 %	55	19	50.5%	44.2%
Proportion of total investing in CDOs			69.2%	30.8%		
Proportion of total not investing in CDOs			74.3%	25.7		

The proportions of regional LGAs investing in CDOs were comparable to the total proportions. However, contrary to prior expectations, the proportion of metropolitan LGAs who invested in CDOs was approximately 6% higher than for regional LGAs. This demonstrated that the uptake of investment in CDOs products was higher (proportionally) in the metropolitan areas. Therefore, it appeared to be redundant to differentiate between regional and metropolitan LGAs. This view was supported by an interview with an audit partner of a large accounting firm involved in NSW LGA audits who stated when asked if they would expect differences between regional and metropolitan LGAs that:

No, wouldn't have made any difference, the council would have a policy, an investment policy, and in that policy there would be certain delegations given to people, and sometimes a delegation could be up to financial manager level, it could be

a director level and it could even be lower than that. It will really depend on the policy the council has and if that policy has been complied to (AP)

The following Table 3.2 has highlighted the total investments in CDOs within both the regional and metropolitan groups for the years 2007-2010. This information has been extracted from the annual reports available from the individual LGA websites. It should be noted that not all reports were available so the total investments and average investments have been calculated on the available reports.

Table 3.2: Local Government Authorities Investments in CDOs According to Groups

Year Group	2007 Rural	2007 Metro	2008 Rural	2008 Metro	2009 Rural	2009 Metro	2010 Rural	2010 Metro
Total Investment in CDOs x 1000	214,524	189,110	188,426	155,015	141,152	109,933	133,332	98,033
Average Investment in CDOs x 1000	6,501	8,596	4,596	6,740	2,614	4,581	2,564	4,456

While the total dollar amount of regional CDO investments were higher than for the metropolitan group, it is also clear that the average investment in CDOs per LGA was significantly higher in the metropolitan area with approximately \$2 million more invested per LGA in the metropolitan area. Metropolitan councils also provide services to a much greater proportion of the population, as the population is concentrated in metropolitan areas.

There were also much larger numbers of unavailable financial reports from regional LGAs than there were for the metropolitan LGAs. The following Table 3.3 shows the reports, which were available online from the individual LGA websites.

Table 3.3: Financial Reports Available Online

Year Group	2007 With CDO S	2008 With CDO S	2009 With CDO S	2010 With CDO S	2007 Without CDO S	2008 Without CDO S	2009 Without CDO S	2010 Without CDO S
Total Regional	54	54	54	54	55	55	55	55
Available regional	33	41	54	52	32	39	52	51
Total Metropolitan	24	24	24	24	19	19	19	19
Available Metropolitan	22	23	24	22	14	15	19	17

Identification of LGAs used for this Research

Because of the identification of LGAs who invested in CDOs it was evident that metropolitan LGAs had the highest proportion of councils that had invested in CDOs, as well as having significantly higher levels of investments in these products. Consequently, it appeared that metropolitan councils were the group that would be likely to provide the richest source of data in respect of why LGAs chose CDOs as an investment product. Therefore it was decided to limit the interview groups to metropolitan councils.

Three groups of participants were identified for the purposes of this research. They represented three coherent multi-sited ethnographic groups who were able to provide insights into the way financial investment decisions were made within NSW local councils. The first group was made up of expert outsiders who provided background to the environment in which local councils function, as well as insights into the historical and cultural aspects of NSW local councils. The second group consisted of five interview participants from three separate councils who had not invested in

CDOs. This group provided an understanding of the factors that influenced investment decisions within these councils and lead them to develop more conservative or ‘safer’ investment portfolios. The third group comprised six interview participants across four councils who had invested in CDOs. This group was able to provide an understanding of the decision making process and explanations of how they arrived at their decisions to invest in these products. The following Table 3.4 outlines the research sites associated with these three ethnographic groups.

Table 3.4: Participant Groups and Research Sites.

Participant Group	Affiliation
Background interviews	Audit Firm (AF)
	Investment Advisory Firm (IF)
	Municipal Council (MC)
Councils that did not invest in CDOs	Council 1 (C1)
	Council 2 (C2)
	Council 3 (C3)
Councils that did invest in CDOs	Council 4 (C4)
	Council 5 (C5)
	Council 6 (C6)
	Council 7 (C7)

Access to a senior audit partner of one of the big four accounting firms became available. A phone interview was conducted with the senior audit partner. The primarily purpose of the interview being to gain insight into the finance decision making process of NSW LGAs and to determine if the senior audit partner could provide insights into what motivated NSW LGAs to invest in CDOs and potentially smooth the way to gain access to some LGAs. It was the researcher’s expectation that it would be more difficult to gain access to finance managers of LGAs that had invested in CDOs than those that had not. The reason for this expectation was that

there was potential for embarrassment from individuals who had made poor decisions, or who lacked the necessary finance skills, or even unwillingness to disclose failures in their respective organisations governance and decision making policies.

During the phone interview, the audit partner offered to act as an initial contact and provide introductions to the finance managers of LGAs that their firm audited. This particular audit firm was the auditor for approximately twenty LGAs of which approximately half had invested in CDOs and half had not. This indicated that the sample group (from this audit firm) was likely to be reflective of the metropolitan population as the sample had the same proportions of CDO investors and non-investors as had been calculated from the overall population. The decision was therefore made to interview four LGAs who had invested in CDOs, and three who had not, from the client list of this firm. Due to the existing client list of this firm, all of these LGAs were in the metropolitan area, which was also the group that it had been earlier determined would provide the most abundant source of data.

The audit partner sent to the firm's client list a request to participate in the research. He provided an introduction and an invitation letter from the researcher (See Appendix 6) asking that if they would advise if they were willing to participate in the research. See transcript below:

I have been approached by Greg Jones to assist him with his research on Council investment decisions - see the attached letter.

Please advise me if you would be interested in participating and I will forward on your contact details.

In discussions I have had with him he seems to be particularly interested in CDOs.

When LGAs responded the researcher contacted them to arrange a time for the interview and provided them with a guide of the potential research questions (see Appendix 4). These questions were open ended and only designed to give an overview so that the interviewer could lead into deeper investigation dependent on the answers provided and where the interview lead. However, one potential issue

which was identified by the researcher was that providing too much information (in the form of the questions) may lead to respondents having preconceived ideas about their responses at interview (Hannabuss 1996, p. 24). The researcher felt that it was necessary to provide enough information about the types of questions to encourage participation and that it justified the risk of influencing later findings.

3.4.3 Impact of Information from Early Interviews

The LGAs being interviewed provided a rich source of information, which will be discussed in the following chapters. However, there were several things mentioned in the initial interviews which resulted in a rethink of factors which may have influenced decisions. Several participants and the audit partner mentioned Nugan Hand Bank, and how that had meant LGAs in 1980 lost a large amount of their investments. Comments made were:

a bank called Nugan Hand Bank was dodgy and the owners of the bank committed suicide and a lot of customers of the bank lost a lot of money. There was a lot of corruption and fraud involved and councils had investments in the Nugan Hand Bank, some councils had investments in it. Following the collapse of the Nugan Hand Bank there was a royal commission into the acts of the Nugan Hand Bank and part of the inquiry was old local government investments in the Nugan Hand Bank. The recommendations coming out of the commission was that councils should only invest in debt securities which were secured and which were paying secured interests returns. When the new local government act was written in 1993, it was with that in mind, but the Minister's order that gave more clarity on that section of the act didn't stick to the letter of recommendation and hadn't changed for many years. So a lot of very smart people came in and a developed product to circumvent the spirit of what the act was trying to achieve. This was pointed out to a division of local government but they didn't act on that until after the Cole inquiry when it was all too late (C3 FM).

our general manager was around in the days of Nugan Hand Bank and experienced the results of their collapse and how it impacted on the council. Therefore when CDOs were mentioned to him he said 'they sound too much like what happened with Nugan Hand Bank, they are too complicated a product, let's steer clear of them. That was one of the reasons that we ended up not investing in CDOs (C3 FM).

Therefore, it became clear that the researcher needed to be cognisant of the historical undertones of both the organisational structure and personnel while conducting and analysing the interviews. These comments served to reinforce Bourdieu's (1996) concept of the importance of habitus within organisations and how it may influence the decision making process. Pre-existing conditions, or prior experiences of the actors, has the capacity to colour the view taken of future events and actions. Individuals may have had either negative or positive reactions to previous decisions and actions are likely to be affected by them when confronted with similar circumstances.

Prior to the interview participants were provided with an information sheet that detailed the interview process (See Appendix 7). They were also asked to sign a consent form, which included permission to audio record the interview (See Appendix 8). While most of the people approached to take part in this research were willing to participate, five refused or did not respond. Those that did not respond or refused to take part in the interviews were all from councils that invested in CDOs. The reply from one potential participant when approached summed up the reasons for that reluctance:

The mere mention of CDOs makes me feel ill therefore I would prefer to pass on this one. I therefore decline the invitation to participate

The remainder of this section discusses a number of potential points of enquiry which were identified prior to conducting the first interview (Alvesson & Kärreman 2011; Alvesson & Sköldberg 2009). After the initial interview was conducted, a number of questions were raised in respect of the usefulness of the responses. It appeared that the participant had prepared responses to the suggested questions and was reluctant to move away from their preconceived response or allow deeper inquiry than they had expected. Interestingly when the interview was drawing to a close and the researcher suggested that they had covered the areas of the research, the participant became more relaxed and verbose. The participant was suddenly enthusiastic about providing more information. Sometimes this was in areas not previously explored and other times to provide clarification and to furnish examples that supported what had previously been discussed. Because of the way the first

participant acted during the interview, additional issues arose. This included consideration of:

- Whether the participant in the initial part of the interview provided responses that expressed what they meant or what they perceived was expected from them
- Was the interviewee giving a performance or presenting a true reflection of their true views?
- When the interviewee's manner changed during the interview, was the early part of the interview a performance and the latter an insight to their authentic view or vice versa?
- Was the participant trying to influence the researchers perceptions of what had earlier been discussed by providing additional explanation?
- Had the participant relaxed, realised that the situation was not threatening and that they were being given an opportunity to reflect and evaluate previous decisions and the basis of those decisions?

It was necessary to consider all these factors both before and during the interviews to ensure that if there were constraints around the responses, that the interviewer could find mechanisms to reduce behaviour that hid the true position and opinion of the participants. If it was possible to identify that the participant was trying to influence the researcher's perceptions then this needed recognition, as it had the potential to have a significant impact on how the information gathered would be later assessed and analysed.

While the words used by the interviewees to describe the events were important, particular attention was paid to the tone and manner adopted by the participants. The purpose of this was to enable the interviewer to determine if the participant was relaxed, trying to conceal information, had an agenda of their own, or even if they were merely presenting the 'party line' when it may have been in conflict with their own actions. Gathering this range of information was going to be essential to enable a complete analysis of the information provided.

The early interviews and the demeanour of the participants emphasised a number of aspects of the interview process that were potentially able to influence the data collected. Participants were careful of presenting their actions in the best position.

Thus, it was essential for the interviewer to reassure participants by convincing them that information would remain confidential and that participants would be anonymous.

Because of the reaction of the participant during the first interview, the researcher adapted the interview procedure in order to find ways to help relax the participants. Before entering into the interview phase of the meeting, the researcher conducted a general discussion so that each of the parties had a general understanding of the other. This was designed to help relax participants and start to build rapport. However, it had become clear that suggesting mid-way through the interview that the major part of the research questions had been covered was the most effective tool in getting participants to relax. This was particularly effective when interviewing those LGAs who had invested in CDOs and perhaps felt that they needed to defend their actions. Often the participants would want to provide greater detail and examples to reinforce what had previously been discussed, even bringing in new information that they perceived might be used as a tool to explain their actions.

3.5 Method of Interview Analysis

Initially it was anticipated that analysis of interviews would be done using the NVivo analysis program, which is a qualitative data analysis program. A training course was undertaken and skills developed in using the program. One of the requirements of this system is to be able to identify the key concepts and themes running through the text and then create branches to analyse what was happening. It was therefore decided to conduct a 'cloud' or word analysis to determine the general themes. While this is a blunt instrument only providing an analysis of the number of times that a particular word is used, it provides a general starting point from which the analysis could then be refined.

It became abundantly clear that as soon as quantification of the text began that there was a potential to miss or inadvertently ignore important sections of the text. There was a need to be able to analyse the text in terms of not only what was being said, but also to consider that the participant may be putting on a performance, and that they were only saying what they thought they should say. Alvesson (2011; 2009)

challenged the concept that data and empirical information is the cornerstone of knowledge development and proposed that the researcher should “not naively take for granted what has been said is a reflection of reality” (Alvesson & Kärreman 2011, p. 103) and highlighted that there is a need to interpret the interviews while considering the context. They suggested that there was the need to evaluate ‘how they talked about certain issues’, ‘are they saying what they expect you to want’ and does ‘what they do in practice reflect what they say’ (p. 103). They also proposed that there is a need to consider the language to determine if the meaning from the text is transparent, or if it was non-transparent, needing to consider if the context was producing version of the truth that fit the social context.

Therefore the decision was made to not use NVivo but to rely on methods that were more intuitive for the researcher. Burnard (1991; 1994) proposed using Microsoft word as a means of sorting text and then categorising the information. This helped identify information that, may have only been mention once, but was of significance to the research. It also provided a mechanism of contextualising the information and marrying it to the way it was used in practice.

All the interviews were transcribed into a word document for analysis. Themes were identified using the categories identified by Bourdieu’s (1977) *Theory of Practice* and a thematic analysis conducted. An indicative transcript is been provided in Appendix 9.

3.6 Ethical Considerations

In conducting research in the business, financial, management or even the local government area there are a number of ethical considerations that must be thought-out. Strict guidelines exist for conducting human research which is based on the medical research model. This requires the approval of the university’s ethics committee, written consent to the research and a code voluntary involvement. The research was conducted in line with the University Of Western Sydney’s ethical guidelines. An ethics application was prepared using the National Ethics Application Form (NEAF 2008), which is a web based ethics application form designed to enable researchers to develop ethics applications which are suitable for human research for

later submission to the ethics committee at their research facility. The application was lodged and approved by the University of Western Sydney Human Research Ethics Committee, and the approval number is H9265. Part of this process included providing a script for the initial contact inviting the potential interview participants (Appendix 6) and an outline of the types of questions that would be asked (Appendix 4). An information sheet in plain language which was required to be presented to interviewees prior to the interview (Appendix 7) and an interview consent form (Appendix 8) which all participants were required to sign prior to the interview commencing.

One of the primary concerns when conducting this research was to ensure that the participants were able to give informed consent to the process. While some researchers (Bryman & Bell 2007) have suggested that a lack of informed consent is not widely debated in academia, it was required to be addressed as part of the ethics application. Informed consent was obtained by the provision of the information sheet to ensure that participants were comfortable with the interview process.

A second issue was confidentiality and protecting participants from any adverse repercussions as a result of their involvement (Robson 2002). This was of particular importance because of the nature of the LGA sector in NSW. It is a sector with a limited number of participants (152 LGAs with often only one finance manager in each). They are likely to know to each other, either through business dealings between LGAs, from participation in finance managers meeting or having attended conferences specific to their field. This was addressed by ensuring the individuals and the LGAs would not be identified. As the financial information of NSW LGAs is freely available, the researcher had to be particularly careful to exclude financial information that may identify participant LGAs and lead to the inadvertent identification of interview participants.

Participation in this research was voluntary and individuals were able to withdraw at any time during the process if they wished to. Participants were advised that the data collected would be de-identified and the interview recordings, transcripts and electronic devices would be securely stored for a period of 5 years after which they would be erased/shredded/or deleted.

3.7 Limitations of this Research Method

As previously discussed, the nature of this research creates a number of limitations. The first issue is that by taking a sample of finance managers in LGAs there was likelihood that the individuals chosen may not be representative of the whole group. This has been addressed in part by trying to test to exhaustion: to the point that information being reported by the interview participants was not new and did not add knowledge and understanding to the issue being investigated. Additionally, the use of a case study approach means that while the results may not be able to be extrapolated across the whole population it may still be possible to theorise as to why the events occurred in the manner in which they had.

Secondly, the analysis of interviews is subjective and open to interpretation (Breakwell, Hammond et al. 1995; Cohen, Manion et al. 2000; Funnell 1998) by the researcher during the coding of responses. To address this concern care has been taken to ensure that the meaning behind the responses has been considered, not just the words, and that the context in which the participants have responded has also been considered when analysing the data.

Thirdly, due to the nature of the inquiry there was concern that participants would be reluctant to disclose information that harmed their reputation or that of their LGA. Obviously no-one wants to appear foolish or incompetent. This was addressed by ensuring that participants were confident that their identity and that of their employers would not be disclosed and that there was recognition that many individuals and organisations were affected, even those with high levels of expertise. Efforts were made to place participants at ease and allow the interview to flow with as little effort as possible. While there was initially reticence from some participants (particularly those who had invested in CDOs), as the interview progressed, and they became aware that this was not an attempt to apportion blame the responses given become less reserved and revealed the true nature of the financial investment decision process.

3.8 Conclusion

This chapter has provided a description of the research method. Both primary and secondary data has been used for this research. The secondary data includes financial and annual reports from NSW council, Minister's investment orders stipulating the types of products that councils are allowed to invest in and circulars to councils issued by the DLG.

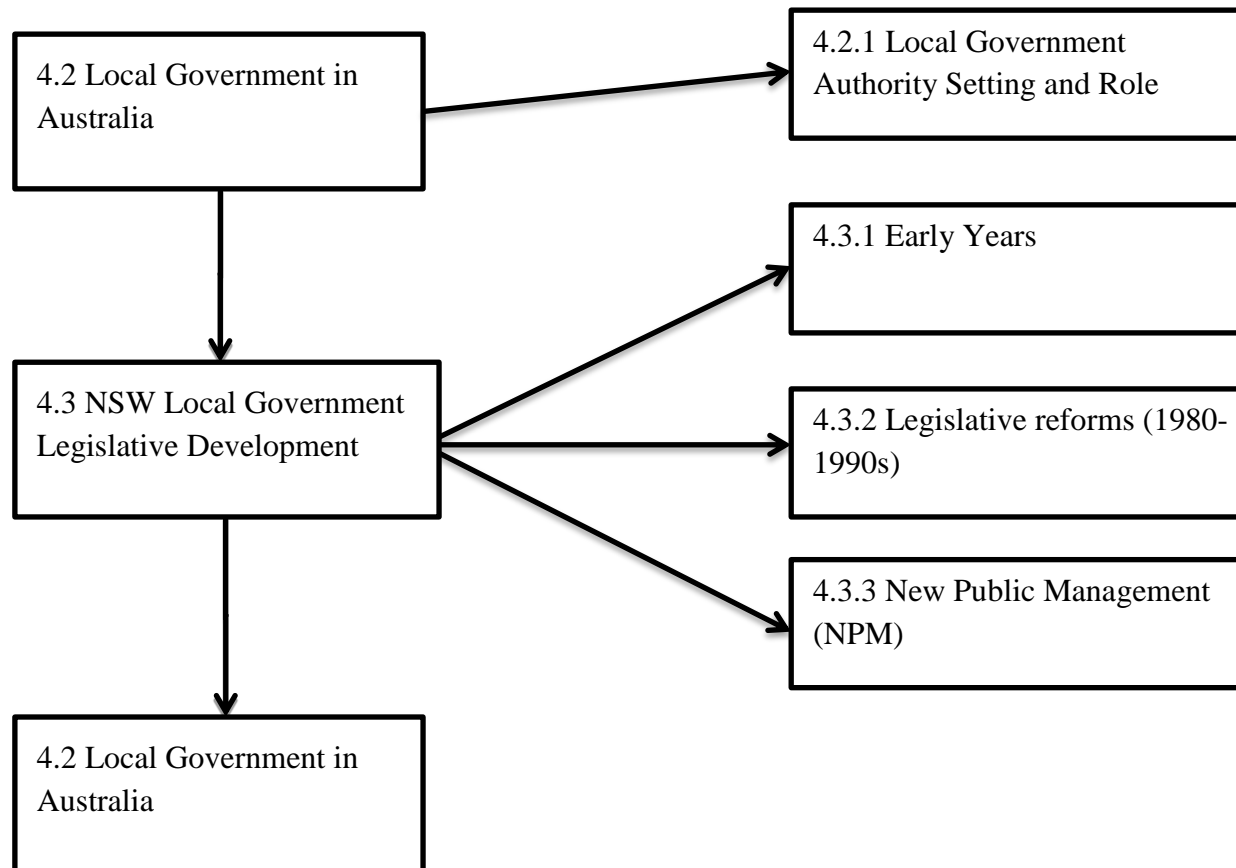
Primary data was obtained from interviews with individuals involved in the financial investment decisions of local councils. The research approach for this was a multiple case study of three coherent ethnographic groups. Potential problems with this approach have been identified and discussed in this chapter. A thematic analysis of the interviews was conducted and the findings have been discussed in Chapter 7. The ethical considerations and limitations associated with this type of research have also been discussed. The following chapter provides background to the local government environment for the purpose of outlining the political, social and economic environment in which local councils function.

Chapter 4: Development of Local Government in Australia

4.1 Introduction

The preceding chapter has provided an explanation of the research design and the analysis of techniques used. However, in order to address the phenomenon of how councils made their investment decisions there is first a need to provide an explanation of the historical context to the evolution of local government in Australia. This will be explored in this chapter by looking at the history of how local government was founded, the purpose for which it was established, the manner in which local government is funded, and how responsibilities have changed and developed over time. As the focus of this research is local government in NSW, particular attention will be paid to the NSW legislative changes which have occurred, and how those changes may have had an impact on LGA investment decisions. The history and legislative environment in which councils have operated and are conducting their current practices will serve to set the scene for how councils make investment decisions within the fields in which they have been framed. Chapter outline is presented in Figure 4.1.

Figure 4.1: Chapter 4 Outline



4.2 Local Government in Australia

Local government in Australia began in early colonial times with the continent being divided into counties and parishes along the lines of the British model which, due to the fact that the sparsely populated new continent could not be compared to the densely packed villages of England, did not work very well (NSW Department of Education, 2002; NSW Government. Parliament of New South Wales, n.d.). After Federation, legislation was introduced by the state governments to consolidate the various forms of local government that had developed. At this time Australian LGAs were conceived as a tool with which to provide basic property services (Warburton & Baker 2005, p. 62) to the community living within the local area. Similarly, to the Federal model, local governments in NSW were initially established by the NSW state government as a mechanism for requiring local communities to provide their own local services and reducing state government duties by delegating them to the local authorities. From the time of the initial white settlement of NSW the Governor had complete authority over all governmental responsibilities, including local government. Subordinate to the Governor were a number of military commanders or civil magistrates who were charged, by the governor, with carrying out the governmental responsibilities. As the early colonial government was unable to provide adequate services to all the local areas, due to a lack of available funds and resources, the opportunity arose for the creation of municipal institutions to carry out some of these duties ((NSW Department of Education, 2002).

The Australian political arena operates under a three tier government system, consisting of federal (Commonwealth) government, state government and local government (Boon, Crowe, McKinnon & Ross 2005). The federal government oversees a federation consisting of six states and two territories, and has been granted their authority to operate under the *Commonwealth Constitution Act 1900* (Burritt & Welch 1997). There are however a number of inequities between federal and state governments which are principally due to their differing capacities to raise revenue and therefore finance their expenditure commitments (Stilwell & Troy 2000, p. 914). The federal government is able to implement and control many expenditure policies by virtue of controlling the bulk of tax revenues (Commonwealth of Australia

Constitution Act 1900), thereby providing the federal government with the power and capacity to exercise a large amount of control over both state and local government expenditure. The federal government collects approximately 76% of the nation's tax revenue, the state's 20% and local LGA's 4%, thereby creating an imbalance of income taxing powers (Stilwell & Troy 2000, p. 115)).

The individual state and territory governments are responsible for specifying the powers and responsibilities of the local government entities within each state (Boon, Crowe et al. 2005). Due to the omission of any mention of LGAs within the constitution (Stilwell & Troy 2000, p. 115), they have no constitutional rights, and are therefore reliant on the states and territories for authority to perform their community functions, for external funding (often via grants), and for the authority to generate revenue through rates (Brown 2005). Local governments receive financial support from state and federal agencies and are accountable to those agencies for delivery of projects and services (Walker & Jones 2006).

Stillwell and Troy (2000, p. 924) illustrated that there was, (and probably still is), a desire by both the Federal and State Governments to control local government. They demonstrated their view by explaining that, while there was a commonwealth government attempt in 1988 to recognise local government in the constitution by conducting a referendum, state government opposition to conducting the referendum meant that the proposal was defeated. This thereby has ensured that local government powers continue to be defined and controlled by State Government Ministers. They are able to remove or reduce local government powers and responsibilities, or even change their boundaries. Nevertheless, this third tier of government represents a significant sector, employing 156,000 people and spending in excess of 10.5 billion annually and could arguably be the most aware of local and regional issues (Johnstone 1995). They are potentially the "most sensitive to" community interests, however, due to insufficient availability of resources and reliance on the power of state governments for their right to operate, they have been "relegated to a subordinate role" (Stilwell & Troy 2000, p. 909).

LGAs are reliant on federal and state government funding yet prior research (Kloot 1999), has shown that there are only "low levels of accountability and very little

performance measurement taking place”. Australian LGAs have been for a great deal of time perceived as inefficient, and unable to manage the commercial elements of their operations (Barrett 2002), and proposals have been made that LGAs should adopt a more business style approach to the management of the local government sector (Hood & Peters 2004; Modell 2005; Skalen 2004; Worthington & Dollery 2002). Community concerns, which have been continually raised, have encompassed disquiet about the quality and comparability of public sector external reports, while also raising questions about both the efficiency, and the effectiveness of public sector management (Barton 1999a; Hoque 2004; 2005). Additionally, one of the major concerns is that local governments, because of the level of trust placed in them, are also rife with corruption. One factor highlighted by Brown (2011), was that insufficient controls, such as failure to have an internal audit function, has meant that councillors have had to rely on reports provided from the general manager or other council staff. This has raised concerns about governance weakness within the LGAs, as there is no check or mechanism in place to confirm the validity of information and reports provided.

Consequently, these concerns have resulted in demands from the public for additional information on how governments manage and spend public funds (Kent 2003, p. 11). By the late 1970s’ due to the absence of specific standards for the public sector, the Commonwealth and State Auditors-Generals began to apply private sector standards to the public sector (Chua & Sinclair 1994, p. 690). However, the accounting profession was not unanimous on the applicability of private sector standards being applied to public sector financial reports (Chua & Sinclair 1994, p. 689) and suggested that there was not a “one size fits all” standard solution when comparing public and private entities, and that private sector practices and standards may be inappropriate to use in the public-sector (Barton 2005; Carnegie & West 2005).

Recently though, there have been changes which “have been imposed on the sector, enhancing local and central accountability, making it more business-like” (Kloot 2006, p. 565). While the emphasis of these changes has been on the accountability for financial and budgetary measures, the performance of programs and people are

also both being measured. The expanding regulation of LGAs continues to increase the need for disclosure in a wide range of areas (Gray 2001). These regulations and funding from state and federal governments impose duties on LGAs to be accountable and provide reports and information to meet both the regulatory requirements of state and federal governments, and to address the needs of a variety of stakeholders.

Additionally, problems have been identified about the difficulties faced by smaller (in population) and under-resourced councils (Dollery 2006; Dollery, Fletcher et al. 1998; Dollery, Wallis et al. 2006; Edwards 2002). These include constraints due to availability of personnel with requisite skills, limitations to their revenue base, lack of financial reserves and capacity to provide services. One solution currently being used to overcome the associated efficiency problems, particularly of small LGAs, has been the development and implementation of a number of reforms to the financial reporting requirements of local governments. These reforms, which included identification and reporting on key performance measures and reporting on a financial year basis rather than a calendar year, occurred in the late 1980s and early 1990s, and were promoted on the basis that they would improve the usefulness for decision-making and enhance accountability of public sector entities (Carnegie 2005).

The preceding discussion has demonstrated that LGAs, while operating in an environment that makes them heavily reliant on the support and funding from federal and state governments, are also charged with performing an increasing range of tasks. LGAs have limitations on the way in which they are able to generate revenue, primarily due to constraints imposed by the state government. For example, they are unable to increase rates beyond the limit that the state government “pegs” rate rises to (See *1993 Local Government Act, Sections 505-513*), and they only have limited options to increase fees and charges to developers and the community as a means of increasing revenue elsewhere. Local councils are unlikely to ‘fail’ in the same sense as private sector firms but if they are unable to meet their commitments and cannot generate additional income then the remaining option is to reduce services (Walker & Jones 2006). Therefore, in an attempt to enhance revenue, LGAs could be

perceived to be vulnerable to promoters of products such as CDOs as returns from investments is one of the few means LGAs have of increasing revenue and therefore could be very tempting.

4.2.1 Local Government Authority Setting and Role

LGAs in Australia hold a unique position in the Australian political arena. They are tasked with providing a wide range of services to their communities, while at the same time, under the Commonwealth Constitution, they do not have any statutory authority or power of their own. Federal and state governments have their authority ensconced within the constitution with their power to operate and raise funds clearly established. Equally, there are explicit limits to the prescribed power and the functions each branch of government is allowed to perform. However, LGAs have no such constitutional powers and only function under the powers and authority granted to them by the state government. Democratically elect councillors, who have the responsibility to provide direction for each LGA, normally oversee them. Those councillors may be removed and replaced with administrators appointed by the state government at any time.

The legislative reforms which have been enacted during the 1990s have had the effect, according to Dollery, Wallis and Allen (2006), of empowering local government with “greater flexibility to change both the way in which it operates and the range of services that it provides” (p. 555). At the same time “community expectations of local government seem to have increased and higher tiers of government have simultaneously devolved various new functions to local authorities” (p 555). This has meant that local authorities have begun providing a wider range of services and moved away from their traditional narrow emphasis of providers of services to property, to a much wider role of providing services to people (Dollery, Wallis et al. 2006, p. 555). The expectations imposed by the state government on LGAs now include responsibility for many social issues such as “health, alcohol and drug problems, community safety and improved planning and accessibility transport” (Dollery et al 2006, p.555). They are also required to be increasingly more active in the application and monitoring of regulation in relation to

“development and planning, public health and environmental management” (Dollery et al 2006, p.555).

LGAs derive the bulk of their own-source revenue from property rates and in NSW, a formal "pegging" regime exists which constrains LGAs - without prior ministerial approval - from increasing rates above broad measures of inflation (Gold 2008). Additional revenue is derived from a range of fees that they are able to charge which include building and development charges and other permits, parking fees and fines, as well as a variety of grants from both state and federal governments.

Due to the reliance by LGAs on funding from both the state and federal government, LGAs are both dependent on public monies to fund their operations and entrusted with managing those public funds and resources. When the *1993 Local Government Act* was introduced, it referenced the *NSW 1925 Trustees Act* and required that LGAs acknowledge that they were custodians and trustees of public assets. Within that role they were required to exercise due care and diligence in the investment of public monies (NSW Trustees Act, 1925, Section 14). Later amendments to the *1993 Local Government Act* removed the reference to the *Trustees Act 1925* (Dollery, Fletcher et al. 1998; Dollery, Wallis et al. 2006). The DLG has provided a range of guidance to LGAs (DLG 2006) in addition to the provisions contained within the *Act*. This guidance has provided details of the responsibilities of LGA officers, the reporting requirements and has emphasised the need to preserve public assets.

Concerns have been continually raised from the community about the reliability, comparability and quality of public-sector reporting with prior research suggesting that there are only “low levels of accountability and very little performance measurement taking place” (Kloot 2006, p. 565). These concerns have resulted in demands from the public for additional information on how governments spend public funds (Kent 2003, p. 11). Driven by these concerns significant changes, “have been imposed on the sector, enhancing local and central accountability, making it more business-like” (Kloot 2006, p. 565). The following section traces the development of NSW legislation.

4.3 NSW Local Government Legislative Development (Early Years)

4.3.1 Early Years

During early colonial settlement of NSW the Governor was responsible for all government activities. As the early colonial government was physically unable to provide adequate service to all areas the governor delegated these tasks either to subordinate military commanders or local magistrates. The *Improvement Act 1833* was introduced to require local parishes to pay for new roads. This replaced the system of road tolls, which previously was the mechanism used to raise funds for roads (NSW Department of Education 2002). The *Parish Roads Trust Act 1840* was introduced to replace the *Improvement Act 1833*, as a means to create a system of elected roads trusts, which were then able to generate funds from both a mixture of road tolls and rates from landowners (NSW Department of Education 2002).

In NSW, the first piece of legislation to establish a system of local government was passed in 1842 under the *NSW South Wales Constitution Act 1842*. This Act allowed, for the first time, the establishment of a system of local government and provided the Governor of NSW with the power to “create district LGAs for the purpose of constructing and maintaining roads, police services, water supply and a variety of other local services and infrastructure requirements” necessary for local areas (Dredge 2001, p. 358). This Act also provided for a system of local government where LGAs were granted the power to make by-laws. The Governor was also given the power to appoint the wardens and councillors to each of the 28 district LGAs he had established. However, available resources were inadequate for LGAs to be able to perform the required tasks and as a result these district LGAs did not last very long. That same year the *Sydney Incorporation Act 1842* was passed and Sydney City was covered by this separate legislation until 1848 ((NSW Department of Education, 2002).

The *NSW South Wales Constitution Act 1842* was repealed with the introduction of the *Municipalities Act 1858*. The new Municipalities Act introduced the notion of representative government; however the population of some of the municipalities

was of a size that it was not financially possible for them to undertake the tasks for which they were created (Dredge 2001). Prior to the *Municipalities Act 1858* there were only 10 local government units throughout all of NSW, this new Act allowed petitions for the creation of new municipalities provided there were at least 50 ratepayers petitioning. Under the new arrangement 35 units were incorporated (NSWEdu 2002). Like the *NSW South Wales Constitution Act 1842* the *Municipalities Act 1858* was repealed and a new Municipalities Act was passed in 1867; however the problem of financial inefficiencies with small LGAs has continued (Dredge 2001). The *Municipality Act 1867* extended the powers of LGAs and allowed for the creation of boroughs where the population was greater than 1000, and also stipulated that municipal districts could not have a population less than 500 people (NSWEdu 2002). 1883 saw the formation of the Municipal Association which later became the Local Government Association in 1906 (NSWEdu 2002). This association was able to provide a common meeting ground for local councils to exchange ideas and develop practices for the system of local government in NSW.

The need for a system of local government was recognised within the *Constitution Act 1902* which provided for a continuation of local roles, with Section 51 containing the following provisions;

“(1) There shall continue to be a system of local government for the State under which duly elected or duly appointed local government bodies are constituted with responsibilities for acting for the better government of those parts of the State that are from time to time subject to that system of local government.

(2) The manner in which local government bodies are constituted and the nature and extent of their powers, authorities, duties and functions shall be as determined by or in accordance with laws of the Legislature.

(3) The reference in subsection (2) to laws of the Legislature shall be read as a reference to laws that have been enacted by the Legislature, whether before or after the commencement of this section, and that are for the time being in force.

(4) For the purposes of this section, the Western Lands Commissioner, the Lord Howe Island Board, and an administrator with all or any of the functions of a local government body, shall be deemed to be local government bodies.”

(Constitution Act 1902, Section 51)

After Federation in 1901, when “the separate colonies of the then British Empire in Australia decided to join together” (Dredge 2001), a new *Local Government Extension Act 1906* was passed (this would later be called the *Local Government Act 1906*), which was implemented as a complementary measure to the *Shires Act 1906* (Larcombe 1961). This Act recognised the needs of non-rate paying members of the community. According to Dredge (2001) this Act “represented a great advance for local government in NSW, establishing the major principles by which modern local government operates” (p. 365) by providing recognition that not only the land holders (the rate payers) formed the community but that other residents were an integral part of the community.

During 1905-06, a compulsory system of local government incorporation was introduced. The *Local Government (Shires) Act* divided the state into shires (except for existing municipals and the Western Division). Additionally the *Local Government (Extension) Act* applied the previous *Local Government (Shires) Act* to municipalities. These two Acts were then combined to create the. This Act removed the powers of LGAs in NSW to make their own by-laws and ordinances and returned the power to the state. By 1910 there were a total of 324 Local Government bodies within NSW with each containing an average population of 5,073 people.

In 1919 the *Local Government Act 1919* was enacted which reflected the principles of the *Local Government Act 1906*. During 1945, provisions for Town Planning were inserted into the *Local Government Act 1919*. This gave new powers to the councils allowing them to prepare town planning schemes and to control all new developments and land use (NSWEdu 2002). The *Local Government Act 1919* remained in place for the next seventy four years until the current *NSW 1993 Local Government Act* was introduced, amending the 1919 Act which at that time was the oldest local government act current in Australia (NSWEdu 2002). However, the

Local Government Act 1919 still left the final decision making powers (particularly in respect to the revenue raising powers and duties of local government) in the hands of the Governor-in-Council or the Minister.

During the period from 1967-1980 there were approximately 90 local government boundary changes in NSW (NSWEdu 2002) which were largely due to merging of smaller and less financial efficient councils. As a result of these amalgamations during the 1970s, 34 regional municipalities and surrounding shires were reduced into 15 larger and supposedly more viable bodies (Worthington & Dollery 2002, p. 508). In the period from 1979-1980 the state government introduced legislation to reduce the number of county and local government districts even though there was significant opposition from both the LGAs and from the general public. In 1985-86, the *Local Government Act 1919* was amended, granting local councils more autonomy, by eliminating the need for LGAs to obtain numerous approvals in order to exercise their normal functions. In the late 1980s a new phase of reform began which focussed on emphasising microeconomic reform, and included provision for the introduction of national benchmarking and competition policies (Worthington & Dollery 2002, p. 496).

The following section focuses on the legislative reforms, which occurred from 1980 to early 1990. These reforms had the stated purpose of improving accountability and governance of LGAs. This period is exemplified by the introduction of New Public Management (NPM) practices which introduced using private sector practices in the public sector on the premise that as they work in the private sector then they would also work and be appropriate in the public sector.

4.3.2 Legislative Reforms (1980-1990s)

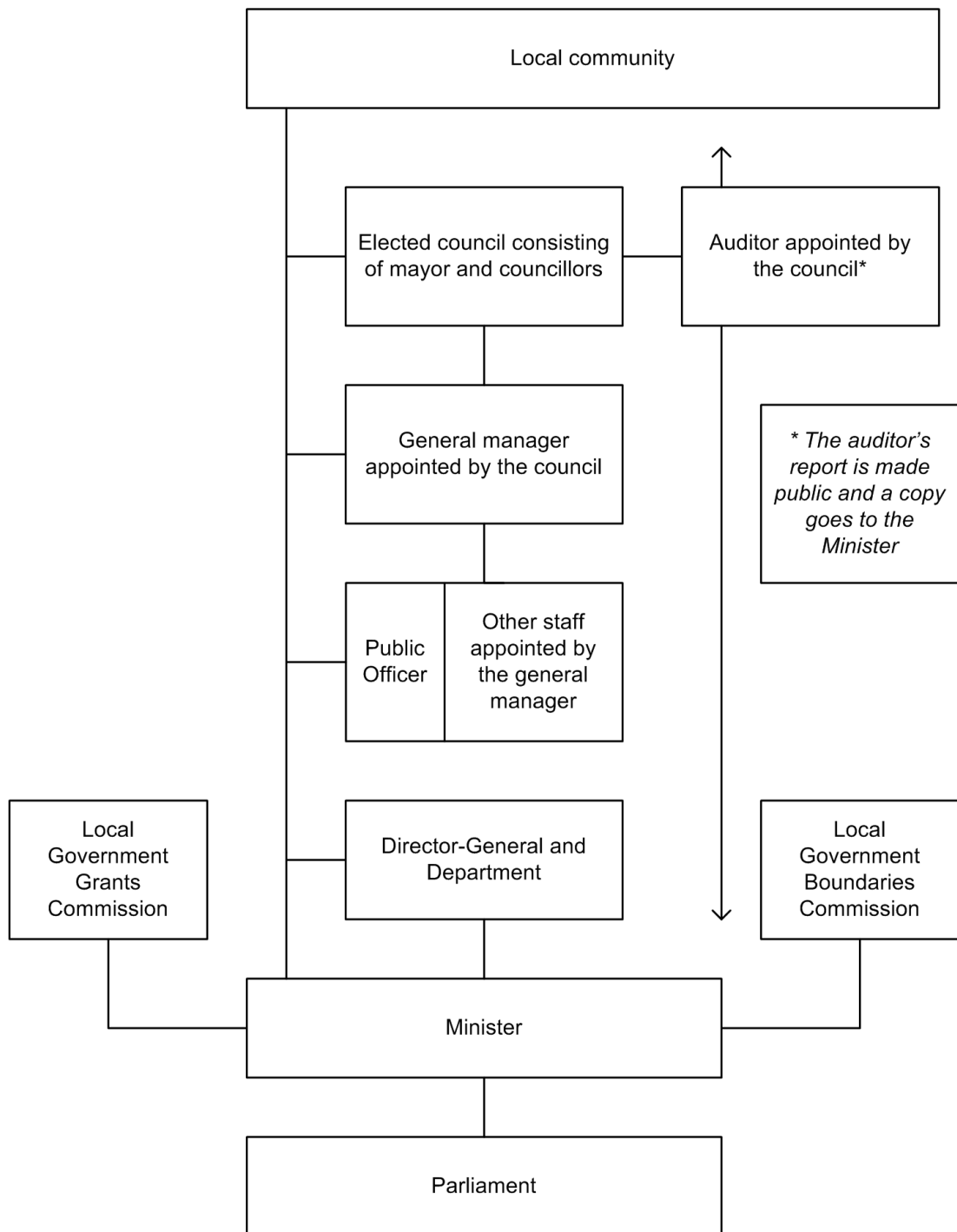
The public sector legislative reforms of both the financial and non-financial aspects of public sector entities began in the 1980s. Legislation enforcing these reforms occurred during the 1990s. They were introduced under the rationale that they would assist in improving efficiency, effectiveness, accountability (Barton 2005, p. 138; Guthrie 1998, p. 2) and transparency (Barrett 2004, p. 2), while also enhancing productivity and competitiveness of the public sector (Boxall 1998, p. 18).

According to Dollery, Wallis and Allan (2006), they have had the effect of empowering local government with “greater flexibility to change both the way in which it operates and the range of services that it provides” (p. 555). During the period “community expectations of local government seem to have increased and higher tiers of government have simultaneously devolved various new functions to local authorities” (p. 555).

Dredge (2001) has proposed that the *1993 NSW Local Government Act* reflects the changes which society has experienced over the past one hundred years including significant economic and technological changes, and that the *1993 Act* addresses both the changing requirements of society and society’s expectations of local government. This act was designed to include provisions to accommodate the changes society had undergone by emphasising “greater accountability by LGAs to their communities; more professional management of the day-to-day activities of LGAs; and increased flexibility to devise methods of efficient service delivery and the performance of regulatory activities” (Dredge 2001 p. 370). These reforms to the financial reporting requirements of local governments were promoted on the basis that they would result in an improvement in the usefulness of the reports for decision making and enhance accountability (Carnegie 2005). However, the two main limitations imposed on local government remained; the relatively small size of LGAs, which inhibits financial effectiveness and the level of power held by the state government.

The following Figure 4.2 extracted from the *1993 Local Government Act* provides a presentation of the structure of the system of LGAs within NSW. Local community has been placed at the top implying that the community is the focus of the legislation and that local councils are there to serve the community. Yet the power and control of within local councils is derived from Parliament. Local councils have no constitutional powers allowing them to function, and are only able to operate at the discretion of the state government. This diagram tends to present a distorted perspective of the power relationship.

Figure 4.2: System of Local Government in New South Wales



(1993 Local Government Act, Chapter 2, Notes)

Financial reports from the private sector are available to a diverse range of users who then rely on the information provided in order to make informed decisions. However, the single form of financial reports provided are unlikely to be able to satisfy the

requirements of all potential users, as each group of users are likely to have differing priorities. Therefore, due to these competing requirements from different users the resulting financial reports are biased towards meeting the needs of the investors, predominately because they are the providers of capital to the organisation and supposedly therefore have the greatest risk and exposure. Similarly, the financial reports and resulting audit reports of local governments are biased towards meeting the requirements of state government (as they are the primary providers of funds, and to whom LGAs are most accountable), which results in other users receiving reduced levels of information. However, it could be argued that the public (as providers of the funds through taxes and rates) should be equal in the hierarchy of users.

Reforms to the reporting processes of the public sector have been an ongoing development with the focus on adopting private sector practices into the public sector. Calls for reforms to local government have been based on the need for greater accountability and efficiency an example of which is Smith (1996) proposed that;

All governments must anticipate and react to continual change and respond to rising pressures from the community, business and government sectors to improve efficiency and effectiveness of their services. Local government is no exception.

Similarly, in 1998, when Nick Greiner was elected Premier of NSW, one of his pledges was that he would reform and enhance government efficiency by taking a business-like approach (Barton 1999b; Barton 2005, p. 140). Acting on advice from US based consultants, he adopted existing accounting rules from the private sector to avoid wasting time by reinventing the wheel (Christensen 2003). Christensen also noted that 'there was a zealous belief (by the consulting firms) that bringing public sector accounting into line with private sector accounting was an inherently righteous objective' (2003, p. 1). In terms of local government this indicated that the approach would be to focus more on being profitable and reducing expenditures. One emphasis that the adoption of a business focus encouraged has been to look towards the private sector as a potential provider of services if they could be more efficient and cost effective. However, a major evaluation of the 1983-1992 structural reforms was unable to confidently attribute productivity gains to the structural reforms.

Principally this inability was because the reforms had occurred during a time of rapid social and economic change there was no definitive way to separate agency performance, impact on cost and clients from the broader social and economic events (Pollitt 2009, p. 287).

The major focus of these reforms was on the introduction of NPM practices into local government management and evaluations. NPM launched a new perspective to the way councils made their decisions and conducted their operations. It significantly influences the attitude and approach of the financial decision makers. The following section provides the background to NPM. The purpose of this is to demonstrate how NPM practices may have influenced the financial investment decision-making process and to explain the type of legislative environment in which LGAs were operating.

4.3.3 New Public Management (NPM)

The legislative reforms during the 1990s have emphasised the practice of New Public Management (NPM) and were suggested to be able to provide benefits such as quality improvement, competitive cost of services, improved managerial performance and long term financial performance (Hood & Peters 2004; Skalen 2004). NPM also provides a theory about how governance should be applied within the public sector (Mehde 2006). The focus of NPM is primarily on mechanisms for reducing or eliminating the differences between public and private sector management. This is normally achieved by removing the emphasis on the process accountability and promoting accountability based on the financial results achieved. These results are then calculated and expressed in terms of performance measures and profits (Hood 1995, p. 94). Hood (1991, p. 4) explained that public sector bureaucrats have developed strong and varied emotions with respect to NPM and that there are two divergent and extreme views. At one extreme is the perception that the 'old' system of public management had irretrievably failed and NPM was the appropriate tool to correct the previous system. Supporters of NPM have presented it as a means of solving management ills by allowing for the 'need' for variations of management styles, provided the basic framework of NPM was not changed. Additionally it is suggested that NPM functions as a "neutral and all-purpose

instrument” (Hood 1991, p. 8) that could be used to meet the needs and goals of whichever political party held power, by simply altering the management system. At the other extreme of this debate is the conviction that NPM is destroying public sector ethics and culture, which had developed over the previous century. Table 4.1 has been used to highlight how Hood (1991) presented the doctrines associated with NPM, the meaning of those doctrines and how they are typically justified by the proponents of NPM.

Table 4.1: Doctrinal Components of New Public Management

Doctrine	Meaning	Typical Justification
'Hands-on professional management' in the public sector	Active, visible. Discretionary control of organisations from named persons at the top, 'free to manage'	Accountability requires clear assignment of responsibility for action not diffusion of power
Explicit standards and measures of performance	Definition of goals. Targets, indicators of success, preferably expressed in quantitative terms, especially for professional services	Accountability requires clear statement of goals efficiency requires 'hard look' at objectives
Greater emphasis on <i>output controls</i>	Resource allocation and rewards linked to measured performance; breakup of centralised bureaucracy-wide personnel management	Need to stress <i>results</i> rather than <i>procedures</i>
Shift to disaggregation of units in the public sector	Break up of formerly 'monolithic' units. Unbundling of Uniform management systems into corporatised units around products, operating on decentralised 'one-line' budgets and dealing with one another on an 'arm's length' basis	Need to create 'manageable' units. separate <i>provision</i> and <i>production</i> interests, gain efficiency advantages of use of contract or franchise arrangements <i>inside</i> as well as outside the public sector
Shift to greater <i>competition</i> in public sector	Move to term contracts and public tendering procedures	<i>Rivalry</i> as the key to lower costs and better standards
Stress on private sector styles of management practice	Move away from military-style 'public service ethic', greater flexibility in hiring and rewards; greater use of PR techniques	Need to use 'proven' private sector management tools in the public sector
Stress on greater <i>discipline</i> and <i>parsimony</i> in resource use	Cutting direct costs. Raising labour discipline. Resisting union demands. Limiting 'compliance costs' to business	Need to check resource demands of public sector and 'do more with less'

(Hood 1991, p. 4)

It is clear from the above doctrines that the focus of NPM has been a shift from directing policy to greater management skills. From processes to output, focusing on the competitive aspects of the organisation with an emphasis on contract provisions (Hood 1995, p. 95) and, on outsourcing of functions that can be resourced from the private sector provided they can be supplied at lower cost. This results based policy fails to take into account the impact on the functions of the LGAs that are expected by the general community. It also fails to address whether private sector providers would be able to offer the level of reliability, or have the ability to supply those services, particularly where there are limited returns from provision of the services.

Critics have proposed that there is very little substance to NPM with the pre-existing problems and weaknesses remaining (Barton 1999b; Funnell, Jupe & Andrew 2009). They claim that the main influence has been changes to language used by public sector organisations in presenting information to the public. A second criticism is that the performance indicator focus has failed to deliver the promised central claim of 'lower costs' and yet another claim questions the universality of NPM as different administrator values will have implications beyond just altering the settings of the management system (Hood 1991, p. 9).

Hoque (2005) proposed that these public sector reforms are a result of the introduction of the National Competition Policy, which promoted the belief that public sector entities need to be more like private sector businesses, outsourcing if external providers could provide the same services at lower costs, and create cost bases similar to private entities. To demonstrate the improvements achieved from local government reforms, Hoque (2005) conducted a case study that considered the impact of the changes to the *1993 Local Government Act*, changes to the local government finance standards, and the impact they had on the practices of a large local government authority in Australia. His focus was on the introduction of NPM ideals into the public sector and he analysed the impact on a local government authority that adopted these ideals. While his study concentrated on a Victorian LGA, the results are useful within the context of the NSW LGAs.

Victorian Example (NPM)

Hoque (2005) suggested that the adoption of NPM, private sector type accounting and reporting, might have been a result of institution style pressure to conform to the societal norms. This therefore proposes the idea that the reforms of local government reporting were not likely to provide greater economic efficiency but to legitimise themselves. The findings from Hoques' (2005) study of Victorian LGAs, conducted in 1999-2000 suggested that the local LGAs reformed their accountability structure, appointed a general manager, and adopted NPM practices in anticipation of the impending introduction of the *1993 Local Government Act*. These actions by Victorian LGAs included developing additional long term planning and strategic direction, replacing previously ambiguous directives with performance targets, service levels and strict budgeting to be implemented by the general manager, who was given a large amount of discretionary power (Hoque 2005). This is similar to the role CEOs in the private sector undertake.

It anticipated that the new legislation would require LGAs to enhance their level of accountability and impart the same type of financial information to local LGA stakeholders as that provided by organisations from the private sector. This was advocated on the premise that private sector accountability and dissemination of information was superior. This implied that LGAs should generate returns on investment capital, comparable to the results achieved by the private sector and maximise income from all sources, making the focus on profit rather than the provision of services. The accountant roles also changed and focused on providing information intrinsic to the elements of NPM. Greater emphasis was placed on budgeting as a governance process, yet it was not the dominant control, with a range of performance measures being used to evaluate performance and decision-making. Yet the financial reporting was still heavily regulated in both procedure and process, hindering full adoption of private sector management practices. Although Hoque (2005) has provided suggestions for why this LGA adopted the policy of NPM, and implies that it has been successful, he does not evaluate how, or if, it has been successful. Whilst Hoque did illustrate that long term planning improved and that

detailed changes occurred to the way performance was measured, he refrained from explaining if this has improved the performance of the LGA.

Hoque (2005) has provided a theoretical framework from which to view the changes to local government sector reporting, and reasons for LGAs to embrace these reforms. He has though done little to explain if these were necessary, or if these changes improved or enhanced the previous reporting methods. He explains that NPM methods bring local government in line with the private sector and makes them focus on returns on investment, however he fails to mention the principal purpose of local government authorities.

While returns on investment, in line with the private sector, may seem good in principle, there is no mention of the fiduciary duty of local government authorities in managing public monies and if they should be involved in “at risk” investments at all. In the context of the problems NSW LGAs now have due to the collapse of the CDO market and the losses which have resulted from the write-down of the values of CDOs (Campion 2012a; b; Cole 2008) it is clear that chasing higher returns, with greater risk, at the expense of preservation of capital may not have been good financial governance practices.

Hoque (2005) implied that NPM methods, such as placing authority in the hands of a general manager, enhances performance, yet does little to explain how this provides additional benefits to the local community. He suggests that outsourcing tasks to the private sector, if they can perform them cheaper, benefits the local community, yet ignores the social cost implicit in this when as a result, services need to be reduced or become less reliable. He also states that government regulation hinders the full adoption of NPM methods without mentioning that local government authorities are there to serve their communities and that profit may not be the best measure of performance. Hoque (2005) has provided a framework to explain why reform of local government authorities reporting and management has occurred, and emphasises the need for additional research into public sector reporting and management principles. He provides reasons for reform, but does little to explain if these reforms improve performance, or even if performance of local government authorities should be judged in the same manner as private sector entities.

One possible explanation for the decision by the public sector to adopt NPM, and private sector practices may, in part, be caused by the perception that it can “incorporate the practices and procedures defined by prevailing rationalised concepts of organisational work and practices” (Meyer & Rowan 1977, p. 340). This rationale presumes that LGA goals, objectives and treatments align with those in the private sector. This premise is also supported by Guthrie (1998) who stated that “the underlying rationale is that the objectives and processes of government management should be (or are) so close to those of the private sector” (p. 16). Barton (1999a) agrees with this rationale by suggesting there is a *belief* [emphasis added] that the financial information needs of users of the public sector and private sector general purpose financial reports are fundamentally similar (p. 22).

The introduction of NPM has had the effect of creating the situation where councils are expected to behave in a like manner to private sector organisations. This implies that maximising returns from investments should be an integral part of NSW investment plans. While this may be in conflict with the ‘prudent investor’ expectation of managers of public funds, most councils who invested in CDOs would be likely to argue that following ministerial guidelines for investment provides sufficient governance and the expectation of efficiency and NPM practices required them to consider these products.

4.4 Conclusion

This chapter has outlined the role, structure and the historical, social, political and economic context in which local governments are situated. It has discussed the legislative reforms that have occurred in response to suggestions (Barrett 2004; Barton 1999b; Cole 2008; Dollery, Wallis et al. 2006; Gold 2008; Hoque & Moll 2001) that local government is both inefficient and lacks accountability. This historical perspective has encompassed the legislative environment in which LGAs function. It highlighted the stated purpose behind the legislative reforms, which occurred during the 1990s. Particular attention has been given to the introduction of New Public Management practices, which were the focus of the *1993 Local Government Act*. It has also highlighted the differences in investment policies

Chapter 4: Local Government in Australia

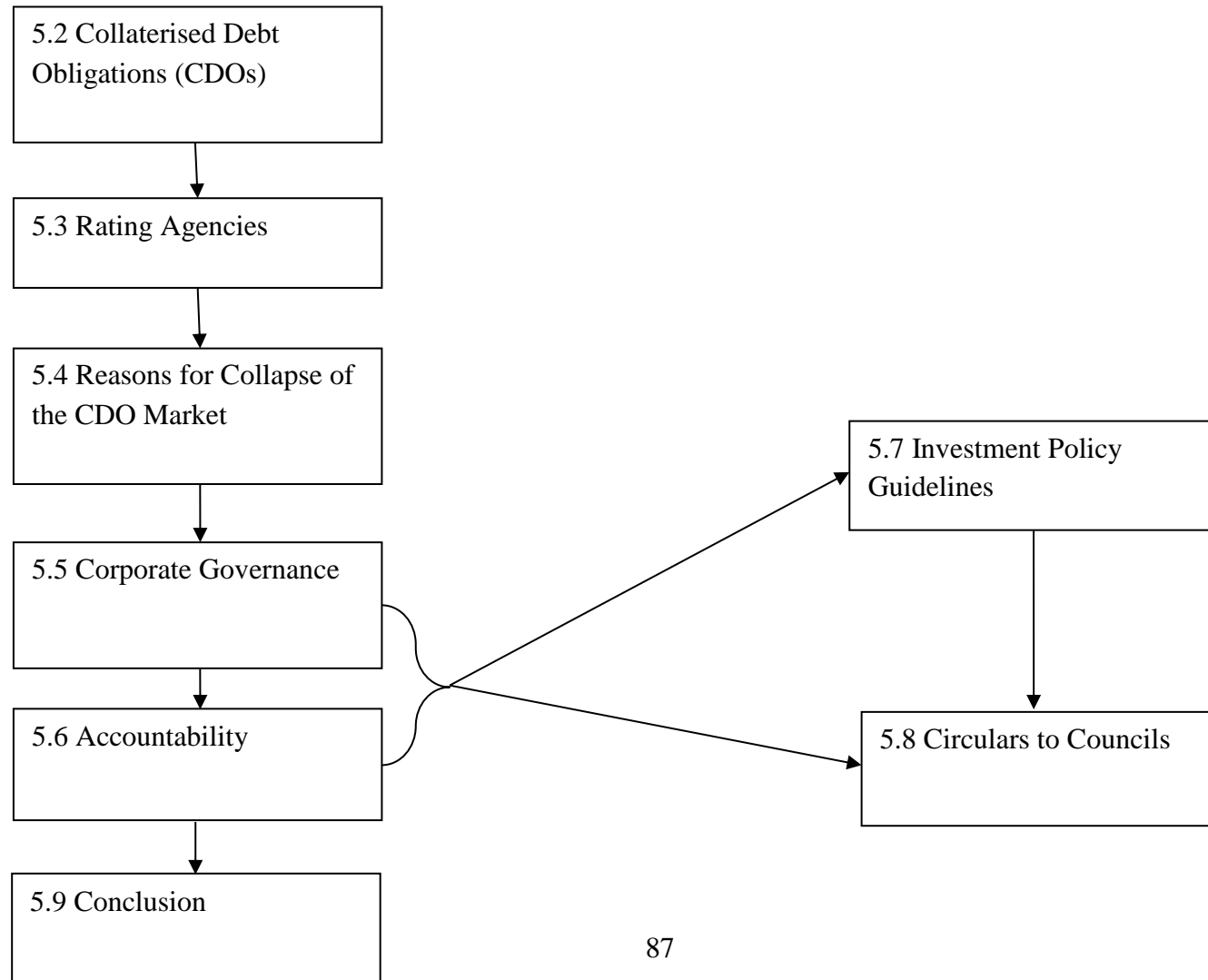
adopted in each state, the factors that have led to different investment policies and why this research has focused on LGAs in NSW.

Chapter 5: Collateralised Debt Obligations (CDOs) and Local Council governance

5.1 Introduction

This following chapter will provide an account of what Collateralised Debt Obligations are, how they were valued and marketed. Specific attention will be given to CDO ratings, how the high rating of CDOs played a role in encouraging investment in these financial instruments, and how those ratings link to corporate governance. An account will be provided of the reasons for the collapse of financial derivatives such as CDOs. This leads to an explanation of corporate governance and accountability in the private sector and how particularly the introduction of NPM has linked the private and public sector interpretation of what is good governance and accountability. Following this will be a summary of the investment policies which governed the investment decisions of NSW LGAs from 1997 through to 2010. This will be used to explain the regulatory environment and restriction (or freedom) permitted for investments in financial products by Councils. As these policies are implemented by State Treasury, and are the tools designed to provide a level of corporate governance around council's investment decisions, these will be used to develop an understanding of the level of constraint on investment decisions. This will be followed by a summary of the circulars to councils for the same period from the DLG. These circulars were the mechanism used by the DLG to provide information and advice on financial investment to councils. Figure 5.1 provides an outline of the chapter.

Figure 5.1: Chapter 5 Outline



5.2 Collateralised Debt Obligations (CDOs)

CDOs arose out of the desire of banks to sell their credit risk on to third party investors via the capital markets. This began in the 1970s and over time they became more and more complex. Therefore, in order to try and understand the credit risk associated with these products, highly complex computer systems were developed to assess them. This eventually led to JP Morgan developing the credit derivative model on which CDOs were based in the late 1990s (Tett 2009b). CDOs are highly complex financial tools that repackage individual loans into a product that can be sold on the secondary market. They are special purpose vehicles that acquire a range of portfolios and issue securities which are primarily backed by the cash flows expected from the acquired assets. These assets were often then sold on to entities based in the Cayman Islands or Ireland as a means to ensure that there was remoteness from the issuer (Benmelech & Dlugosz 2009, p. 4). “They are essentially a pool of debt instruments in which investors take tranches with different levels of risk” (Tett 2007). Or, as described by Ray (2006, p. 184), CDOs are investment shells which “contain all types of rated and unrated securities which include bonds, promissory notes, project-finance loans, leases, etc.” which were then sold as a package. They were called ‘collateralised’ as they were backed by collateral (in the form of assets) which was expected to provide a guarantee of security to the lenders. When they consist of corporate debt or mortgage backed securities they are referred to as asset backed securities (Adam, Jhooty & Wong 2005).

The problem with these types of products was that they were often so complex, and had so many institutions involved in each CDO, that investors could not be certain of what they were acquiring and had to rely on the advice of the banks and institutions who issued and marketed the products (Amadeo 2009) to assess the value of each product. The sale of CDOs meant that the risk associated with them was transferred from the financial institutions to the retail sector (Kiff & Fender 2005). This has meant that the recognition of the associated risk was delayed due to the time it took to emerge in the form of realised losses within the retail sector (Borio 2007). Additionally, it was not just retail investors who lacked the technical ability to understand what it meant to invest in CDOs, it was also many of the sophisticated

and institutional investors as well who failed to understand the fundamental risk of the product (Blaxhall 2007).

CDOs often contain hundreds of underlying assets and to model the cash flow from them requires the use of sophisticated cash flow software (Benmelech & Dlugosz 2009). One of the significant aspects of CDOs was that they were instruments that packaged the expected cash flows from mortgage debt rather than the mortgage debt itself (Rolfe 2009). CDOs were set up with a series of 'tranches' with the top tranche normally holding a AAA rating. The intention being that investors holding AAA rated tranches would only suffer losses when all the underlying tranches had been wiped out (Tett 2007). Typically, there were 120 or more institutions involved in each individual CDO. Each of those institutions may have had different credit ratings for both the organisation itself, and for the assets which each of them lodged within the CDO. Therefore "CDOs literally create thousands of new assets covering the entire risk/return spectrum" (Ray 2006). CDOs were constructed to be able to withstand a number of defaults. Defaults occurred when any of the companies within the 100 plus institutions involved were unable to meet their debt obligations and filed for bankruptcy. When defaults exceeded the capacity of the CDO product to sustain them (via cash flows) the principal amounts invested were placed at risk (Port MacQuarie-Hastings Council 2012). If within a CDO there was only one default the return was more than halved, two defaults meant that there may have been no return on the investment. If there were three defaults then there no return and a risk of losing some capital and if there were five or more defaults then the likelihood of any return or recovering any capital was very low (Blaxhall 2007).

CDOs were created and marketed as a rated product that could perceivably be comparable to other rated products like the market for bonds. This apparent ability to compare 'like' products was able to engender a degree of confidence in CDOs in the minds of potential investors and, for corporate investors, met their governance requirements of investing in particular rated products. Rating agencies were used to provide a mechanism for evaluating the CDOs and to introduce an element of due diligence to the process. However, as has been covered earlier, CDOs were based on a portfolio of assets within a large number of different institutions. Therefore to rate

these products required not only assessing the probability of each of those institutions defaulting, it also required making assumptions about the recovery rates and the simultaneous defaults within a pool of assets and then combining an assessment of the credit risk associated with each of the individual assets to arrive at an evaluation of its true rating (Ray 2006; Tett 2007; 2010).

CDOs were able to offer to potential investors the prospect of diversification (Partnoy & Skeel 2006) and, particularly for institutional investors who were confined by restrictions on their portfolio, provided the opportunity to invest in traditionally non-marketable assets. They also encouraged investors with different risk profiles to choose their level of risk by providing tranches with different ratings which would suit their investment criteria and governance requirements. The most senior tranche had first claim on the underlying assets and the most junior the last claim and hence the most risk. However, in comparison to equivalent rated bonds, a tranche in a CDO encompassed more risk. This was primarily due to the spread of the assets within the CDO, and because as soon as a particular tranche incurred any loss, it bore all the subsequent losses until it was exhausted (Black & Rai 2005).

While some investors were attracted to these products because the spread of assets provided diversification, the higher spreads also meant that the product was potentially exposed to greater risk. Investor demand for CDO products was substantially driven by the credit ratings assigned to them (Benmelech & Dlugosz 2009). Significantly, the expected loss and risk profile was much higher for CDOs than for equivalently rated bonds and some investors were unaware of their exposure to those risks (Black & Rai 2005).

As there was evidence of reliance by investors on the credit ratings of CDOs (Campion 2012b; Collins 2007; Gray & Barrett 2007; Tett 2010) the following section provides an overview of credit ratings. It provides an understanding of what credit ratings are, how they were developed, and how the credit ratings impacted on the way CDOs were perceived by investors.

5.3 Rating Agencies

The precursor to bond rating agencies was mercantile rating agencies, which were established to provide an assessment of a merchant's ability to pay their financial obligations. This occurred because of the 1937 financial crisis. In 1941 Louis Tappan established the first mercantile credit agency (Cantor & Packer 1994). The ratings industry expanded into the securities market in 1909 when John Moody began to rate US railway bonds. The following year Moody began rating utility and industrial bonds. Poor's developed their ratings in 1916 and Standards produced ratings in 1922, these 2 rating agencies later combined to become Standards and Poor's (S&P) (Cantor & Packer 1994). Since their inception credit rating agencies have been regarded as the intermediaries with the availability of information and necessary skills to be able to appraise the creditworthiness of corporations. Rating agencies have gradually expanded that role to incorporate the appraisal of both corporations and financial instruments. They have become central to the operations of financial markets around the world due to the perception that credit rating agencies are the preeminent authorities in the field of creditworthiness (Rousseau 2006). An explanation of the different ratings levels has been provided in Appendix 10.

The use of ratings as a tool to provide governance to mitigate the dilemma of different interests and incentive for investors and portfolio managers has been common (Cantor 2004; Harris 2010; Tett 2009a). By basing portfolio governance on the ratings of individual investments, investors are able to ensure that portfolio managers limit exposure to high risk products (Cantor 2004). However credit rating agencies rely on the information supplied to them from issuers and all agencies get the same information, yet not all the ratings from different agencies are the same. How each agency determines their credit rating decisions is kept secret and they do not disclose the probability of default of a particular rating level (Cantor 2004; Ray 2006). Additionally they emphasise that ratings are both qualitative and the result of professional judgement and do not ensure that capital will be protected, they state that they are a reflection of the risk and return (Cantor & Packer 1994; Tett 2007; 2009a) with even the highest rated products still having a risk of failure (Adam, Jhooty & Wong 2004). The higher the statistical risk of failure the lower the credit

rating given to the corporation or institution (See Appendix 10). The rating of a CDO was a reflection of the quality of the corporate names within them (Port MacQuarie-Hastings Council 2012), however with up to 200 companies being involved in a particular CDO, it only required a small proportion of those companies to have problems to severely impact the CDO product. Credit agencies however do not suggest that their ratings provide a guide to credit worthiness, but propose that they be considered as recommendations and an indication of investment values (Gold 2008) and that the investor is required to evaluate the risk associated with the investment. Moody's (2012) have provided an explanation of what credit ratings are and provided a rationalisation of how they should be used when considering a particular investment by stipulating that credit ratings;

must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, selling or holding. (Moody's 2012)

The clarification provided by Moody's (2012) served to illustrate the point that investors were required to make their own analysis of the risk associated with the purchase of each individual CDO. They also highlighted that even products with the same rating may have had different risks due to the "limited number of rating classes used in grading thousands of bonds" (Moody's 2012). In hindsight the CDOs marketed to NSW LGAs were overrated and sold to an audience who did not understand the complexity of the products (Dorizas 2008). Appendix 11 shows the default probability for rated products which demonstrates that even highly rated products can fail. The following section provides an explanation of possible reasons for the failure of the CDO market.

5.4 Reasons for Collapse of CDO Market

There have been a number of suggestions, which have promulgated reasons for the collapse of the CDO market. These have included the complexity of the product

(Adam, Jhooty et al. 2004; Amadeo 2009; Ray 2006), reliance on credit ratings and the lack of understanding of the underlying risk characteristics of CDOs (Kiff & Fender 2005), and the greedy mind-set of financial institutions and markets (Harris 2010; Tett 2009b; 2010). All of these factors have had an influence and examples have been provided by authors who suggested that the aggressive leverage policy implemented by Lehman Brothers' played a major role in the collapse of the CDO market (Adam, Jhooty et al. 2004; Collins 2007; Gold 2008; Gray & Barrett 2007; Jones, Abraham & Ross 2011; Jones & Bowrey 2010). Other factors described included "bad regulation, lack of transparency, and market complacency brought about by several years of positive returns" (Zingales 2008, p. 2), which created an environment and expectation of wellbeing and security. When this expectation was subsequently shown to be unrealistic, it precipitated the collapse of Lehman Brothers. Prior to filing for bankruptcy on 14th September 2008, Lehman Brothers' were the fourth largest investment bank in the United States, and promoted a wide range of investment schemes (Zingales 2008). In Australia, the CDO products promoted by Lehman Brothers were marketed initially as a Lehman Brothers CDO and were later sold through their investment arm that was called Grange Investments. O'Brien (2008, p. 80-81) stated that these repackaged debt products were "fundamentally miss-priced by rating agencies.....inherently unstable.....and provided with implausible and unsustainable credit rankings". He further suggested that investors who had governance mandates which precluded them from investing in products of less than a particular rating "followed hedge funds into products in which the ownership of economic risk was, at best, unclear" (O'Brien 2008, p. 81).

One of the principal investment products which Lehman Brothers' aggressively marketed and promoted to the NSW LGAs were CDOs, and their collapse (predominately due to the overvaluation of these products) has led to a significant write down by NSW LGAs of those particular financial assets (Cole 2008). The collapse of the CDO market is credited with having led to the subsequent Global Financial Crisis (GFC). The US senate report (Levin & Coburn 2011, p. 1) highlighted that;

the crisis was not a natural disaster, but the result of engineered high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street

and further observed that “no regulator was charged with identifying, preventing, or managing risks that threatened the safety and soundness of the overall U.S. financial system,” (p. 41). Similarly the US Financial Crisis Inquiry Commission identified that “the captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks” (Angelides, Thomas, Born, Holtz-Eakin, Georgiou, Murren, Graham, Thompson, Hennessey & Wallison 2011, p. xvii).

Lehman Brothers marketing of CDOs targeted at LGAs because they were seen as organisations that had large amounts of free money available for investment. Lehman's were “notorious for marketing investment schemes to LGAs which have resulted in those LGAs losing millions of ratepayer's dollars” (Roskam 2008, p. 9). Because of the resulting loss of trust in Lehman Brothers, which stemmed from the collapse of the value and loss of confidence in CDO's, there was consequentially a total financial collapse of Lehman Brothers. They have been “generally credited with precipitating the near total collapse of confidence that subsequently engulfed the international monetary system” (Roskam, 2008, p. 9).

The purveyors of CDOs have proposed that the buyers of these mortgage-related instruments were sophisticated investors who were capable of making informed decisions. This is a reflection of the legal definition of a sophisticated investor, being anyone who invests more than \$500,000 and is therefore under the law deemed to be knowledgeable enough, or have sufficient resources to employ expert advice, and is therefore, able to make informed decisions about the investment product (O'Brien 2008). Conversely it does not appear either credible or accurate that only knowledgeable investors purchased these products (Morgenson 2010). The following section defines corporate governance in both the private and public sectors, highlighting the factors, which are able to demonstrate good governance, and discusses the factors that differentiate good governance practices within each of those sectors.

5.5 Corporate Governance

There are a variety of definitions of what good corporate governance entails. In Australia, while technically the system of corporate law is state based, in practice the primary legislation is the *Corporations Act 2001*, as the states all provide reference to the Federal Act within their own legislation (Hill 2010, p. 1). In recent times the commonwealth government has increased the focus on corporate governance (Bowrey 2008) as a means of increasing assurance and demonstrating adequate oversight of government bodies. From the perspective of the Commonwealth, corporate governance refers to “the processes by which organisations are directed, controlled and held to account. It encompasses attributes authority, accountability, stewardship, leadership, direction and control exercised in the organisation” (ANAO 2003, p. 6). Similarly, Uhrig (2003, p. 2) described corporate governance as “the power of those in control of the strategy and direction of an entity ... taking into account risk and the environment in which it is operating”. Barrett (2002, p. 8) proposed that the generally accepted meaning of corporate governance encompasses “how an organisation is managed, its corporate and other structures, its culture, its policies and strategies, and the ways in which it deals with its various stakeholders”. Likewise, Edwards (2002, p. 51-52) described governance as “dealing with all forms of the organisational relationships”, and that good governance is able to “assist performance, provide accountability, transparency, participation and efficiency”. She also highlighted that the introduction of private sector practices into the public sector has created the assumption that the corporate (private) form of governance can be readily adapted to the public sector.

The focus in recent times on corporate governance has been mainly on the impact of poor corporate governance, which has led to the collapse of a number of organisations (Allan 2006; Mak, Deo & Cooper 2005; Parker 2005). These events have led to increased interest in “regulatory and other responses to improving corporate governance in the private sector” (ANAO 2003, p. 6).

While the attention of corporate governance has been primarily on private sector organisations, it is equally important for public sector organisations to have strong corporate governance structures. Public bodies are responsible for the management

and administration of public funds and are therefore expected to have good corporate governance systems in place (ANAO 2003; APSC 2005; 2007). Edwards (2002) acknowledged that the corporate governance structures in both the public and private sectors have areas of commonality particularly in relation to performance and the roles and responsibilities of their governing boards and executive officers. This has led to a significant push for the public sector to adopt private sector corporate governance processes and structures. In the public sector the increased focus on performance and responsibilities is consistent with the move to “new managerialism” in the public sector (Jackson & Lapsley 2003, p. 360) and the perceived need of the “public sector to improve its efficiency, effectiveness and accountability” (Barton 2005, p. 138; Guthrie 1998, p. 2).

The Australian Stock Exchange (ASX) has issued a range of corporate governance principles and recommendations and consider an “if not, why not” approach provides a “robust and flexible structure for governance disclosure and balances the genuine governance interests of public capital markets” (ASX 2007, p. 6). An “if not, why not” approach means that if organisations are not following the guidelines then they will to explain why they believe that following the guidelines is not necessary or appropriate. These principles are outlined in the Table 5.1 below.

Table 5.1: ASX Principles of Good Governance

Number	Principle	Method of Achieving
1	Lay solid foundation for management and oversight	Recognise and publish roles and responsibilities of board and management
2	Structure the board to add value	Composition and size to adequately discharge duties
3	Promote ethical and responsible decision making	Actively promote
4	Safeguard integrity in financial reporting	Structure to verify and safeguard
5	Make timely and balanced disclosure	Timely and balanced disclosure of material matters
6	Respect the rights of shareholders	Facilitate exercise of rights
7	Recognise and manage risk	System of risk oversight and management
8	Encourage enhanced performance	Review and encourage board and management effectiveness
9	Remunerate fairly and responsibly	Level of remuneration reasonable and sufficient and relationship to performance defined
10	Recognise legitimate interests of stakeholders	Recognise legitimate legal and other obligations

(Adapted from ASX 2007, p. 10-12)

While LGAs are not public companies and are therefore not governed by these rules, the introduction of New Public Management (NPM) has meant that similar expectations may be presumed to be equally appropriate and apply to local LGAs (Edwards 2002). Likewise, the Australian Auditor General, Pat Barrett suggests that it would be a mistake to dismiss this guidance as only being relevant to listed companies and that it should be used to provide broad pointers for the public sector particularly in the areas of management, risk, ethics and performance (ANAO 2004, p. 34).

The Local Government Shires Association (LGSA) has identified that there is an element of ambiguity when discussing corporate governance. When the term "corporate governance" was used in the context of the Independent Inquiry into the Financial Sustainability of NSW LGAs it was used interchangeably to mean both "local democracy and high level corporate and administrative management" (LGSA 2007a). The LGSA later proposed that any practice of governance should incorporate a range of activities which are aimed at "achieving better outcomes in community engagement, strategic & services planning, asset management, risk management, performance monitoring and financial management". As changes to any of these activities are likely to impact on one or more of the other they suggested that to achieve good governance there needs to be a "continuous process of planning, coordinating and resourcing these activities" while also monitoring delivery of services as well as the "overall performance of the governing body" (LGSA 2007b, p.3). For LGAs, governance revolves around the need for state parliament to hold the local authorities accountable for their actions (Sendt 2002). In measuring good governance it is a case of how well the governance functions meet the accountability requirements expected from parliament, thereby creating a fundamental link between good governance and auditing.

The Department of Local Government (DLG 2010a) has subsequently acknowledged that while the *1993 Local Government Act* ignored risk management as a part of good corporate governance, they now concede that risk management is an essential component of effective corporate governance which LGAs need to incorporate in their investment practices. The DLG now proposes that in order to develop good governance for LGAs there is a necessity to rely on "the robust independent review of management, finances, risks and operations by LGA's governing body and a properly constituted audit committee which reports regularly to LGA's governing body"(DLG 2010a).

One explanation of good public sector governance has been provided by the Australian Public Service Commission (APSC) who described it as being based on a range of principles, which are shown in Table 5.2.

Table 5.2: Australian Public Services Commission - Description of Governance Principles

Principle	Australian Public Services Commission-Description
Accountability	Being answerable for decisions and having meaningful mechanisms in place to ensure the agency adheres to all applicable standards
Transparency	having clear roles and responsibilities and clear procedures for making decisions and exercising power
Integrity	acting impartially, ethically and in the interests of the agency, and not misusing information acquired through a position of trust
Stewardship	using every opportunity to enhance the value of the public assets and institutions that have been entrusted to care
Efficiency	ensuring the best use of resources to further the aims of the organisation, with a commitment to evidence-based strategies for improvement
Leadership	achieving an agency-wide commitment to good governance through leadership from the top

(Adapted from APSC 2007)

Additionally, the APSC have stated that good governance needs to be about how the agency uses the governance procedures to:

- Contribute to overall performance and delivery of activities
- Ensure it meets legal and regulatory requirements (APSC 2005)
- Meet community expectations of probity, accountability and openness (APSC 2007)

The principles of good governance have also been outlined by the Australian National Audit Office (ANAO, 2003) who have identified a similar range. Their descriptions are summarised in Table 5.3 (Bold added).

Table 5.3: Australian National Audit Office-Description of Governance Principles

Principle	Australian National Audit Office-Description
Accountability	where public sector organisations and the individuals within them are responsible for their decisions and actions, and where they are subject to external scrutiny ;
Transparency	having clear roles and responsibilities and clear procedures for making decisions and exercising power
Integrity	is based on honesty, objectivity, and high standards of propriety and probity in the stewardship of public funds and resources ;
Stewardship	reflects the fact that public officials exercise their powers on behalf of the nation, and that the resources they use are held in trust and are not privately owned;
Leadership	is one of the more crucial principles. It sets the tone at the top of the organisation, and is absolutely critical to achieving an organisation-wide commitment to good governance; and
Efficiency	is about the best use of resources to achieve the goals of the organisation, and is also about being able to prove that the organisation has indeed made the best use of public resources .

(Adapted from ANAO 2003, p. 7-8)

The sections in bold demonstrate that the focus of the ANAO is significantly more on external examination and the recognition that public sector organisations are charged with managing public funds and resources for the benefit of the community in general. The ANAO have also highlighted that governance stems from the top and leadership is a crucial element for achieving good governance.

The good governance recommendations which have been provided for public sector organisations (ANAO 2003) are not legislated, therefore LGAs are not forced to comply, however similarly to the Australia Stock Exchange (ASX) an ‘if not, why not’ condition has been imposed. This means that if LGAs are not following the guidelines they are required to provide an explanation of their reasons for not doing so. One major difference between the private and public sectors is that in the private sector the contributors of capital (shareholders) are recognised as providers of risk capital, while in the public sector, and particularly local LGAs, it would appear inappropriate to consider either governments or rate payers as providers of risk

capital. Therefore, the blanket application of private sector governance guidelines may be improper. Equally, when it is taken into account that prior to the *1993 Local Government Act*, LGAs were required as trustees of public funds, to primarily consider the preservation of capital (NSW Trustees Act 1925), then investment in any type of at risk product would appear in conflict with their fiduciary duties. However, it should be noted that reference to the *NSW Trustees Act 1925* was removed when the *1993 Local Government Act* was introduced. Therefore, normal private sector practices of investing or maximum return may be inappropriate if protection of capital is seen as a priority.

One mechanism that was in place for the governance of LGA investments was through the investment policies, circulars to LGAs and guidelines provided by Treasury and the DLG. Up until the GFC, LGAs were permitted to invest in a range of credit rated products, this represented a method of providing governance over the investment practices. However this relied on the credit ratings being credible and being able to provide assurance about the products, which appears to have been lacking in respect of CDOs (O'Brien 2008; Tett 2007). The following section provides a description of what comprises accountability and underscores the importance of LGAs being held accountable for their actions.

5.6 Accountability

While the emphasis of public sector reforms has been on the financial and budgetary measures for financial accountability, the performance of programs and people are both being measured. The expanding regulation of LGAs has continued to increase the need for disclosure in a wide range of areas so that the actions of LGAs can be scrutinised and allow them to be held to account for those actions (Gray 2001). These regulations and reliance on funding from state and federal governments impose duties on LGAs to be accountable and provide reports and information to meet both the regulatory requirements of state and federal governments, and to address the needs of a variety of other stakeholders. Accountability is seen as an essential component of good management and practice, particularly as LGAs have the responsibility and duty of managing public money. This has been demonstrated by the requirement of the *NSW Trustees Act 1925* which highlighted that LGAs, as

managers of public funds, have a fiduciary responsibility to both protect public money and assets, and to ensure that they manage those funds for the benefit of all their stakeholders (1925).

However, accountability is a difficult concept to define (Carnegie 2005; Carnegie & West 2005; Trippett & Kluvers 2010) with the general consensus being that in order to be accountable; an essential requirement ought to be that one party must be obliged to provide a full account of events to another party. Within the LGA context, councils are required to provide a variety of reports and accounts to the state government (via the Department of Local Government), yet does that make them accountable? The providing of information may be an essential component of accountability (Funnell 2003; Funnell & Cooper 1998) however the availability of additional information does not automatically lead to greater accountability (Broadbent & Laughlin 2003). Accountability requires openness, transparency, that there is someone to whom you are required to report, and that there are consequences for inappropriate actions (Barton 2005).

The following section reviews the Minister's orders and DLG 'Circulars to Councils' in order to provide an understanding of the investment guidelines and policies with which LGAs were required to conform during the period from 1997 through to 2011. In particular, attention has been given to identifying the financial investments policies, which NSW LGAs were following in the period preceding the GFC. The purpose of this was to show the investment environment in which LGAs were functioning, and how the Minister's order provided a framework within which LGAs were required to make their investment decisions.

5.7 Investment Policy Guidelines

NSW LGAs have been permitted to invest in a diverse variety of products. Approved products have been stipulated by the NSW Treasury and have been subject to a series of changes over the last decade and a half. Significant changes were made to the guidelines after the GFC began and the release of the Cole Report (2008) which highlighted the losses suffered by NSW LGAs. The following Table 5.4 has highlighted the types of Ministry approved investment products available to NSW

LGAs during the period from 1997 through to 2011. The investment policy documents issued by the Minister as well as the circulars provided to LGAs from the DLG have been included in Appendix 12. While most of these documents are available from the DLG website, there were several, which were unavailable from that source, and these were obtained from a financial investment advisor to LGAs who was interviewed during this research project.

Table 5 4: Summary of Minister's orders by Date

Policy date/Type of investment	02/05/1997	01/05/1998	17/03/2000	16/11/2000	15/07/2005	31/07/2008	12/01/2011
Deposits	Deposit with the Local Government Investment Service Pty Ltd	Unchanged	Unchanged	Unchanged	Unchanged	Deposit with Local Government Financial Services	Deleted
Securities	Bill of exchange drawn or accepted by a bank	Unchanged	Debentures or securities issued by a bank, building society or credit union	Unchanged	Deleted		
Treasury Deposits	Deposit with the Treasurer	Unchanged	Deposit with New South Wales Treasury Corporation or investment in Hour-Glass facility of New South Wales Treasury Corporation	Unchanged	Unchanged	Unchanged	Unchanged
Body Issued Securities with Credit rating	Deposit with funds manager parent entity (immediate or ultimate) Maintaining minimum credit rating by Standard and Poor's of A, or Moody's of A2	Unchanged	Any securities which are issued by a company or body with a Moody's Investors Service, credit rating of ``Aaa", ``Aa1", ``Aa2", ``Aa3", "A1" or "A2" or a Standard & Poor's Investors Service, credit rating of ``AAA", ``AA+", ``AA", ``AA-"; "A+", or "A"	Unchanged	Unchanged	Deleted	
Securities given a Credit Rating			Moody's Investors Service credit rating of ``Aaa", ``Aa1", ``Aa2", ``Aa3", "A1"; "A2" or ``Prime-1" or a Standard and Poor's Investors Service, credit rating of ``AAA", ``AA+", ``AA", "AA-", "A+"; "A"; A1+" or ``A1"	Unchanged	Added Fitch Rating Credit rating AAA, AA+, AA, AA-, A+ or A	Unchanged	Unchanged
Government Securities			Any public funds or Government stock or Government securities of the Commonwealth or any State of the Commonwealth	Unchanged	Unchanged	Added or territory	Unchanged
NSW Guaranteed Debentures			Any debentures or securities guaranteed by the Government of New South Wales	Unchanged	Unchanged	Deleted	

Table 5.4 continued next page

Table 5 4: Summary of Minister's orders by Date (Continued)

Policy date/Type of investment	02/05/1997	01/05/1998	17/03/2000	16/11/2000	15/07/2005	31/07/2008	12/01/2011
LGA Debentures			Any debentures or securities issued by a LGA	Unchanged	Unchanged	Unchanged	Unchanged
Mortgage			Mortgage of land in any State or Territory of the Commonwealth	Unchanged	Unchanged	Restricted to 1 st mortgages and 60% of value	Deleted
Land Purchase			Purchase of land in any State or Territory of the Commonwealth	Unchanged	Unchanged	Deleted	
Bank deposits			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	Unchanged	Unchanged	Combined to any authorised deposit taking organisation	Unchanged
Credit Union Deposits			Interest bearing deposits with a building society or credit union	Unchanged	Unchanged	Exclude subordinate debt obligations	
Bills of Exchange			Any bill of exchange which has a maturity date of not more than 200 days; and confers on the holder a right of recourse against a bank, building society or credit union an amount equal to the face value of the bill	Unchanged	Unchanged	Unchanged	
Shares				Inland Marketing Service	Deleted		

The preceding Table 5.4 has demonstrated that prior to the collapse of the CDO market in 2007, and the subsequent write down of investments in those types of products, it was permitted for NSW LGAs to invest in a wide range of products. Predominately they were allowed to invest in products that either, had been issued by a company with a credit rating of A or better, or securities which had been given a credit rating of A or better. This therefore assumed that there was an ability to rely on the validity of credit ratings assigned to each of the individual CDOs, and that they were an appropriate tool with which to govern the investment decisions of LGAs. The production of investment policy guidelines with which LGAs were required to comply established the concept that the guidelines were a mechanism with which the Minister could govern the investment actions of LGAs. Therefore LGAs were able to invest in CDOs where the primary issuer had a credit rating of A or better provided the tranche in which they invested was rated A or better. This therefore meant that LGAs were able to invest in products that they would not normally have been permitted to invest in, provided they were contained within a suitable CDO.

As there was a policy reliance on the credit rating of investment products, and the ministerial guidelines stipulated the appropriate rating level, it is likely that some LGAs may have assumed that meeting the guidelines and complying with directives from the DLG satisfied their corporate governance requirements with respect to investments. It is also likely that some LGAs were unaware of the risks associated with these types of investments. As CDOs were typically offering 2-3% greater return than similarly rated bonds it would also seem logical for LGAs to try to maximise the returns from their investments if they were unaware of the allied risk.

Recognition of risk with CDOs was difficult even for sophisticated investors and this coupled with the prevailing economic conditions which were showing reasonably stable 2% growth in GDP (RBA 2012, Appendix 13), steadily increasing interest rates and increasing bond returns from 2000-2001 (Eslake 2011a; b) provided LGAs with the expectation that capital growth and investment returns would continue into the foreseeable future (see Appendix 14). However what had occurred, primarily due to the nature of the assets backing CDOs was the creation of a bubble which

overinflated the true value of CDOs (Adam, Jhoo et al. 2004; Levin & Coburn 2011; Tett 2007; 2009a; 2010).

From a Bourdieuan perspective, the ministerial investment guidelines created a boundary to the field in which LGAs were required to function by providing an outer 'fence' which the financial investments were constrained within. Individual LGAs also had their own investment policies and while those who made the financial investment decisions were required to fit within the ministerial guidelines, they were also influenced by the habitus of the particular organisation in which they worked. The existing habitus of the LGAs was able to affect investment decisions policies. Those LGAs who wished to be less conservative were restricted by the ministerial guidelines, while those who were more conservative were able to eliminate some of the options available. The more conservative LGAs were able to address their particular risk acceptance criteria through the implementation of more restrictive governance constraints within their own investment policies.

However, it can be seen that the relaxation of the ministerial policies, which occurred in 2000, opened the door for LGAs who wished to pursue aggressive investment policies to indulge in higher risk investment activities. The subsequent closing of investments in derivatives and rated products during 2008, was a result of the losses sustained by LGAs who took the opportunity to invest in higher risk products (Cole 2008) than had been allowed prior to 2000. This has clearly demonstrated that there were, and are problems, which arise when policies allow too great a flexibility in investment decisions. Greater flexibility encourages higher risk behaviour by organisations with a habitus that supports, or at least does not discourage, undertaking risk.

Alternatively, South Australia (SA) LGAs had a higher level of flexibility in their investment decisions, with the capacity to invest in almost anything, yet they were largely unaffected by the failure of the CDO market (Chaplin 2009). The primary reason for that was that LGAs in SA did not invest in CDOs even though they were permitted to. The crucial element of SA LGA investments was that they filtered their investments through the LGFA and that organisation had an existing habitus which was foremost of a conservative nature. They looked for and invested in low risk

investments and secured their investments against failure by purchasing investment guarantees from the SA state government. It was the collective habitus of the SA LGAs, in conjunction with their investment body, which ensured that local authorities in SA were protected from the CDO investment product collapse.

Therefore, it can be seen that the relaxation of the NSW Ministerial guidelines ensured that individual LGAs would have reconsidered the products in which they were able to invest in. However, the individual LGAs were able to control the level of risk that they were willing to undertake through their own investment policies. It could be argued that as this change implemented by the Minister, and the DLG, may have encouraged NSW LGAs who relied on the policy as a mechanism of governance, to take up opportunity to engage in these products (which in the case of CDOs were high-risk investments). However, ultimately it was the habitus and acceptance of risk within each of the individual LGAs, which was the crucial component in the determination of whether or not they were disposed to engage in these types of investments. It may also have been that some LGAs failed to recognise the risk associated with these investments. This may have been due to an over reliance on advice of the DLG and the ministerial investment orders, or by taking the view that having permission to invest in CDOs was a reflection of the safety of these products.

5.8 Circulars to Councils

This section tracks the changes that have been made to the ministerial investment policies and subsequently communicated to councils through the ‘circulars to councils’.

The 1998 review of investment powers of councils occurred due to changes following the:

proclamation in March 1998 of the Trustee Amendment (Discretionary Investments) Act 1997 that amended the Trustee Act 1925 to provide that all trustees must invest in a prudent manner (the prudent person rule) (Appendix 12.2, 98/38).

Chapter 5: Collateralised Debt Obligations

The controls in 1998 on councils were largely a result of the recommendations of the Stewart Royal Commission which:

highlight what can happen given poor local decision making when organisations and classes of investment thought previously to be reputable and safe have proved to be otherwise (Appendix 12.2, 98/38).

Circular 98/38 also emphasised that:

However, investment in a listed security is not a guarantee against loss or failure of an investment, nor does it relieve a trustee of their duty to invest funds in a prudent manner (Appendix 12.2, 98/38).

Circular 98/38 also states that the “prudent person” approach leaves the question of investment entirely to the discretion of the trustee. That discretion, however, must be exercised in accordance with the rule, which was laid down in 1830 in *Harvard College v Amory* 26 Mass (9Pick) 446 that outlines expectations as;

All that can be required of a trustee is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to permanent disposition of their funds, considering the probable outcome, as well as the probable safety of the capital to be invested (Appendix 12.2, 98/38).

The trustee is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would. The trustee must, at least once in each year, review the performance (individually and as a whole) of trust investments. Local councils would not be expected to achieve maximum yields, but the reasonable yields otherwise expected from normal management by prudent people; a balance between earnings and risk (Appendix 12.2, 98/38).

This circular has introduced the idea that councils should take the approach that they need to get reasonable returns, which is open to interpretation as depending on a person’s nature what is reasonable for one may be conservative, or speculative to another.

The prudent person rule

The prudent person rule requires a person to act as a prudent person would. This is however open to interpretation. The free dictionary (Farlex 2012) defines the prudent person rule as, an investor being required to invest “with discretion, care and intelligence”. It also acknowledges that this is a subjective description which is open to interpretation. Similarly the Public Trustees Queensland (2008) has set out principles that a prudent person should follow. These are what must be taken into account when exercising investment decisions;

- (a) the purpose of the trust and the needs and circumstances of the beneficiaries;
 - (b) the desirability of diversifying trust investments;
 - (c) the nature of a 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 at the end of, the term of the proposed investment;
 - (k) the total value of the trust estate;
 - (l) the effect of the proposed investment for the tax liability of the trust;
 - (m) the likelihood of inflation affecting the value of the proposed investment or other trust property;
 - (n) the cost (including commissions, fees, charges and duties payable) of making the proposed investment;
 - (o) the results of a review of existing trustee investments
- (Public Trustee Queensland 2008, p.7)

The prudent person rule has “opened the door on to modern investment strategies” (Pozen 1977, p. 32) and has created a different concept of what type and level of risk is acceptable. There is an argument that assuming the finance manager does not breach the state government investment guidelines, the investment policy of the council, and acts with reasonable care, then their primary responsibility is to act in the best interests of the portfolio stakeholders (Lehane 1995). The prudent person rule expanded the opportunities for investment but fails to provide governance of investments due to the ambiguity of what a prudent person is.

Circular 00/16 continued the prudent person approach and reference to the *Trustees Act* 1925. Reinforcing that;

A council or entity acting on its behalf should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. A prudent person is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would (Trustee Amendment Discretionary Investments Act 1997 section 14 A (2)) (Appendix 12.4).

A council should develop an investment strategy as part of its overall financial plan. The strategy should, as a minimum consider the desirability of diversifying investments and the nature and risks associated with the investments (Appendix 12.4).

This circular has incorporated the idea that councils should *consider* (emphasis added) diversification as a means of reducing risk.

Circular 00/16 provided an explanation of how councils should use credit ratings of products stating that:

Credit ratings are a guide or standard for an investor, which indicate the ability of a debt issuer or debt issue to meet the obligations of repayment of interest and principal. Credit rating agencies such as Moody’s and Standard and Poor’s make these independent assessments based on a certain set of market and non-market information. 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. Even given this challenge, ratings provide the best independent information available (Appendix 12.4).

This circular explained that council should only use ratings as a guide to investments and that ratings do not ensure capital protection. However, the guidance provided from this circular states that ratings are the *best information* (emphasis added).

Circular 0071 removed reference to the Trustees Act 1925 as of June 2000. It also added that investments were only allowed if they complied with the forms of investment notified by the Minister and published in the gazette. Additionally it highlighted that there was an update requiring councils to “have an investment policy” which complied with the legislative and investment guidelines issued by the Minister (Appendix 12.5).

Circular 05-53 introduced minor changes to include Fitches rating agency and additional investment products (Appendix 12.6).

Circular 06-70 again only made minor changes. However it also highlighted that the DLG was concerned about councils using third parties to manage their investments. This circular emphasised the prudent person rule and that councils are responsible for their investment and that that responsibility cannot be allocated to another party (Appendix 12.7).

It is of concern that some third party investments may be outside the Minister’s Order. When investing through third parties a council, or entity acting on behalf of a council, should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. An investment adviser or dealer acting on behalf of a council should be licensed by the Australian Securities and Investment Commission (ASIC) (www.asic.gov.au) (Appendix 12.7).

Circular 07-38 restated the previous rules (Appendix 12.8).

As a result of the Cole report circular 08-10 (Appendix 12.9) instigated reforms of the investment order, excluded managers of investment products from acting as advisors, desired councils to withdraw from investments in rated products as soon as practical and reintroduced reference to council’s responsibilities stemming from the *Trustees Act 1925*.

Circular 09-20 advised of the draft investment policy and provided councils with an overview of proposed changes to investment policies (Appendix 12.12).

Circular 10-11 introduced the new investment policies (Appendix 12.13).

Circular 11-01 again made changes to investments further restricting them (Appendix 12.14).

As can be seen from the above summary of the circulars to councils, the Minister's orders and the DLG gradually allowed greater flexibility in allowed investment products from 1998 through to 2008. As a result of the GFC, the Cole Report and losses from investments, the reaction was to strictly limit the types of investment in which councils could consider, although it did allow grandfathering of existing investments. The actions from the Minister and the DLG have been reactive rather than proactive. The guidelines gradually expanded, including the removal of reference to the Trustees Act 1925, required councils to make their own assessments of risk while acting as a prudent person. The prudent person rule is open to interpretation and there was no guidance as to acceptable levels of risk acceptance. These guidelines created an environment where councils were unsure of how they should invest. If they took on risk, there was no clear indication of what level was acceptable to a prudent person, and if they did not take on risk, were they acting too conservative and limiting the returns that a prudent person would expect.

5.9 Conclusion

This chapter has detailed the types of investment products that councils were allowed to invest in. the focus of this research is on council investments in CDOs. CDOs are a highly complex debt instrument that is not backed by assets but rather by the flow of cash from those instruments. They were rated products and this chapter has outlined the flaws within the mechanisms used to rate both them and the issuing institutions. Ratings are a tool that the Minister and DLG used as a form of governance over financial investment products. However, there was limited understanding of how those ratings were acquired and allocated. This chapter has also analysed the Minister's orders and circulars to councils related to investment

products. This analysis has provided an understanding of how the investment landscape changed from the late 1990s through to 2008.

As the landscape changed so did the types of products that were available for councils to invest in. Early CDOs were more secure, being secured by the debt, than the later products which were backed only by the cash flows from that debt. The Minister's orders were a tool to control the governance of investments and provide a level of accountability for council investments. The relaxation of the types of products in which council could invest served to diminish the levels of governance. Similarly, the removal of reference to the *1925 Trustees Act* and the associated responsibility to ensure the priority of capital protection for investments, created an environment around financial investment that encouraged more aggressive practices. This may be a result of the introduction of NPM practices in councils, where they are expected to achieve similar investment results as could be expected from the private sector.

The following chapter will provide an analysis of the interviews with individuals involved in the investment practices of NSW councils. This analysis is done through the lens of categories outlined in Bourdieuan *Theory of Practice*.

Chapter 6: Interview Analysis and Findings

6.1: Introduction

The preceding chapter has provided a précis of the Treasury Ministerial Investment Orders and the circulars issued by the DLG. The purpose of this was to delineate the investment landscape in which NSW LGAs were engaged and to provide the context, from which to analyse the interviews.

This chapter analyses the interview data relative to the political, social and economic environment as viewed from a Bourdieuan perspective. As previously described in the research method (chapter 3), interviews were conducted with three discrete groups of participants involved in how decisions were made in NSW LGAs. Table 6.1 provides an identifier for each of the organisations and the individual participants.

Table 6.1: Background Interviewee Details

Participant Group	Affiliation	Interviewees
Background interviews	Audit Firm (AF)	Audit Director (AD)
	Investment Advisory Firm (IF)	Investment Advisor (IA)
	Municipal Council (MC)	Former Town Clerk (TC)
Councils that did not invest in CDOs	Council 1 (C1)	Finance Manager (FM)
		Finance Officer 1 (FO1)
		Finance Officer 2 (FO2)
	Council 2 (C2)	Finance Manager (FM)
	Council 3 (C3)	Investment Officer (IO)
Councils that did invest in CDOs	Council 4 (C4)	Finance Manager (FM)
		Assistant Finance Manager (AFM)
		Investment Manager (IM)
	Council 5 (C5)	Finance Manager (FM)
	Council 6 (C6)	Finance Manager (FM)
	Council 7 (C7)	Finance Manager (FM)

The first participant group supplied background to the investment environment in which local councils function and included three individuals, one who worked outside councils involved in providing advice and auditing services, an investment advisor who had knowledge of the way investing decisions were made, and a former town clerk who was involved in making investment decisions. The second group was comprised of councils who did not invest in CDOs. The third group was made up of councils who invested in CDOs.

The three main themes identified from the interviews were governance, financial products and support networks. Governance refers to the way in which investment decision-making was controlled and reported. Financial products relates to the understanding of CDOs, the manner in which they were marketed and how the risk associated with CDOs was evaluated. Support networks are the fields that were external to the respective councils that were able to influence perceptions and understanding of CDOs. The three main themes were further divided into sub-themes as shown in Figure 6.1. This chapter brings together these various themes according to Bourdieu's *Theory of Practice* within the categories of fields, capital and habitus while considering the perspective of each of the three participant groups. The chapter outline is presented in Figure 6.2.

Figure 6.1: Themes and Sub-Themes Emerging from Interviews

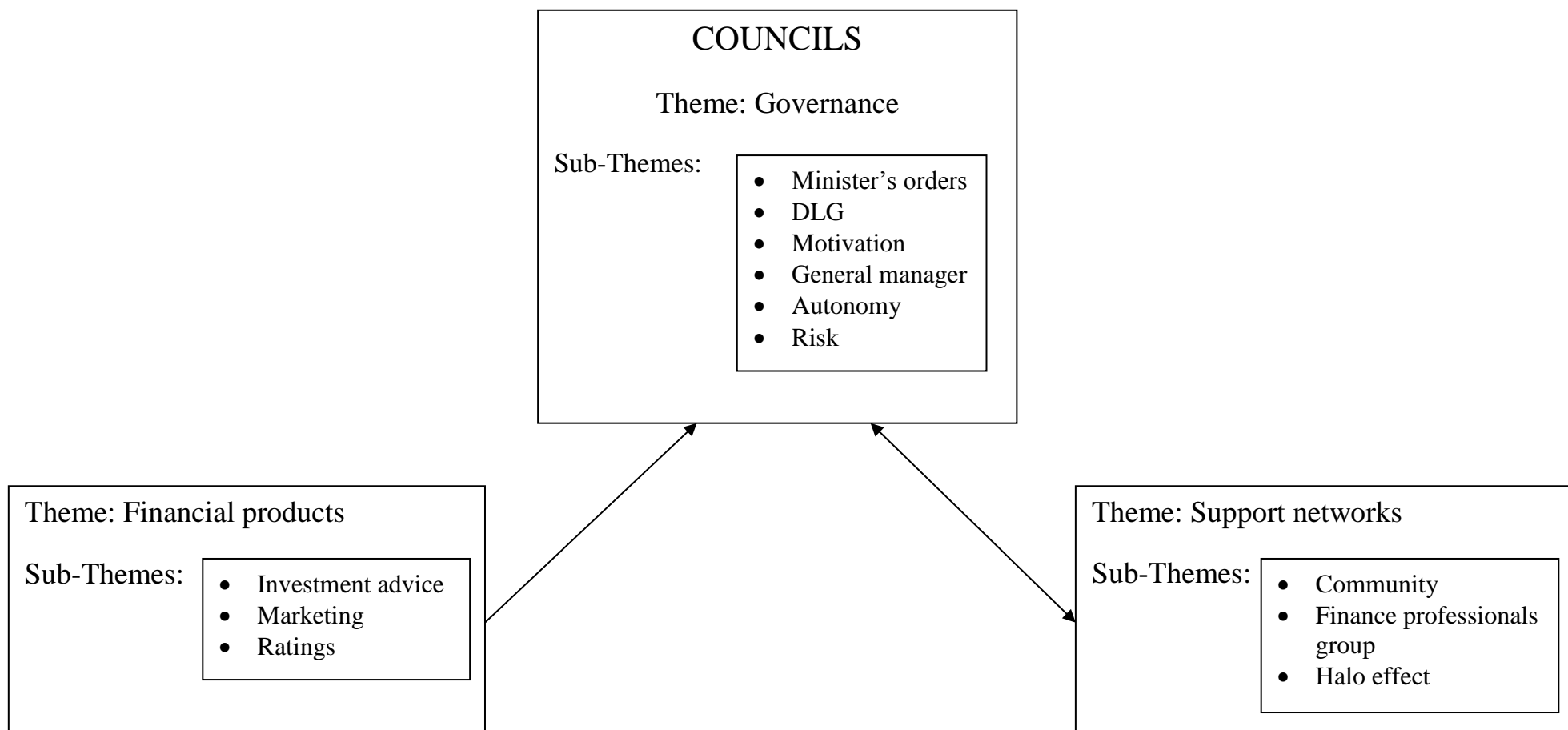
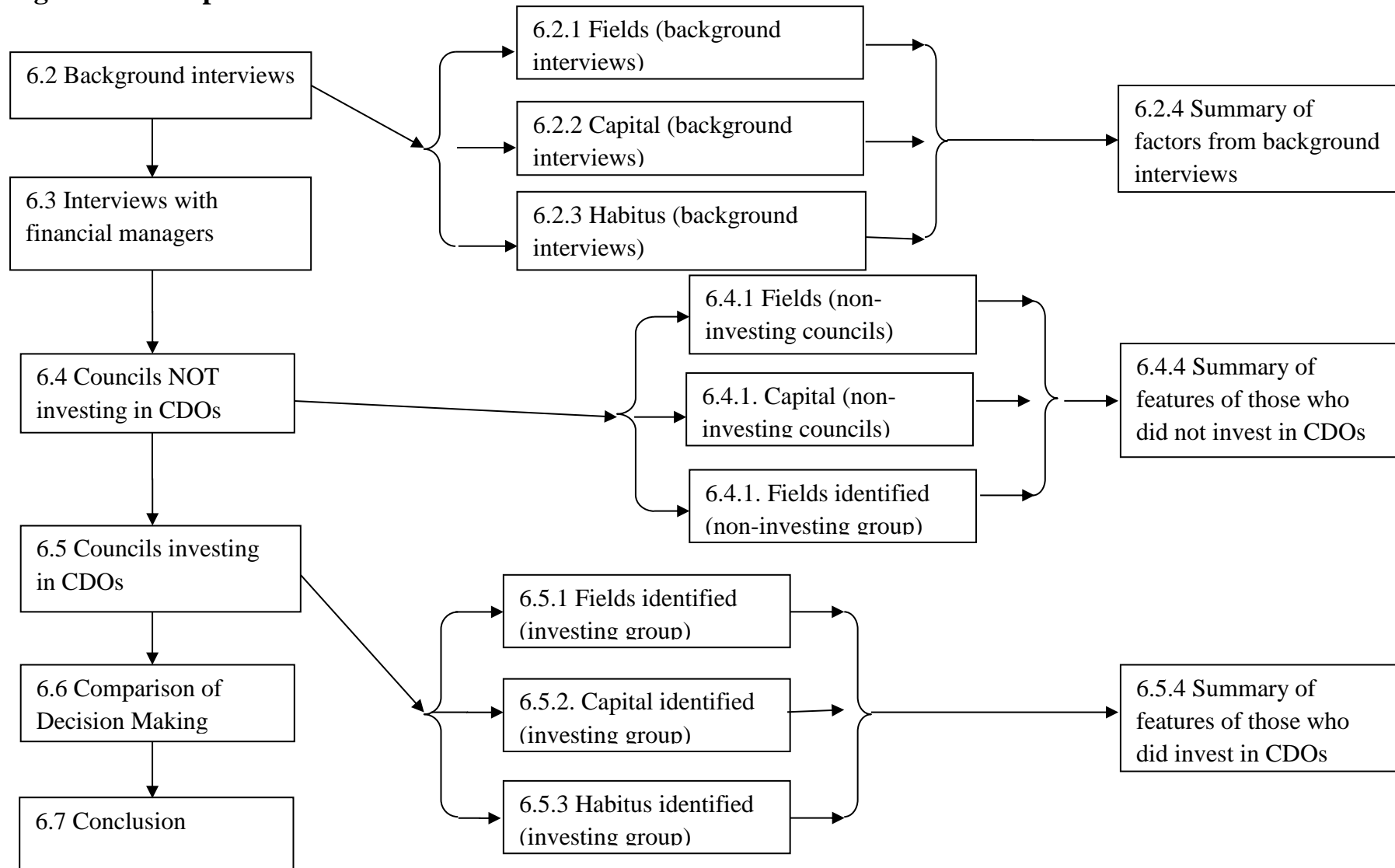


Figure 6.2: Chapter 6 Outline



6.2 Background Interviews

The first participant group consisted of three individuals who could impart knowledge of the setting in which local councils function. The purpose of these interviews was to gather background information about the practices, policies, knowledge and skills required by NSW LGAs to be able to manage financial investments. The first participant was an audit director (AD) of one of the big four accounting firm who was responsible for the audit of more than twenty NSW local councils. This participant had intimate knowledge of the investment decision-making process within local councils and experience with their practices. The second participant was an investment advisor (IA) who provided investment advisory services to a number of councils, accounting firms and law firms. The goal of this interview was to obtain information about investment practices and influences that affect investment decisions. This individual came from a structured finance background; incorporating both tax based and leveraged leasing. He explained his role as follows:-

I switched from being a product person packaging deals 20 some years ago and set up my own business and acting as an advisor. We advise all the major accounting firms, all the major legal firms a lot of corporates and quite a few councils (IA).

The third participant from this group was a former town clerk (TC) who had been in charge of financial investments for a large metropolitan council during the 1980s. This participant was able to present an historical context to the investment process and the manner in which similar products were marketed within local councils. The primary purpose of this interview was to develop an understanding of the investment practices during the 1980s. The secondary purpose was to determine if there were similar practices to current and if there were events which occurred during that period which might have an influence on current practices, or on the habitus of local councils.

These interviews supplied information that demonstrated a range of issues that needed to be considered when identifying the factors able to influence investment decision-making. The interviews were initially analysed using wordle (Fienburg

2011), with the purpose of developing a cloud image of the key words used by each individual, to see if common themes emerged. Individual results were very similar and hence a combined analysis was performed with the results represented in Figure 6.3.

Figure 6.3: Cloud Analysis of Themes: Background Interviews



While a cloud analysis is a blunt instrument, due to the dependence on the frequency of words used, it provided an initial level of analysis that generated themes of investigation. Common generic terms were eliminated to reduce clutter and to establish the primary concerns of the participants. General themes of enquiry that were identified from this analysis related to the DLG, the *1993 Local Government Act*, organisational history, marketing of the products, policy, Minister's orders, bank failures and product ratings. Three main themes were developed from this analysis. Those themes are governance, financial products and support networks. Within each of the main themes a number of sub-themes were identified. Table 6.2 identifies which of the three participants were concerned with each of these aspects. Since the themes encompassed multiple Bourdieuan categories, the analysis of the interviews was able to consider these intersections. For example it was possible to recognise that capital vested in an individual was a result of the habitus of the organisation.

Table: 6.2 Analysis of Themes Background Interviews

Themes	Categories		
	Fields	Capital	Habitus
Minister's Orders	AD		
DLG	IA		
Marketing	AD, IA, TC		
Halo Effect	IA, TC		
Community	IA		
Autonomy		IA, TC	IA, TC
Investment Advice		IA, TC	
Motivations			TC, AD, IA
Risk			IA, TC

Note Audit Director (AD), Investment Advisor (IA), Town Clerk (TC)

Using these themes as background, the interviews were further analysed and the following sections discuss the findings under the various Bourdieuan categories: fields, capital and habitus. The remainder of the chapter discusses these findings

6.2.1 Fields (Background Interviews)

Fields are metaphors for spaces in which to identify themes such as the practices and values within local councils. Fields are networks of interacting relationships and systems. The themes related to fields which have been identified from the background interview have been separated into three main themes of governance, financial products and social networks. Those main themes have been further divided into sub-themes to describe the events. The following sections describe those related to governance of investment decisions.

6.2.1.1 Governance

Under the first main theme of governance, two sub-themes have been identified. They are the Minister's orders and the DLG. These were able to exert influence over the way investment decisions were governed and controlled within local councils. These represented a critical element in the decision-making process. The manner in which they exerted influence is discussed in the following sections.

Minister's Orders

As previously described in Chapter, 5 the Minister's investment orders stipulated the types of products in which councils were permitted to invest. Inadequacies were identified by the audit partner and the investment advisor in both the investment orders and the manner in which the DLG provided interpretations of those orders. These interviews also presented an historical perspective of NSW local council investments and possible reasons for LGAs choosing to invest, or not invest, in CDOs. The audit director highlighted problems with the Minister's orders and the manner in which they were interpreted stating that "the Minister's order contained some elements in it that were very inconsistent". The primary problem identified by AD related to the fact that "they could invest in any institution [with the appropriate credit rating],.....even if the credit rating of the product was D, because they were being issued by a company or an institution that had a credit rating above the required level".

Department of Local Government (DLG)

The second theme concerned the DLG which disseminated information from the Ministry, such as Minister's orders and circulars, to councils. The investment advisor suggested that this body lacked the skills and knowledge necessary to provide advice on such a complicated product as CDOs. Evaluating the risk of CDOs was left in the hands of the respective councils. The investment advisor believed that the DLG was a field that was incapable of supervising investment products such as CDOs. The following quote is a demonstration of that perception.

They [the DLG] were just not qualified to evaluate CDOs. Councils are not qualified to assess this. They are not even qualified to assess risk within their own municipality,

they lose money on deals, and they can't assess development risk. How could they expect to develop risk assessment on structured products produced by some of the smartest guys in the world. The Department of Local Government just aren't qualified well enough ... to make policy issues and they get influenced by product producers. They get seduced by the product providers who come in with a triple A rated product (IA).

The audit director was also dismissive of the efforts of the DLG stating that “a number of people pointed this out to the division of local government that actually administers these things and they did not do anything about it” (AD). Being allowed to invest in non-rated products, because of the rating of the institution, meant that councils could use this discrepancy as justification for their investment decisions. This practice was highlighted by the audit director, stating that “councils relied on the fact that it didn't have to be rated and used that as justification for buying the investments” (AD). The Minister's orders by virtue of the authority associated with them carried substantial capital, however the ambiguity associated with them meant that the capital was diminished.

From a Bourdieuan perspective, this demonstrated that fields which may be considered to be amongst the most influential, such as Treasury and the DLG, were providing information, which contained errors, which then created a situation that required councils to develop their own interpretation of the Minister's orders. This demonstrated that the DLG had been acting in a reactive rather than proactive manner. This also placed the onus on individual councils to ensure that they understood the ramifications of their investment decisions.

6.2.1.2 Financial Products

This section identifies and describes the sub-theme within the main theme of financial products developed from the background interviews. The sub-theme identified marketing as a field able to influence investment practices. This is described in the following section.

Marketing

The marketing of CDOs, was conducted in a systematic manner involving using high profile personalities, experts, and coercion. When discussing why some LGAs had, or had not, invested in CDOs, the audit director proposed a number of factors that may have influenced the decision making process. These included advice not to invest, limited information about the products coming from the sellers of the products, the level of trust council officers had in the promoters of the products, and requirements to understand the risk of the products. The audit director pointed out that some clients invested in CDOs even after advice not to do so such as “it’s your decision you can buy them but they’re too risky but the risk involved doesn’t warrant the return you’re getting”. The audit director also explained that understanding of CDOs was limited and the markets did not disclose all the information about the products. The following quote highlighted the audit director’s view:

I don’t think they pointed out all the characteristic or what a CDO really was, particularly the fact that it had a credit derivative component, which meant you were insuring someone else’s risks. Very few of the people who bought them understand them, and I don’t think they understood the principal that if you had names within the CDO that collapsed, that weren’t able to pay up, then the council may be asked to make up the difference, which is essentially, what ended up happening (AD).

The marketing practices used by sellers of CDOs had similarities to marketing practices used previously. This historical perspective demonstrated that high pressure selling was something that had been around for many years and was adopted by marketers of CDOs. This was highlighted by the town clerk (TC) who was concerned about the high-pressure selling techniques employed by salespersons from both the banking (particularly Nugan Hand Bank) and insurance industries. These techniques included using sporting personalities and former individuals from within the industry to make use of networks, as well as offering higher returns and approaching senior members of the councils to create pressure. Examples provided by the town clerk included using “former rugby league players, or ... one of the insurance companies used a retired town clerk. He was a ... former president of the town clerk society” to market insurance to councils. Another example related to the marketing practices of

merchant banks “they were very competitive because they were up against the bigger more stable major banks” (TC).

The selling techniques used by Nugan Hand Bank were to use external agents as a mechanism to influence decisions. The practice of employing salespersons who had worked in the same business or social community was a tool to make use of established networks and encourage trust in the products. These were contrivances, designed to influence the existing council habitus and encourage investment.

The investment advisor commented that the high commission paid to marketers of CDOs was an indicator that the products incorporated high-risk elements. This view was demonstrated by the comments that;

advisors were pulling commissions of 3 or 4% ... that is a sure sign to someone in my business that there is something more to this than meets the eye. As soon as there was a default down at the bottom of the thing then the whole thing stepped down. Implicitly investors were taking last cab of the rank even though they were saying you were at the top of the pile (IA).

When discussing those councils who did invest in CDOs, the audit director provided a number of insights to explain what the possible motivations and the types of marketing pressure to which the finance officers were being subjected. The audit director suggested that “they trusted these people and [council officers] just believed whatever they told them”. The audit director also adamantly expressed the opinion that the marketing techniques used by the promoters of CDOs were very aggressive and thus a number of individuals were pressured to invest in CDOs. Examples included suggestions to the finance managers that CDOs “can give you better returns than what you are getting. If the finance manager wasn’t cooperative, [Marketer] would then go to the director above him, if he wasn’t cooperative, [Marketer] would go to the general manager and if the general manager wasn’t cooperative [Marketer] would go to the Mayor. Another factor that the audit partner felt was significant was the lack of financial knowledge when it came to investing in sophisticated derivative products such as CDOs combined with a reliance on relationships developed with the promoters of the products. The audit director proposed that:

councils didn't really understand what a CDO was. They didn't understand credit derivatives were involved, [councils] were not just buying a fixed security they were also insuring someone else against default by some of their ... councils didn't really understand the nature of the products they were buying (AD)

All the background interviews revealed information about how these types of products were marketed. They mentioned how councils were seduced into buying via a number of mechanisms. Other selling techniques involved suggestions that council officers were being negligent in not getting the best available returns, going to people higher within the council, and using the fact that other councils had invested as a tool to encourage investment. The investment advisor suggested that councils "would get seduced" by the marketing spiel.

6.2.1.3 Support Networks

The local council community is a relatively small business sector. Being a small group it allows the opportunity for communication between councils and development of knowledge from the experiences of others. There were two themes identified from the fields related to support networks. These are the halo effect and community and are described in the following sections.

Halo Effect

The halo effect relates to the way councils could have their investment practices influenced by the actions of other councils. If larger councils, whose practices were respected by other councils, invested in CDOs then there was potential for marketers to use that as support to promote their products and encourage others to invest. The investment advisor placed particularly high importance on the halo effect, suggesting that the promoters of CDOs focused their attention on the larger councils knowing that if they could get them involved then there would be a flow on effect from smaller councils "once one person does it, then that becomes 5 then 10 then 20" (IA).

This was an indication that the fields, as described by Bourdieu, were able to influence the making of investment decisions. While positive information was flowing easily from council to council (field to field), due to the lack of competition between councils, the reverse did not work as well. Negative

information was restricted due to lack of specific knowledge within some fields, and because of the influence by the field occupied by the sellers of the CDO products.

The town clerk also provided examples of how the halo effect influenced councils in the past. The town clerk stated that “it’s just a flow on effect. ... Nugan Hand Bank, they tried to use [the halo effect] as leverage, saying that other councils are doing it so you should be doing it as well” (TC). It was not only the banking industry that used the halo effect to market their products. The town clerk also provided an example of the marketing of insurance to councils suggesting that if bigger councils were using a particular insurance broker then “some smaller ones fall in behind” (TC). The investment suggested that some councils “were dominant and that dominance encouraged other councils to invest’ (IA) proposing that dominance did not necessarily stem from superior knowledge and skills but from their personality and their ability to convince others (IA).

This was also an example of the halo effect where smaller councils would follow the lead of larger councils. The banks trying to market their products would leverage on the fact that larger councils had invested with them. This demonstrated how the fields in which an organisation functions could have an effect on practices. The network of Local councils exchanged information and tended to influence behaviour of individuals.

Community

Local councils operate within their respective communities. They also as a group, function within the wider general community. Community perceptions of the performance of councils have the potential to bring pressure to bear on council operations. Publicity surrounding losses from investments and the perception of poor investment practices has stimulated community interest. There have been recent calls in the press for the state government to take over council investments (West 2012a). These calls have suggested that councils lack the expertise and knowledge to manage financial investments. The investment advisor expressed agreement in the premise that local councils were not capable and did not have the skills to make sound

investment decisions stating that “[Councils] are not qualified to invest their money”. However was more reserved about who should manage the funds, saying that some sections of the state government would have the skills while others may not. The investment advisor expressed the opinion that “Treasury is capable of developing policies, procedures and review processes with far more intellectual rigor applied to them than the councils could possibly apply”. The investment advisor recognised that returns from existing treasury products gave slightly lower returns than councils were getting from most of their existing investments but proposed that that was reasonable as returns are a “reflection of risk and reward. Councils would have saved a lot more money had [a central investment] policy been in place years ago” (IA). The investment advisor expressed firmly his belief that while Treasury would have the relevant expertise to manage a large portfolio, that “the department (DLG) does not have the expertise ... they are verging on incompetence”.

The investment advisor also suggested that the nature of councils, and the fact that they are not competing with each other enhanced the flow of information between councils. This suggested that the lack of competition between councils was another factor that led to increased investment in CDOs. Those individuals were encouraged to invest because other councils had invested in CDOs. If that was the case then the researcher proposed that the reverse should also be true. However, the investment advisor disagreed saying that; “the flow of negative information was not happening, primarily because very few councils understood the product enough to be able to effectively argue about the negative components of CDOs” (IA). Sellers of the products were actively ensuring that only positive information was being disseminated and there was “reluctance by finance officers to be seen as having made poor decisions” (IA).

6.2.2 Capital (Background Interviews)

The second Bourdieuan category, capital relates to the influence that an individual or organisation is able to wield. This influence may be by virtue of the position held, perceived expert knowledge, respect, force of personality, or even availability or command of resources and skills. The following sections highlight the types of capital themes identified from the background interviews. These themes have been

subdivided into the main themes of governance, financial products and support networks and further sub-divided into sub-themes. These are identified and explained in the following sections.

6.2.2.1 Governance

Within this section governance refers to the theme that showed the influence of capital on investment decisions identified from the background interviews. This theme was autonomy and related to how much autonomy was permitted to the councils and those making the investment decisions. The historical perspective related by the town clerk demonstrated previous practices. These practices placed a large level of authority in the hands of the person in charge of investments. References to the marketing practices of Nugan Hand Bank provided a demonstration of the capital vested in the role of town clerk.

Autonomy

In the context of these interviews, autonomy refers to the level of freedom to make investment decisions delegated to the individual finance managers and investment officers. The town clerk provided a historical perspective and highlighted the level of supervision and oversight of investment decisions by management during the 1980s. The town clerk declared that previously there had been limited oversight of investments, and thus the habitus of the organisation allowed a great deal of autonomy for the person in charge of the investment portfolio. The assumption by management was that the person in the investment role would do their job with limited oversight. The town clerk was “in charge of [councils] investment portfolios ... decide where the money was going ... and was given not a lot of scrutiny by the organisation despite a fairly substantial amount of money. While there was reporting made to the general manager and council it was “just standard it would just go through no questions asked”.

The habitus of this council allowed the town clerk to make investments with limited oversight. This level of individual autonomy vested the town clerk with a high level of capital. The presumption was that town clerk had the necessary skills to make proper investment decisions and would act in the best interests of the council.

The town clerk reminisced about the period when Nugan Hand Bank began targeting councils as a source of investment funds. Emphasising that “there was very little interest on council’s investment, in the council portfolio on the part of the elected councillor’s” (TC). He provided an example of when a councillor’s interest in the investment portfolio was stimulated when a friend involved in Nugan Hand Bank approached the councillor. As a result of that relationship the councillor proposed that the council should “be investing in this great bank called Nugan Hand Bank” and provided reasoning that “other councils were investing with them, [ZZZ] council for example and we should be investing with them as well” (TC). The town clerk was uncomfortable with this approach and had reservations about whether there were any benefits to be gained from investing with Nugan Hand Bank and decided not to enter into any business with them. This demonstrated that even when there were significant levels of pressure from individuals within the council, the capital vested in the position of town clerk was sufficient for the town clerk to resist and make decisions in the best interests of the council.

6.2.2.2 Financial Products

This section describes the theme identified from the background interviews associate with capital. This theme is investment advice and is explained in the following section.

Investment Advice

In the context of these interviews investment advisors relate to individuals external to the organisation that the individual making investment decisions sought advice from. The town clerk explained there needed to be “a relationship and an element of trust” for this to work. Advisors have capital due to their expert knowledge of the area and availability of information. The investment advisor stated that Standards and Poors provided “a CDO evaluator. This was available for people acting as advisors to download” (IA), however for councils to be willing to listen to that advice the advisor needed to command respect and trust. As explained by the investment advisor, even councils to which he gave advice not to invest in CDOs still did so. The reason provided by the investment advisor for giving advice not to investing in CDOs was

that the products were too complicated, however several of the councils that received this advice believed that they understood the product due to the explanations they were provided with from the sellers of the products. This demonstrated that those council officers trusted the seller's product description more than the advice from the independent advisor.

6.2.3 Habitus (Background Interviews)

The background interviews provided an explanation of the set of dispositions within the culture which tends to shape practice. The habitus is the culmination of past events, knowledge and behaviour that serve to influence behaviour in the present. The themes identified from the background interviews have been grouped under the main themes of governance, financial products and support networks and are explained in the following sections.

6.2.3.1 Governance

The themes related to governance have been separated into three sub-themes of autonomy, motivation and risk. These three themes serve to demonstrate how each of them influenced the habitus of the councils and those responsible for making investment decisions. Descriptions of the events surrounding Nugan Hand Bank served to create a particular habitus in some councils, therefore some explanation of those events and their influence on the habitus of councils and council officers is provided to explain the effects. That habitus may have changed, however, if personnel who experience the collapse of Nugan Hand Bank were still working in councils when CDOs were being promoted then that corporate history may have permeated through to the habitus surrounding investments in CDOs.

Autonomy

The first of the sub-themes within governance is the level of autonomy experienced within councils. Autonomy includes considering the level of supervision within councils and mechanisms for governing council's actions through the Minister's orders and circulars to councils from the DLG. Established practices within councils determine the levels of autonomy that may be allowed to particular council officers.

The information provided by the town clerk served to set the historical perspective and explain how levels of autonomy may have been established.

The level of expertise required for that role of town clerk was clear, but there was only limited expectation that the individual would have superior investment skills. While the town clerk was responsible for the financial investments, there was no specific requirement for experience or specialist knowledge. Training undertaken by the town clerk included “studying subjects in financial management ... at that time I was qualified”. The statements by the town clerk raised questions about the level of expertise that was required of investment managers, given that there was no specific training in managing investments, and whether the expected skill level had changed in recent years. This also brought attention to the habitus within the councils related to investment practices. It was evident that if there were not sufficient controls or corporate governance (as there was during the 1980s), then the decisions would be directly influenced by the skills and knowledge of the investment manager.

The structure in the council where the town clerk worked allowed for oversight by the general manager but in practice, unless there was a problem the town clerk was able to make investment decisions and then just report the results. Prior to the events surrounding the collapse of Nugan Hand Bank, the town clerk believed that “investment was pretty much a low level of importance....rarely was there any interest shown on the part of the councillors”. Subsequent to Nugan Hand Bank collapse, there was additional interest given to investment practices and “investment reports got more scrutiny”. This could have provided direction for the way that CDOs were evaluated.

The corporate governance practice of local councils has an influence on the habitus of the organisation. The investment advisor suggested that some councils believed that complying with the Ministerial investment orders was sufficient to discharge their corporate governance requirements. The investment advisor stated that:

Councils are highly regulated... the department initially they set the guidelines and regulate what councils can and can't do. [DLG] set up a policy that says [councils] can invest in AAA, AA, or A+ then that is ok. Then councils rubber stamp it....they didn't have to think about it.

Problems with CDOs were not universal to all Australian States “In Queensland investments go through QTC [Queensland Treasury Corporation] they did not have the problem” (IA). Changes to the Ministers investment order such as including removal of reference to the *Trustees Act 1925* was a “policy failure” (IA), and the introduction of “prudent person arrangements didn’t help much, they are too vague” (IA).

Similarly, the investment advisor suggested that if the individuals in authority had knowledge of the Minister’s orders that existed prior to and immediately after the introduction of the *1993 Local Government Act*, then they was more likely to have an established habitus that would encompass aspects of the *Trustees Act 1925*. That habitus would have included the primary concern for the preservation of capital, which would also suggest reasons for councils adopting a conservative habitus. When the *1993 Local Government Act* was written it incorporated capital protection, however as described by the investment advisor “people came in and developed products to circumvent the spirit of what the act was trying to achieve” resulting in the governance and control of investments failing to be managed in the spirit of the legislation.

Motivation

The analysis of the interviews suggested that the second theme, motivation, sat within the habitus field. When discussing whether councils should have been investing in CDOs the investment advisor was adamant that they should not, citing a number of reasons. These included primarily concerns expressed about taking on risk and that risky investment should not be included in local council portfolios as they did not have the skills needed because “they are not fund managers” (IA). There was also the proposal that as public funds were being used capital protection should be paramount as “Council money is ratepayer and developer money and grants money and it is very special, it has to be protected” (IA). Additionally, the investment advisor explained that CDOs evolved from the “initial CDOs ... [which] were set up as a product where banks could package risks in physical transactions. They were fine. [when CDOs] ... became synthetic things changed. It was the replication of debt”. The investment advisor believed they were far too complicated a product for

anyone other than experienced derivative investors. The product raised a number of alarms for him due to its complexity and the commissions being paid to agents selling the CDOs. Thus the investment advisor actively argued against council involvement in CDOs.

The background interviews provided information in relation to historical factors, which may have influenced the decision-making process within councils. One of these factors related to previous bank failures, which had resulted in councils sustaining losses. A second factor was the feeling that promoters of financial instruments developed products which met the requirements of the Minister's orders if not the intent.

From a Bourdieuan perspective, this demonstrated that if the councils' corporate history encompassed losses during the period of Nugan Hand Bank, or if individuals who were around in the period when Nugan Hand Bank operated then the councils were likely to have a more conservative approach to investments. For councils whose officers were in positions to influence decision making, who experienced the events of that period, the influence of previous bank failures was potentially able to create a habitus that would require capital protection and be of a conservative nature. Therefore it is appropriate to briefly consider the collapse of the Nugan Hand Bank.

During the 1980s the Nugan Hand Bank emerged onto the market. The recollections of the Town Clerk provided an understanding of that time and the methods Nugan Hand Bank used to attract investors.

Following the collapse of the Nugan Hand Bank there was a royal commission into their actions. Part of the inquiry was old local government investmentsand the recommendations coming out of the commission was that councils should only invest in debt securities which were secured and which were paying secured interests returns (IA)

The economic conditions prevailing during the 1980s may have been a factor reducing oversight, as it was relatively easy to achieve good returns without pursuing high-risk investments, characterised by "high interest rates and high competition" (TC). Thus the economic climate influenced the habitus and promoted the idea that

high returns from investment were the norm. This had the effect of encouraging speculative investment.

Risk

There is an element of risk associated with any investments and this is the third field identified in the field of habitus. Councils were required to develop their own willingness to accept the trade-off between risk and reward. Council officers' perception of risk was influenced by the habitus within the organisation. The risk of investments related to the risk of loss of capital and the risk that returns may be reduced or non-existent. One factor that the investment advisor focused on was the acceptance and understanding of risk in relation to investments. Citing one council as an example, the investment advisor demonstrated that successful investments encouraged risk taking and that some councils actively pursued returns with little consideration of the associated risk:

Council [YYY] invested in [a property trust] because it had a rating. That was dumb. They got lucky with the equity market it wasn't a credit product and TPG carries a rating for its own borrowing, it is not a rated entity and they got legal advice that this was a qualifying investment. The entity was rated as a borrower it does not mean that the entity itself was rated. ... They approached the Department of Local Government and they told them to make up their own mind (IA).

The investment advisor was also critical of practices where the true results of investment were hidden within the financial reports, via the amalgamation of figures. He believed that the investment officers were trying to distance themselves from taking responsibility, and provided an example of the practices of one council stating that:

Council [YYY] had CDOs and while the net result was ... they only lost a few [CDOs] in terms of capital, they also didn't get returns on their investment and they seem to think that that is acceptable. I think they buried their lack of returns though reasonable investment elsewhere, which meant that overall it, didn't look too bad (IA).

From a Bourdieuan perspective, this demonstrated that the habitus of a council was a major contributor to the types of investment decisions they were likely to make.

When a council made good returns they were willing to disclose that information, however when they had losses the information related to returns on investments ended up being consolidated and effectively hidden from external scrutiny.

The investment advisor confirmed that there was a significant amount of confusion about the products. These were long-term investments, which were sold as tradable commodities. Analysing the risk behind CDOs was very difficult and from a risk perspective there were aspects which should have caused alarm for investors. The investment advisor believed that CDOs “looked suspect from the beginning” stating that they lacked transparency and were structured in ways that prevented analysis of the counter parties. While CDOs offered higher returns they also provided exorbitant commissions to the promoters of them, far in excess of the industry norms.

When asked if consideration of risk was a part of the investment process the Town Clerk acknowledged that this was “not on the radar at that time”. As risk was not one of the factors the town clerk considered when making investment decisions there was no suggestion that banks and other established financial institutions should be questioned about risk associated with products being offered. There was an element of comfort in dealing with institutions where business had already been conducted.

When considering investment product the town clerk placed a significant reliance on established relationships and the trust developed with particular providers. While face to face dealing with investment providers were not normal the town clerk would on a day to day basis have phone communications. This contact served to establish relationships and an element of trust. One reason the town clerk decided not to invest in Nugan Hand Bank related to the fact that there had been no prior dealings or developed trust. Willingness to accept risk is influenced by the habitus, so in the case of the town clerk, the decision not to invest with Nugan Hand Bank directly related to how comfortable the town clerk was with the relationship. In this case the habitus of the organisation did not encourage seeking new relationships while the existing investment providers were proving satisfactory.

6.2.4 Summary of Influencing Factors (Background Interviews)

The background interviews provided information about factors that might influence investment decision-making practices. Five of the most significant factors have been summarised in this section.

The first factor was that previous experiences such as failed investments, or institutions that had failed would have created an institutional history and experience that was capable of influencing current behaviour. The example of the Nugan Hand Bank failure and the subsequent losses experienced by NSW Local Councils would have influenced the habitus and created an environment in which investors would seek to minimise risk. However, this clearly depended on the institutional memory of those events. If the individuals who had experienced the events were no longer within the organisation then that corporate history, and memory of those events, was much less likely to influence present actions.

Secondly, both past and present investment policies may also have influenced investment decision-making practices. The Ministerial investment policy and guidelines in place at the time of the decision to invest in CDOs provided a restriction on the types of investment. However, as previously demonstrated these guidelines changed over time. Reference to the *Trustees Act 1925* was removed from the *1993 Local Government Act*, but there would have been individuals still in place who remembered that restriction. This was demonstrated by the fact that some of the individual council investment policies still reference the *Trustees Act 1925*. That corporate memory helped to develop a habitus of conservatism and concern for protection of capital.

The third factor that became apparent was the influence of the aggressive marketing practices. These practices were not only restricted to the finance industry but also were evident in other industries dealing with local councils such as the insurance industry. While the pressure applied from the marketing personnel, including the use of well known sporting personalities, created a level of distrust, the use of well-known identities from within the local government sector had the effect of generating trust.

The fourth factor influencing investment decision-making practice was recognition of risk. The skills of the finance officers needed to be sufficient to identify and understand the risk associated with particular products. The investment advisor suggested that local council officers did not display these skills and that those individuals who did possess the high level skills would be more likely to seek employment in the much more lucrative private sector. There was evidence that CDOs gave excessive returns (greater than the industry norms) and high commissions were being paid to the sellers of CDOs. The financial advisor suggested that this should have served as a warning about the inherent risk of the CDO type of products.

The fifth factor identified was the influence of the prevailing economic conditions. In times of high returns and growth (such as during the early to mid-2000s), the investment manager's job was relatively easy and the level of oversight reduced. During this time investment returns were improving, and the expectation was that councils were able to achieve high rates. This may have provided an environment (*habitus*) which reduced the recognisable warning signals when larger than expected returns were offered.

The final factor that arose from these interviews was related to the influence that the behaviour of one council could have on another. The halo effect was mentioned suggesting that some councils may have been influenced by other councils who invested in CDOs. This would have applied if they had respect for the expertise of the other council, or if the other council was perceived as a leader in the field. This particularly related to larger councils, as they were perceived as having additional resources and were therefore more likely to have capacity to recruit finance officers with the necessary skills.

The following sections focus on the interviews conducted with the finance officers. These interviews were conducted to gain their perspective of how investment decisions were made. These interviews provided a lens into the decision making process and the influences that were involved in that process. A Bourdieuan lens was applied to these interviews to identify aspects highlighted by analysis of Bourdieu's categories of fields, capital and *habitus* as discussed in chapter 2. These

included the fields that influenced the financial decisions, the habitus in which those decisions were made, the way in which the habitus was affected by others, and the capital that particular individuals and fields were able to wield.

6.3 Interviews with Council Officers

Interviews were conducted with two groups of finance officers from metropolitan councils, and an obvious separation between those councils who chose to invest in CDOs, and those who did not. There was existed also a distinction, although less clear, found within the group of councils who did invest in CDOs. Some chose to invest in CDOs after extensive investigation of the products and made informed decisions. They were also aware that there was an element of risks associated with CDOs, while some councils made the decision to invest with low levels of information. The level of awareness of risk varied across councils. Some councils were pursuing the greater returns provided by CDOs and had only limited understanding of the associated risks, while other councils appeared willing to accept the risks associated with these products to achieve higher returns.

The first interview group provided background information with respect to local government and the subsequent analysis was presented in the previous section. The second participant group involved interviewing finance officers of three metropolitan councils where the decision was made to not invest in CDOs. In some cases, the interviewees included other council officers who were involved in investment decisions. This group indicated reasons that they chose not to invest as well as an overview of their respective council's practices. The third participant group included council officers from four metropolitan councils which invested in CDOs. They had divergent views of the risks associated with these products and varied in their willingness to accept risks. There was also a range of mechanisms underlying the investment decisions.

The following subsections provide an analysis of the interviews and distinguish between the second and third participant groups to demonstrate how the investment decision-making varied. While there were a number of common factors identified, the various councils viewed the same factors in different ways.

6.4 Non-Investing Councils

Personnel were interviewed from three metropolitan councils that did not to invest in CDOs. A cloud analysis of each of these interviews was performed but there were very few apparent differences between them. The following Figure 6.4 is the cloud analysis of the three combined interviews, which provided an overview of the focus for their responses.

Figure 6.4: Combined Cloud Analysis of the Interviews Non Investing Councils



This analysis revealed terms which were considered when analysing the interviews. These included the repeated terms of conservative, government, policy, guidelines, rate and capital. These terms provided a starting point for analysis of the interviews. The analysis revealed a number of particular characteristics within these three councils, which either explained the existing habitus, or demonstrated influences on the habitus of the organisations. These included the level of autonomy available to the finance officers and the use of investment advice as well as the acceptance and recognition of risk as summarised in Table 6.3.

Table 6.3 Analysis of Themes Non Investing Councils

Themes	Categories		
	Fields	Capital	Habitus
Minister's Orders	C1, C2		C3
DLG	C1, C2, C3	C3	
Finance Professionals Group	C2, C3		
Community	C1, C2, C3		
Ratings	C1, C2, C3		C1, C2, C3
Investment Advice	C1, C2, C3		
Marketing	C2, C3	C3	
Autonomy		C2, C3	C1, C2, C3
Risk			C1, C2, C3

Note: Council 1 (C1), Council 2 (C2), Council 3 (C3)

The following section explains both, the common factors within these councils and areas of difference between them. Categories from Bourdieu's *Theory of Practice* as discussed in chapter 2 have been used to segregate these factors. The first of these categories "fields" is analysed in the following section.

6.4.1 Fields (Non-investing Councils)

Analysis of the interviews with officers from non-investing councils revealed that there were seven distinct themes which emerged as relevant to Bourdieu's category of fields. These themes have been grouped under the main themes of governance, financial products and support networks and have been described in the following sections.

6.4.1.1 Governance

The interviews with council officers from councils who did not invest in CDOs identified two themes related to governance that influenced investment decision-

making within Bourdieu's category of "fields". The two themes were Minister's orders and the DLG. These are discussed in the following sections.

Minister's Orders

As discussed earlier the overarching policy which councils were required to comply was founded on the Minister's orders controlling investments by NSW councils. While this policy provided the benchmark, councils were also required to establish individual investment policies within their own councils. The respective council policies could not go beyond what was stipulated by the Minister, but they could adopt a more conservative approach if they desired.

The interviews with finance officers showed that the policies within each of these councils varied, and generally allowed more aggressive investing than that in which these councils engaged. Amendments to the *1993 Local Government Act* meant that "we did change our policy slightly" (C2). It was evident that the ministerial guidelines formed a base for their investment decisions, and that they formed their respective policies around them. Mention was made of how the local government investment services lost money "local government superannuation they lost a lot of money in CDOs" (C2 FM). It was apparent that these councils viewed the actions of that body as irresponsible and "because of their investment record we stopped investing money with them, even though the policy it allows it" (C2). This provided an example of a council restricting use of an allowed investment because they had concerns about how that particular investment performed. One council did take on higher risk products (Managed funds), primarily due to them being allowed under the ministerial guidelines, however, they refused to invest in CDOs. The primary reason for not investing in CDOs was because they had difficulty understanding the product and what the risk associated with them was. This lack of understanding increased the perception of risk to an unacceptable level for this council officer.

These councils took a conservative approach to investment and ranked themselves as "more conservative than other councils" (C2). They judged the quality to their investment performance based on how they compared to the BBSW (Bank Bill Swap rates). One council explained their investment performance by saying that with the

BBSW running at 4.98% that their “performance last year of 6.75%” (C1) was a reflection that even a conservative approach could get good returns. These returns were achieved while following the ministerial guidelines but avoiding investments where the capital was placed at risk, “capital protection was important rather than going for that extra 1-2 %” (C1 FM). The emphasis for this council officer was that the investment portfolio belonged to the community and therefore they assessed their investment decisions against the level of risk they believed the community would be comfortable with. The key feature of councils in this group was that they treated their investment portfolios as though it was community property and needed to be protected.

Department of Local Government (DLG)

The DLG is the government body to who the NSW councils are required to report. As described in earlier chapters the DLG provided circulars to councils offering guidance on investments and disseminate the Minister’s orders governing investments by NSW LGAs (DLG 2006; DLG 2009a). This section shows council officer’s perceptions of actions by the DLG and the value of advice provided.

It was evident from analysis of these interviews that these council officers lacked confidence in the DLG’s ability to give responsible and accurate advice. They also believed that what advice was forth coming was ambiguous “the Department of Local Government ... they don’t prescribe exactly what they want ... they won’t commit” (C2). There was a perception that the DLG was more interested in preserving their own position and could not be relied upon to extend opinions for which they may be later blamed. These council officers explained that the DLG passed the responsibility to understand these products back to the respective councils saying that the DLG when asked for an opinion would say councils must “understand the risk and make their own decisions” (C2 FM).

These council officers recognised that they had a lack of skills in financial investment but felt unwilling to trust that the DLG was any more skilled. They felt that the DLG had passed on this responsibility to the independent investment advisors “knowing that many councils had external advisors” (C2). They felt that

when the DLG added “CDOs within their [investment] policy ... knowing that council officers are not investment gurus” (C3) that it implied CDOs fell within the prudent person definition. They felt the DLG needed to take some responsibility for the resulting problems following the collapse of the market for CDOs. From a Bourdieuan perspective this field had the capacity to influence investment practices but chose to abdicate the capital that the field had the capacity to command.

6.4.1.2 Financial Products

Within the fields related to councils who did not invest in CDOs there were three themes identified from the interviews grouped under financial products. These sub-themes relate to the manner in which CDOs were understood, explained, promoted and valued. These sub-themes are analysed in the following sections.

Investment Advice

Some councils had independent investment advisors; this section highlights whether the councils who did not invest in CDOs used independent advice and how much they relied on that advice. It was well known that Grange was in the business of selling CDOs while at the same time were providing investment services. Grange were also trying to take over whole investment portfolios and to manage them, principally by investing in CDOs. While CDOs were one of the financial instruments that collapsed during the GFC, there were other products such as managed funds that the DLG subsequently decided also represented too high a risk. Some councils may have not invested in CDOs but may have had other products which were later perceived to be high risk.

Investment advisors played an important role in the decisions by these councils not to invest in CDOs. This field was able to influence the decision-making process by virtue of their expert and product specific knowledge. Even though councils were not committed to abide by the advice given, a high level of trust had been developed between these councils and their advisors, resulting in council officers being reluctant to ignore that advice. One example given was that “we used Grove Financial advisors and they were quite good they didn’t advise us to go into anything risky” (C2 FM). The comment from another council officer was that we “rarely go

against their advice to their credit they said no [to CDOs] from the start” (C3 FO), demonstrated the level of trust placed in some investment advisory firms.

There was evidence of other investment advisors who were both providing investment advice and at the same time selling CDOs. This gave a perception of unprofessionalism, and as is explained in the following quote highlighted concerns about the independence of investment advisors. “Others [investment advisors] came in and it just got a bit out of control. Hence we have moved away from advisors completely” (C2 FM), which resulted in a decline in the level of trust in advisors. The following statement expressed why that trust was diminished, “Some advisors recommended CDOs. Maybe they were on commission” (C3 FO2). Most finance managers readily acknowledged that they did not have the financial investment skills to fully understand the market and the various products that were available and that there was an element of luck in not investing in CDOs. The use of professional investment advisors created an element of security and they were perceived by this group as a mechanism to reduce risk. The reasons for this were that finance officers did not “believe that [they were] financially able or qualified to bypass their [advisors] information” (C3 IO). When the advisors provided assessment of risk such as “too much risk involved in CDOs” (C3 IO) with the finance officers were willing to accept that evaluation. Council 1 discussed investing in CDOs and sought financial advice which they eventually took. They believe that the advice meant they had “dodged a bullet ... we were lucky in some respects” (C1 FM).

Investment advisors, that were truly independent, were a field that exerted a large amount of influence on decisions to invest in CDOs or not. That influence was tempered when the advisors had a vested interest in promoting particular products, but not eliminated.

Marketing

An understanding of how CDOs were marketed and presented to councils was necessary to ascertain how investment decisions may have been influenced. If they were marketed from a security perspective, with guarantees of capital protection, then they would have been more attractive to councils concerned with minimising

risk. Knowledgeable and influential marketers may have provided the impetus to consider taking on these products.

Generally, from the perspective of these councils, the marketing of CDOs was poorly executed. As demonstrated by the following quote the general feeling was that the sellers of the products did not understand CDOs well enough to be able to explain them clearly, “even those trying to sell it didn’t know the full story I blame the sellers of the products” (C2 FM). The way that CDOs were explain left some council officers confused, “ I found them very difficult to understand they were talking about tranches ... a bucket of companies ... I couldn’t understand them. There was a real chance of capital loss” (C2 FM).

There was also a perception that the promoters were more concerned with their commissions than they were with meeting the needs of the clients. There was a perception that the marketers focused on the profits to be made, for themselves and the councils without fully understanding the products and associated risks. The following quote highlighted some of the concerns of the council officers, “I think [the seller] was looking at their margins ... some councils were quick to jump into bed and saw a return above their BBSW (Bank Bill Swap rate)” (C3 IO).

There were also concerns about the way marketers presented themselves, “they were coming in as though they were an independent advisor” (C3 IO). This type of approach concerned these councils as they recognised that the marketers were trying to portray themselves as experts in the investment arena, while at the same time promoting an investment product that they “couldn’t, or wouldn’t explain well enough” (C3 IO). The marketing field tried to inhabit the investment advisor field as a means of controlling the capital of that field. This ploy worked to a limited extent but these councils became aware of the practice, which made them more cautious.

Ratings

The level of understanding and confidence in ratings provided by the rating agencies had the capacity to influence investment decisions. These three councils all expressed an element of scepticism about the value of ratings issued by the rating agencies “there is an argument over what rating really means” (C1 IO) there were

suggestions that AAA ratings in some cases were not accurate, but they still used ratings as a guide to the security of investments stating that “we use the rating and invest in banks that are rated. But only if they’re AAAs” (C1 FM). They were more concerned about ensuring that the funds were secured by government guarantees, than whether the issuer was rated. Government guarantees meant that these councils were happy to invest with the institution even if it was not rated. They had high levels of trust in the Australian Banking regulations and “oversight of the industry by APRA” (C2 FM) (Australian Prudential Regulatory Authority). Changes to government guarantees of credit unions meant that some of these types of investments “would mean we would look more closely at them” (C2 FM).

One was even willing to invest in non-rated institutions but was concerned about security and government backing of the institution. If the ratings were perceived to be a measure of security then councils may have relied on them as a tool to afford a level of governance. These councils used their investment policies to limit the amount that was invested in lower rated products as a means of limiting losses, the “maximum that we could invest in non-rated or BBB institutions for term deposits things like that it was only 5% of the portfolio” (C3 FM). Product ratings was a field that these councils were concern with, and used in making their investment decisions, but that they were not entirely sure of.

6.4.1.3 Support Networks

Within the councils who did not invest in CDOs there were groups who provided advice and consultation to the council officers. These groups represented fields which influenced investment decisions by helping to reinforce the conservative nature of these councils. The interviews with these councils revealed two groups who did this and they are discussed in the following sections.

Finance Professionals Group

The finance professionals group was a group of council officers working in the role of finance officers from a particular area in NSW. There are approximately four such groups within the state. The researcher’s expectation was that professional groups would have provided a mechanism to discuss investment

products and identify problems with specific types. This type of forum should have provided a system to allow exchange of information throughout the finance managers' networks. These councils admitted only limited influence from the finance professionals group. They were surprised that some councils were influenced by presentation from the sellers of the CDOs at those functions "who were actually sponsoring the financial professionals meeting ... and some councils fell for" (C2). The most important factor for them seemed to be if they could understand and evaluate the products and the underlying risk, stating that "we were conservative, didn't know enough about them ... weren't comfortable ... so we didn't invest" (C3 FM).

While the financial professionals group was a field that did not appear to have a great influence over this group of interviewees. It was partly due to the council officers being uncomfortable with their level of understanding of the products and the information available. The required information that would have encouraged this group of participants to invest in CDOs was not forthcoming from the finance professionals group. These councils were more influenced by the surrounding local government community in which they were involved. The following section describes that relationship.

Community

Local government in NSW is a relatively small community. There are 152 councils across NSW and they communicate with each other either directly or through meeting at conferences and workshops. The following quote demonstrates one perception of the local government community, "Local government is a funny place as everyone talks to each other" (C2), particularly those in close proximity. There are conferences held, at least annually where council officers are able to meet their counterparts from different LGAs, exchange information and develop networks. "We often met with finance managers from other councils and would talk about the market and what was happening" (C1). These networks have the capacity to identify problems and to also influence investment decisions. Some councils, such as the large metropolitan LGAs were perceived to have more skilled and experienced staff, and therefore if they invested in CDOs it may have encouraged others to do so.

However, these councils appeared to have developed a local government community of like-minded organisations. “We liaise with ... counterparts from other councils and the ones that we were dealing with, all had similar views. All conservative, we tend to stick together” (C3 FM). This suggested that they were not as influenced by the larger councils as they were by the councils within their sphere of operations. These councils regularly communicated with each other and were able to see that some other councils were being more aggressive, and more willing to take risks than they were. Having other council officers who were just as conservative to discuss things with was seen as an advantage.

6.4.2 Capital (Non-investing Councils)

Capital was vested in the fields of investment advice, marketing and in the individuals who had the authority to make investment decisions. However, capital was dependent on the respect and trust that these groups and individuals were able to generate. Negative changes to the levels of trust correlated to a reduction in the level of capital either of these fields was able to exert. Therefore investment advisors due to the lack of trust in their independence, due to most of them marketing products while also providing advice meant that these councils did not believe they had sufficient capital to influence decision-making.

6.4.2.1 Governance

The theme that these interviews revealed as having the most capital was the authority vested in the positions within councils. This is discussed in the following section regards autonomy.

Autonomy

The level of oversight and amount of autonomy to make decisions directly influenced the capital that council officers commanded. Positions such as the general manager of the councils automatically contain high capital levels. The level of capital controlled by the finance manager, their ability to make decisions without gaining prior approval varied within this group. This group of council officers felt free to make decisions without consultation if those decisions were within the council

investment policy, “our policy [controls what we can invest in] and I [could make investments] within the policy and no-one would reprimand me” (C2 FM). This particularly related to transactions that could be considered normal, however when the investments were less normal they would seek approval from the general manager. As one officer described when discussing investments outside the norm, “I would go to the general manager and seek approval” (C2 FM). Potentially, the investment decisions could be made by the finance manager and not reviewed if they were given that level of authority “council approves is our policy [The policy] gives us the authority to go and work within the guidelines” (C3 FM). In those cases, it was the nature of the investment manager that was the dominant factor, and that level of independence enhanced their capital. If the decisions were required to be agreed to at a higher level, then capital controlling investment decisions would have resided at that higher level.

Changing the management of NSW council’s investment portfolios to a central investment body would have the effect of removing that capital from the council and council officers and putting it in the hands of the new body. There have been recent reports in the news (West 2012a) suggesting that council investments be transferred to the NSW Treasury in return for treasury bonds. The suggestion was that Treasury should become the banker as the councils lack the “expertise to adequately manage large investment portfolios” (West 2012a), and that “councils are not experienced enough” (C3 FM). The reason for this was outlined as “There is a need for closer scrutiny and control over local government operations, particularly as they involve significant State and Federal Government grants. Control of the investment portfolios is the first step” (West 2012a, p.19). When asked about this sort of proposal, council officers gave little support to the concept.

Council officers argued against central management of investments on the grounds that while suggestions were that “treasury is where the expertise is but they’re the ones who wrote the policy that we worked under” (C3 FO2) and that “they could lose money, they would have, they have more risk capacity but could still invest in CDOs and lose money according to the policy in place (C3 FO1).

One of these councils was particularly reluctant to hand control of their funds to a central body. One of the principal reasons was that they did not view Treasury as competent, or to have the necessary skills to manage their money. There were also concerns that conservative councils (such as them) may end up in investments that did not fit with their risk averse nature. There was much more support for an investment fund which had government guarantees. Such as South Australian councils who “have a local government finance organisation run under the LGAs and they give good market rates and bonuses throughout the year if you invest and borrow with them. And they are government guaranteed” (C3 FO1).

6.4.2.2 Financial Products

Within the theme of financial products there was one sub-theme identified from the analysis of these interviews which related to capital. That was the theme of marketing and it is discussed in the following section.

Marketing

The sellers of the CDOs portrayed themselves as financial advisors but when questioned about the products were unable to provide enough detail about the products. So, while they presented as salesmen they were acting more like investment advisors and this made these councils uncomfortable and did not engender trust “they wanted to take over our whole portfolio” (C3 IO). This with an attempt by the sellers of the CDOs, to portray themselves as imparting expert investment knowledge, instead of presenting themselves as marketers for a product They were trying to be [like our advisors]. Acting like independent advisors” (C3 IO). This purpose was to enhance their capital and use it as a marketing tool.

6.4.3 Habitus (Non-investing Councils)

As previously discussed in chapter 2 habitus refers to the set of dispositions that influence practice and is a result of past events and experiences. The following sections provide an analysis of the habitus factors identified from interviews with council officers from councils who did not invest in CDOs.

6.4.3.1 Governance

The interviews with councils that did not invest in CDOs revealed three sub-themes related to the main theme of governance relevant to the habitus of the councils. The sub-themes identified revealed how these councils perceived risk, how the Minister's orders affected their perception of CDOs and the level of autonomy finance investment officers within councils enjoyed. These are discussed in the following sections.

Risk

This section analyses the nature of the three councils who chose not to invest in CDOs and how they perceived risk. The nature of each the respective councils had the capacity to influence the practice of investment decision-making. If the upper management and the council were accepting of risk, then the likelihood was that the financial officers would take that lead and investigate investments giving higher returns and encompassing higher risk profiles. Alternatively, if the habitus of the council was risk averse then the financial officer would have been likely to focus only on secured investments.

The predominant characteristic of all these councils was that they professed to be of a conservative nature. They viewed the funds with which they were charged with managing as something to be protected for the benefit of the community, and that it belonged to "the ratepayers", it is not our money" (C2 FM).

The conservatism of which they spoke appeared to be organisation wide, from the councillors through to the officers, "we are very conservative, and this comes right from our councillors" (C2 FM). Similar comments were made from another council who stated that "the general psyche is within council that we are there to preserve funds for our ratepayers because we have services that we must continue into the future and we have got to have the money to do that" (C1 IO).

Minister's Orders

Some council officers mentioned the removal of reference to the *1925 Trustees Act* from the *1993 Local Government Act* and while they saw this as a weakening of the

investment requirements imposed by the Minister, they also believed that the intent of the *1925 Trustees Act* was still prevalent (at least in their councils). While reference to the *1925 Trustees Act* had been removed, these councils applied the prudent person rule as meaning the same as protection of capital, stating that “the prudent person clause [in our policy] means that we are prudent in everything that we do ... the idea behind prudence is to ... preserve councils funds and do everything in the best interests of the rate payer” (C1 IO). Particular mention was made of the requirement to act in a prudent manner and they perceived taking risks with public manner as acting contrary to that requirement. The habitus of the councils was such that avoiding risk and preservation of capital was foremost in their minds and an “extra 1-2% was not worth risking the capital” (C1 FM). This view appeared to be motivated by the precept that they were responsible for managing ratepayer’s funds and that taking risks of any sort with other people’s money should be avoided.

From a Bourdieuan perspective, it was evident that the habitus of the field played an important role in dictating the types of investment and acceptance of risk, which could be considered by the finance manager. There was an overwhelming recognition of the precept that the money being invested was not theirs and that they had a responsibility to protect public funds.

Autonomy

This section highlights the levels of oversight and governance of investment decisions within each council. The level of oversight and governance was an indication of the habitus within the council. The predominant characteristic was that the council developed and approved an investment policy, which reflected the council’s willingness to accept risk, stating that what “council approves is our policy. They are the guidelines, which we work within” (C3 FM). The implementation of that policy was left in the hands of the finance manager and general manager and “council officers are left alone and the general manager runs the place (C2 FM). Decisions about “whether to invest ... is with the General Manager and Director. The Finance Manager makes recommendations and reports to the Director who makes the final decision” (C3 FM). In this council the capital was vested in the position of general manager, however, the habitus of the council allowed only limited autonomy.

Investment decisions were often made in conjunction with qualified investment advisors, although they were not bound to take the advice given. Generally, these councils abided by investment advisors advice and the “general manager always signs off on any new investment provided we have [advisor] backing, and assurance to recommend ... the investment (C1 FM).

One interviewee (C3 FM) in describing the council’s current investments suggested that they were boring and vanilla. This demonstrated that this finance manager felt that the current investment portfolio was too safe and lacked excitement. Tone changes when talking about higher returns and better returns indicated a desire for more excitement, and perhaps more aggressive investment policies. The interviewee readily acknowledged their lack of investment skill and knowledge and the need for reassurance and support by independent investment advisors. This individual felt restrained by the policy and appeared to like the excitement of pursuing higher returns nevertheless the structure and habitus of the organisation was sufficient to curb what appeared to be their natural tendencies.

6.4.3.2 Financial Products

Understanding and trust in the validity of mechanisms to value CDOs played an important role in determining the habitus related to financial products. The following section analyses the effect of product ratings on the habitus surrounding the perception of CDOs.

Product Ratings

CDOs are a complex product and this section highlights how they were perceived by the respective councils and how well they thought they understood them. Some capital protected CDOs were available on the market “but if they were underwritten by the Icelandic banks it was a problem when they went down and who could have expected that” (C1 FM). If rates had been the primary factor in making investment decisions then as “[CDOs] were allowed if they were triple A rated” (C1 FO1), it may have been sufficient to encourage councils to invest in them. The primary concern, of these councils, with CDOs was the difficulty in understanding how they worked. The tiering of CDOs created a level of complexity and raised concerns about

the associated risk. Even products that were secured had levels of uncertainty due to the way they were structured, “There was a whole chain of people or companies involved in them. They are all tiered ... we didn’t go near them (C2 FM). The high rates of return raised alarms and some councils decided that “the rates were too attractive to be realistic (C3 FM). These comments demonstrated that these councils did not accept that relying on the product ratings was sufficient protection.

6.4.4 Summary: Features of Non Investing Councils

The previous sections have developed evidence of six main factors that led to these councils choosing not to invest in CDOs. A summary of these main factors is listed below:

Nature of the Organisation: these councils were all conservative. They viewed the funds that they managed as belonging to the community and they saw themselves as trustees of that money. While they report their activities to the DLG they did not see themselves as responsible to the DLG, they felt responsible to the community. They were risk averse and preferred to have investments that were not only capital protected but also government guaranteed.

Governance: All finance managers reported up to the general manager who approved decisions. Investment practices were governed primarily by compliance with the Minister’s orders, and secondly by policies of each council. Those policies had been generated internally, sometimes in consultation with external advisors and then been approved by the councillors. Regular reports were made to council regarding the state of investments.

Investment advice: Most of these council officers relied on advice from investment advisors and credited the advisors with keeping them out of CDOs. Regular contact and flow of information was essential. Investment advisors were seen as having the skills, experience and market knowledge which council officers lacked. Not all advisors were viewed in this manner and the main criteria that was desired was to be able to develop trust in the advisors. Independence was also required and those that provided both investment advice and promoted products were viewed with caution.

Marketing: These councils did not appear to have been heavily influenced by the marketing of CDOs. Their conservative nature provided a level of protection. There were low levels of trust in the sellers and a belief that the people selling the products did not understand them and that they were primarily concerned with the commissions they would get from the sale.

Department of Local Government: They were seen as not being able or willing to provide support in respect to the investment decisions. They were perceived as being unwilling to take a stance so that they could avoid future criticism. The DLG served as a conduit that conveyed the Minister's orders, provided circulars and advice to councils but not as the body from which useful information was generated. These council officers portrayed the DLG as lacking the skills and knowledge to be able to provide investment advice.

Finance Professionals Group: This body did not influence behaviour within these councils, however there was a clear recognition of the importance of the local government community. They were happy to consult with other councils, but were inclined to trust other councils who were of a similar nature to themselves.

6.5 Investing Councils

Approximately half of NSW councils invested in CDOs. The focus of this research is on NSW metropolitan councils and interviews were conducted with council officers from four metropolitan councils who invested in CDOs. The primary council officer involved in investment management was the finance manager, while in one council this also included two other officers, one of which had undertaken specific training to evaluate CDOs. As previously mentioned a cloud analysis was performed of these interviews to gain an overall perspective of the major themes of the interviews, although this was only used as a guide. The following Figure 6.5 shows the cloud analysis of the interviews with the four councils who invested in CDOs.

Figure 6.5: Combined Cloud Analysis of Interviews: Investing Councils



Figure 6.5 demonstrated that these councils focused on the investment portfolios, risk and returns, policy and the influence of government. These themes were further developed in the analysis of the interviews.

The following Table 6.4 highlights which participants provided information in each of the areas discussed during the interviews. Using the tools from Bourdieu's *Theory of Practice*, the following sections explain within the main themes of governance, financial products and support networks, the sub-themes developed from the interviews with council officers of LGAs who chose to invest in CDOs.

Table 6.4: Analysis of Themes (Councils investing)

Themes	Categories		
	Fields	Capital	Habitus
Minister's Orders	C4, C5, C6,		
DLG	C4, C6, C7		
Community	C6		
Finance professionals Group	C6		
Product ratings	C4, C5, C6		
General Manager	C4	C4	
Investment advice	C6, C7	C4, C5, C6 C7	
Autonomy		C4, C5 C6, C7	C4, C5, C6, C7
Motivation			C5, C6, C7
Risk			C4, C5, C6, C7
Marketing			C5, C6, C7

Note Council 4 (C4), Council 5 (C5), Council 6 (C6), Council 7 (C7)

6.5.1 Fields (Investing Councils)

Those councils who invested in CDOs were influenced by a range of different fields. Some councils were more susceptible to influence from external fields than others. This section highlights those fields and demonstrates that the influence of fields was not universal across all councils. This demonstrated that to influence practice, a range of influences, acting in concert is more likely to persuade council officers to make these types of investment decisions. The first main theme discussed is governance and is introduced below.

6.5.1.1 Governance

There were two sub-themes identified from the analysis of interviews with councils that invested in CDOs related to governance within fields. These are discussed in the following sections.

Minister's Orders

The councils who invested in CDOs were consistent in saying that they relied on the Minister's orders and Circulars to Councils. They used the orders as a "mandate ... to give an overriding order for what [could be] invested in" (C4 FM). The orders were a mechanism to establish the types of approved investments, and enabled these councils to feel that they had provided sufficient governance over their investment practices. Ratings were the dominating factor as there were "no restriction on the institution or the type of product that could be invested in, so long as the issuer satisfied the rating criteria" (C5 FM).

One factor that was acknowledged may have restricted an aggressive investment practice was the intent of the *1993 Local Government Act*. The finance manager (C6) mentioned the changes to the act and the removal of any mention of the *Trustees Act 1925*, which had focused on a priority of capital protection. The FM (C6) suggested that older investment officers would remember the existence of that requirement but as time passed less attention was paid to it.

It was not only what the Minister's order specifically mentioned as approved investments, which influenced these councils; it also included the products that were not explicitly excluded. Some councils were adamant that as there was no exclusion of CDOs, then that implied they were an allowed product. While "(CDOs) didn't start evolving until about 2000 ... it was still accepted even though it was not in the 1993 Act that the focus was on capital protection. The Trustees Act was no longer required in the Local Government Act ... protection of capital was a practice for a lot of years" (C5 FM) or at least until CDOs appeared on the market.

Department of Local Government (DLG)

These councils saw the DLG in the role of watchdog, they were aware that the DLG understood that councils were investing in CDOs, however, they lacked confidence in the DLGs ability to understand the products. They lamented the lack of action from the government bodies in providing guidance and seemed to desire clear rules and instructions as to the meaning behind the orders. They suggested that the “DLG had a responsibility, they are a watchdog on local government they are not practitioners ... I don’t believe they knew what was going on. They didn’t come along and say we think this thing is wrong” (C6 FM). There was a perception that the DLG were unwilling to get involved and that councils were being left to make their own assessment of investment products and the associated risks.

The view was the DLG did not want to take responsibility for adverse outcomes and that they may not have had the necessary skills to provide advice. However the DLG did provide provision for “CDOs in their templates ... and they had best practice guidelines out by financial professionals” (C6 FM). “[The DLG] were not any help ... they are reactive not proactive” (C6 FM).

In trying to provide an insight into the Minister’s orders and the lack of clarity provided, one council detailed their experiences. They were looking at a product that was on the edge of what they believed was allowed under the orders. They sought legal advice to determine if it met the requirements of the Minister’s order. The advice they received was that it was allowable under the existing investment orders. As a check, to ensure that they were not in breach of the orders they approached the DLG and asked for an opinion. The reply was that the council should “go and get an investment or financial opinion ... it was too hard for them. They did not want to prescribe” (C6 FM). The council decided to take up the investment which was a long term, 5 year investment, hoping for a 33% return over that period. They “reached that target in 14 months. They went in with \$10 million and came out just under \$15 million in 14 months” (C6 FM). The reason for moving out of the investment was that they received investment advice that the product was unlikely to continue giving those sorts of returns. Two months after exiting the product it collapsed. To most prudent investors this would have served as a warning and a reason to exercise more

caution. However in the case of this council, the councillors became [confident] ... thinking that they were good at investments. They were saying “... this was good what else can we get into (C6 FM). The DLG never asked to see the letter that this council had received from their legal advice, nor did they ask what the opinion was in respect of the investment. This council officer “would have loved the department to put a clarification on it” (C6 FM).

Policies within each of the councils reflected the requirements of the Minister’s orders but how they acted on those policies varied. The Ministers “investment policy and [internal] investment strategy ... were kept separate documents” (C4 FM). Each council viewed acceptable levels of risk in different manners and in some cases were “more restrictive than what the Minister’s order” (C4 FM). This was dependant on the nature of the council and general manager. These councils were looking for greater earnings from their investments and appeared willing to take on higher levels of risk in return. They used diversification and restrictions on amounts within particular products as an instrument of control and governance.

A second council officer explained that they used the Minister’s orders to determine what was “an appropriate level of risk” (C7 FM). From that they developed their own investment policy with which they complied. As that policy, in line with what the Minister’s orders allowed, included investments in CDOs, there was not involvement from councillors. The only interest from councillors was that the investments were within the framework that council had approved.

The Minister’s orders and the DLG were fields with the mechanisms to control and govern investment behaviour. However, the ability to arrive at different interpretations of the orders and the reluctance of the DLG to provide clear cut guidelines these fields did not exert as much influence as they had the capacity to for.

6.5.1.2 Financial Products

Within the theme of financial products there were two sub-themes drawn from analysis of interviews with council officers from council that invested in CDOs. The first field was rating of products and these councils used ratings as a governance mechanism for investments. The second theme was investment advice. These

councils did not rely on advice to any significant extent. These themes are analysed further in the following sections.

Ratings

While these councils had some concerns about the value of ratings they still used them as a tool to evaluate the products or the institution who had issued the product. Ratings were used as a governance tool in deciding the quality of an investment, “credit rating is the key thing for us to preserve the capital” (C4 FM). This council would try to evaluate where the underlying risk lay within the CDO and use the ratings of the issuing institution as a tool to assess the risk of the product. The fact that the Minister’s orders allowed investment in both products and institutions which had Moody’s or Standards and Poor’s ratings provided these councils with permission to invest in CDOs. There was a belief that credit ratings supplied assurance about the security of the institution and/or the product. As “CDOs, SMP and futures and other products were all AA and AAA rated products” (C5 FM) this council officer accepted the inclusion of CDOs as allowed products within the Minister’s orders as an endorsement of CDOs. “Everyone read in that Minister’s order that CDOs were eligible due to the ratings” (C6 FM). Even though this council had concerns about the “value of recommendations and ratings from Standard and Poors” (C6 FM), they still invested but enforced strict terms on the investment limits and the institutions in which they would invest.

The rating agencies represented a field that due to the expert knowledge and power associated with them having the right to allocate ratings for both institutions and products, were able to exert a large influence over the perceptions of CDOs by council officers.

Financial advice

Financial advisors did not play a large role in influencing behaviour with this group of councils. Only two of these councils used an advisor at the time, and the advice received from one was that an investment in CDOs was allowed under the guidelines. The problem with the advisors of that council was that “they had a vested interest. If you have a look at their history they were advisors for local government

but they were also agents for managed funds” (C6 FM). The other council who had an investment advisor, only used them in “developing an investment policy for the council” (C7 FM), and did not seek specific advice on risk associated with CDOs. There was no discussion of whether or not CDOs were an appropriate investment vehicle for councils. This field did not appear to have a significant influence on this group of participants.

6.5.1.3 Support Networks

These interviews revealed that fields representing support networks were able to influence investment decision-making behaviour. There were two sub-themes identified comprising the local government community and the finance professional group. These sub-themes are analysed in the following sections.

Community

There were two disparate views presented about the local government community. One council officer proposed that “Local government is like a company, very independent. There is not a lot of exchange of information” (C5 FM) and that interaction with other councils was limited. The suggestion was that councils operated independently as separate entities. These participants presented the view that the field of the local government community did not have a significant influence on behaviour as like-minded councils consulted with each other. As they had similar natures and acceptance of risk, this supported the existing habitus and reinforced existing practices.

Finance Professions Group

The finance professionals group served to help finance officers in councils to feel less isolated and provided an opportunity for an exchange of information and feedback on what was occurring in the sector. This was not the only group finance professionals could source for advice. One participant commented that “NSW Finance professionals association in their best practice investment guidelines and there were investment guidelines specifically for investment in CDOs. There was no one out there that was saying don’t invest in them” (C6 FM). This group was not

necessarily providing advice to invest in CDOs, but a best practice guideline to help decide if it was an appropriate investment. However, these councils took the inclusion of CDOs in the guidelines as an endorsement of the products.

The Finance Professionals group was a group of finance professionals from approximately 20 different councils; they would meet monthly and exchange information. CDOs were marketed at these meetings, as a result of the promoters of CDOs sponsoring the meetings. One of the attractions of CDOs was that they offered larger returns than could be achieved from other types of investments, “they were sexy at the time as far as investments were concerned” (C6 FM). At one meeting there was a debate between a seller of CDOs and an investment advisor. This served to bring to the attention of the finance officers that there were some problems with the products. One of the primary issues was that what appeared to be different CDOs, may have the same entities named within them. If the councils were looking for diversification, as a tool to reduce risk, then this was a significant factor. As a result of that meeting one council officer went back to the office and reviewed the council investments in CDOs. “I went down from about 52 mil to about 19 where I made sure that the portfolio that we had basically did not double up a lot on these names” (C6 FM).

The finance professionals group mentioned was a field which had significant influence on less risk averse councils, primarily as they brought in external groups such as banks and marketers of CDOs in the roles of experts. This had the effect of allowing the field of finance professionals to be affected by those external fields.

6.5.2 Capital (Investing Councils)

The capital controlled by individuals and fields external to the councils was able to provide an influence on these councils. Capital refers to the level of authority vested in a position, person or group. The following sections outline the types and levels of the influence available within these categories.

6.5.2.1 Governance

Under the main theme of governance there were two sub-themes identified as capable of exerting capital influence over investment decisions. The sub-themes identified are the capital vested in the role of general manager and the level of autonomy of those in charge of financial investment were permitted. These sub-themes are analysed in the following sections.

General Manager

The general manager had the capacity to influence investment behaviour. Their capital stemmed from the authority residing in their position within the council. If the finance manager had delegated authority to make investment decisions then the capital resided in that position. Investment decisions are often “based on who might be in the positions of authority” (C4 AFM). Within this council the general manager was in favour of seeking returns on investments, such as were available from CDOs. The finance manager followed that guidance in investigating and ultimately investing in these products.

Autonomy

None of these councils liked the proposal that control and management of their investments should be in the hands of the State Government. Their experiences with state run investment bodies have been that they were inefficient and it was difficult to get appropriate services from them. These council officers proposed that current state run bodies do not actively manage funds well, they lack the necessary skills, they do not provide returns that were readily available from term investments and that the reporting about investment is unsatisfactory. They believed that they had managed the council portfolio well stating “we have been able to build up a portfolio which is quite suited to our needs” (C4 FM), suggesting that if they had been able to place their own superannuation funds within the portfolio then they would have achieved greater returns than was available from professionally run funds. This council officer also suggested that the available funds run by treasury were “one of the most volatile around” (C4 FM) and they would not like to be involved with them. Similarly suggestions were made that “T-Corp is poorly controlled. They do not

manage it well” (C5 FM). Likewise another finance manager proposed that they “get more satisfaction out of the big banks CBA, Westpac ... and it enables diversity” (C6 FM) and that T-Corp “customer service and rates are terrible” (C6 FM). Experience from another council highlighted that the current state run investment body (T-Corp), named within the ministerial investment orders, provided poor “levels of the reporting ... and the returns were not good” (C7 FM) as a reason why they withdrew their investment with them.

These councils all believed that delegating their current capital power to make investment decisions to a state run body would be detrimental. They based their opinion around the performance and reporting of financial investments currently being provided from existing state bodies. They were also reluctant to relinquish their current capital allowing them to control their own performance and did not want portfolios to be lumped together where each council would be forced to accept risks contrary to their preference.

6.5.2.2 Financial Products

Capital was conferred on those possessing expert knowledge and experience. These councils only had limited exposure to investment advice. The majority of them did not have an investment advisor but did rely on advice from knowledgeable people from the banking industry. Part of the reason for not using investment advisors was a belief that there were very few who were independent and therefore these council officers had low levels of trust in representations from them.

Financial Advice

Two of these councils did not have investment advisors at the time of investing in CDOs. “We used people who understand investments. [we got advice from] people who we knew in the banking community” (C4 FM). Generally, the advice provided to these councils was from within the banking community and from people from the finance industry whom the council officers had experience with and trust in, those “contacts we have in the industry ... typically those in the Big 4 banks ... people who we have established relationships with” (C4 FM). Of the other 2 councils, one had an investment “advisor at the time but they were not very good” (C5 FM) and who was also

selling CDOs, which impacted on the independence of the advice provided. The other council had an investment advisor, although the purpose was principally to develop and review the investment policy rather than to provide specific advice on investments.

One council suggested that prior to the release of the Cole report there was “no independent advice” (C5 FM) available as most people portrayed as advisors were also getting commissions on sale of the investment products. This officer also suggested that finance managers were unskilled in this area and had insufficient investment knowledge.

There was one council officer, using an advisor about whom there were independence concerns, who suggested there were other advisors saying “councils have a fiduciary responsibility to not to lose the capital” (C6 FM). That advice would have meant no investments in any at risk products. The issuance of a DLG circular recommending an “independent investment advisor” (C6 FM) gave this finance manager an opportunity to seek an advisor who was not involved in marketing investment products.

The capital vested in investment advisors relied on the level of trust that council officers felt they had in those advisors. The trust was diminished when the advisors were also selling CDOs. The councils who invested in CDOs were more likely to not have advisors or if they did they only had limited levels of trust and placed less reliance on their opinion.

6.5.3 Habitus (Investing Councils)

As discussed in chapter 2, habitus refers to the social norms that guide behaviour, actions and thinking. The habitus of councils that invested in CDOs had particular traits. The following sections analyse the factors that provided means to influence the investment decision-making processes of councils that invested in CDOs. This has been done under the main themes of governance, and financial products.

6.5.3.1 Governance

Under the main theme of governance these interviews revealed three sub-themes that shaped how investment decision-making. These sub-themes are autonomy, motivation and risk. These sub-themes are analysed in the following sections.

Autonomy

Within these councils, it was evident that the council officers followed the process of making investment evaluations and provided reports to council. This was particularly relevant when they were “normal routine decisions” (C6 FM) and the finance manager was free to “make the decision” (C6 FM). One officer suggested that the council “does not provide good control” (C5 FM) due to the need on occasion to make quick decisions to take advantage of fluctuations in the short term money market. This council officer also stated that while they have an internal investment policy, that policy originated from the finance officer and therefore the decision-making quality was “dependent on the quality of the person in the finance role” (C5 FM). Council participation was limited to setting the policies, which governed the investment decisions and provided the investment met the policy stipulated by the council then the General Manager was free to make their own decision.

Governance of investment decisions flowed from the policies established by the councils. The general manager was then free to make the final decisions within that policy framework. There was an apparent freedom for the finance manager to make recommendations about types of investments, including term and amounts, with the primary concern being managing cash flow so that funds were available when needed. The general manager governed the investment philosophy (within the framework of council policy) and if they were conservative, there was little motivation for the finance manager to challenge that perspective. While reports were always provided to council, and approval for policy changes was sought, “understanding of CDOs and explanations to councils” (C7 FM) only improved after the CDO market had begun to collapse.

Two of these groups expressed the opinion that there was a general lack of skills within the local government community to fully understand what CDOs were and the

risks associated with them. It was suggested that due to the higher salaries offered in the private sector, finance professionals with greater knowledge and skills tended to gravitate to those positions. There was the suggestion that larger councils were able to offer better management and had less mismanagement of investments.

Training in how to evaluate CDOs was offered to finance officers within local Government. Officers within 2 councils either had finance experience or undertook training offered to improve their knowledge of how CDOs worked. There was recognition that many CDOs, although issued by different entities were essentially made up of the same underlying companies. This recognition meant that these councils were able to avoid that problem and invested in a diverse group of CDOs to spread their risk. This did not mean that the CDOs were all protected, but did mean that a collapse of the underlying companies within a particular CDO was limited to that investment and not all of them. “There were not many finance managers in local government that had financial knowledge and background to assess the risk of CDOs (C5 FM).

One council was very active in trying to understand CDOs. They described CDOs as comprised about 120 entities across a number of categories insurance finance and a number of other categories as well. So if you buy CDOs then more than likely that you will have some entities in all of your CDOs. “I think that we were finding a correlation of 60-70% similarity” (C4 IM).

There was an obvious attempt to develop a broad base of knowledge and skills. They reinforced their knowledge by consulting with financial advisors and confirming their decisions. While they invested in CDOs they still considered themselves as conservative and limited their exposure.

Each of these councils lost money through their investments in CDOs. The following transcripts outline the extent of the losses experienced by these councils. While they talk about the losses of capital, they also made losses in respect to the revenue flows from these and other investments. None of the CDOs which failed, paid coupons and some, even where they managed to recover the capital, also failed to give any returns.

Chapter 6: Analysis and Findings

We had about five [CDOs]. Three of them have matured. The two that are left have gone through restructures we have not fully provided against we do not believe they are going to mature and we are purely getting coupon income on them (C4 FM).

We only lost one stock which cost 1.5 million and other stock is quite safe. CDOs are not all bad. Sometimes people only see from one extreme to the other extreme (C5 FM).

We have lost one CDO completely. In our 19 million of CDOs, there were a lot there that got valued down to one dollar because there was really no market for them. That was the very big difficulty at the time because the guidelines came out that the market values had to be shown within the financial reports and that you needed to get a reasonably good independent valuer to do it and no one could do it (C6 FM).

We got out of two of them without loss prior to the GFC it was more good luck than anything else. We still had two CDOs when the GFC struck we got advice and they seemed reasonable enough. But they both died a painful death not long after. The full \$2mill was written off over a period of about 18 months. We took the approach that we would write them down to the value at the time. \$1.56 million in 1st year and \$418,000 the next in 2008, we got no return at all except for the coupon payments and then they just stopped it and the whole thing went bang. It was just good luck that we didn't lose more (C7 FM).

These councils justified their decisions around limiting their losses, and in some cases thought they had done well to ONLY lose a couple of million. They acknowledged that they had also not received returns on these products but did not see that as an issue as they had managed to get sufficient returns from other investments to reach their targets. None of these council reported poor investment returns in any of their financial reports, they were able to get sufficient returns from their other investments to meet their self-imposed benchmarks. Therefore, there was only a limited outcry about these council's investments, as the only obvious impact was when they wrote of the capital losses.

Motivation

One of the main problems for these councils was that during the period from 2000 to 2005 there was very little indication to them that there may be a problem with CDOs.

This was highlighted by previous experiences from those who had invested in the products early after their release. “It is hard to say that the decision to invest in CDOs at this council was wrong. Just because they are CDOs does not mean that they are bad. The early CDOs ... the risk was not high they were well secured” (C5 FM) it was only after 2005 that they became synthesised piling “debt on top of debt” (C5 FM). Returns from the investments were good and the finance managers were unaware of potential problems associated with them. The individuals who had the ability to provide advice were also those selling the products. CDOs had proven over a period of more than five years to be able to give good returns however as they developed they appeared to encompass additional risk with “everyone looking at the returns but you have to look at the underlying business overall as well” (C4 IM). These councils lamented the fact that there was little media reporting to identify that there may be a problem with CDOs. Both of these councils followed the media reports as a mechanism to monitor market reactions although “media and other outlets did not have this on the radar” (C5 FM) prior to 2007.

These council officers considered that the general lack of knowledge about CDOs, lack of skills and experience all contributed to the decisions to invest in CDOs. While there were no alarms sounding in respect to CDOs the prudent person approach was to consider maximising returns. The lack of information and understanding of these products contributed to a habitus within these councils that encouraged investment in products offering greater returns than was available elsewhere.

One of these councils was an aggressive investor. The primary motivation for this was the desire to maintain the buying power of their funds to enable them to meet their future requirements. As “property values were going up something like 9-15% per annum” (C6 FM) that council wanted to hedge their investment funds against the gains that were being achieved in the property market so that they had sufficient resources to make future property purchases. This council recognised that “you couldn’t get normal investments to get that” (C6 FM). There were no products on the normal investment market that gave equivalent returns to what was being experienced in the property market “Only CDOs ... that was the strategy that this

council had” (C6 FM) to try and hedge their investments against future property purchase requirements. The justification for chasing return equivalent to the property market returns was that the funds in their portfolio emanated from developer contributions, earmarked to buy property in the future for community requirements such as car parks.

The principal motivation for investing in CDOs was to maximise the investment returns, offered by these products. This is demonstrated by the statement from one finance manager who said primarily we “invested for the higher returns ... the returns were 50 to 100 base points above the term deposits” (C5 FM). While CDOs were normally offered on a 5 to 7 year term, they were marketed as being liquid and easily tradable. These councils looked on them as long term investment products and did not trade them regularly. Another reason provided for investing in CDOs was that ignoring the higher returns offered by the promoters of CDOs would have portrayed the council as being excessively conservative.

One council in particular did not wish to be perceived as over conservative and invested in CDOs to demonstrate that they were actively investing council funds. These motivations stemmed from the habitus within these councils requiring them to maximise returns and trying to marry investment returns to their future needs. This council officer stated that they “invested in CDOs mainly to show we were actively investing and not being conservative for conservative sake, it was recognition that our portfolio wasn’t getting returns that private organisations were” (C7 FM). This was an indication that the community expectations arising from the introduction of New Public Management (NPM) encouraged this council to try and mirror the investment performances being achieved in the private sector.

Another motivation suggested by two of these councils related to the economic conditions at the time. Around 2000 the market was giving good returns and therefore there was an expectation of getting good interest rates and “CDOs were flavour of the month” (C6 FM). Because there was good returns the marketing of CDOs was aggressive to these councils, with them being promoted as giving 2-3% better returns than was generally available from other investments. Marketers were actively chasing the councils business “one guy would say you can get 8.7% another

would say you can get 8.9 and another would say take mine you can get 9.1. It was like a bidding war” (C6 FM). The belief was that the early CDOs were a secure investment and that the GFC caused them to fail, not that they were a product which was flawed. By 2005 the market returns for capital secured products had reduced but CDOs were still giving greater returns. The suggestion was that with a booming market everyone expected it to continue and little thought was given to what might happen when the market conditions became more constrained.

Good economic conditions, a bull market and normal high returns encouraged a habitus of expecting good returns from investments. The fact that CDOs were being widely used and there were no expectations of a market failure, or few indicators that the GFC would occur encouraged higher risk taking than would have been expected if the market and economic conditions were less buoyant.

Risk

Risk acceptance by these councils was influenced by their previous experiences. Three of these councils viewed themselves as unwilling to take on higher risk even if the returns were commensurate with the risk, but for 2 of them, their understanding of the risk associated with CDOs was limited, and for council 4 they understood that there was an increased level of risk but for them it was an acceptable risk. They did not approach these investments blindly but “did a risk assessment as to the risks we were facing and price comparison with competitors that are out in the market ... in terms of risk assessment we concentrated on the underlying credit rating of CDOs” (C4 FM). The reliance on credit ratings as a mechanism to evaluate risk indicated that this council was unable to adequately evaluate the full risk of these investments themselves and were relying on the accuracy of the rating agencies judgements. However, they stated that “one of the reasons why we never joined any class actions because we did research and I am not going to stand up in court and say we went into this blindly because someone misled us. We actually went in and did studies” (C4 FM).

Council 5 had a substantial proportion of their portfolio invested in CDOs. They looked for ways to minimise risk and as explained that CDOs “representing about 16% of our portfolio ... spread across institutions to reduce risk ... and made sure that

they were different ... diverse” (C5 FM). These actions demonstrated that they were conscious of the risk and tried to minimise the impact while still pursuing the greater returns available.

However, at the opposite end of the scale council 6, after successful investments, (as described in the previous section), were encouraged to greater risk acceptance within the organisation. The previous investments were at the limit of what was acceptable under the Minister’s Orders, and they acknowledged that they were lucky to get out of the investment before it failed, but the narrow escape was not what was remembered, it was the success of the investment, which had the greatest influence. Willingness to take on risk was reflective of the habitus within these councils. Even after the CDO market had collapsed and they had lost money invested in CDOs this finance officer was decrying what may have been stating that “in a perfect world if they had stayed where they were we would have made a motza out of them I mean that was what everyone was basically saying” (C6 FM).

These councils displayed a mixed perception of their respective natures. Most portrayed themselves as conservative, even though they had invested in CDOs stating that “some [CDOs and other rated products] as too volatile for what we wanted” (C4 FM). Other justifications for describing themselves as conservative were that they had not moved straight into CDOs when they came on the market. Three of the four councils wanted to investigate the products before they invested in them and one of these even pointed out that they “missed out” (C7 FM) on some investments due to their cautious nature. The influence of the general managers’ previous experiences and history appeared to influence the actions of the finance manager. One council highlighted this explaining that “our General Manager ... was ultra-conservative and had an excellent memory, remembered every bank collapse and was not fussed about CDOs” (C7 FM). The recollection of previous experiences, particularly of those general managers willing to apply their capital, resulted in the habitus of the respective councils being affected.

One council was significantly less conservative and invested large amounts in CDOs. They were willing to push the boundaries of the Minister’s orders and pursued investments that previously would not have been considered allowable under the

Minister's orders. They were the "first councils to test the Minister's order on the grounds of investing directly on the stock exchange" (C6 FM) and suggested that they were "adventurous" (C6 FM). They actively chased higher returns and were willing to take on higher risk to achieve those goals.

The organisational philosophy appeared to emanate from the general manager throughout the organisation. Whether these councils viewed themselves as conservative in nature, or more adventurous, individuals with authority influenced the nature of the organisation. However, if the finance manager was more conservative than the general manager was, they were able to rein in aggressive behaviour from above by restricting the types of recommendations that they made. The habitus within these councils meant that even if the investment policy allowed investment in CDOs the finance manager was still in a position to restrict investment in risk related products.

6.5.3.2 Financial Products

There was one sub-theme that emerged from the interviews with officers from councils that invested in CDOs. That sub-theme was the marketing of CDOs to councils. This fitted within the main theme of financial products and is analysed in the following section.

Marketing

The promoters of CDOs subjected all of these councils to aggressive marketing practices. Marketing practices included using well-known individuals from the finance community and the sellers portraying themselves as experts and presenting themselves as advisors rather than someone selling a product. The following quote depicts the demeanour presented by the sellers of CDOs, "they came in like they were providing advice ... if salesmen come here with products that they say are good then the people here at the time would buy" (C5 FM). Common practices included going over the head of the finance manager to the general manager and even to the councillors, implying that the finance manager was too cautious and failing to fulfil their fiduciary duty by ignoring the greater returns available from investing in CDOS. The following quote provides an example of these types of selling practices "[They pushed] right up to the director level. We know that they tried to push to

CEO and mayors in some councils. They approached the director here at that stage. It would have been that IM was their first contact and then the 2 of us then met or sometimes with our immediate boss and then if they contacted the director then all 4 of us would discuss the CDOs” (C4 FM). They were sold as a tool to allow councils to get the same or even better returns than was available in the property market. There was also an implicit threat applied in some cases where the marketers stated they would “go over your head I will go to the GM” (C6 FM) if the finance manager was hesitating about investing in their products.

Using well known individuals from the finance community was also a marketing ploy used, as explained by one finance officer “Grange employed a fellow finance manager practitioner, he was good and he did know them backwards, he knew them better than anyone else in local government did. At a finance professionals meeting he tried to tell the whole 18-19 of us ... that only two councils in the room were doing the right thing by the council the rest were irresponsible” (C6 FM) in not investing in CDOs and maximising investment returns. Another suggestion was “the criticism that was coming to us from the investment community and through the general manager was that we weren’t discharging our responsibility to be prudent because we weren’t receiving the great returns we could have been getting from CDOs” (C7 FM). This was a result of marketing practices and depictions that CDOs were safe and there was no reason not to invest in them.

Another product-marketing tool used by Lehmans, was packaging all of the councils’ investments into a managed portfolio. Lehmans would offer to manage all the funds and invest them in CDOs. As one finance manager explained “(Lehmans) created these IMP, Individual Managed Portfolio, they convinced councils to sign up to them ... their whole portfolio was CDOs. They had traded at least 20 times in one month at least one or two a day, 20 times in what is it 22 working days ... they were getting magnificent returns but the thing was at the end of the day was that they were feeding the commission to these people and they had no diversity in their portfolio” (C5 FM). This meant that the council would have handed responsibility of their investment management to a second party (Lehmans), which should be considered as

not within the expectations of a prudent investor. None of these councils took up this option they saw it as an irresponsible action to allow others to control council funds.

The marketing practices were designed to modify the existing habitus within councils and encourage them to invest in CDOs. The companies selling CDOs encouraged councils to trade what was in reality a long term investment as though it was short term. This created greater commissions for the marketers of these products.

6.5.4 Summary: Features of Investing Councils

The previous sections have developed evidence of a range of factors that led to these councils choosing to invest in CDOs. A summary of the main factors identified by these participants is listed below:

Nature of the Organisations: The message from these councils was mixed. Three believed that they were conservative. They had investigated the products, or taken expert advice when making these decisions. The fourth council also thought that they were conservative but were willing to pursue higher returns and actively sought to not only establish, but to push the limits of the Minister's investment orders.

Minister's Guidelines/DLG: All of these councils relied on the ministerial guidelines, circulars to councils and information from the DLG, when making their decisions to invest in CDOs. The ministerial guidelines provided them with the impetus to consider investing in CDOs and other rated products. Without the introduction of rated products as an investment vehicle within the Minister's orders these councils would not have invested in CDOs. The addition of rated products to those orders created an impression of legitimacy for these products.

The DLG was seen as inefficient and lacking the skills to be able to provide meaningful advice and assistance with respect to investment decisions. There was a perception that the DLG was unwilling to express opinions for fear of being incorrect and that the councils were left to make their own determinations of the credit worthiness of products and the risk.

Governance: These councils had governance procedures. They complied with the Minister's orders, individual councils developed their own investment policies,

which were ratified by the councillors, and within those policies the general manager was able to confirm the investment decisions of the finance officer.

Local Government Community: There were different perceptions of the value of the local government community. One view was that councils operated independently with poor exchange of information. The alternative view was that networking within the finance professional group provided good insights into what was happening in the investment arena.

Risk: These councils were generally of the view that they were risk averse, and that the decisions to invest in CDOs were based on reasonable evaluations of the products. They felt that if they had been fully aware of the risks then they would not have invested in them. One council believed that they had a good understanding of the products and even though they suffered losses it was due to external failures over which they had no control.

However, C6 achieved good returns from an investment which in hindsight was very risky, and even after what was a close call, which could have resulted in substantial losses, were encouraged to continue searching for investment which could provide larger than normal returns and assume more risk.

Ratings: While there was a level of uncertainty with respect to the value of rating, all of these councils used them as a tool to evaluate their investments. There was a general belief that rating provided a level of assurance and governance. The fact that the Minister's orders allowed rated products encouraged these councils to invest in CDOs.

Motivations: Investment in CDOs was motivated by several factors. One was a desire to maintain the buying power of their money by seeking returns which mirrored what was occurring in the property market. This was because many of these funds were earmarked for property purchases in the future. A second factor related to the economic conditions at the time, which were booming, and there was a view that councils should be getting returns comparable to what was available in the open market. A third factor identified that there had been a halo effect with respect to one

council (C7). It was evident that the decision to invest in CDOs was influenced by the fact that other, respected and powerful councils, had also invested in CDOs.

The fourth factor identified was that there was a lack of information in the media and from investment groups about the dangers of CDOs and that within local councils there were few, if any, who had the skills to understand the potential problems.

Investment Advisors: Most of these councils did not have investment advisors who could advise them in types of investments. The one council who did received advice that CDOs were a suitable investment primarily as it met the ministerial guidelines. There was a lack of trust in investment advisors as most of those around during the early 2000s were also selling the products so had a vested interest in encouraging investment.

Marketing: All of these councils expressed the opinion that aggressive marketing of CDOs occurred. These council officers exhibited low levels of trust in the promoters of CDOs, and recognised that commissions were the prime motivation of the sellers. The common complaint was that the marketers would go over their head to the general manager and say that the finance officer was not acting prudently by ignoring product's which gave such good returns. There were accusations that if they did not invest they would be losing investment income though being overcautious.

6.6 Comparison of Decisions-Making Factors

All of the councils, both those who invested in CDOs and those that did not, believed that they were of a conservative nature. While this was their perception, the actions exhibited by some of these councils do not comply with the normal understanding of conservative behaviour. The accepted view of conservatism, as defined by the Merriam-Webster dictionary, is the desire to maintain the existing views and conditions, and structures of the organisation, and that moderation and caution are demonstrable conservative actions.

However, councils who did not invest in CDOs have demonstrated a conservative nature, and a habitus, which encompassed the idea that council investment funds belong to the community and should not be placed at risk of loss. That was not the

same for all of those who invested in CDOs. While some of them took care in making the decisions, investigated the products and arrived at a considered opinion, it still does not make them conservative. All except one acknowledged that they did not fully understand the products, but they still decided to invest. One purchased CDOs because of investment advice received, even though they acknowledged that they had reservations about the independence of the providers of that advice. Another recognised that there was additional risk but believed they had sufficient knowledge and skill to understand the risk and that it was an acceptable risk. One mentioned that they did not want to be seen as conservative for conservatism's sake, and then miss out on achieving the higher returns that were being offered. This indicates that while they took care in making the decisions, and (for three of them) moderated the size of their investments, this did not make them conservative.

The fourth of these councils suggested they had been conservative; however, this council at one stage had more than 50% of their portfolio invested in CDOs. They extended the limits of the Minister's orders to make investments that were not the norm for local councils and actively pursued investments which provided returns greater than available from secure investments. The nature of this council embraced a more speculative approach to investment. The habitus of this council encouraged a higher acceptance of risk and was influenced by successful prior investments.

All of the council officers interviewed relied on the Minister's orders as the basis for their investment practices. They all fundamentally trusted the determination of ratings as a tool to evaluate the organisations issuing investment products, however, there were some concerns expressed about the reliance of the rating of the products. Minister's orders and product rating were aspects of the habitus that were common to all the councils interviewed. Differences created by the variety of investment policies between each council created disparities in the habitus. Some specifically prevented investment in CDOs and were conservative; highlighting the concept of capital protection, while others created the opportunity to engage in investment practices that were more speculative.

The DLG was seen by all these councils as ineffective in providing advice and exerting control over investment decisions. There was a strong perception that the

DLG avoided making rulings as a means of protecting themselves from criticism. The belief was that the DLG wanted to put the responsibility back on the respective councils to understand CDOs and to develop individual risk acceptance levels. As a potentially powerful field of influence, the opinion was that the DLG had abdicated its responsibilities.

There were common suggestions that the nature of the organisations was heavily influenced by the nature and experiences of the general manager. In one of the councils that did not invest in CDOs it was evident that while the finance manager would have liked to take a more aggressive approach to investment, the existing nature of the council and general manager was able to constrain speculative inclinations. The habitus within this council placed barriers to prevent risk taking and encouraged capital protection.

All these councils believed that they had adequate governance practices in place. They followed the guidelines imposed by the Minister's orders, they had developed their own investment policies and reported regularly to council about the performance of the portfolio.

Those that did not invest in CDOs were sceptical about the value of ratings issued on products. Whether this was due to an inability to understand how they were developed or if this was a general mistrust of the financial market was unable to be determined. Those that did invest used product ratings as a guide and were more willing to use the assigned ratings as a measure of governance of their investments.

Those councils who had investment advisors were more likely to have not invested in CDOs. There was only one council who invested, that had an investment advisor, and they took advice that the product (CDOs) complied with the Minister's orders and was a suitable investment for them. All of the councils who did not invest in CDOs relied on advice from their advisors that while the product met the guidelines, it was also complicated and was probably not the sort of product that they should consider. There were concerns about the independence of investment advisors. When CDOs were first introduced, there were very few advisors around. Those advisors

that were around were also involved in selling investment products, which meant that they could not be considered to be providers of independent advice.

The marketing of CDOs to NSW councils was aggressive and was a clear attempt to influence the prevailing habitus within local councils. The marketers attempted to influence the habitus by seeking to market their products to those with higher levels of capital. Those councils that did not invest in CDOs were able to resist the marketing tactics used by the sellers of CDOs. One of the primary reasons for this was the nature of the councils and of those within the councils who controlled the capital and set the expectations. The conservative nature and habitus of these organisations was sufficient to negate the marketing techniques used.

The councils who invested in CDOs did not have the existing habitus to work against the marketing practices. Even though they recognised that the marketing was aggressive, that some of the practices were suspect, and that they distrusted the sellers of the CDOs, they were convinced to invest in CDOs. This indicates that they were persuaded to invest largely because of the higher returns offered and partly so that they were not seen as being too conservative.

There was evidence that the halo effect had some influence on investment decisions. Investment in CDOs by high profile councils had the consequence of encouraging investment by councils who were wavering. Successful investments, and the resulting higher returns, achieved by some NSW councils also had the result of encouraging investment by other councils. Similarly, councils who did not invest were influenced by the actions of their neighbouring councils who were of a similar nature.

6.7 Conclusion

This chapter has highlighted the themes that the interviews revealed about influenced investment practices, within a Bourdieuan framework. It was evident that no one theme dominated or excessively influenced investment practices. Nor was any one of Bourdieu's categories central to controlling investment decisions. Instead, there were a range of elements that, acting in concert, directed portfolio managers and finance offices to make their respective decisions.

Chapter 6: Analysis and Findings

The engagement of independent investment advisors was one factor that was suggested to have significant influence. However, prior to the collapse of the market for CDOs, there was a severe limit to the number of such advisors within the local government arena. Decisions to invest, or not, in CDOs were made within an environment where Bourdieu's *Theory of practice* tools of fields, capital and habitus were all able to aid and hinder the investment decision-making process.

The following chapter will provide further explanation of the findings developed from the analysis of these interviews. This will be done within Bourdieu's framework and focus on how the interaction of a range of factors worked in conjunction to direct investment practices.

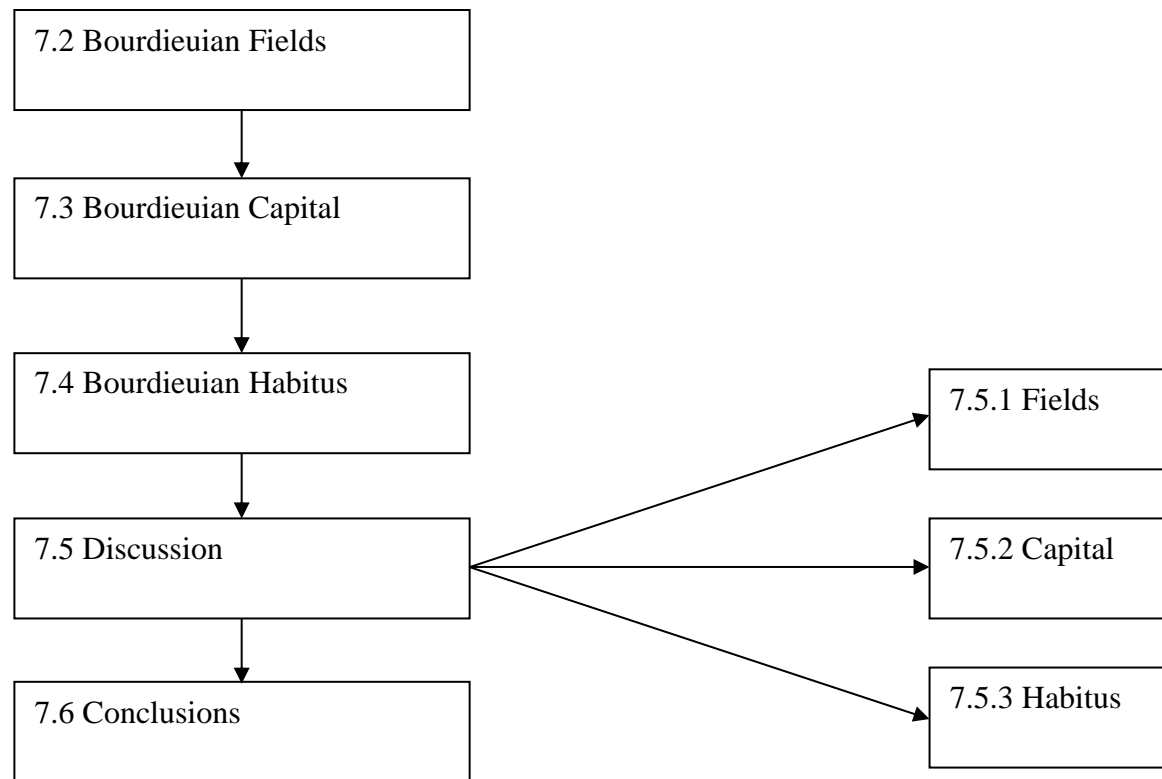
Chapter 7: Discussion of Interviews

7.1 Introduction

Analysis of interviews with the three groups of interviewees has been conducted in the previous chapter. This chapter discusses the findings from the analysis of the interviews. The tools to understand the decision process have stemmed from Bourdieu's (1997) *Theory of Practice*. He proposed that there are three categories from which influence is exerted on how practice functions within an organisation, which he categorised as fields, capital and habitus. The factors identified from the interviews, that have influenced investment decision-making have been distributed within the three categories described by Bourdieu.

There are themes that are common to more than one of these categories. The reason for this is that capital cannot exist separate to a field, an individual may have a high level of capital in one field such as the place of employment and a lower level when in another field such as when in a professional group. Similarly, those with capital may have influenced the habitus of an organisation by virtue of the authority they commanded. The following sections of this chapter provide the results of the thematic analysis of the interviews using Bourdieu's categories. The subsequent sections present a discussion of those results and how they align to Bourdieu's categories. Figure 7.1 presents an outline of the chapter.

Figure 7.1 Outline of Chapter 7



7.2 Bourdieuan Fields

As discussed in chapter 2 fields are a metaphor for the space where it is possible to identify elements such as the institution, agents, practice, discourse and values (Webb, Schirato et al. 2002, p. 86). Individual local councils are themselves a field and they are surrounded by a large number of other fields. This research has shown that while some fields were able to exert direct influence on how decisions were made, there were others who unexpectedly played insignificant roles. This section presents the fields that served to encourage or discourage investment in investment products that subsequently turned toxic, and highlights those fields which due to their prominence and level of authority, were expected to exert large levels of influence.

Minister's Orders

The Minister's investment orders are the conditions under which the NSW State Government permits local councils to make financial investments. The types of investment products are stipulated by the orders and local councils are restricted to only these investments. They have changed over the period covered by this research (pre 2000 through to 2010). When these conditions changed in the early 2000s products such as CDOs became an allowed investment. This change, created the implication that CDOs were suitable investment products and had the effect of encouraging investment in CDOs, or at a minimum, that councils should consider them. This created a culture that suggested councils who did not invest were failing to maximise returns from their investments and that they were too conservative. It also served to encourage councils who had not previously been able to invest in rated products to consider those types of investments.

The Minister's investment orders served as a governance tool. Until the orders were changed, NSW local councils could not invest in rated products. This was an effective tool in controlling investment practices. When the rules were relaxed, it placed a greater reliance on the skills of individuals within LGAs to understand the implications of investing in rated products.

After the introduction of the *1993 Local Government Act* there was an additional focus on NPM. This meant that there was an expectation for local councils to try to

function in a similar manner to the private sector (where profits are a primary concern). There was an increased pressure on local government to be efficient and to maximise earnings potential. Therefore encompassing investments that offered greater returns conformed to that principle. The other significant change that occurred was the removal of mention of the *1925 Trustees Act*. This Act had specifically mentioned that the preservation of capital was a primary requirement of local government investment practices. The removal of this weakened the controls over local council investments. Instead, a requirement to act in a prudent manner was introduced. This requirement is subject to a range of interpretations. Prior to allowing rated products as a form of investment for local councils, it was clear that these types of investments were not prudent. Once they became permitted investments it would have been difficult to argue that a prudent person would not invest in them.

Department of Local Government (DLG)

The role of the DLG is to distribute information and provide support to NSW councils. They publish circulars to councils and issue the Minister's investment orders. NSW local councils are required to report their activities to the DLG. These reports include the general and financial reports. There are also a range of other reports which councils are required to lodge with the DLG. These include investment reports, state of the environment reports and other compliance reports. The DLG is in a unique position in that they provide advice and assistance to local councils, they are the body to which councils are required to report, they furnish templates for councils to structure their financial reports and they distribute the Minister's orders. However, this research has determined that the council officers interviewed universally felt that the DLG had failed to address the issue of CDOs. The interviewees presented the view that the DLG appeared to want to distance itself from controversy, and while it issued financial reporting templates that included CDOs, they required councils to make the decision to invest or not. When advice was sought from the DLG, the common response was that councils needed to make their own assessment of different investment products. This research has demonstrated that although the DLG did not exercise its capacity to exert authority over investment decisions this capacity existed and would have controlled some of the speculative investments by councils.

Rating Agencies

Rating agencies did not constitute a field that exerted influence over the investment decisions of NSW LGAs. However, due to the reliance on the Minister's investment orders by finance managers, and the reference to being able to invest in rated products, the allocation by rating agencies of AA and AAA ratings to CDO products affected decisions to invest in them or not, because of the belief that ratings provided an assurance of capital protection.

CDOs were highly complex investment products which often comprised investment products from 120 or more different institutions, and the determination of the value of the CDO stemmed from the expected cash flow from the instruments issued by these institutions. Financial failure of 1 or 2 of these institutions resulted in diminished returns, failure by 2 or 3 resulted in no returns at all, and failure of 4 or 5 meant that the capital was lost.

There have been a number of suggestions that the ratings applied to CDOs were inappropriate (Kiff & Fender 2005; Levin & Coburn 2011; Ray 2006; Tett 2007; 2009b; 2010). It has also been suggested that local councils should not have been involved with investing in them (Angelides, Thomas et al. 2011; Benmelech & Dlugosz 2009; Blaxhall 2007). Considering the subjectiveness of the ratings and the inability to determine how ratings were determined, along with the complexity of CDOs it appears that local councils should not have been involved with investments in high risk products.

The Minister's investment orders provided a level of governance over investments by local councils. The incorporation of rated products into allowed investments resulted in CDOs becoming allowed investments. As CDOs were such a difficult product to assess because of the risk of losing both the investment returns and the capital, local councils relied on the ratings to provide corporate governance of their investments. Although the rating agencies did not say that ratings provided an assessment of capital protection, this research suggests that this is the way they were used.

Local Government Community

This research has shown that the local government community has the capacity to influence investment practices. Councils of a similar nature tended to communicate between themselves and provided support of investment practices and policies. Both groups of councils, those who invested in CDOs and those who did not, found support for their decisions within their circle of like-minded councils. However, there also was evidence of the influence of the halo effect. This meant that often the larger councils who were perceived by smaller councils as being more knowledgeable, and having the resources and skills to make informed decisions were able to influence other councils, often without even being aware of their influence.

Professional Groups

The local government finance group is a group of finance professionals from approximately 20 different metropolitan councils. This group would meet monthly for the purpose of exchanging information and providing professional support for members. This field was in a position to be able to influence financial investment decisions. They accepted sponsors for their meetings; promoters of CDOs would sponsor the events, and in exchange, they had the opportunity to market their products. This served to provide some credibility to the CDO products and encourage investment. The finance officers were able to discuss what they were investing in within their respective councils, identify problems and highlight what was successful. As CDOs were providing greater returns than were available from other products in the market, this served to imply to those not investing in CDOs that they may be acting in too conservative a manner. Those who were comfortable with investing in CDOs were able to exert influence over those who were more conservative. Equally, when problems with CDOs were identified, that information permeated throughout the finance professionals group, albeit at a slower rate due to reluctance by some individuals to be seen as foolish.

Investment Advice

Three of the councils who invested in CDOs did not have investment advisors. This was an indication of their nature and their confidence that they were able to make

investment decisions without guidance from outside advisors. All the councils who had investment advisors acted on that advice. Even though that advice varied and resulted in one council investing in CDOs, it demonstrated that the investment advisor field exerted a large amount of influence.

There was a need for the advisors to be respected and trusted for that influence to be effective. There were suggestions that some finance managers were unwilling to trust advisors, particularly during the early 2000s, due to there being limited numbers of advisors and that of those available many were involved in selling CDOs and similar investment products. This meant that finance managers were uncertain of the independence of the advice they were offered.

Marketing The marketers of CDOs were often individuals who had worked in local government as financial managers and been actively and successfully, involved in investing in them. These individuals were recruited to use their links with the local government network, as a mechanism to engender trust. Other people selling CDOs were from the banking and finance industry. These people supposedly had expert knowledge of the products and were able to market CDOs on the basis of having specialist knowledge.

This field was able to exert influence over finance managers, due to the perception that they had specialist knowledge and experience, as well as highly developed networks and contacts within the local government community. One aspect that inhibited this influence was the awareness that the promoters of CDOs were on commission and had an incentive to sell the products and encourage trading in them. The commission that the marketers of CDOs were earning was approximately 3%, which was substantially higher than marketers of other investment products received. This was not generally known, but those that were aware of it were more cautious of investing in CDOs.

7.3 Bourdieuan Capital

Capital refers to the capacity of an individual or group to exert influence over practice by virtue of tangible and intangible resources controlled. These include such things as specialist knowledge, position, reputation and skills. However it should be

noted, that from a Bourdieuan perspective “capital does not exist and function except in relationship to a field” (Bourdieu & Wacquant 1992, p. 110). This demonstrates why themes such as marketers have been discussed in both fields and capital. While individuals may have a high level of capital in one field, they may have significantly less in another. Therefore, to be able to influence behaviour they need to exert their capital in the field in which they have the most influence.

Investment Advice

By virtue of the perceived specialist knowledge, experience and skills vested in investment advisors they were able to control capital capable of influencing decisions. The lack of investment advisors in the local government arena during the early 2000s influenced their level of capital. There was evidence that very few of the advisors were independent as they were also involved in selling investment products on commission. This meant that the level of capital that they were able to command diminished. The trust, which should have been evident and engendered in them as professionals, reduced due to the perception that they were working for commissions. As more players entered the field, whose focus was not on selling investment products, and who maintained independence, investment advisors capital and ability to influence decisions was enhanced.

Marketing

The marketers recruited to promote CDOs came from investment banking backgrounds and commanded good levels of capital because of their expertise. This enhanced their ability to market CDOs. Similarly, individuals from within the local government community who had experience buying and trading CDOs successfully were recruited as a mechanism to exploit the local government network. These marketers were able to wield capital in the form of demonstrable success in the field and encourage investment in CDOs.

General Manager

This research has demonstrated that the capital that resided in the position of general manager of a local council was sufficient to control investment activities. If the general manager felt that CDOs were an inappropriate investment product, then they

were able to prevent or restrict investment in them. The setting of individual council investment policies was heavily influenced by the perceptions of the general manager and they were able to exert significant control over the level of risk undertaken. Normal investment decisions were made by the finance manager who would then just report up the line. Where investments differed from the norm the finance officer would seek approval from the general manager. When CDOs were first considered that became a consultative decision. After the initial investment decision had been made to invest in these types of products, the subsequent decisions involving CDOs had less oversight from the general manager; however, the general manager commanded sufficient capital to override decisions by the finance manager.

Finance Manager

The finance manager had differing levels of capital in each of the councils interviewed. In some councils the finance manager made the investment decisions, (albeit within the parameters of the investment policy), and had the authority to make those decisions. This particularly related to routine decisions, although in some cases it covered all investment decisions. While the general manager could override these decisions, in some of the councils checking by the general manager was only a formality. In councils who chose not to invest in CDOs, there was a stronger level of reporting and oversight. The finance manager would make investment recommendations and before they could proceed, they had to be approved by the general manager. This was evident with C3, where the finance manager clearly liked the cut and thrust of aggressive investments and making deals, yet the policy, and particularly the capital, of the general manager restrained the more aggressive investment traits exhibited by the finance manager.

Rating Agencies

Rating agencies commanded capital through their expert knowledge and experience. They were responsible for allocating ratings to both the companies issuing CDOs and the individual products. The Minister's orders on investment allowed councils to invest in products that had specific ratings. Rating agencies had the capacity to influence investment decisions through the allocation of ratings.

Rating agencies provided analysis tools to allow investors and investment advisors to assess returns and risk associated with CDOs. However, NSW councils primarily relied on the ratings given by the rating agencies and did no independent analysis of their own. Viewed in the light that Standard and Poor's (S&P) were paid in excess of US\$13 million to provide ratings of CDOs during the housing boom in the US, it raises questions about the independence of the rating analysis and whether pressure was applied to achieve particular ratings (Sorkin & De La Merced 2013), particularly when taking into account how sophisticated and complex the products were. It was also difficult to determine the flow on effects of an event such as the GFC on individual companies and economies. The capital vested in rating agencies gave them the ability to influence investment decisions made by a wide range of users.

7.4 Bourdieuan Habitus

Habitus refers to the environment, history, structures, policies and procedures surrounding the individuals making financial investment decisions. In an established organisation the habitus would normally be relatively stable and based on the combined experiences and knowledge accumulated within the organisation. However there are factors that were able to influence the existing habitus of an organisation. Individuals bring with them their own preconceptions and beliefs which have been shaped by their experiences, knowledge and education. Changes in personnel, or their level of capital, can influence the habitus within an organisation. Marketers coming into councils trying to sell CDOs attempted to change the existing habitus by challenging established beliefs and attitudes. The following sections provide an explanation of the themes that controlled and influenced the habitus.

Councils

The habitus within local councils cover a diverse range. Some councils had a habitus that was very conservative and risk averse. The reasons for this included;

- prior experiences where they had lost money,
- the habitus was affected by the attitude of the general manager,
- there was a perception that the funds they invested belonged to the community and therefore any risk was inappropriate and
- the nature of those making the decisions.

The habitus of other councils were less conservative. Previous successful investments led to expectations of similar results. There was also a view that they should be maximising returns and avoid being perceived as too conservative. The desire was there to match returns achievable in investment fields such as the property market in an endeavour to maintain buying power in the long term.

Department of Local Government (DLG)

The DLG had the capacity to influence the behaviour of finance managers. They are the body to whom LGAs are required to report, they disseminate investment guidelines and provide circulars to councils highlighting suggested practices and raising issues. However, the interviews revealed that the DLG was reluctant to provide advice or assistance. They placed the decision-making process back in the hands of the individual councils, abdicating their responsibility to guide and inform. The perception of the finance managers interviewed was that the habitus of the DLG was to avoid responsibility, and that they were unwilling to express opinions for fear of being wrong. This left a vacuum as far as the finance managers were concerned.

Minister's Orders

The Minister's orders influenced the habitus of councils interviewed. The changes to the orders in the early 2000s had the effect of drawing attention to rated products as an investment. The inclusion of rated products created an impression that they were something that councils should be investing in, and that failing to consider them was excessively conservative. Removal of reference to the 1925 Trustees Act, and the

priority of capital protection engendered an aura of more speculative investment practices being encouraged. Stipulations that investments should take the approach of a prudent person, within this investment framework and the principles of NPM, implied that councils were expected to act as organisations would in the private sector would.

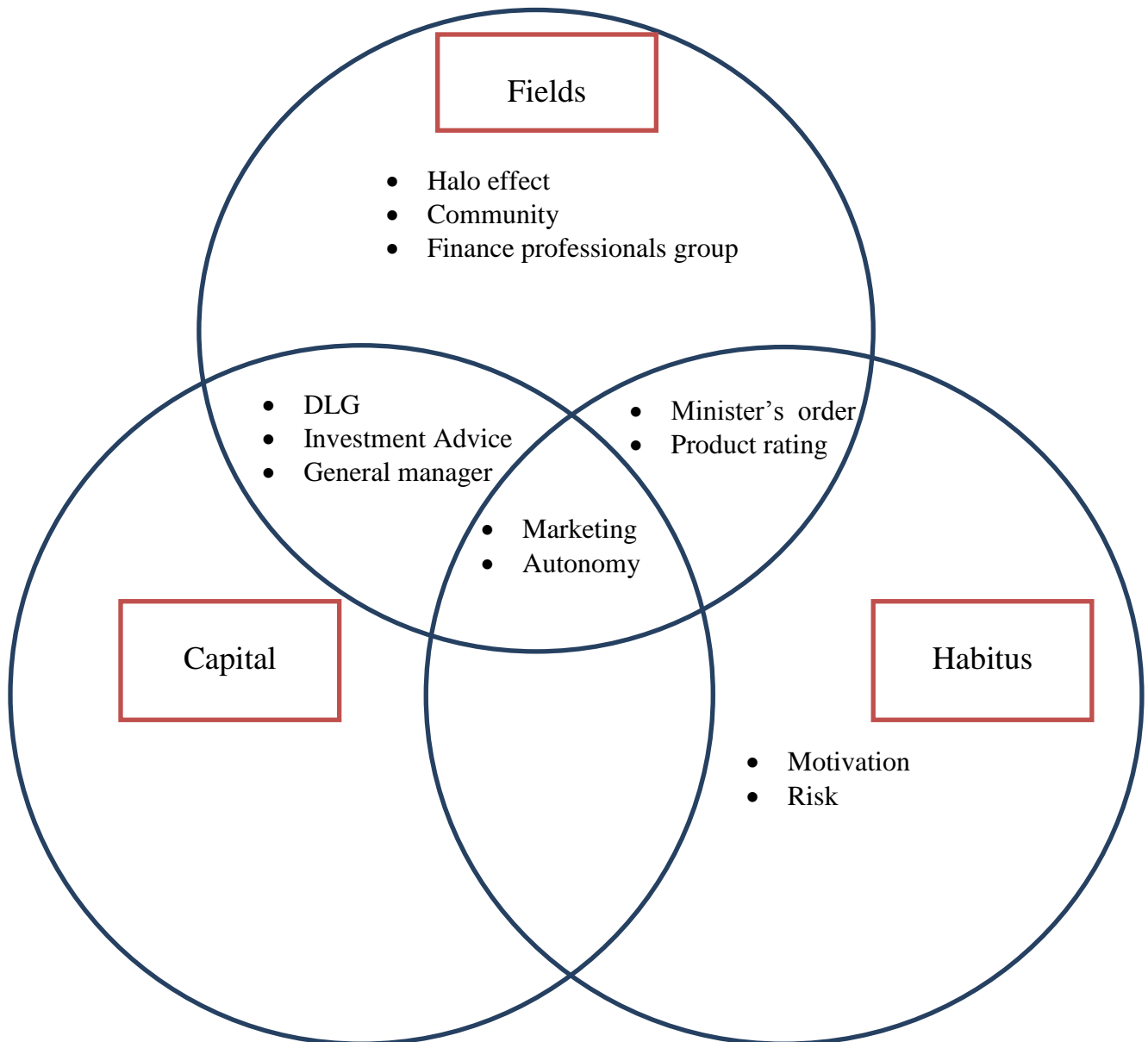
Marketing

The organisations and individuals marketing CDOs attempted to influence the habitus of NSW councils. This was done by suggesting that failing to invest in CDOs meant that the council was not maximising returns, that the officers making the decisions were ultra conservative and the council was not meeting the requirement of taking a prudent person approach. The companies selling CDOs recruited individuals able to influence decisions. They employed former investment advisors from the banking sector, who had previously provided financial advice and assistance to NSW local councils. They also recruited finance managers from the local government community to tap into the networking opportunities. Marketing was also conducted through professional networks such as the finance managers group as a mechanism to present CDOs as a legitimate investment for local government.

Sellers of CDOs tried to present their products in a manner that implied those not taking the opportunity were not fulfilling their fiduciary duty. If the finance manager rejected approaches to buy CDOs, the marketers would proceed up the hierarchy of the organisation to the general manager and propose that the finance manager was not doing a proper job.

The following Figure 7.2 highlights the factors that the participant groups identified as having influenced the way financial investment decisions were made. These have been grouped in the categories identified in Bourdieu's (1977) *Theory of Practice* to highlight the interconnectivity and relationships of those factors. There are no factors solely within the category for capital. This is consistent with the view presented by Bourdieu who proposed that capital cannot exist external to a field.

Figure 7.2: Interview Themes within Bourdieu's Categories



7.5 Discussion

In line with Witte (1972) this research has looked at the decision-making process in its entirety and sought to evaluate the factors that have influenced investment behaviour. The factors have been assessed using the tools outlined by Bourdieu's *Theory of practice* (Bourdieu 1977; 1990b).

7.5.1 Fields

The field that exerted the most influence over decisions was the Minister's investment orders partly due to the influence they had on the habitus of councils. Prior to the mid-1990s councils were required to abide by the *1925 Trustees Act* and the condition of preserving capital. This resulted in conservative investment practices, in capital protected products. The removal of that constraint and the introduction of more liberal investment guidelines including investments in rated products opened the door to those wishing to pursue higher returns and take on additional risk. The changes also signaled to the local council community that they should be considering these types of investment, so those who would not have looked at rated products were encouraged to do so. The Minister's orders were there to restrict speculative investment and provide governance of investment practices. Relaxing the rules resulted in lower levels of effective governance on local council investments. Additionally, the DLG failed to provide advice and assistance to finance managers putting the responsibility back on the respective councils to assess and understand the risk associated with different types of products.

The other section of this field that led to diminished governance was the requirement (*1993 Local Government Act*) to act as a prudent person. The prudent person rule requires that when making investment decisions they should be made, as a prudent person would, with "discretion care and intelligence". This implies that the person investing should understand the risk to capital and returns of the investment. It is, however, impossible to quantify what level of risk a prudent person would accept. This condition created a high level of subjectivity to investment decisions. A prudent person may believe that they should maintain the real value of their portfolio, accept that other finance professionals were commonly investing in CDOs and achieving

good returns from these rated products, and that they may not be acting in a prudent manner if they did not seek to maximise their investment return.

The investment guidelines issued by the Minister set the stage for local councils to invest in CDOs. Finance managers were free to make their own choice to invest or not, but the opportunity was created when the investment guidelines were expanded to encompass rated products. The inclusion of rated products in the allowable investment lifted these products into the investment consciousness of local council finance managers and provided a sense of legitimacy. In some cases this implied to finance managers that failing to invest in these products were excessively conservative, resulting in diminished returns, and not what a prudent person would do.

The researcher was left with the belief that many NSW local councils managed their organisations as though they were separate entities accountable only to their local community. In Bourdieuan terms they were separate fields in control of their own destiny. There was a strong perception gained that local councils believed they should be able to function separately to the wider public sector. Comments such as “local government is a small community” and “councils are like companies” FM (C5) and “we see ourselves as more conservative” FM (C7) demonstrate that each council saw itself as different from other public sector organisations and from each other. The researcher was left with the perception that many of these councils functioned as separate fiefdoms free to make their own decisions and choices and that their accountability was limited to their respective councils and communities.

7.5.2 Capital

Capital resided in a range of individuals and groups. Finance advisors exerted influence over decisions to invest, or not in CDOs. One of the councils interviewed invested after taking investment advice and the three councils who did not invest received advice not to invest. Some of the reasons not to invest did not relate to CDOs being a poor investment but that as they were such a complicated product that these councils could not understand them and so should not invest. The reason why investment advisors had the capital which enabled them to influence decisions was

because of their expert knowledge and experience. In this research it has been shown that this level of influence was diminished due to the realisation that some investment advisors were also promoting investment products and therefore could not be considered independent.

The other main effect of capital influencing investment decisions, related to the capital that resided in the position of council General Manager. General Managers, as a consequence of the authority resident in their position, were able to control investment practices. If they were risk averse then they had the capacity to manipulate the provisions within their respective council investment policies, and even where the policy allowed investment in at risk products, were able to restrain actions of subordinates who were willing to pursue higher risk investments than the general manager was willing to accept. Evidence of general managers exerting their capital was less evident in councils who invested in CDOs. Presumably this was due to them accepting that investment in CDOs and other higher risk products were suitable investments for their council. There were some suggestions that general managers who were not risk averse and wished to generate higher investment returns instilled a more aggressive investment attitude in their finance managers. This reasoning relates to the fact that investment decisions that were outside the norm, had to be approved by the general manager and if approval was forthcoming then they were giving tacit approval to those types of investment.

7.5.3 Habitus

The habitus had the effect of influencing the decision-making process. There were a number of habitus factors around the investment products themselves. These included:

First, the policy allowing investment in rated products created a perception that rated products were suitable investments for local councils and that failing to consider them was an indication that the finance manager was not fulfilling higher duties. Secondly, that by following the Minister's investment guidelines council officers believed that was sufficient to ensure that there was adequate governance of

investments. Thirdly, that the ratings applied to investment products was a tool providing capital protection and assurance of the quality of the investment products

The habitus within each council was different and had a significant impact on investment practices. Where the residual history of the council included problems with investment in the past, even going back to the collapse of the Nugan Hand Bank during the 1980s, they were unwilling to consider products incorporating risk. Some councils had a prevailing habitus that was ultra conservative and a culture that public funds should not be placed at risk of loss. Whereas there were other councils who were more accepting of higher levels of risk. Some researched CDOs and believed they had a good understanding, they held the opinion that they were conservative, understood that there was some risk investing in CDOs, but for them it was an acceptable risk. Other councils pushed the boundaries of the Minister's investment orders and invested in products containing high levels of risk. When they were very successful with one such investment then the habitus became more encouraging to look for high return investments and fostered a perception that they were skilled investors. Even though the finance manager acknowledged that there had been a lot of luck in that previous investment and that they could have incurred substantial losses.

Companies marketing CDOs attempted to influence the habitus of councils by using experts to add credibility to their products, and going over the heads of finance managers when their initial approaches were rejected. They would claim that the finance managers were being too cautious and not meeting the requirement to act in a prudent manner by denying the council the opportunity to maximise their returns from what was an approved investment product.

7.6 Conclusion

This chapter has initially provided an analysis of the interviews with individuals who were able to provide background information about the history of local councils. They described the manner in which investment and other financial decisions are made and the financial investment and decision-making environment. Interviews

with individuals involved in making investment decisions within NSW local councils were then analysed.

These interviews revealed those factors that were common and dissimilar between councils who invested in CDOs and those who did not. From a Bourdieuan perspective, the fields of influence around LGAs had an impact on the investment decisions. The Minister's orders provided a frame of reference, which finance officers could use to justify that investment decisions were subject to good governance practices. While the use of ratings to evaluate financial investments may have been a flawed tool, those who invested in CDOs claimed that as the Minister's orders allowed it, and the DLG issued templates which included reporting methods for CDOs, this established that rated CDOs were in line with what was expected for good investment governance. While the state government via the investment orders was a field, which influenced behaviour, the DLG, who was responsible for administering the orders, was a field that did not appear to be significant.

A second field, which influenced decisions, was the local government community. Other councils who had and those who had not invested in CDOs provided support to those making the investment decisions and afforded backing for their actions. Like-minded councils, with similar natures, supported the various investment decisions. Larger councils influenced the decisions of others, even if at the time they were unaware of the fact. The marketers of CDOs were aware of this and used it as a tool to encourage others to invest. Professional groups, such as the finance professionals' group, also influenced decisions. Marketers of CDOs sponsored meetings where they promoted their products, as a mechanism to legitimise their products. This was an effort to influence the field and encourage investment in CDOs.

External investment advice was a third field that exerted influence. Both those councils who invested and those who did not invest in CDOs relied on external advice to make their decisions. As there were a limited number of advisors working in the local government area at the time, there was little choice between advisors and some of the advice given was biased as they were also selling investment products.

In relation to Bourdieu's term "capital", there was evidence to say that individuals with the capacity to influence decisions were able to do so. LGAs that had a general manager, who had a conservative nature and was unwilling to take on investment products that entailed risk, were unlikely to invest in CDOs. Even when the investment policy within the council allowed this type of investment, the capital inherent in the office of general manager was sufficient to control the actions of people in subordinate positions.

Capital residing in investment advisors was also able to influence the decisions of finance officers within some councils. The designation of being an investment advisor carried with it weight of authority and the capacity to sway opinion. Even with concerns expressed regarding the independence of investment advisors during the early 2000s, advisors were still able to influence some local councils to invest in CDOs due to the capital residing in their professional role and the resultant confidence that gave in their opinion.

As stated earlier, capital does not exist external to a field. Rating agencies, by virtue of their expert knowledge and authority, were able to influence the perceptions of investors in CDOs. This capital was greatly enhanced in the perceptions of financial investment decision-makers when rated products were included in allowed investments following changes to the Minister's orders in the early 2000s. Even though some council officers were concerned about the validity of the ratings given to some CDO products, ratings by virtue of their capital were seen as the best tool to evaluate the security and value of a CDO.

Habitus is the third of the tools Bourdieu used to explain his theory of practice (Bourdieu 1977; 1990b; Webb, Schirato et al. 2002). The habitus of the local councils interviewed played a significant role in how investment decisions were made. Councils, which had a habitus that was conservative, not only in appearance but also in practice, were unlikely to have invested in CDOs. Officers within those councils expressed an ethos that viewed investment funds as belonging to the community, and they regarded any risk to those funds as unacceptable. Aspects of the habitus that constrained excessive risk taking included the level of autonomy granted to finance managers, the reporting structure, previous experiences and the

culture of the council. The habitus of some councils provided support for risk taking. Where reporting of investments was just a governance structural requirement and did not provide assessment of risk and a control mechanism, it allowed independent action by the finance manager within the investment policy.

The habitus in some councils was influenced by events and external fields. Successful investments in high-risk products created changes to the habitus and expectations within the organisation. Success generated desires to replicate previous returns, encouraging higher risk taking.

Marketing techniques used to sell CDOs to LGAs were a clear attempt to influence the habitus of those organisations. The use of high profile personalities, and finance professionals to promote CDOs was an attempt to legitimise the products and influence decisions. Suggestions such as finance managers were ‘not acting in a prudent manner’ and that they were ‘too conservative’ were devices used by CDO marketers to manipulate the existing habitus. When sellers of CDOs refused to accept negative responses from the finance managers and went to individuals with higher authority, it was an attempt to find someone with the capital who could change the prevailing habitus in the organisation. Marketers use of the finance managers’ forum as a vehicle to promote their products legitimised CDOs, and reinforced the concept that prudent investment could include investment in these products.

The habitus of local councils was both supported and influenced by other fields, such as the local government community and the finance professionals group. Other councils with similar core beliefs and habitus encouraged like-minded behaviour. Sponsorship of the finance managers’ meetings enabled promotion of CDOs in an environment that displayed support for them.

This chapter has provided an explanation of the findings developed from the interviews with three groups of participants. It has identified the factors affecting the investment decision-making process of local council investment managers, within the categories developed from Bourdieu’s *Theory of Practice* (1977). From those categories of fields, capital and habitus conclusions have been made about the significance of each. The following chapter will provide an overview of the thesis. It

Chapter 7: Discussion of Interviews

provides conclusions about the behaviour of investment decision-makers, influences on investment decisions and furnishes suggestions on improvement of investment practices within NSW local councils.

Chapter 8: Conclusions

8.1 Introduction

This thesis has used a case study methodology investigating three coherent ethnographic groups to investigate the factors that influenced whether or not NSW local councils invested in CDOs. Interviews were conducted with individuals involved in the local government investment decision-making process. The preceding chapters have outlined the motivation for this research, the researcher's philosophy and reasons for using Bourdieu's *Theory of Practice* (1977) to analyse the factors that influenced investment practices. The method used for this research was qualitative, using semi-structured interviews. The research also included thematic analysis of investment guidelines to develop an understanding of the background to investment policies.

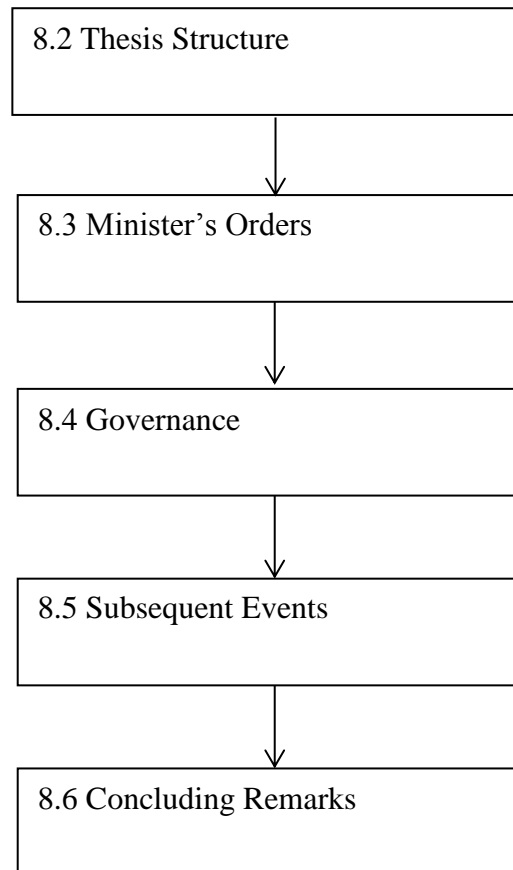
The historical aspects of the social, economic and political environment in which local councils function highlighted the themes that influenced investment decisions. These included *1993 Local Government Act* changes and the introduction of New Public Management (NPM) practices into local government. Arising from modifications to the *1993 Local Government Act* changes were made to investment guidance provided through the Minister's investment orders and hence the impact on investment governance. Changes to the Minister's orders also drew attention to the use of ratings as an instrument for evaluating different investment products.

The interviews provided insights into how participants made their decisions and the factors that influenced the decisions to invest or not in CDOs. Bourdieu's (1977) *Theory of Practice* was used as a lens to analyse and explain the investment decision-making process. The interviews demonstrated how governance of investment decisions functioned and the factors that councils considered important. They revealed those fields that exerted control and those that provided guidance. The interviews uncovered the importance of the effect of both individual and collective capital on decision-making. Above all, the interviews demonstrated that the habitus of the organisations played a critical role in the investment decision-making process. The following sections discuss the results of this research and provide

Chapter 8: Conclusions

recommendations for development of investment practice and policy for local councils. An overview of this chapter is provided in the following Figure 8.1.

Figure 8.1: Chapter 8 Outline



8.2 Structure

Chapter 1 outlined the motivation for this research that arose from the release of the Cole Report (2008). The resultant evidence from this report exposed that extensive capital losses had been incurred by NSW council's following their decisions to invest in CDOs. The Cole Report demonstrated that some of the investment products used by NSW local councils were not secure, that significant capital losses had been sustained as a result of those investments and many councils had pursued a high return, high risk financial investment strategy. Gold (2008) suggested that these losses were a result of poor financial investment governance and imprudent investment decisions (p. 51). The losses sustained by NSW local councils raised questions about investment of public funds and whether councils should be required to achieve normal market returns that are comparable to the private sector, or if public funds should be only invested in capital protected products. These losses also broached the question of how and by whom, public funds should be invested, controlled and managed. This chapter also described the thesis structure and furnished reasons for the focus on NSW councils.

The theoretical framework underpinning the research was presented in Chapter 2. The researcher adopted a subjectivist approach believing that reality is socially constructed. This approach aligns with the concepts of decision theory and particularly Witte's (1972) proposition that the decision-making stages are performed in parallel. The categories outlined in Bourdieu's *Theory of Practice* (1977) were used to analyse the decision-making process within NSW local councils. Analysis was conducted under the construct that investment practises were influenced by the fields, capital and habitus surrounding the decision-makers.

Chapter 3 detailed the research and analysis methods. The first part of the research method looked at the ministerial guidelines and investment orders governing the investment decisions of councils. The second part, which was the major component of this research, involved interviews with both, individuals external to the councils who had knowledge of the decision-making processes within councils, and participants from within councils who were involved in making the financial investment decisions. This chapter also highlighted the limitations of a case study

approach and research method. These limitations including the fact that the results may not necessarily be transferred to different groups given the interviewees may not have been representative of the population, there was a chance of interviewer bias in analysing the interviews, and interviewees may have hidden their true natures or feelings and been reluctant to disclose confidential information.

The setting in which local government operates in NSW places constraints and expectations on local councils as was discussed in Chapter 4. This chapter traced the historical reasons for establishment of local councils, explained the purposes and functions councils perform and they were established to undertake. An explanation of how those functions evolved was also presented. By then tracing the changes to the expectations of the roles that councils undertake and the development of legislation governing their operations this chapter has provided background to the environment in which councils currently operate. The legislative reforms that occurred, particularly the introduction of NPM and the requirement that councils adopt private sector practices as a mechanism to improve performance, created an atmosphere and expectation that the public sector would be able to achieve investment performances similar to the private sector.

NSW local councils invested in a range of different financial products during the early 2000s which including CDOs. An explanation of those types of financial products has been provided in Chapter 5. The chapter then supplied reasons for councils investing in CDOs and why the market for CDOs collapsed. The reasons included, first a reliance on product ratings as a tool to evaluate the security of CDOs and secondly, that financial investments by local councils were, and still are, governed by the Minister's investment orders and the circulars to councils from the Department of Local Government (DLG). This chapter presented an analysis of the changes that occurred to the investment conditions within Minister's orders and circulars to councils from 1998 through to 2010. The Minister's orders were an instrument with which to govern council's investment practices. Chapter 5 highlighted that constraints within the investment policy relaxed, and that there was only limited guidance provided by the DLG via the circulars to councils. This created an environment where councils were confused about the types of products in which

Chapter 8: Conclusions

they could invest and allowed aggressive investment by individuals interested in pursuing higher returns.

Chapter 6 described the participant groups interviewed and provided an analysis of their responses. Three groups of participants were interviewed, the first consisted of people external to councils who were able to present information about investment practices and supply an historical perspective relating to local investment practices. The other two groups of interviewees were responsible for making investment decisions and were employees of councils who had decided to invest (second group), or not (third group), in CDOs. These interviews demonstrated that financial investment decisions were not reached in isolation and that a range of themes simultaneously exerted influence on the decision-making process. These themes were sorted into categories according to Bourdieu's *Theory of Practice*. They were then analysed in terms of fields, capital and habitus to show which had the greatest influence on investment decision-making and the main themes of governance, financial products and support networks to demonstrate how they were interconnected.

Chapter 7 presented the findings established from the interviews. These findings were separated into categories depicted by Bourdieu's *Theory of Practice*; fields, capital and habitus. There was evidence of a strong overlap of themes that were common to more than one of the categories. This chapter described those overlaps and suggested reasons for their occurrence. The group of councils that did not invest in CDOs were conservative and held that taking on investment risk to achieve greater returns was an inappropriate management of public funds. The group that made investment decisions within councils who invested in CDOs provided a variety of reasons for those choices. Those reasons included accepting advice from external advisors, not wanting to appear too conservative and a desire to achieve returns equivalent to the capital growth that was being experienced in the property market. The application of the lens of Bourdieu's (1977) *Theory of Practice* to analyse the findings demonstrated that the results were consistent with Bourdieu's contention that capital did not exist on its own, external to a field.

8.3 Minister's Orders

Two main components have emerged from this research. The first, examined in Chapter 5, comprised a discussion and analysis of changes to the Minister's orders and the guidance available from the DLG via circulars to councils. The Minister's orders and DLG guidance were supposed to provide a governance mechanism and control over management of local government investments. However from 1997 through to 2007 the range of allowed investments increased and began to incorporate rated products. During the early 2000s removal of reference to the *1925 Trustees Act* from the *1993 Local Government Act* also eventuated. From that change it could be inferred that the need to protect capital was no longer a priority of the Minister. This created an environment which encouraged local councils to pursue higher returns from investments and resulted in also assuming higher risk of capital loss.

The DLG was in a position where they were disseminating the Minister's orders relating to investments. They were perceived by councils as the "authority" when it came to evaluating the types of investments that were allowed. However, it was evident that the DLG was either unwilling or unable to make judgements on the types of investments. This lack of guidance frustrated councils seeking assistance and promoted investing decisions that pushed the boundaries of what was allowed.

The inclusion of rated products within the types of investments allowed by the Minister created the impression that ratings provided some surety over the products. As a reaction to the losses sustained by NSW councils reported in the Cole report rated products are no longer an allowed investment for NSW local councils (DLG 2009b; DLG 2010a; DLG 2010b). Inclusion of rated products as allowed investments within the Minister's orders implied that councils could feel confident in using ratings as a governance mechanism over their investments. However, ratings were an imprecise tool with which to measure the capital security of investment products and even the rating agencies did not suggest ratings should be relied on as an indication of capital security. Prior to their removal even the DLG stated that ratings should not be used to evaluate the security of investment products. Nevertheless, both the rating agencies and the DLG left it to the investors to make their own determination of the risk associated with any product. This logic has proved to be flawed as investors such

as local councils lacked the skills to evaluate the risk associated with CDOs. There was clearly a policy failure by the Minister in incorporating rated products into allowed investments. The investment guidelines and policy have changed to reflect the events during the GFC and the subsequent recognition that ratings do not provide security for investment products. Investments allowed by councils are now described as “bland” and “vanilla”. The question remains as to whether the Minister’s investment policy is an appropriate governance mechanism for control and form of over local council investments when such policy failures can occur.

This research established that councils were constrained by the Minister’s investment orders. When the allowed investment products incorporated the use of rated products, there was a section of the local government community who embraced the changes and pursued investments with higher risk. Nevertheless there was another section that was uncomfortable with these products and did not invest in them. Strict policy guidelines that prevents investment in products placing capital at risk, is a tool that prevents speculative investing. However, it also prevents councils maximising returns by investing in capital protected products, if those products are not included in the allowed investment list. If the DLG or another approved body had the willingness and the required skills to provide sound investment advice, with the power of veto, then councils could gain greater returns without placing their capital and investment dividends at risk. The current mechanism of reacting to events and changing the policy to reflect the prevailing political and economic environment is inefficient and reactive and fails to serve the interests of councils seeking to maximise investment returns. As a form of control over investments this study has demonstrated that unless the policy and guidance are sufficiently unambiguous, then policy fails to function as an effective governance tool. To meet the needs of council’s, investment policies need to reflect the underlying purpose of making investments. That purpose also needs to be clearly defined either as focused on protection of capital or maximising returns, or maximising returns from government secured products.

8.4 Governance

The second component that emerged from this research was whether governance methods were able to control investment practices within the councils involved in this study. Investments were made within the guidelines of both the Minister's orders and the policies developed by each council. Councils developed their policies in conformity to the Minister's investment orders, and then adjusted them to conform to other influences. Those influences were comprised of the habitus of the organisation, influence from external fields such as investment advisors, and the capital, particularly of those in authority.

The categories from the framework presented in Bourdieu's (1977) *Theory of Practice* served as a useful mechanism to evaluate how influencing factors interacted and helped shape the investment decision-making process. Councils that were very conservative and risk averse only invested in government secured products, indicating that the habitus of those councils was the dominant factor. Other councils saw it as their responsibility to maximise returns to gain the most benefit for their council. This was a reflection of the influence of the introduction of NPM practices into local councils. NPM developed the expectation that public entities should seek to emulate the investment performances of the private sector. The habitus, capital and fields acted in concert to direct investment behaviour. Investment practices also changed over time as a result of changes to personnel, economic conditions, expert advice and influence from external fields.

There are a number of implications for councils in relation to investments. Councils need to be aware of the factors able to influence investment behaviour. One mechanism to control investment behaviour would be to establish clear guidelines and policies that reflect both the council and local communities' expectations for investment management. By recognizing that the general manager, by virtue of the capital vested in their position, are potentially the most influential individual within the organisation. Councils may seek to recruit individuals possessing similar beliefs to that of the council and community, or failing that, install controls and procedures to manage behavior. A clear and unambiguous the investment policy would function

as an effective control and prevent unacceptable practices. The council investment policy must stipulate the level of risk that the council is willing to accept.

Investment policies that have been stipulated by the State Government have changed over time. This has often been as a result of the condition of the prevailing market. During the period from 2000 to 2007 the investment policies in NSW gradually became more liberal and allowed investment in a wider range of products. This was possibly due to the fact that the market was growing and returns increasing. There was an expectation of continued high growth and good returns. When the GFC occurred and it was seen that NSW councils had lost significant amounts of money from investing in allowed products the reaction from the State Government was to limit the types of investments in which council could consider. This reactive approach to determining policy has only limited use. A more effective method would be to determine the types of investment allowed for local councils from a perspective of stewardship and preservation of capital.

Level of risk that is acceptable to councils will of course vary across councils however there have been suggestions that any risk of public funds should not be allowed and that councils priority should be to protect public monies. The *1925 Trustees Act* specifically stated that as trustees of public funds capital protection should be a priority therefore any risk under those guidelines would be unacceptable. There is a need to develop clear guidelines so the council officers are able to understand their responsibilities to protect the interests of stakeholders.

This should be developed through a consultative process with the local community to align council risk acceptance to what the community is also willing to accept. Councils should also seek to become involved in networking with other councils so that they can learn from the experiences of others and generate exchange of information. Governance of investments could be strengthened by actively seeking expert advice from independent investment advisors and other experts in the field. Skills of those charged with making investment decisions should be assessed and improved where required. Investment officers should also maintain a general understanding of the economic environment in which they operate to allow recognition of potential issues.

Adoption of private sector expectations of returns from investments set unrealistic expectations of returns if councils are unwilling to also accept the associated risk. The *1925 Trustees Act* has been reintroduced into the Minister's orders and while that remains, capital protection of investments is a priority and therefore acceptance of any risk would appear incongruent with that goal. However, as was experienced with the collapse of the market for CDOs, even so called capital protected CDOs failed. Therefore, to secure investments, councils should consider adopting policies that only allow investment in government insured products.

In this study discussion also encompassed the concept of all council investment portfolios being managed by a central body. The councils interviewed assess their investment performance based on the Bank Bill Swap rate (BBSW). All of them expressed the opinion that their investments had performed well as they were achieved rates 50 to 100 points above the BBSW. They were universal in saying that they disagreed with current calls in the press to centralise NSW local council investments. The reasons for this included that:

- they were achieving rates above the BBSW;
- they were more conservative than some other councils, so to relinquish control may result in them holding investments in products that would not suit their risk acceptance, and
- existing government investment bodies such as TCorp were unable to give returns equal to what is achievable from very secure investments like term deposits with the four major banks.

It would appear that there is not an existing government body sufficiently skilled, or trusted, that could manage the investment portfolio for all NSW councils. Equally, the councils interviewed acknowledged that they did not have the skills to properly evaluate products such as CDOs. The external investment advisor interviewed suggested that such skills do exist in Treasury and that it would be able to manage this sort of investment. If there was to be central investment of local government funds then the controlling body would need to have clear guidelines that specified what level (if any) of risk would be allowed. This body would have a large portfolio to manage and hence significant negotiation power. It would be able to attract highly

skilled personnel and reduce the current duplication of investment functions by officers in each council doing the same tasks.

This research demonstrated that some councils believe, and act as though they are independent bodies, with little accountability to anyone other than their own communities. While the DLG is supposed to provide oversight and governance of councils this study suggests that it was inefficient, lack appropriate power to enforce compliance, possess insufficient skills and knowledge to command respect and currently are unwilling to express opinions for fear of being found incorrect. This may very well be a result of insufficient resources and an inability to attract personnel with the required skills.

One of the problems appears to be that the DLG lacks the power to enforce compliance in some areas. In terms of governance of financial reporting, councils are required to provide their financial reports in a timely manner and to have internal audit committees. However even if they fail to provide the reports by the due date or decide to not have an internal audit function, or if they do fail to have sufficient independent members on the audit committee there are few if any repercussions for these decisions. This is further developed in Appendix three. There is a need to provide the DLG with the necessary legislative power to enforce good corporate governance practices.

There is no evidence to suggest that council investment portfolios could not be run from a central body. This research has shown that current management of investments is duplicated across each council and achieves similar results, and that the level of investment knowledge and skills within councils is limited. Councils with divergent perceptions of risk expressed an unwillingness to engage with a central investment body. One way in which this could be addressed would be to establish strict investment guidelines so that investments could only be made in government guaranteed securities. There would be a need for Treasury to develop an investment policy that stipulates what types of investments are suitable for public funds. The conservative approach is that public funds should never be placed at risk, while the alternative view is that public entities need to achieve returns similar to the private sector which aligns with the current perspective of embracing NPM practices.

There is a need to develop consensus over the management of public funds in order to adequately safeguard public funds.

8.5 Subsequent events

Since this study was instigated several attempts have been made to hold the rating agencies accountable for the decisions to invest in CDOs (Freed 2010; Schneider 2011; Stempel 2012). A number of legal actions have also been instigated, primarily internationally; however until recently no legal action had been successful. The first successful case against rating agencies occurred in Australia (West 2012b). The ruling accepted that councils had been duped by rating agency Standard & Poors (S&P) into buying toxic investments and that S&P had been acting in the interests of merchant banks not the investors. This case related to synthetic derivatives, which are closely related to CDOs. This case is the first to declare that rating agencies have a duty of care to investors and that they can no longer hide behind disclaimers to prevent liability (West 2012b). There has also been one successful action against a seller of CDOs and also occurred in Australia. This case relied on evidence that Lehmans had misled local councils and that they had misrepresented CDOs to councils. The reason that this case was successful was that Lehmans had taken over the management of the investment portfolios from some councils and failed to evaluate the risk of the CDOs properly. CDOs in which investments were made were rated at the highest rating of AAA, which did not accurately represent the risk of the products (Schneider 2012).

There have been investigations in the United States of America related to the collapse of the CDO market. These investigations by Federal and State Governments have chosen to pursue rating agency S&P in a civil action instead of criminal proceedings, as a lower standard of proof is required. The basis of the claim is that S&P misrepresented the true ratings of CDOs and that they were motivated by fees generated from providing ratings of CDOs and pressure from Wall Street (Sorkin & De La Merced 2013).

These lawsuits have provided encouragement for others wishing to take action against the developers and marketers of CDOs as well as the rating agencies which gave CDOs high ratings. In Australia the Rembrandt ruling (Shanahan, 2012; West

2012b) and the decision against Lehmans (Schneider 2012) have also highlighted that if there is an established relationship with an investment advisor, even an unwritten one, then the advisor has a fiduciary duty to disclose all factors and risks related to the investment products. In particular, they are required to declare interests that they have in any products they sell. The reason for this is that investment advisors hold a position of trust and confidence in the minds of investors and they should be able to rely on full disclosure of the structure and risk associated with investment products (West 2012b).

8.6 Future Research

There are a number of possible limitations with respect to this research. While the interview groups were possibly reflective of the population there is no assurance and therefore the information gathered may not be reflective of other councils and may not be transferable. This is of course due to the very nature of the research and the fact that the interviews were designed to draw out personal experiences and perceptions. The interpretations developed from this research are the result of the researcher's interpretation and while every attempt was made to limit the researchers influence it is unlikely that all personal bias of the researcher has been excluded. Generalising these results to all NSW councils may not be possible; however, they do indicate the problems surrounding council investment decisions and issues related to the protection public funds.

There has been however, been a number of questions which have arisen from this research. These questions could provide a basis for future research. The power of different groups within the local government community has been demonstrated from this research. This research has demonstrated that councils that were perceived as having more knowledge and resources were relied on to set the tone for the types of investment practices. As described by Bourdieu (1977) "Economic power lies not in wealth but in the relationship between wealth and a field of economic relations, the constitution of which is inseparable from the development of *a body of specialized agents*, with specific interest; it is in this relationship that wealth is constituted, in the form of capital" (p.184). The power relationships which were allowed to develop suggest that local councils were influenced by a diverse group of forces. These included finance professional, professional bodies, investment advisors

and those involved in marketing financial products. Further research is required to develop and explain how this array of influences may be controlled and used to support investment decision making.

There have also been a number of lawsuits which have been successful against the sellers of CDOs. The implications of this is that there may be changes to the way investment products are marketed and the level of information and understanding of financial products which should be developed before investors can become involved in them. Further research in the area of product disclosure information and the responsibilities of investors could be conducted.

The political power of the State and Federal Governments will also be further investigated. The State Government had the power to stipulate the types of investment in which local councils were able to invest. As a result of the collapse of the CDO market and substantial losses incurred by NSW councils the investment policy guidelines have become more restrictive. Changes to policy and the level of control exerted by State and federal Government could also be further researched.

Another area of further research will relate to the proposed changes to the level of autonomy granted to local councils. There are currently calls to incorporate local councils within the constitution. There are also suggestions that local councils should not be permitted to control their investment portfolios and that the State treasury should assume that responsibility. This discussion could be further researched to provide an understanding of the consequences of these proposals.

Additional research could also be conducted in relation to the concept of stewardship of investments in local councils. It is unclear at the present time what the role of an investment officer within councils should be. From one perspective the role should be to preserve the investment capital of the organisation for its intended purpose. Attaining sufficient return on that investment to maintain the buying power of those funds may also be seen as preserving the capital. Alternatively, perhaps the role of the financial investor should be to maximise returns for the purposes of achieving the best revenue from the investment? There are currently no clear guidelines as to what level of risk is permissible with the only form of guidance that financial managers

should act as a prudent person. Research in the area of what good stewardship and the types of acceptable risk will be conducted.

8.7 Final Remarks

The interviews with council officers analysed in Chapter 6 revealed that while councils that lost capital as a result of the failure of the market for CDOs had written down their portfolios to reflect that fact, there was also a systematic attempt to hide losses resulting from diminished or nil returns from those investments. As described by one interviewee, even though that council did not achieve returns from over \$10 million of investments for several years, they were still able to meet their targeted yields from their overall investments. This meant that the reported revenues did not cause alarm within the local community. Therefore lost revenue of more than \$500,000 per year did not appear in any reports. The amalgamation of investment returns effectively hid disappointing results from some investments. The manner in which reporting of investment income is presently conducted effectively hides poor performance from some investments.

As discussed in Chapter 4 local councils are in an unusual position. They are required to provide a wide range of services to their communities within a funding model over which they have no control. Councils are reliant on the State Government determinations for rate rises due to the rate pegging arrangements. Constraints on their ability to self-determine the level of rate revenue create a desire to maximise returns from other sources.

Similarly, the introduction of NPM practices into the public sector has created an expectation of achieving the same results that can be attained in the public sector. Whether that sort of expectation is reasonable within the local government sector is open to question. Should public sector organisations be expected or even allowed to pursue high risk projects? Whether public funds should only be invested in government secured products is open to debate. However if the priority is to preserve them then only government backed securities should be allowed. The reaction of the State treasury to the GFC has led to a reduction in the types of permitted investments for NSW local councils. There is a need to discuss the investment roles of councils and determine what should be the accepted practice. Is the protection of public assets at the core of public sector psyche, not the quest for profits? Modeling public sector

decisions on what the private sector does appear incongruent with the goal of an organisation established with the aim of service provision and protection of public resources.

The decisions whether or not to invest in CDOs were affected by a diverse range of factors. In some cases these factors were apparent and obvious to onlookers; however there were some factors that were less apparent. The perspective of the decision-makers was influenced by their experiences and knowledge of the investment sector. There were disparate perceptions of the value of independent investment advice. The reasons for this were due, at least in part, to doubts about the true independence of the advice provided. There were also concerns that there were only a limited number of investment advisors who were both familiar with the local council arena and available to local councils.

The interviews analysed in Chapter 6 also exposed the fact that council investment performances were generally being compared to the BBSW and that most councils were exceeding that base rate. Even when some councils were not obtaining returns from CDOs, they were able to achieve the base rate and therefore meet the returns expected from their investment portfolio. There was also apparent duplication of investment decision processes across the local government community. Therefore; calls to have a central investment body are not without merit.

There were a number of concerns about investment management expressed by council officers. One of those concerns related to handing investment funds to a State run body. There was a lack of trust that any state run body would be satisfactory and the examples cited were that the existing state run investment vehicles do not provide sufficient returns, nor do they provide satisfactory reporting. A second concern was related to conservative councils who did not want their portfolios in high risk investments. For a central investment body to function successfully there would need to be, clear and explicit guidelines controlling the types of investments that were allowed, with a power of veto from individual councils. It would be necessary for any such guidelines to also detail the nature of investments and whether capital protection is paramount. If capital protection were the stipulated requirement, then investments would need to be limited to government secured or insured institutions

and products. There would also need to be an investment body established that had the resources, skills and experience to properly manage investments.

Interviews with council officers highlighted that the attitude toward risk of the general manager permeated throughout the organisations. In respect of investment decisions, where general managers were conservative or had experienced negative investments in the past, they restricted speculative investments even if the policy approved by councils allowed more aggressive investment practices. While the investment decisions were more conservative in some cases than the policy allowed there was no suggestion that any investment decisions exceeded the boundaries of the individual council policies. This demonstrated that investment policies developed within the councils, limited speculative decisions to the boundaries stipulated within the council policy. Councils when making investment policy decisions should therefore understand that personnel in positions of authority may change and that the investment policy should govern and control investment practices.

There were a large number of factors identified from the interviews that affected the way investment decisions were made. Examining the factors independently would have developed a disjointed and confusing analysis. The use of Bourdieu's *Theory of Practice* and his categories of fields, capital and habitus have provided a framework to understand the investment decision-making process of the councils involved in this case study. The council investment decision-making process investigated in this study can be explained by applying Bourdieu's *Theory of practice* (1977) framework. By reviewing the factors identified within those categories, and then considering them in their entirety, the inter-relationships could be understood. This framework demonstrated that investment decisions were not made sequentially, nor were they made in isolation. There were many competing factors that investment decision-makers needed to consider simultaneously. This process resulted in sub-optimal results in some instances.

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Appendices

Appendix 1: Ministerial Investment Order

Appendix 1.1 Ministerial Investment Order, July 2005

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 day of 15TH JULY 2005


Hon DAVID CAMPBELL MP
Acting Minister for Local Government

Appendix 2: Investment Policies of Australian States.

State	Policy
New South Wales	Adopted a hybrid model which allows LGAs to invest in a Treasury approved list of authorised investments. Acceptable investments are those that comply with a Ministerial order under section 625(2) of the <i>Local Government Act</i> 1993, and this list is published in the NSW Government Gazette. LGAs are required to meet the requirements of the act and provide reports on their investment activities which certify that they comply with both the act and councils investment policies.
Queensland	Employ a “restrictive trustee” model which allows investment in only approved investments and a centralised funds management model. The choice of models depends on the size and sophistication of the respective authorities. Most LGAs invest funds in institutional products managed by the Queensland Treasury Corporation and Queensland Investment Corporation (Gold, 2008).
South Australia	Rely on LGAs being responsible managers of prudential funds, with a majority of financial investments being made through the Local Government Finance Authority of South Australia. This authority provides debt funding and liability management services to the LGAs. While LGAs in South Australia are unable to invest directly in shares or derivatives, they can however invest through equity instruments such as unit trusts and managed funds (Gold, 2008).
Tasmania	Apply a modern fiduciary model where LGAs are permitted to invest in any product that a trustee is authorised by law to invest trust funds. Additionally they are also permitted to invest in any investment product that the Treasurer has given approval (Gold, 2008).
Victoria	Adopted a hybrid model where LGAs are able to invest in a prescribed list of guaranteed securities using approved depositary institutions and trusts. They are required to only invest in short and long term debt securities that have a minimum credit rating level (Gold, 2008).
Western Australia	Have taken a de-centralised "modern fiduciary" model which impose significant duties on the officers of the LGAs to invest prudently while also having sufficient scope of knowledge to understand the purpose of the investments in which they are engaged (Gold, 2008).

(Adapted from Gold 2008)

Appendix 3: Alternative theories used in prior research

Other theories have been used in prior research to explain actions of the practices of local councils in Australia. This section briefly outlines some of the theories which have been used, provides reasons why they are not being used in this research and why the financial decision making of LGAs do not appear to be satisfactorily explained by these theories.

Institutional Theory

Early researchers in the area of institutional theory have proposed that organisations operate within a social framework of generally accepted norms and values, and have emphasised the “taken for granted” nature of institutional rules which then become inculcated into the values and social meaning of the organisation (Oliver, 1991; Meyer, 1977; Zucker, 1987). This theory postulates the existences of rationalised myths, isomorphism and legitimacy of actions. It therefore proposes that organisations are passive, only responding to external influences from more powerful and hierarchically superior bodies such as state, federal or even global influences.

As a result, in relation to NSW LGA, it could be proposed that the result of the pressures being exerted by external entities to conform to the “norms” have resulted in reporting that does little to provide useful information to stakeholders, and only meets the formal and informal requirements of political and legislative bodies. Pilcher and Dean (2009) suggest that “such pressures do provide a possible explanation as to why LGAs appear to be fixated with political stakeholders” (p.186) when it comes to the method and types of reports provided. However a more reasoned suggestion as to why LGAs provide the types of reports which they do, addressing the needs of the political stakeholders may be due the their reliance on State and federal funding and the requirements imposed on them to provide reports that comply with parliamentary expectations.

Legitimacy Theory

Legitimacy is often explicitly linked to rationality. Dillard *et al* (2004, p. 517) explain that rationality provides the legitimating conditions for evaluating practices.

This supports the view that if implementation of NPM practices and implementation of social and environmental reporting can be considered to be rational reforms, then the adoption of these reforms by LGAs should result in a greater level of legitimacy in society. This emphasises the concept that business values such as cost-effectiveness, operational rationality and productivity (Skalen, 2004, p. 251) can also be viewed as a legitimising process.

Legitimacy theory proposes that an organisation's survival is dependent on social and political support, via the delivery of socially responsible activities (Gaffikin, 2008, p. 203) which are able to meet the requirements imposed from both the political framework, and the needs of the community. This proposes that organisations such as LGA will seek to legitimise their actions to the providers of financial support such as the state and federal governments. Legitimising their actions to the general community will come secondary due to the reliance on external resources. In an effort to legitimise actions, organisations often seek to demonstrate that they have conformed to the norms and the regulatory environment in which they operate. The financial reporting process is dominated by the regulations imposed on LGAs.

Stakeholder Theory

Stakeholder theory suggests that organisations will seek to address the needs and expectations of their stakeholders, particularly those who are able to exert power (Gaffikin, 2008). LGAs in NSW have a diverse range of stakeholders who are interested in a wide variety of information. Each of these stakeholder groups will have different requirements and conflicting interests which need to be at least recognised by the LGA. Gray (2001) proposed that a number of layers of information need to be provided including;

- information defining elements of the stakeholder-authority relationship
- information required to discharge responsibilities through law and regulation

Appendices

- information that the authority wishes to report to their stakeholders including their mission statement
- information addressing the preferences and requirements of the stakeholders

Gray (2001) attested that using a systematic approach such as this enables local government authorities to “produce reports” that would be able to claim “completeness and transparency” (p12) while also providing the ability to give assurance in the eyes of the stakeholders that their needs are at least being considered.

Reasons why Institutional, Legitimacy and Stakeholders Theories have been rejected

First, an analysis was conducted of the compliance of LGAs in NSW with the lodgement of financial reports by the due date. It became clear from this analysis that a significant proportion of LGAs do not lodge their reports in a timely manner, possibly as there are no penalties for failure to lodge on time and they do not consider that they will be significantly impacted by not meeting the deadlines.

Financial Reporting Compliance

The State Government is the body with the power and authority over LGAs; they are able to remove councillors and appoint administrators and control their funding. The DLG has in place requirements for LGAs to provide annual account within a particular time frame each year (DLG, 2010a). In the private sector failure to provide reports by the due date would be likely to raise serious concerns from the providers of risk capital particularly, and potentially would impact on share price and shareholder confidence. However for LGAs, as the state government is the principal stakeholder, and the only body to whom LGAs can be said to be accountable, the ramifications of failure to lodge reports are significantly lower. The following Table highlights the compliance with the mandatory lodgement dates by NSW LGAs during 2008-09.

Local Council compliance with report lodgement dates

	Annual Report		State of the environment		Financial report		Access and equity statements	
	No of councils	%	No of councils	%	No of councils	%	No of councils	%
2009								
On time	124	81.6	135	88.8	147	96.7	135	88.8
Not on time	28	18.4	17	11.2	5	3.3	17	11.2
2008								
On time	102	67.1	105	69.1	140	91.2	N/A	N/A
Not on time	50	32.9	53	30.9	12	8.8	N/A	N/A

(Adapted from DLG, 2010a)

While the on time lodgement of reports has improved, it is also clear that the LGAs don't feel the same pressure to lodge on time as the private sector. Failure by private sector entities to present reports at the annual general meeting would not meet the needs of the stakeholders and would impact on the entities. However as LGAs primarily report to the state government (as the principal stakeholder), and the penalties for failure to meet deadlines are minimal, it appears that LGAs are less stringent in performing the reporting functions. Therefore it would appear that they are not meeting the needs of their primary stakeholder (State Government), nor do they seem to be trying to legitimise their actions.

Audit Committee Compliance

Secondly, an analysis of LGAs compliance with the recommendations from the DLG that they establish an internal audit committee was undertaken. Internal audit committees are used as a mechanism to provide governance and meet the needs of parliament (DLG, 2008a; DLG, 2008b; Sendt, 2002). It became apparent that a large proportion of LGAs are not complying with the DLG (2008a) recommendations for

the existence and the structure of internal audit committees, which are put in place as a measure of good governance.

Internal and external auditing functions are often considered to be similar however there are, along with those similarities and synergies, a number of differences. The external auditing of LGAs is a statutory provision which provides an opinion about the accuracy of the accounting and financial reports under the *Local Government Act 1993*. That opinion is made available to the stakeholders of the LGA and the audit work and extent of the audit has been mandated by the accounting and auditing regulations. Internal auditing differs from external auditing in that while external auditing is primarily used to provide independent assurance about the organisation, the principle areas of concern for the internal audit functions are on the internal operations of the organisation. These include a focus on how to monitor and improve internal controls, identifying areas of risk and evaluating methods of elimination, reduction and limitation of those risks, governance of the LGA (DLG, 2008a) by assisting them to meet the accountability needs of parliament (Sendt, 2002) and, assisting organisations to achieve their objectives by providing an independent, objective assurance and consulting activity which is designed to add value and improve the LGA's operations.

For LGA officers and councillors, an effective internal auditing function is able to provide a valuable resource due to the knowledge which internal auditors are able to develop about the organisation, its culture, environment, operations and risk elements. Hence the internal audit function forms an important component of a LGA's corporate governance framework (Subramaniam, 2004). Internal auditors are an integral part of the organisation but need to maintain separation and independence from management. Activities of the internal auditing are far more wide ranging than the external auditor (who is primarily concerned about the accuracy of the financial statements), and consider anything which may impact on the success of the organisation. This is achieved by evaluating and finding ways to improve the effectiveness of managing risk, organisational controls and the governance aspects of the organisation (Kemp, 2009). While the tasks, areas of investigation and activities of the internal auditor may be influenced by management, the intent is that they are

able to also provide an independent perspective. Independence is achieved by the internal auditors reporting their findings directly to the audit committee, who then report to LGA, thereby maintaining a level of separation of the internal auditors from management.

However for independence to be successfully achieved there needs to be an effective and independent audit committee in place. The internal audit committee performs a key role in supporting and overseeing internal audit activities by establishing the importance and direction of the internal audit process (DLG, 2008b), reviewing activities, directing special investigations, understanding the organisations specific risks and approving resources when required. While the audit committee should not assume day to day oversight of the internal auditors they need to have a good understanding of the internal audit functions to satisfy themselves of the adequacy of the internal audit function and ensure that satisfactory procedures are in place (Gay, 2005). The internal audit should be a major source of information for the committee about the organisation and open lines of communication are essential to allow proper flow of information (ANAO, 2004).

Members of the audit committee need to have the necessary skills, qualities and independence of mind to be able to function autonomously of management and act objectively in their deliberations. The strength of the audit committee should be the ability to demonstrate independence and the power to demand and seek information and explanations (ANAO, 2003). The Auditing and Assurance standards board have issued a guide to good practice and although it is primarily focused on ASX (Australian Stock Exchange) listed companies it provides good guidance for public sector committees. One of the essential components highlighted for a committee to be effective is that the committee be free of undue influence with the committee members not having executive powers, management functions or delegated financial responsibility (ANAO, 2003). A majority of independent members and an independent chair of the committee would demonstrate the ability to operate unencumbered by management and provide assurance the LGA are able to receive advice from an independent perspective (ANAO, 2003).

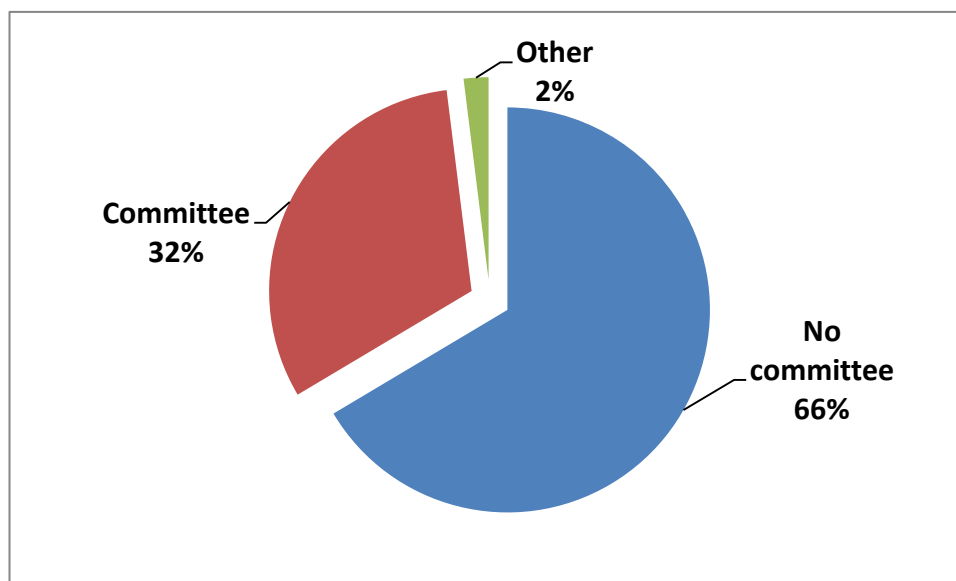
This is reinforced by recommendations from the NSW Department of Local Government (DLG) that there be a strong, independent representation of members who are external to the LGA. The DLG suggested structure is that the chair be one of the independent members, that there should be 1 or 2 additional independent members and 1 or 2 councillors (DLG, 2008b) and the LGA staff should only attend meetings in an observer capacity. While the DLG internal audit guidelines allow that the mayor or deputy mayor could be a member of the audit committee (although not the chair) this was later revised (DLG, 2010) to address the issues of independence and recommended that the mayor not be a member of the audit committee.

This was supported in a study by Sterck and Bouckaert (2006) who concluded that when the audit function was mandated by regulation, and where an audit committee was in place, that corporate governance was enhanced. At this stage the DLG Internal Audit Guidelines (2008b) state that good governance requires the key component of an audit committee, as it is pivotal to the governance framework, internal audits and it is strongly recommended that all [emphasis added] LGAs have an internal audit function to provide good internal governance, ensure consistency, improve risk management, control and governance and instil public confidence (DLG, 2008 b, p. 7). Additionally the guidelines highlight the need for external audits to satisfy statutory requirements and for effective risk management which should be overseen by both the LGA and the audit committee (DLG, 2008, p. 8-9). For LGAs their ultimate aim should be to serve the public interest and provide services to the community on behalf of the government (Uhrig, 2003, p. 30).

Review of Reporting and Audit Committee Compliance

A review the 2009-2010 Annual Reports of the 152 NSW LGAs and their websites was conducted to determine which LGAs had an internal audit committee. Of the 152 LGAs 101 (66%) provided no indication they had an audit committee while 48 (32%) LGAs indicated they did have an audit committee. Of the three remaining LGAs one had a governance committee which covered audit, one had developed an audit charter and one LGA's website was inaccessible. This data is displayed in the following Figure Appendix 3.1.

Figure Appendix 3.1: Audit Committees in NSW Local Councils



The next stage of the review examined the structure and membership of each audit committee to evaluate the level of independence of the committee. Of the 48 audit committees, it was found that the Mayor of the LGA was a member of 21 (44%) of those committees. This information is detailed in the following Figure Appendix 3.2.

Table Appendix 3.1: Regional and Metropolitan Council Audit Committees and Mayoral Participation

Council Type	Audit Committee	Audit Charter Only	No Audit committee	No Web site access	Total	Mayor on committee
Metropolitan	20	2	21		43	9
Regional	28		80	1	109	12
TOTAL	48	2	101	1	152	21

(Jones, 2011)

Discussion of Audit Committee Compliance Results

This research was based on information sourced from the LGAs' websites, and their annual reports, and therefore there remains the possibility that audit committees do exist in some other LGAs; however information about them has not been made

publically available. If that is the case then the researcher believes that in the interests of both being independent and demonstrating independence, that current disclosure practices are ineffective in providing information to stakeholders. If these results are an accurate reflection of the current LGAs who function with and without audit committees it demonstrates that LGAs present compliance with DLG guidelines and the recommendations for good corporate governance are inadequate. Presently there is not a mandated requirement for LGAs to have an audit committee however it is strongly recommended by the DLG and similarly to the ASX good governance guidelines (ASX, 2000), there is a “if not why not” condition which requires LGAs to explain why they are not following the guidelines.

With two thirds of LGAs in NSW not having an audit committee it is clear that with DLG guidelines lacking the force of legislation, compliance with them is therefore greatly diminished. Even though the DLG has issued revised guidelines (DLG, 2010b) to address issues of independence, one of which was that the mayor may not be a member of the audit committee, this has not been complied with. As explained earlier 21 (44%) of LGAs that have an audit committee also have the mayor as a member and in some cases the mayor is also the chair. In these circumstances it seems difficult if not impossible for the audit committee to be able to serve its primary function of providing independent advice to management and the councillors.

Both these elements indicate that LGAs are not concerned with, or do not feel compelled to either meet the needs of stakeholders, legitimise their actions or comply with the rules around the institution. They appear to believe they are able to function separately, with little consequence for failing to meet State Government expectations, as though they are able to exist in fiefdoms of their own. This demonstrates that institutional, legitimacy and stakeholder theories do not fully explain the actions and practices of NSW LGAs and that the use of Decision Theory coupled with Bourdieu’s *Theory of Practice* will enable a deeper understanding of how councils made investment decisions.

Appendix 4: Interview Questions

Greg Jones 16928679 NEAF application attachment

Schedule of interview questions (open-ended)

1. Who within the organisation is responsible for making investment decisions?
2. Is there an oversight body to whom reports are made?
3. Describe your understanding of the investment decision making process?
4. Describe your understanding of Department of Local Government's investment policy guidelines.
5. Is there an existing internal investment policy and if so describe?
6. Has the investment policy changed in recent years, and if so how?
7. Describe your understanding of your council's fiduciary duties.
8. What particular skills exist within this organisation for investment making decisions?
9. Has the organisation ever sought independent investment advice?
10. If so when, for what purpose and from whom?

Appendix 5: Councils Who Did and Did Not Invest in CDOs According to Type.

	Did not invest in CDOs	Invested in CDOs
Regional Councils	Ballina Shire Council Balranald Shire Council Bathurst Regional Council Bega Valley Shire Council Bellingen Shire Council Berrigan Shire Council Bogan Shire Council Bombala Council Boorowa Council Bourke Shire Council Brewarrina Shire Council Carrathool Shire Council Clarence Valley Council Cobar Shire Council Conargo Shire Council Coolamon Shire Council Cooma-Monaro Shire Council Coonamble Shire Council Cootamundra Shire Council Cowra Shire Council Dubbo City Council Dungog Shire Council Forbes Shire Council Gloucester Shire Council Greater Taree City Council Greater Hume Shire Council Gundagai Shire Council	Albury City Council Armidale Dumaresq Council Bland Shire Council Blayney Shire Council Broken Hill City Council Byron Shire Council Cabonne Council Central Darling Shire Council Cessnock City Council Coffs Harbour City Council Corowa Shire Council Deniliquin Council Eurobodalla Shire Council Gilgandra Shire Council Glen Innes Severn Council Goulburn Mulwaree Council Great Lakes Council Griffith City Council Gunnedah Shire Council Guyra Shire Council Port Macquarie-Hastings Council Hay Shire Council Inverell Shire Council The Council of the Municipality of Kiama Leeton Shire Council Lismore City Council

Regional Councils	<p>Did not invest in CDOs</p> <p>Gwydir Shire Council</p> <p>Harden Shire Council</p> <p>Jerilderie Shire Council</p> <p>Junee Shire Council</p> <p>Kempsey Shire Council</p> <p>Kyogle Council</p> <p>Lachlan Shire Council</p> <p>Lake Macquarie City Council</p> <p>Liverpool Plains Shire Council</p> <p>Lockhart Shire Council</p> <p>Mid-Western Regional Council</p> <p>Murray Shire Council</p> <p>Murrumbidgee Shire Council</p> <p>Nambucca Shire Council</p> <p>Narrandera Shire Council</p> <p>Narromine Shire Council</p> <p>Palerang Council</p> <p>Queanbeyan City Council</p> <p>Shellharbour City Council</p> <p>Snowy River Shire Council</p> <p>Temora Shire Council</p> <p>Upper Hunter Shire Council</p> <p>Urana Shire Council</p> <p>Wagga Wagga City Council</p> <p>The Council of the Shire of Wakool</p> <p>Warren Shire Council</p> <p>Weddin Shire Council</p> <p>Wentworth Shire Council</p>	<p>Invested in CDOs</p> <p>City of Lithgow Council</p> <p>Maitland City Council</p> <p>Moree Plains Shire Council</p> <p>Muswellbrook Shire Council</p> <p>Narrabri Shire Council</p> <p>Newcastle City Council</p> <p>Oberon Council</p> <p>Orange City Council</p> <p>Parkes Shire Council</p> <p>Port Stephens Council</p> <p>Richmond Valley Council</p> <p>Shoalhaven City Council</p> <p>Singleton Council</p> <p>Tamworth Regional Council</p> <p>Tenterfield Shire Council</p> <p>Tumbarumba Shire Council</p> <p>Tumut Shire Council</p> <p>Tweed Shire Council</p> <p>Upper Lachlan Shire Council</p> <p>Uralla Shire Council</p> <p>Walcha Council</p> <p>Walgett Shire Council</p> <p>Warrumbungle Shire Council</p> <p>Wellington Council</p> <p>Wingecarribee Shire Council</p> <p>Wollongong City Council</p> <p>Yass Valley Council</p> <p>Young Shire Council</p>
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Metropolitan Councils	Did not invest in CDOs	Invested in CDOs
	<p>Bankstown City Council</p> <p>The Hills Shire Council (Baulkham Hills)</p> <p>Blacktown City Council</p> <p>The Council of the City of Botany Bay</p> <p>Camden Council</p> <p>Campbelltown City Council</p> <p>Hawkesbury City Council</p> <p>Holroyd City Council</p> <p>Council of the Municipality of Hunters Hill</p> <p>Kogarah City Council</p> <p>Lane Cove Municipal Council</p> <p>Marrickville Council</p> <p>Mosman Municipal Council</p> <p>North Sydney Council</p> <p>Parramatta City Council</p> <p>Rockdale City Council</p> <p>Warringah Council</p> <p>Waverley Council</p> <p>Wyong Shire Council</p>	<p>Municipality of Ashfield</p> <p>Auburn City Council</p> <p>Blue Mountains City Council</p> <p>Burwood Council</p> <p>City of Canada Bay Council</p> <p>Canterbury City Council</p> <p>Fairfield City Council</p> <p>Gosford City Council</p> <p>Shire of Hornsby</p> <p>Hurstville City Council</p> <p>Ku-ring-gai Council</p> <p>Leichhardt Municipal Council</p> <p>Liverpool City Council</p> <p>Manly Council</p> <p>Penrith City Council</p> <p>Pittwater Council</p> <p>Randwick City Council</p> <p>Ryde City Council</p> <p>Strathfield Municipal Council</p> <p>Sutherland Shire Council</p> <p>Council of the City of Sydney</p> <p>Willoughby City Council</p> <p>Wollondilly Shire Council</p> <p>Woollahra Municipal Council</p>

Appendix 6: Invitation Letter

Greg Jones 16928679 NEAF application attachment

Invitation letter/email

My name is Greg Jones and I am a PhD student at the University of Western Sydney. My research is in the area of Local Government corporate governance and investment practices. I would like the opportunity to interview you about the way financial investment decisions are made within your council.

The interview would be at your place of work (or elsewhere if that is more convenient) and should take less than an hour of your time.

The purpose of the interview is to develop an understanding of the investment decision making process including existing (and previous) policy, types of skills possessed by the decision makers, independent advice sought, understanding of the council fiduciary duties and Department of local government guidelines.

Your assistance with the research would be greatly appreciated. If you are willing to participate could you please reply by return email to 16928679@student.uws.edu.au

Thanking you in anticipation

Greg Jones

Appendix 7: Participant Information Sheet

Participant Information Sheet (General)

Project Title: Financial Investment Practices of Australian Local Government: A Corporate Governance Perspective

Who is carrying out the study? Financial Investment Practices of Australian Local Government: A Corporate Governance Perspective

Dr Phil Ross: Supervisor

Dr Anne Abraham: Supervisor

The research will form the basis for the degree of Doctor of Philosophy at the University of Western Sydney under the supervision of Assoc Prof Phil Ross (Head of School of Accounting) and Dr Anne Abraham (Assoc Head of School of Accounting).

What is the study about? The purpose is to investigate local government investment practices and develop understanding of corporate governance aspects of investment decision making

What does the study involve? Participants will participate in an interview which will be conducted at the participant's place of employment (or another place of their choosing) and the interview will be audio recorded to allow review of comments made

How much time will the study take? Interviews are expected to not take any longer than one hour.

Will the study benefit me? Whereas there is no specific benefit for participants, involvement in the research will provide an opportunity to reflect on financial decision making processes.

Will the study involve any discomfort for me? The project has negligible risk for participants. The only discomfort will be providing time to participate in the interview.

How is this study being paid for? The study is being done as part of a PhD and no sponsorship has been sought or received

Will anyone else know the results? How will the results be disseminated? All aspects of the study, including results, will be confidential and only the primary researcher will have access to information on participants. The results will be disseminated, in anonymous format, in a doctoral dissertation and also in refereed conference papers and journal articles.

Can I withdraw from the study? Participation is entirely voluntary: you are not obliged to be involved and - if you do participate - you can withdraw at any time without giving any reason and without any consequences.

Can I tell other people about the study? Yes, you can tell other people about the study by providing them with the chief investigator's contact details. They can contact the chief investigator to discuss their participation in the research project and obtain an information sheet.

What if I require further information? When you have read this information, Greg Jones will discuss it with you further and answer any questions you may have. If you would like to know more at any stage, please feel free to contact

Greg Jones: 0409 973 329 or 16928679@student.uws.edu.au

Dr Anne Abraham: Supervisor, Ph 9682 9212 or a.abraham@uws.edu.au

Phil Ross: Supervisor, Ph 9685 9451 or p.ross@uws.edu.au

What if I have a complaint? This study has been approved by the University of Western Sydney Human Research Ethics Committee. The Approval number is H9265

If you have any complaints or reservations about the ethical conduct of this research, you may contact the Ethics Committee through the Office of Research Services on

Tel +61 2 4736 0229 Fax +61 2 4736 0013

or email humanethics@uws.edu.au.

Any issues you raise will be treated in confidence and investigated fully, and you will be informed of the outcome.

If you agree to participate in this study, you may be asked to sign the Participant Consent Form.

Appendix 8: Consent Form

Human Research Ethics Committee

Office of Research Services

This is a project specific consent form. It restricts the use of the data collected to the named project by the named investigators.

Participant Consent Form

Project Title: Financial Investment Practices of Australian Local Government: A Corporate Governance Perspective

I....., consent to participate in the research project titled Financial Investment Practices of Australian Local Government: A Corporate Governance Perspective .

I acknowledge that:

I have read the participant information sheet and have been given the opportunity to discuss the information and my involvement in the project with the researcher/s.

The procedures required for the project and the time involved have been explained to me, and any questions I have about the project have been answered to my satisfaction.

I consent to participating in the interview and understand that there will be an audio recording made of the interview

I understand that my involvement is confidential and that the information gained during the study may be published but no information about me will be used in any way that reveals my identity.

I understand that I can withdraw from the study at any time, without affecting my relationship with the researcher/s now or in the future.

Signed

Name

Date

Mr Greg Jones

38 Kathryn St

Kanahooka NSW 2530

Appendix 9: Indicative Transcript (C6)

Interviewee: C6

Interviewer: Greg Jones

Date: February 23rd 2012

Time 10 am

C6: Invested in CDOs

R: What I am looking at is the process involved in making investment decisions

Yes

R: What corporate governance practices you have, what safeguards you have and particularly around the time of investing in CDOs

Yep no problem

R: Did you invest in CDOs

Yes Yes we did I mean it was flavour of the month back then. A lot of councils got involved in them. We have been pretty good. I have been manager of finance here about ten years and when i inherited the role we had 52 million dollars of them.

R: In CDOS?

Yeah By the time I got in to them I got it down to about 17 million. I got out of them. What happened is we have a south east metropolitan finance professional group. There are rock groups in local government but ours is AAA rock we take in Council A and Council B and all that ... in this ABC financial professions group. It would of back in... oh when was the height of the thing would have been 07-08 when the trouble was. I took over the portfolio here about 2003 so probably about 05 maybe even a little before that. Our group gets together, all the finance mangers and we get a sponsor that sponsors us they throw in a thousand bucks and what we basically do is we go to a location away from the offices, it might be a hotel or something, or LLL town plaza or ... and here we took them to PPP regional gallery that so of thing. So it gets them out of house. We get these guest speakers on different topics and basically the sponsorship pays for the hire of the facility plus lunch ect. Now we have been doing the successfully now since 2004 2005. It's been good because it has allowed all those councils the all 18-19 of us to share things including what happened here with the investments. But the main thrust of my story is that about 05 we had the Commonwealth sponsor us and they had merged with First State Colonial at that

stage and the Commonwealth they were all, they were all guilty of it, they were all basically at the end of the day flogging CDOs there was nothing else shall we say sexy around at the time as far as investments were concerned. CDOs was it and you could get great returns and obviously risks were in there and we knew a fair bit about them but there were other risks we were not exposed out or given out especially through Grange or Lehmans at that time.

We sat in this room and the Commonwealth Bank (CBA) sponsored it and we had a guest speaker from first Colonial who had just been merged with them and he bashed the shit out of them. He told you all the problems with them, the duplication in names and where they were, and here were the CBA the sponsor sitting there and what ended up happening on the floor was a great big debate between CBA and their new partner First Colonial. So it was great. The pros and the cons, CBA saying that there was nothing wrong and this guy well he showed how they were duplicating names how they were the same in many of them he gave examples, he did all this and the dangers of them and it was basically at that point that at that meeting that I came back and I thought that I am going to have a really good look at what we have got in this portfolio at what I have inherited, and they were everywhere. You would have for example Ford Motor Company, you would have 13 CDOs and you would have the name in 11 of them, you know, so as soon as you had a credit default, Bang, they were a credit default on the whole 11 of them. They had these triple CDOs they had all sorts of things and names for them and the names were repeated and it became when you looked at the cross of CDOs that were out there, there was a lot of companies that were duplicated in a lot of these and they were the same names and hence I went down from about 52 mil to about 19 where I made sure that the portfolio that we had basically did not double up a lot on these names and that they were reasonable products

R: So were you able to get out of them easily?

They were tradable they were very, very liquid and very tradable

R: In 2005?

Yes and hence the irresponsibility of Lehmans in the way they used to trade them. See there were two thoughts here, there were two thoughts, CDOs had a maturity date you could get them for three five seven years, even ten years fifteen years right. Now the way they were designed they paid handsome coupons and some of them were what was called capital guaranteed you know they were good so long as the financier being the bank or whoever didn't fall over but the bottom line was we looked at them as a long term investment. We had a portfolio where our strategy here and it still is today and you are talking about our policies and that and it's in our policy at the end of the day is that we know where our cash flows are and what are our what we call our working funds for our day to day operations and budget and

Appendices

what they are, are short term funds. You have got to keep the cash flow rolling over and it is just logical at the end of the day it is just like your home budget.

R: Right

Over here you had things like section 94 developer contributions where they could only be used for a specific purpose you had a plan for them and they were to embellish this park or do this in six years' time or seven years' time or whatever. Now we had well over 50 million dollars of these section 94s and we also had other reserves that we knew we would not use for four or five years or whatever. They were our long term monies we did not need that money at that time, our portfolio is normally about one hundred and twenty million investment out at any time it goes between say 100 to 120. So half our portfolio was long term and the other half was keeping it short term.

R: And where were the short term invested?

Yeah term deposits managed funds things that were very liquid, obviously the short term you wanted liquid. Now the argument out there was that CDOs were highly liquid and they were. But because they had a term to them that wasn't the reason that I got into them. I got into them as a long term investment based on maturity dates. I did not want to be trading CDOs every day of the week like a lot of people did.

R: Right

So what Lehmans did at the end of the day was they came in and they convinced the market that CDOs were very highly liquid and even though they had maturity dates of five years, I mean why have five years at the end of the day that is a long term investment. They were flogging them as highly liquid and therefore short term investments. Hence they created these IMP which you have probably heard about, Individual Managed Portfolio, they convinced councils to sign up to them. They were trading there was one councils, I ... can't tell you the name of them because of confidentiality reasons but if you have read a lot you will probably find out in the end anyway. It was one country council down the Hume Highway that basically signed their whole portfolio up to Lehmans they went into this IMP and their whole portfolio was CDOs now at the end of the day what happened was that was their short term money and everything. While here we are talking about 120 million this was a council with 10-15 million in investments and they were all in CDOs.

I went down there I had a visit for a reason and I talked to the person down there in relation to investments and they asked why we had not signed up to IMPs and I told them the reasons and he said no we are getting great returns and they showed me a statement that they had from Lehmans, it was a monthly statement, and they had traded at least 20 times in that month at least one or two a day, 20 times in what is it 22 working days, they had traded nearly every day a CDO. And the reason for that

was that Lehman's being the trader at the end of the day got a certain commission out of them so this is where it all gets done to irresponsibility and did they do the right thing. So what happened here is I looked at it and I was just aghast and I said but they are trading every day. And they said yeah but look at the returns. They were getting 8.7%. they were getting magnificent returns but the thing was at the end of the day was that they were feeding the commission to these people and they had no diversity in their portfolio, they had them all in CDOs and it was just against to look at what they did. So all those events triggered to me to go you know our portfolio is all about diversity, it always has been, it's about making sure that you have coverage in reasonable entities, you don't have too much coverage across any one entity, you don't have as far as the risk is concerned, you don't have 525 of your portfolio or 100% of your portfolio at the end of the day in CDOs and so we had equity link notes we had CDOs we had managed funds we had term deposits we had floating rate notes we had all sorts of things. And we had them well diversified at the end of the day so ... when the financial crisis hit we had about 19 million in CDOs and the other problematic ones were the equity or property link notes which were Longreach products at that stage. Now the thing with these products the Longreach ones they were long term too because they had a maturity now they were based on paying coupons again but if it got to a certain level that would stop and then they were guaranteed at the end of the term, they would build up the capital until you got your capital back so they were capital guaranteed as well. So the thing was we had roughly about 30 million of those. So we had about 49 we had our long term in investments wrapped up in what we called long term products which were the CDOs and the equity link notes. So about 49 million all up. Today even though we pared the market rates in the books of the account out of that 49 million we have lost one CDO completely, that was Blue Gum that was four and a half million dollars the rest of them they have all matured they have all basically paid there is I think about 23 million left on the books, one of those is four and a half million which matures in April which in Flinders CDO so once again with those we have got all the non-capital guaranteed off our books so we have got none of those CDOs, we have got one that is listed as a capital guaranteed which was Nexus Topaz it doesn't come off for a few years and then we have one CDO left. We have about three Longreach notes left and most of them mature over the next twelve months or so. So I guess unfortunately for the community we lost one which was four and a half million but in relation to the total amount of our whole portfolio we ended up pretty good out of it. We set a strategy with council at the time where we talked to them about capital guaranteed we talked to them about ... there was a lot of ...when the bust happened there was a lot of confusion there was a lot of before they fall any further let's get out of them. So if you had a CDO which was four million and now the market was saying the value was down to two we had some people saying let's get out of them. Now you had to make a decision at that time you could have got out and had a capital loss of two million and then for that period try and see if you could make that

back up in interest to see if you could get back to the value and in most cases they were well down in value you couldn't do that. So you had to cut your losses and say look there is no coupons here but the main thing was that the strategy was lets hold them, lets hold them. They were there for a long term investment so we went back to the philosophy that we put them on in the first place, they were a long term investment lets hold them there as they are a long term investment unfortunately coupons are not paying but at the end of the day the capital value of those section 94 monies should come back.

There was a lot of pressure on, a lot of pressure in this council as well, because those section 94 monies we were talking about were basically there to ... and what council uses them here is they are there for specific purposes where they have been collected as developer contributions and in most cases they are to embellish land for parking or reserves or whatever it may be. What this council has got is the most of our portfolio is nearly 90% of it is to purchase land to meet that criteria. So if it is to provide parking it will be earmarked to purchase that property there in ten years' time it will be parking. That property over there in five years' time to do that. What was coming from the council the manager everyone at the end of the day was gee whiz we have got to hedge something here because we have a future liability here whereby we have got to pay to get that block of land and the shire I think the.... I think over the ten or fifteen year period we looked at there was something like in the Southerland shire property values were going up something like 9-15% per annum. You couldn't get investments to get that. Only CDOs and those types of things hence the push came in and a lot of councils were the same A lot of councils won't say that but that was what happened. The push was to try to hedge the asset, the investment against the liability to see if you could keep the up with the market rate of what you were going to do out there. That was one of the strategies that this council had. That is one of the reasons that we went into the CDOs and the equity link notes they were great returns they were really good.

R: But the risk was there?

The risk was always there I said to the council that the risk is there at the end of the day

R: So the risk in CDOs was identified early on?

The risk in CDOs I guess the risks were identified but they weren't identified to the duplications, the same names, the bases within them of how they worked I guess at the end of the day I have got a reasonable idea but they were a complicated animal to explain to people at the end of the day you know they were really sort of complicated and the thing was they were the flavour of the month everybody was into them at the end of the day. Some councils didn't, I didn't want the exposure to the extent that we had in them but basically at the end of the day to do the performance and get to

where we wanted to be, that was it. In a perfect world if they had stayed where they were we would have made a motza out of them I mean that was what everyone was basically saying.

I think where the irresponsibility came in; I think there is a few things here. Councils had to take some responsibility yes, but I don't think they were a product that should have been exposed to the government or charities or any of those types of institutions. So it gets back again to the sloppiness in relation to how they were marketed and how they were rated by Standard and Poors and all these sorts of things and how

R: So do you blame the ministry guidelines for that or Lehmans or something else?

I think there was a whole lot of circumstances, I think Lehmans bent a lot of it. I think they did a lot of things especially when they moved into the names and they got exposed in the sub-primes and all this sort of stuff. Nobody was saying to us at the back end of this that some of those products in name could have been involved in the sub-primes which was happening in America. People knew of these things through the current affairs programs that these things were going on but not to the extent of how it filtered right through and I think that is the thing. I mean to me these guys were involved in it. What was it Fanny May and the other one. I mean it got back if you really want to know where the blame started I guess it goes back to the US government I mean it was there was an article in the New York Times or something a journo who expressed real concern about the US Government were basically they the Government were out to improve they wanted to make the housing market statistics they wanted to make everything grand and great and this story goes on and I believe it's true because it's got support and this journo expressed great concern that they were pushing for these type of mortgages to give it to low and poor income people to at the end of the day to push the market percentages up in the US and make it look better and everything else.

The companies did that and then you had your commission hunters and I guess they were part of the sales reps that did all these things and so who to blame it's too big I really don't know. I think it started with the US nothing would have happened if it didn't get that push then it went to the greedy sharks who wanted the commissions and the mortgages foreclosing and all this sort of stuff at the end of the day the then CDOs got mixed up in it but certainly I think Lehmans and some of the others pushed way over the risk exposure lines to sell they went should we stop here or should we keep pushing it and they kept pushing it I think that is where it all came undone.

The ministerial guidelines they would not have known what was going on. Let's be honest.

R: Don't they have a responsibility to?

They do, they do, but they are a watch dog on local government they are not practitioners at the end of the day as far as I am concerned I don't believe they knew what was going on. They didn't come along and say we think this thing is wrong to give you an example If they had some responsibility for it and they could see what was going on they would not have put template financial statements out that in the investment part of it in note 6 it had lines there that had equity link notes collateralised debt obligations, it was in their template so they knew that we were in that. You wouldn't have had the financial professionals come out with an investment guidelines paper that basically gave you guidelines for investing in CDOs.

R: Who was that?

That was the NSW Finance professionals. So if you go to guys like oh who is the best to go to there, oh guys like [finance manager], over at LLL Council. You could try the financial professional website but you may need a password but certainly Tim Butler there were guidelines out that showed best practice investment guidelines. In there ,there was investment guidelines specifically for investment in CDOs so there was no one out there that was saying don't invest in them. There was a couple of guys around the guy from Spectra Finance* which was local here that said councils have a fiduciary responsibility to not to ... not to lose the capital full stop. So his point and it was a good point, his point was that if there was any consideration of capital being lost at all Local Government and others should not be investing in it. And that would have meant no CDOs no equity link notes.

R: What if the CDOs was a capital protected product?

It would have met the guidelines but if you talk to the external auditor he will basically say you have lost all that interest that inflationary dollar terms over those years.

R: So they were not capital protected?

Yeah that is basically it. The thing is sure you are behind in that but you have got to from our point of view we looked at it and said that if the face value of it is return then it would be the same as that section 94 money sitting there without being invested. Now what do we do, do we lose the capital, if we can capital protect it then that is great, so capital protection came in and it is a loose term as you would be aware but it was basically there as another I guess selling point for councils to be able to go in saying it is protected.

R: But you are still reliant on the financial institution backing it to be viable?

*Publically available information

That was another thing with those equity property linked notes we would not touch them unless they were a reasonable bank now what's a reasonable bank today? I guess you could have said that Lehmans was one of the big four and that was a reasonable bank. Look this is personal I did not like Lehmans. Maybe that was why I was more protected than a lot of the others and haven't lost as much as them. They were a hard sell company that came in.

R: How did they market?

They marketed aggressively. They marketed it as though you were doing something wrong if you didn't go into it. They marketed it from the point of view that you had great returns. I had two reps in here won't mention their names and one of the lasses turned to me and said that they were trying to hard sell it and that was the end of it for me when they turned to me and said that these were safer than a term deposit. And I said and I had one of my staff here and she would be happy to confirm and I said you are kidding me are you telling me that I can put my grandmothers inheritance into a CDO and it will be safer than putting it into a high grade bank term deposit. And she said yes. And I said I don't need to discuss this any further, that is the silliest thing I have ever heard. They said no over the long term of 25 years and I said no it's ridiculous we are not talking about 25 years. So they had a hard sell where they tried to make people believe that you were doing the wrong thing if you weren't getting the best returns. You see it all got back to the philosophy of hedging the asset against the liability. A lot of councils were the same but they won't sort of say that but it was a fact of trying to keep it abreast with that because you were losing value anyway hence it went bust and we lost it anyway but the bottom line was trying to keep it up there.

The markets were booming if you remember everybody was great, no one thought about the 7 or 10 year cycles where they go back down and all of that and out there in the market place you just need a little pin prick in the balloon and they all go running and they all start selling on the stock exchange you know and it is a very reactive market. Since those times at the end of the day the thing was it was a hard sell they had a guy I don't know if you have researched David Rosenbloom I don't know if you have heard of him.

David* was a fellow finance manager practitioner at KK council and he went in there and he took personal control as manager of finance in there on the CDO portfolio and he traded them. He traded them as though they were rugby league cards you know he would just trade them. And we would have our financial professionals meetings right and David would come along and he would have a Canadian or American accent I don't know what his background was and he used to tell us how you are doing this

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and doing that anyway there were a number of things operational wise where I had a few clashes with him over different things and I said to [Finance manager] I don't think that sitting there as manager of finance trading CDOs making money for the council at the end of the day is really a role. It is one of your roles but it is not the role and he sort of took a bit of an exception to that. Next thing I knew he has gone to Grange, because he was so good at these things, and he did know them backwards, he knew them better than anyone else in Local Government. Grange took him up and he became their head sales guy. He used to go out to the councils and he was one of the reasons he hard sold these IMPs. Now a couple of years down the track or a year and a half after he had been with grange who you know Lehman's took them over. I never dealt with Lehman Brothers under the title Lehman's. Never OK. All my CDOs and dealings were with Grange

Right

Then they were with Grange prior to David Rosenbloom* OK. So that is where it got personal at the end of the day because I did not believe what this guy was doing was right in relation to how he was flogging them off as day to day liquid assets that you could just trade and get as much out of it because you could see behind it and see that they were getting very generous commissions. And I thought it was wrong. Anyway what we ended up doing at one of our financial professional meetings was we invited him along because Grange sponsored the session the day and he came along and he talked about treasury management. And he sat in that chamber with all of these councils the whole 18-19 of us and basically put a presentation up and told the whole room that only two councils in the room were doing the right thing by the council the rest of you were irresponsible

That went over... I was chairman of that group at that stage and I thought oh David you Anyway they listened to it and he went through it and he showed them how with CDOs you have got this so the sell was there. So some of these poor buggers sitting there, the fresh finance managers or whatever at the end of the day are looking at this and thinking that maybe I am doing the wrong thing. There was a sell of hey you are not doing your job here you're not doing the right thing which was really wrong. When he got out of the room some of the old heads in that room Gary Mills from Marrickville and some of the other boys who had been around as long as me they basically said don't invite that prick back here again. Because we are not going to sit here and listen to that you know. And I thought well you know they sponsored da da da da. Apparently so it goes he went to North Rock which is one of the Northern Councils did the same thing and they threw him out after 10 minutes. They had the balls to do it we didn't. Maybe I should have but I thought oh well no-one is

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objecting here we might as well let him go with it but he basically for the older heads he cruelled it. But I just wonder there was some young blokes in there and some of those councils invested more in CDOs. And some of those councils signed up for IMP which was what he was pushing.

I have been interviewed by Piper Alderman* and all sorts of things because we are part of the group that is looking at getting some of our interest back I guess because other than Blue Gum we have got the other principles back but you know I always said to them... the question they asked me was I ever approached to go into an IMP and the answer was yes I was once David came in here He talked to me about it and he talked about hedging loans and he talked about all sorts of different things and basically had the paper work to say you know sign there for an IMP. What about if I take some of your portfolio and manage it for you, not all of it but some of it. But their focus was all or some of it if they could not get all. At that time I had one problematic CDO at that stage. What was it? I ended up getting rid of it I can't remember the name Coolgardie or something they all had strange names. So I said to him OK David I won't sign that but I will give you 1 CDO that you can tell me how you are going to manage it and get me greater returns. So I gave it to him and he said but that one is problematic. I said that's why I am giving it to you if you can't do that one what is the point of giving you the others. He said let me think about it. He went away and I never heard from him. So the bottom line was that was a bad egg, he knew it, I got rid of it I mean I could tell by the simple expression that oh that is a problematic one that one. I thought well he knows the market better than anyone, I have milked a bit of info here I better get rid of the bloody thing. I sold it a little bit under but still. But the bottom line here was that it was a con so yeah I think that Lehmans in the IMP that they had certainly we did not signup, a lot of councils did, I think they were a little irresponsible in it as well at the end of the day.

R: When you said no did Lehmans make any other approaches?

Yes they did. QQ the guy I mentioned from the financial professionals at PP mentioned that they did that to him. What was good was this financial professionals group that we have, its a network and guys get to talk to each other and guys were starting to talk about the types of approaches that they were doing. For some of them it was a bit too late I mean, they had a greater influence, and I don't know the statistics on this so i will stand corrected on this, but I think they had a greater influence with their IMP in the country regional areas. Because they don't have the expertise they don't have the people. Some of those councils a guy will do four jobs where I have an individual in each one of those jobs so they specialise. So the small council officers have so much on their plate so signing that over to them like some of the councils did at the end of the day was easy for them.

*Publically available information

R: So that made sense to them.

Yeah but to me it was like giving up the keys to your car to them for them to drive and it just wasn't there. I never ever approached the council I never even went near the management to say do you want to consider an IMP. That was a judgement on my own part that we wouldn't go into that. I was never comfortable with it, I wasn't comfortable with them.

R: So you had that level of authority to make that level of decision?

What with our policy is that the council gives the authority in relation to investment decisions and those types of things down to the general manager the director of corporate services and the manager of finance, myself. Now if there is a big trade or something wherein we might lose money or something. Recently we got out of a Longreach note about 2 years earlier than its maturity. We have an investment advisor, Denison Advisory, I don't know if you have heard of them. They did all the sums. Now to sell that equity link note the Longreach note to get out of it early, make a capital loss, invest it in something else, so that when the time of the maturity of the normal note would have come up we would have been in front, and we are we are about \$300,000 in front. It was a magnificent opportunity because what it was, it was only 18 months ago, it was to go into a term deposit for that couple of years with Investec Bank at 7.65% and I have still got it on the portfolio and the rate was so good and it was an opportunity that we got out of the other. Now that decision I would not do myself, because were taking a capital loss on it. That decision I consulted with the director and the general manager and we even consulted with some councillors to say what do we do with that. So they could bring the records in now and say we have surplus cash of this amount and I will say invest it here or leave it in the CBA high saver or something like that. They might come in and say this 2 million is maturing we need it cash flow wise for the next 6 months we do all our cash flows. What will we put on we will get quotes for rates we might get 3, 4, 5 or a dozen quotes because we get all the rate sheets anyway and the we will come back we will look at it and I will make the decision where to invest it at the end of the day. So those types of normal routine decisions I will make the decision at the end of the day on the rates. It is not difficult now it is only term deposits or floating rate notes now, so unless you are going to go and invest in a Spanish bank or something like that there is not a lot of decisions to make with it. Certainly when the CDOs and equity link notes started to come in, yes the decisions were there to be made. I put a monthly investment report up to council anyway and in those I tell them the trades we had each day, even the Longreach notes were pretty liquid there was no problem if they had any issues with them at the end of the day.

We were probably pretty adventurous because we had ... how do I say this...I guess we did a couple of things whereby we did them well or we were lucky, I don't know.

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We were the first councils to test the Ministers order on the grounds of investing directly on the stock exchange. I don't know if you know about that.

R: No

What happened it was all centred around this hedging this section 94 again. Now we have a property division in here it has got about 50 million property portfolio of which we get out of and we've got commercial properties all sorts of things. So that property director over there has different contacts in the market, property markets all that sort of thing. So this goes back to before the bubble burst this would have gone back to probably 04, back then 03-04 and it's an interesting story. Do you want to hear it?

R: Yes

It's an interesting story, because this will give you an insight into the ministers orders and the lack of understanding or the lack of knowing what to do. OK. From their perspective

R: right

We came along and we said to the council, ok you want to hedge this so we said ok what if we took ten million dollars and sourced a product out that we thought was reasonable, that would get us high returns and be able to keep the asset above the liability. They said right. So we went away and we engaged a high profile property consultant by the name of Hamish Flet who worked for a lot of big companies lend lease all those, contracts to them. He now works a lot with superannuation funds those types of things. So he came along and he said unlisted property trusts and we said... problem is they are not highly liquid so if we needed the money then they would be very difficult to get out of. You can get out of them but it might take you 12 months or so to get out of them you can't say you want your money in three days. We didn't think it conformed with the ministers order, we had a good look at them and we got a legal opinion and the legal opinion said no I don't I don't think so. So Hamish turned around and said what about property listed and they said interesting, so we went away had a look and we came back. Again we went and got a legal opinion, outside, they looked at it, they looked at the ministers order, I forget which part it was in relation to its rating and they said what are you interested in, we said general property trust and Westfield's. Five Million in each. The legal opinion said that we believe you have got grounds and you can do it. We said are you sure. They said yeah. So we decided we would go to council. We went up to council...so these decisions are outside of me. These are decisions I would take to council, so it is day to day stuff is mine but basically anything like this is definitely the council first, even above the general manager. We took it to council and their biggest concern was they had had fights with Westfield's all these years and they did not like Westfield's. We

were saying no this is Westfield's Property this is a different company. They said no, no we don't like Westfield's we don't like the connotation. So we said right we will put it all into general property trust but no that is not diversifying 10 mill that is 10% of our portfolio sitting in one thing. They said no let's do that. So they made that decision. We said not but they wanted to go ahead, and some of the old heads on the council even today say wasn't that a great decision we made. We went into that general property trust. Our strategy was to hold it there for five years, we had a target that we wanted to achieve in five years, and we had reached that target in 14 months. We had got 33% interest in 14 months. We got something like 2 million dollars capital growth on it so we got all these coupons....We went in with \$10 million and we came out just under \$15 million in 14 months. The investment advisor we had at the time SSS said pull out.

R: So was SSS an external advisor?

Yeah SSS he is the guy that does consultancy for the super funds. He said no get out now you have achieved your targets, that's all you wanted to achieve, I can tell you now that I don't believe that that will be maintained if you stay in there. Now insider trading whatever you want to call it, you are more expert with this than me, does it happen, well.... We pull out of it get all this money then 2 months later Stocklands come out and say that they are putting a merger bid over general property trust this is the share price we are offering and it went way down. Now that merger never went ahead Stocklands never got up, someone else got up and I can't remember who that was but they still got merged at the end of the day the general property trust. So the timing was impeccable. The reasons to get out were that we had achieved the targets and they were not going to be maintained but I still say was there something we didn't know and that this bloke did know. But what that did especially in the council those we a bit cocky and were thinking that they were good at investments. They were saying gee this was good what else can we get into. So they didn't have a problem with CDOs they didn't have a problem with these risk things. We would say what the risk was with things and everyone was driven by this getting the asset hedged against the liability and I think that ummm.. I am glad that I pulled back the CDOs from the 40 something mill down to the 19 at the end of the day. Those some of those did go into the equity, property linked notes but it was acceptable, everyone was accepting it and I think this was the thing.

When we did that general property trust thing before we even invested in it we wrote a letter to the department of local government. We said that we have a legal opinion that suggests that we can do this could you please give us your opinion. They wrote back to us and said that we should go and get an investment or financial opinion on this.

We said what a lame answer. The bottom line was it was too hard for them. They did not want to prescribe over that. We said we had a legal opinion. What really interested me was that they never asked to see it.

R: Who did they want you to get the opinion from?

They wanted an independent investment or financial opinion and as far as we were concerned we had an independent legal opinion in relation to the ministers order and the act. They did not even ask us what the legal opinion was, which part of the ministers order did it affect, you know what i mean. That was like to the councillors' well OK then we wil test this and we went out on it. Out there, there was a lot of debate going on in Local Government circles about what we did. Did you guys do the right thing No we disagree you should not have done it. Yes we think you have done well. So there was a lot of support and there was a lot of criticism in relation to what we did. The bottom line was the council made the decision. Sure we put the proposition up there but they were the ones that wanted to hedge the asset make sure that the liability was always covered. We got out of it made a motza everyone seemed like heroes. At the end of the day it could have easily fallen down. Good decision or luck? I think we had some very good advice behind us when to get out and what to do, possibly good luck. Even the markets out there the banks and others said this is unbelievable and I can't testify today but the bottom line is I think equity link notes and some of these products that came along may have been a reflection of something that we did. Where we went outside the circle and did well. I would hate to think that it was the cause because the bust came about because of CDOs after all.

And when we did that we got a lot of investment houses coming in here and saying oh that was bold da da ... and we have got this new product coming up and that, so they would put the ideas up and I found that we were getting bogged down with salesmen from outside coming in under the pretention of having a investment discussion and then basically put a proposal up on the board to you. Of which they wanted input from us because we had been successful with the other and we had sort of gone through it. And in the end I said hang on, we are losing sight of what we are doing here, we have got to get back to core role not helping these buggers going around. And certainly the Longreach guys they were all CBA. They were the CBA investment heart room of local government, Rob Nankerville, Stuart Burns, those guys and basically at the end of the day they left. They left and I got a phone call it was before Christmas sometime. They said we have left the CBA and I said why. They said we can't tell you we have confidentiality but in a month we will pop up. The in a month they popped up with these equity link note and that.

So I don't know it seemed to be that the ministers order was there, how you read it, whether you read it black and white, I think people at the end of the day lost the intention of it, I think that is the word as opposed to how you read it in black and white. Certainly the legal opinion that we got on the property listed trusts to me was

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stretching it, it wasn't in the best intention of the ministers order. The ministers order wasn't written well i mean and that's another thing, it could have been more explicit. The other thing was that they (DLG) did not have the expertise down there to know what was going on, they didn't call anyone in to talk to them. They could have called us over the general property trust thing and we would have gone done there and gone through the thing and showed them but certainly they can't say they didn't know what was going on. They knew what was going on because they had CDOs in there templates they had best guidelines out by financial professionals who were a different body but certainly the department vets all that material that comes out so there was no Hey guys stop it get out of CDOs don't do this. There was no introduction in the ministers order to stop you doing this as well. Everyone read in that ministers order that CDOs were eligible due to the ratings. Under Standard and Poors ratings.

R: So do you think that purchasing shares on the stock market were eligible under that order as well?

You could have tested it like we did with the property trust and we invested in it because of the rating of it allowed us to. But outside the Ministers order everybody said shares are not allowed.

R: So are you saying that the accepted practice was that shares were not allowed even though the ministers order did not exclude them?

Exactly and what we did was we tested the order. We would have liked ... I would have loved the department to put a clarification on it and say no you cant.

R: Or yes you can?

Yeah or yes you can. But they wouldn't and they didn't.

R: Would you say that the removal of reference to the 1925 Trustees Act from the 1993 Act and the protection of capital was not longer stipulated, that it was still the practice to protect capital.

Yeah it was no longer required in the act. I would say that the protection of capital was a practice for a lot of years. I think that the older heads, I'm 55 so I have been in local Government for a long long time. A lot of us would have known that it was there previously, certainly with the roll over and new people coming in they would not have know about the old act and would have focussed on the new act unless they looked into it a bit deeper. I don't think that message would have got to them.

The act was there in 1993 as you said, these things (CDOs) didn't start evolving until about 2000, I believe that there was a time there where it was still accepted even though it was not in the 1993 act that the focus was on capital protection. As time went on the products evolved the market got very bullish, they came out they were

very aggressive in promoting the products. One guy would say you can get 8.7% another would say you can get 8.9 and another would say take mine you can get 9.1. It was like a bidding war at the end. They were similar products but they were working hard at selling them. I think it was a combination of a lot of the things that I have said, hedging the asset, basically at the end of the day no real guidelines in relation to these things. I don't think the department knew the implication of them the real risk of them at the end of the day. But I also don't think that the department wanted to get into that either.

R: That surprises me because ASIC made mention of these products in 2005 saying that councils were involved in them and they are high risk. The only thing that i have seen for the department is that councils are required to identify the risk.

Yes the department cannot just wash their hands of this. I mean I have worked with the department of a long, long time and had my issues with them. The GPT thing was an example there was just a need for some guidance, they were not any help. The best way to describe them is that they are reactive not proactive and that is the way that they have always been, they have been like that in a lot of instances. They commissioned Michael Cole to do the Cole report which you have probably read. One of the people who Michael interviewed was me. I went in and saw him I was part of the interview process. They had about 6 finance managers across the state talk to him and I went in. Now it was interesting because I didn't know Michael Cole but I knew his brother really well, he is a solicitor. Not a friend but an acquaintance and i went in there we chin wagged a few things first of all to get know each other a little and then talked to Michael about it and we went through a number of things. Now the thing with Michael was that he kept referring back to T Corp which at the time he was still a director of it. I am pretty certain that he was a director but if you look at the Cole report it will list it in the back and a lot of people didn't know that. I mean he makes a statement in the Cole report that these were no good these others were no good and even managed funds are no good. Shouldn't invest in them and hence Local Government doesn't invest in managed funds now however a really good managed fund which will be allowed is TCorp and he was making these statements and I said hang on you have a vested interest in TCorp and he said oh no I wouldn't put that in the report I am just saying it to you. Anyway it did come out in the report, you read it, it gives a advertisement in the report which I thought was very bad but then it went on to say councils shouldn't have done this they shouldn't have done that. I believe that in that report but I can't testify to it because Michael Cole has spoken to me a number of times after it, that there was some suggestion in the original drafts that the department had some responsibility in it. But you can't say that when you are commissioned from the department so it got vetted.

It was supposed to come out in November and it didn't hit the streets until about March i think and that was why. I rang Michael a number of times and at the end I

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kept getting his young assistant and he just kept saying it is with the department. I said are they bodging it up and he said no they are looking at it. And that was the reason they were not going to take responsibility for something in which they were not proactive with and that is how I say it.

R: What do you think of the idea of the State Government managing funds for councils?

The closest thing we have to that is NSW TCorp and I do not have a penny with them. Not one penny. OK why, their service is shit, it is absolutely terrible, you ring up and you can't get anyone you can't talk to anyone. You talk to investment houses you go to conferences you will get calls from these guys they come in and they keep you up to date with the market they tell you what is happening. I would not know one person in TCorp, they don't go to the seminars they don't put up a stand at the conferences they don't want to get to know you they don't want to meet you. So the customer service side is terrible and their rates are terrible, they are absolutely terrible. I don't think it is a good thing, I get more satisfaction out of the big banks CBA, Westpac those ones and it enables diversity as opposed to just going into TCorp.

R: so in respect of where you are going in the future when the federal government guarantee of credit unions ends will you only invest with the big banks?

I would probably still invest in credit unions. They are still very regulated through APRA and others. The thing with the credit unions is that with APRA there is an agenda to swallow up all the small ones and convert them into big ones I don't know if you know that. We have had our own credit union here in the southern shire the employees credit union and we have had that for 35 years and we could just not compete now. The regulations that APRA put on us the things we had to do how we had to conform to legislation was far beyond a small credit union.

R: Were you involved in that credit union?

I was involved as part of what they called the audit committee. But certainly my left arm man out here Greg Hayes was treasurer and he knew what was going on. But certainly the pressure from APRA was more and more for the smaller ones to dissolve and get eaten up. We ended up getting Sydney Credit Union. So what I am suggesting is if that is the case the smaller credit unions will disappear and the bigger ones will maintain. They will be APRA regulated still, I would think hard about the credit unions that I would put money into but I still get advice from Denison Advisory if I have doubts.

R: so did you have investment advisors at the time of CDOs.

No Sorry yes we did but that was not very good, that was Grove Investment Advisory at the time. What ended up happening at the time the whole thing hit the fan the department put a circular out and they said it is also recommended that you have an independent investment advisor. Recommended, they didn't say mandatory they said recommended, so they always cover themselves with the wording of things.

I had Grove and there was a guy at Grove Andrew and he was very good, he used to ring up and say this is going on, this is going on, this is going on and what ended up happening was Grove dissolved into CPI or something like that and then got eaten up and Andrew got let go. The hearsay in the market place at the time was..... CPG Research Advisory that is what they are called now. The vibe at the time was that they were going to change direction and that they were not going to be in that investment advisory role of Local Government, so I rang the CEO up and expressed concern that Andrew Valner had been let go, how important he was at that time and couldn't see why he had been let go, ok business is business, but he was the best technical advisory that I knew in the Local Government market and he was good and that was why I had them. The CEO said no we are not changing direction, I will bring out the chairman of the board and we can have a talk. So they came out here and I said look I am really hearing that you are changing direction look I will give you 3 months and I got introduced to the guy that was replacing Andrew, they ended up not getting a brass razoo they ended up changing direction it was bullshit what they were telling me. As far as they were concerned they didn't want Local government. So I rang up Brett Westwood and I said to him look I am pulling out. He said what do you mean. I said 3 months and I haven't heard anything. I said I have a CDO, Flinders that has had a default I have heard it from everyone else but from you lot, you are our investment advisory you haven't let me know anything or even sent me a email. He said oh oh look I will look into it and find out for you. I said no use finding out I know it's gone and you haven't said anything the service is no good. So we pulled out.

So I took that circular that came out as an opportunity to look elsewhere, we ended up with Denison Advisory, but certainly Grove at the time were our advisors but they had a vested interest. If you have a look at their history they were advisors for Local Government but they were also agents for managed funds, so they also used to sell managed funds. Which is a pretty big conflict. But the problem was that there was no-one around Grove was it there was nobody else basically. A couple of the other guys jumped ship and came out as Oakvale and they have never really rocked the boat with me. They had a vested interest because they started selling CDOs as part of their thing. They are with Marrickville council still I think. So I just bit the bullet and went to Denison they have a nice number of about 12 councils and that is about it and they just manage those and we get terrific advice from them. I can ring them up at the spur of the moment and say I have got this what's it like, what's this credit union like and they will say we will get back to me. Half an hour later they will get

back tell you the ins and out, yeah they look reasonable, how long are you going for oh 6 months and they will say that will be fine. So i probably would.

The portfolio you look at it now and I always use the word when looking back to CDOs its not very sexy. It's some term deposits and some floating rate notes. There are some really good floating rate notes starting to come out now they went very dead there for a while. Senior debt, floating rate they went very very dead didn't here from the banks for the last three or four years since the bust. Now they are starting to come out again and they are offering good rates i mean they are offering 1.5 up to 18% above the swap rate the floating rate which is quite good. So the floaters are starting to come back in they are the big banks the CBA the Westpac's etc the rest are just term deposits and unfortunately the term deposits talking about diversification they are now 52% of my portfolio I can't do anything else because there is nothing there. So you can only diversify by institution because you have no opportunity for other types of products to look at, so that's it. If you asked me the question what would be the simplest method of handling the investment portfolio yes give it all to TCorp that is the lazy way. You can give it all to TCorp ring them up every day or get them to get into our file look how much we have got and they can invest and that would be it. But you won't get the rate of return with the diversification that we have got across the board. I think we are running up at the moment we are well above the average. Our portfolio is running at 5.57 compared to the average of 4.96 so we are doing quite well there at the end of the day.

R: So is the 4.96 the state average?

It is the full year to date annualised interest yield UBSA which is 4.96 that is what we benchmark it against so we are 5.57 we have probably got a few more funds in cash flow than I predicted and that is probably because we are stagnating in the works so we should probably be picking that up I am hoping but at the moment we have got a reasonable portfolio but very heavily loaded into term deposits. Floaters.

You still have some CDOs?

Yes this one dated the 20/3/12 it is good and dusted that will pay up so that will give us the 4.5 (million) back that is well on track. Nexus is out there it will stay for a while. That's it remember I said there was only one CDO left that's it they have all gone out of the portfolio. We show the right downs on these in the portfolio. To put that in perspective at the height of it in 07-08 out of 52 mill of grandfathered products let's call them that which is what the Cole report said to call them of the 52 mill 19 mill was impaired so that is basically 40% of the portfolio of CDOs was impaired. So to bring that to today we lost Blue Gum for 4.5. So if you take 4.5 from the 52 then we are down to 48 mill and all the rest have matured and paid up except these ones and that impairment is just over 2 mill. Hence when I say we got out of it pretty well compared to other councils we did.

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R: but did you get returns as well or just the capital/

Mainly just the capital. 4.5 hurt but it is nowhere near some councils who had 10-15 mill it was really drastic for them. So we bounced back from 19 mill impairment take the 4.5 off so say 15 mill impairment down to only 2 so we have fought back 13 mill on the books.

R: What is the history of the council and the general manager and what influence did that have on investment decisions?

Experience definitely helps look 10 years on from when we first started CDOs or 20 years on from when I first got involved in investments today would I have probably done things a bit different I probably would have its called experience. You can't beat that experience. Nugan hand was a long time ago but those that experience that would have been more careful. Our general manager is 62 now and has been here 30 years as GM and may not have had exposure to Nugan. But if you had been impacted but Nugan hand then that would influence your decisions now. If we had had that experience then i would believe it would be a fair call to not invest in CDOs I think experience has a lot to do with what is done now. I made investment decisions and i had a fair amount of investment experience there but when i said that the country rural council do not have the experience they have a high turnover It was easy to take on a IMP and everyone said how stupid it was to give the keys to the car for someone else to drive and enter into an IMP. I can see how they probably did it because they probably had people who were not experienced and it is easy in hindsight to sit and blame.

R: Of course and it was not only councils who were caught.

It was a whole ream of things. We have gone through the history here today of all these thing if it didn't start with the subprime in the US would it have happened. I don't know. The hard sell that these were as safe as fixed term deposits was absolutely ridiculous. And if they were saying that to other clients then I think that was strange.

That finance group that i talk about i relate that because all the finance officers go to it. We had some young fellows in some of the councils and they invested in IMPs. If you are a young bloke and you are coming up and you haven't got the experience and you are getting a hard sell and you are getting told by David Rosenbloom that you are irresponsible you are not doing the right thing and then you are getting the threat I will go over your head I will go to the GM you have got to feel for those guys because they would be starting to doubt themselves.

Tim Butler he said they went over his head they went over I think it was (NNN council), he is not there now. Their GM was smart and he rang them up and said this guy has come to me you better do something about it. In other words he was not

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willing to entertain David and so they told him not to come in the door again, they told him that he was out. That was the type of hard sell it was it got to the stage where it got nasty. You can't come back here again. I never had that with David, we definitely had a relationship of respect but definitely saw that we were two different creatures and that would make us clash.

R: Did you have an internal audit committee?

Not at that stage. Internal audit was introduced, hang on Julie went over there she was one of my staff and she went over there when I got the manager's job in 03 so internal existed. But not in the form it is now there was no committee then it came in several years later in the middle of the GFC. Its chairman is an independent local government practitioner the director over at Fairfield council, it consists of the external auditor which is part of his terms of his contract to be part of that committee, the internal auditor one of our directors which rotate every 2 years and myself. But that is under review now as a result of the new guidelines that are coming out.

R: Some councils have the mayor on the audit committee does that happen here?

No the GM is very clear and concise on administrative role compared to the community role of councillors. Our external auditor is on a lot of internal audit committees throughout local government.

R: Did the external auditor make any comment about investment in CDOs?

That's very interesting. The external auditor was very interested in what they were and how they how they worked. Our external auditor iswho happens to be the person that writes the code accounting practice for the department or was commissioned and engaged by the department to write it. Hence why CDOs and all these other titles got into the templates to be part of the financials. Because the external auditor was very interested in how they worked and what they did and everything else. And we had a number of discussions in here about what these beasts were and how they worked and what went on and all that sort of thing and at the time of all that happening the rates of return and what was going on was astronomical. Rockdale council for example had an equity link note that they invested in, I think they put a couple of mill in and then they had a very urgent collapse of a road over there in a suburban area with a massive hole that had collapsed and all of a sudden Rockdale council who were on a tight budget had to find \$400,000 to mend this hole. So they looked at their investment portfolio and one of the Longreach notes that they had put 2 mill in was already worth 2.6 mill and they cashed it in and solved their problem. So there were a lot of good stories coming out about these products. They were again there for long term for me but they were liquid so there was a lot of good stories in relation to how Rockdale solved their problem and that they would not have been able to do it under normal types of investments. The external auditor to me

was accepting of them. Definitely (external auditor) to me was even though he will say today that he was never in favour of them being a product that Local Government should have been investing in. I think his view on them were that they were very complicated but he didn't say don't invest in them. It gets back to personal view and I know (external auditor) very well and he is very conservative. (external auditor) would invest in property which he has he's got property at Mount Victoria, put your money in term deposit or super and that is about it. The portfolio the way it is now is probably very much to (external auditor) liking. So from a personal viewpoint I think he has got that opinion, certainly at the start when all this happened he soaked it all in but there was no indication to me that this is bad or that we shouldn't be in it. Look to give you an indication, we engaged before we went out and entered into that property trust what we ended up doing is we went to expression of interest. We said to the market we have got 50 million dollars of section 94 of which we believe we could invest 10-20 million dollars long term our target is to achieve a rate of 9% to keep abreast of what is happening. Expression of interest a number of things but basically asked the market to respond, we got about 18 responses from the market. (external auditor) was one on the panel with us. Our external auditor was on the panel with me, the director of property and at the time that consultant MMM. So we didn't make a decision on unlisted or property trust simply on oh that sounds good. We made a decision on that by doing this expression of interest. A lot of the stuff that came back didn't conform to the ministers order and had to be ruled out. You know you had your boutique banks Babcock and Brown and all these that came in they were ruled out. But (external auditor) sat there and he knew what we were looking at and he knew what some of these products were like. Macquarie came in, CBA came in they did presentations and they were centred around a mixture of CDOs, equity linked type products and all little fancy things. And when explained you could understand them I mean CDOs were a lot more complicated obviously but the way that they were framing it and the way that they were looking at things they were introducing products whereby certain things happen, they went into different asset sector and equities and property and unlisted property. So (external auditor) at that time was on that panel so he knew what was coming around and what was there. So I think in all fairness to (external auditor) it was happen there and I think he was waiting to see what happened, he may have not liked it personally but he certainly did not give an opinion to us guys that he didn't like it. In hindsight once it went bust, oh why would you invest in these things. That's (external auditor) that's the way that he is.

The whole CDO thing is certainly a good talking point around investment and markets and local government. Everyone had a different point of view and I guess a different acceptance of risk but certainly Lehman's had a hard sell and they certainly had some irresponsibility in relation to it, that's how we saw it.

R: Do you think that the information that you were getting was misleading?

I think that it wasn't all there, that was what it was. When Piper Alderman got involved in it and started to come in they wanted different things, there were term sheets and different things and there were things on the surface but they wanted much more than that they wanted a number of technical sheets disclosure documents. They basically said have you got this this and that and we would say well no should we have that. They would say that with this product this should have been displayed and this should have been shown and those things weren't there. Now when you looked into those they explained in a lot more detail a lot more of the risk in relation to them. Especially what could happen to them in those sorts of markets you know those credit markets but the bottom line was that there was certainly things not given to us. There was certainly... you think about this ... you are going to invest in something you get a term sheet or you get information on it there was certainly irresponsibility in trading 20 times a month for a council on their portfolio without them know what they were putting it in and out of. Those councils to me just gave their responsibility away and they can't do that. They had a responsibility they can't just do that and they did. If you look at Lehmans you would have to say that they were irresponsible to their clients in doing those things because they didn't give them term sheets or anything. Me they did they gave me certain things and we looked at them, never went into an IMP so I never had that problem that the other councils have got. With Piper Alderman's action which we are doing there are 2 classification of council in the action, those in the IMP and those that weren't we are not in the IMP.

Certainly those in the IMP have a better chance or higher chance of success. However there was still a lack of disclosure in the things that we got when we looked at it and looked at what we should have been getting.

There were also some quirky little differences under some of the CDOs as well. I get annoyed with Blue gum, we lost Blue gum, I get annoyed with Blue gum because one of the terms with Blue Gum was that it had a manager, it had a manager that managed the portfolio. That was one of the highlights of it was that it wasn't just being watched by Grange or someone else it had a manager. Now what ended up happening was that somewhere in the terms and conditions of this investment they changed the manager and the investors had no rights, that decision was made by whoever held the collateral at the end of the day. Now the thing was they changed the manager to Line or something it was a Singapore Company. Now the manager got changed and we had no right over that, now I guess we could have sold out of Blue Gum at the time but looking at i thought the manager has changed what has happened here. Three months after line got in they went and took 3 entities out of the CDO and substituted them with the three Icelandic Banks. Now the question is if that manager had not been changed would the other one have put it in the 3 Icelandic Banks but the bottom line was that what happened was beyond the control of the investor. Something's were in the control of the investor, now the attractiveness of

that CDO was that it had a manager and low and behold someone could change it and they could make that decision all of a sudden the three Icelandic Banks went in and then 8-9 month later they were the banks that went bust. And what happen in the CDO was that you had three credit defaults straight away and in hindsight when you look back you say oh what a decision they made how stupid was that. Then you think about it and go oh well I didn't have control over it the only thing that i could have done was sold the bloody thing but how did I know that Icelandic Banks were going to fall over. You would think that the investment manager would have the investment nous far greater than you and me sitting here if they are involved in those markets. So some things happened with some that were different like that. That was 100% loss completely gone. There is a lot of them gone but fortunately Blue Gum was the only one we had.

R: Was that just pure luck as to which you got involved in?

Yeah I get to back to what I said at the start of the conversation, the ones that went Esperance and all that and you have a look at the names in there at lot of the companies appeared again and again is those and you were asking for trouble with those in there. You might have had ... it was interesting because the Icelandic Banks that this mob put into Blue Gum were I some of the other CDOs already so why that decision was made to do that I am not sure. It was based on the fact that at the time when it came out that the three that they removed were high risk or some bloody thing so they brought these in which ended up defaulting quicker than the others at the end of the day.

It was interesting because there was a lot of duplication in them and you got one company defaulting and it could have been in 20 of them. That was what happened with Fanny May. Then you started to get the Lehmans CDOs because they started to do some themselves with this Vincent Moray, another guy that i didn't get along with , mainly because I couldn't understand him, I just used to say I don't understand what you are saying I am not investing in that. If I couldn't understand them then I didn't invest, they had to make sense and that is obvious. Then you had Lehmans doing these other ones whereby they were the financier and they were in the names of the underlying CDO as well.

R: When you were impairing the CDOs how were you getting them valued?

The only values you could get were from the sellers of the CDOs. There were a lot of CDOs that in our 19 million of CDOs there were a lot there that got valued done to one dollar because there was really no market for them. That was the very big difficulty at the time because the guidelines came out that the market values had to be shown within the financial reports and that you needed to get a reasonably good independent valuer to do it and no one could do it. There was no one out there.

R: that would have made it difficult to audit I would assume?

What they did, I don't know about other councils but we discussed it with (external auditor) and he basically said we can't vouch for the valuation and we agreed that they put a qualification on the investment valuations. I said that fair I can't argue about that because I don't know what the values are and no one out there can tell us.

It was interesting times because you would get phone calls particularly from Grange or Lehmans saying that they have got a buyer for your CDO if you switch you can make 10 grand on it you can do this or you can do that and you could guarantee that they were making the same on it at their end of it. But to deal with them it was you could sell it and they would go and we have got a great one for you to switch into and they would try to keep you on the hop. Things like, this buyer wants to buy it but he has to buy it today, so they used this type of sell. And they would say look you can make 20,000 or 30,000 on this and when you are talking dollars it is fairly high.

R: You are saying some councils were doing 20 a month then that is substantial?

Yeah so they would say we can get you out make 20,000 and switch into this. The easy way for a council is to say OK and leave it with them but again because it was so quick you didn't see the terms and conditions of the new one that you were going into. So we said no, we basically always said no. They had a battle with us because they still wanted to promote the CDOs as short term and we held our position that they were long term. I had a number of debates with them, Jill May was one of them from grange at the time and I used to say to Jill we have got them for long term, I don't want to trade them every day or once a week or anything they are yielding 8.39% or whatever the one you want to take me to will give me 8.39% and give me a 10,000 profit it makes sense but that is not why I bought them they were for long term and that was our position. They didn't like that and that was why Rosenbloom hardly came near us because he knew we wouldn't budge from that position. If they had their way we would have been trading almost daily so virtually like being signed up to an IMP they wanted you trading. More so than the banks or any of the others who sold CDOs. They did not apply as much pressure.

R: Thank you for your time.

The finance group is there to help finance managers who are feeling a bit isolated so if you get to the end of this and want to present a talk or something get in touch. It is there as a bit of a think tank. We normally have some presentation prior to lunch, then lunch and then general business. That was really good networking. It was very common for someone to say has Grange or Lehmans depending on who they were at the time have they come to see you about their product Esperance their new CDO. Yes they have we got in or no we haven't, so it provided good feedback.

R: Was there good exchange of information?

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Reasonable exchange of information we didn't discuss the investment portfolio all the time it was more if something was eating someone or they weren't sure about something but generally around those times during the day,... well let's face it, the people who sponsored the day were generally the investment market people. The Granges, the Longreach the CBA so as part of the deal for them to sponsor the day and give over their 1000 bucks for lunch was they got an hour spot so investments were always on the agenda whether it was for that hour of presentation or not. Sometimes the presentations would end you would go to lunch and get into general business do you believe that crock of shit that was shown to us today from the sponsors. That was good it good feedback. The group was finance managers so it was much more than just investments.

We are now being sponsored by the banks still and more diversified IT and solution houses.

You should talk to ZZZ council. They have a good grasp. RRR understands these sorts of investment and he was interviewed by Michael Cole. Coles report did not show anything about what led up to investment in CDOs. I'm hoping that what you are doing will show a bit of what the culture was that led to decisions. The Cole report left a bad taste the department has hidden their involvement and it has just been put back on the councils being to blame

END

Appendix 10: Explanation of Ratings from Moody's and Standard and Poor's

Investment Grade Ratings			Speculative Grade Ratings		
S&P and others	Moody's	Interpretation	S&P and others	Moody's	Interpretation
AAA	Aaa	Highest quality	BB+	Ba1	Likely to fulfill obligations, ongoing uncertainty
			BB	Ba2	
			BB-	Ba3	
AA+	Aa1	High quality	B+	B1	High risk obligations
AA	Aa2		B	B2	
AA-	Aa3		B-	B3	
A+	A1	Strong payment capacity	CCC+	Caa	Current vulnerability to default, or in default (Moody's)
A	A2		CCC		
A-	A3		CCC-		
BBB+	Baa1	Adequate payment capacity	C	Ca	In bankruptcy or default, or other marked shortcoming
BBB	Baa2		D	D	
BBB-	Baa3				

Notes The other agencies listed in Table 1 use the rating symbols of the first column, with the exception of DBRS (H and L symbols in place of + and -) and CBRS (H and L symbols in place of + and -, and + symbols that correspond to second and third letters) The agencies follow a variety of policies with respect to the number of ratings symbols given below B-

(Source Cantor, 1994)

Appendix 11: Recent Default Probabilities for Rated Securities

Obligor rating	Five-year-default Probability (%)	Ten-year default Probability (%)
AAA	0.38	1.29
AA (High)	0.44	1.55
AA	0.55	1.89
AA (Low)	0.69	2.40
A (High)	1.06	3.39
A	1.26	4.04
A (Low)	1.48	4.87
BBB (High)	2.06	6.48
BBB	2.77	8.51
BBB (Low)	4.15	12.00
BB (High)	6.98	18.18
BB	11.09	26.10
BB (Low)	15.55	34.19
B (High)	20.21	42.34
B	31.14	54.96
B (Low)	52.28	70.92

(Source Adam, 2004)

Appendix 12: Ministry Investment Orders and Council Circulars

Appendix 12.1: Minister Order:-Forms of investment May 1997



Circular No: 97/27
Date: 19 May 1997
File No: FF97/0218/1
Contact: Thomas Winder
Phone No: (02) 9793 0628

ORDER OF THE MINISTER NOTIFYING FORMS OF INVESTMENT

Attached is a copy of an Order of the Minister notifying forms of investment for the purposes of section 625 of the Local Government Act, 1993. The Order is to be published in the Government Gazette on 16 May 1996 and is to take effect on and from the same date. The Order replaces the previous Order published in the Government Gazette of 18 March, 1994.

The new Order includes provision for a council depositing funds with a funds manager listed in the Order, providing the following conditions are satisfied:-

1. any reinvestment of a council's funds by the funds manager must be in a security authorised by the Trustee Act 1925 or in an investment of the kind referred to in paragraph (a), (b) or (c) of the Order; and
2. an investment with a funds manager is contingent on the funds manager or its controlled parent entity (immediate or ultimate) maintaining a satisfactory minimum credit rating given by Standards and Poor's of A, or by Moody's of A2.

Attention is particularly drawn to the following provision:-

"In the event of a credit rating of a funds manager or its controlling entity falling below the required minimum, or in a security that no longer complies with the Trustee Act 1925, a council must make all necessary arrangements to withdraw the deposit as soon as practicable".

A recent review conducted by the Department found that all funds managers or their controlled entities listed in the Order complied with the minimum rating criteria, as approved by the Treasurer, of A by Standard and Poor's and of A2 by Moody's. Nevertheless, it is a council's responsibility to ensure that its funds manager maintains this minimum credit rating.

Garry Payne
Director General

LOCAL GOVERNMENT ACT 1993 - ORDER

(Relating to investments by councils)

I, ERNIE PAGE, 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, with effect on and from 16 May 1997 notify the following forms of investment for the purposes of section 625 of that Act:

- (a) a deposit with the Local Government Investment Service Pty Ltd;
- (b) a bill of exchange that is drawn or accepted by a bank (being a bank within the meaning of the Banking Act 1959 of the Commonwealth or a bank constituted by a law of the State or of the Commonwealth);
- (c) a deposit with the Treasurer;
- (d) a deposit with a funds manager listed below that is re-invested by the funds manager (on behalf of the council concerned so that the council retains the beneficial ownership) in a security authorised by the Trustee Act 1925 or in an investment of the kind referred to in paragraph (a), (b) or (c). An investment by means of a deposit with a funds manager listed below is contingent on the funds manager or its controlled parent entity (immediate or ultimate) maintaining a satisfactory minimum credit rating given by Standard and Poor's of A, or by Moody's of A2.

In the event of a credit rating of a funds manager or its controlling entity falling below the required minimum, or in a security that no longer complies with the Trustee Act 1925, a council must make all the necessary arrangements to withdraw the deposit as soon as practicable.

AMP Investments Australia Limited

ANZ Funds Management

BNP Investment Management (Australia) Limited

BT Asset Management Limited

BT Australia Limited

BT Custodians Limited

BT Securities Limited

Citicorp Investments Limited

Commonwealth Funds Management Limited

Commonwealth Management Services Limited

CS First Boston Australia Investment Management Limited

First State Fund Managers Limited

GIO Asset Management Limited

Hongkong Bank of Australia Limited

HKB Managed Funds Limited

Appendices

Macquarie Investment Management Limited
Mercantile Mutual Investment Management Limited
National Australia Fund Management Limited
National Mutual Funds Management Limited
New South Wales Treasury Corporation
Pental Nominees Pty Limited
SBC Dominguez Barry Funds Management Limited
TrustWest Investment Funds
Westpac Investment Management Pty Limited

Dated this 2nd day of May 1997

ERNIE PAGE, MP

Minister for Local Government

Appendix 12.2: Minister Order:-Forms of investment May 1998



Circular No: 98/38
Date: 14.5.98
File No: FF97/0218
Contact: Derek Lewis
(02) 9793 0625
lewis.d@dlg.nsw.gov.au

FORMS OF INVESTMENT - MINISTER'S ORDER

Attached is a copy of an Order of the Minister notifying forms of investment for the purposes of section 625 (2) (b) of the Local Government Act 1993. The Order is published in the Government Gazette on 15 May 1998 and takes effect on and from that date. The Order replaces the previous Order published in the Government Gazette of 16 May 1997.

The new Order notifies the authorised investment powers of councils following the recent proclamation of the Trustee Amendment (Discretionary Investments) Act 1997 that amended the Trustee Act 1925 to provide that all trustees must invest in a prudent manner (the "prudent person rule").

The Department strongly advises councils to follow the list of authorised investments (as authorised by section 14 A (2) of the Trustee Act 1925 as in force immediately before the commencement of the new Act) as provided for in the transitional provisions, Part 2 (4) of the new legislation.

In keeping with existing arrangements it is the responsibility of each individual council to determine if its investments are authorised in terms of the listed securities provided by section 14 A (2). Given the range of investments available it is not considered that councils would need to invest in other forms of securities.

Accordingly, at this point the forms of investments available to councils remain the same. However the need to examine the provisions of the Local Government Act relating to investment powers of councils will be undertaken as part of the forthcoming review of the Act.

Garry Payne
Director General

New South Wales Department of Local Government
66-72 Rickard Road, Bankstown NSW 2200 Locked Bag 1500, Bankstown NSW 2200
Tel: (02) 9793 0793 Fax: (02) 9793 0799 TTY: (02) 9707 2508
Email: dlg@dlg.nsw.gov.au Web: <http://www.dlg.nsw.gov.au>

LOCAL GOVERNMENT ACT 1993 – ORDER

(Relating to investments by councils)

I, ERNIE PAGE, 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, with effect on and from the 1st May 1998 notify the following forms of investment for the purposes of section 625 of that Act:

- (a) a deposit with the Local Government Investment Service Pty Ltd;
- (b) a bill of exchange that is drawn or accepted by a bank (being within the meaning of the Banking Act 1959 of the Commonwealth or a bank constituted by a law of the State or the Commonwealth);
- (c) deposit with the Treasurer;
- (d) any security authorised by section 14 A (2) of the Trustee Act 1925 as in force immediately before the commencement of Schedule 1 [2] to the Trustee Amendment (Discretionary Investments) Act 1997;
- (e) any security with an authorised funds manager that must invest or maintain an investment in any security authorised by section 14 A (2) of the Trustee Act 1925 as in force immediately before the commencement of Schedule 1 [2] to the Trustee Amendment (Discretionary Investments) Act 1997;
- (f) an investment by means of a funds manager listed below is contingent on the funds manager or its controlled parent entity (immediate or ultimate) maintaining a satisfactory minimum credit rating given by Standard and Poor's of A, or by Moody's of A2;
- (g) In the event of a credit rating of a funds manager or its controlling entity falling below the required minimum, or investing in a security that ceases to comply with section 14 A (2) of the Trustee Act 1925 as in force immediately before the commencement of Schedule 1 [2] to the Trustee Amendment (Discretionary Investments) Act 1997, a council must make all the necessary arrangements to withdraw the deposit as soon as practicable.

AMP Investments Australia Limited

ANZ Funds Management

BNP Investment Management (Australia) Limited

BT Asset Management Limited

BT Australia Limited

BT Custodians Limited

BT Securities Limited

Citicorp Investments Limited

Commonwealth Funds Management Limited

Appendices

Commonwealth Management Services Limited
CS First Boston Australia Investment Management Limited
First State Fund Managers Limited
GIO Asset Management Limited
Hong Kong Bank of Australia Limited
HKB Managed Funds Limited
Macquarie Investment Management Limited
Mercantile Mutual Investment Management Limited
Merrill Lynch International (Australia) Limited
National Australia Fund Management Limited
National Mutual Funds Management Limited
New South Wales Treasury Corporation
Pandal Nominees Pty Limited
Royal and Sun Alliance Asset Management Australia
SBC Dominguez Barry Funds Management Limited
Trust West Investment Funds
Westpac Investment Management Pty Limited

Dated this 1st day of May 1998

ERNIE PAGE, MP

Minister for Local Government

Appendix 12.3:-Circular:-Consultation on Review of Investments Dec 1998



Circular No: 98/94
Date: 4/12/98
File No: FF97/0218
Contact: Derek Lewis
(02) 9793 0625
lewis.d@dlg.nsw.gov.au

REVIEW OF AUTHORISED INVESTMENT POWERS OF COUNCILS CONSULTATION DOCUMENT

As previously advised in Council circular 98/38 (Forms of Investment – Minister's Order) there is a need to review the investment powers of councils.

The review is necessary following the proclamation in March 1998 of the Trustee Amendment (Discretionary Investments) Act 1997 that amended the Trustee Act 1925 to provide that all trustees must invest in a prudent manner (the "prudent person rule").

Accordingly the Department is seeking the views of councils regarding the appropriate policies and procedures to apply to the investment powers of councils as outlined in the attached consultation document.

Councils are invited to submit comments. Comments should be directed to Mr Derek Lewis, Principal Finance Officer, by mail to Locked Bag 1500, Bankstown 2200; by fax to (02) 9793 0799; or by e-mail to lewis.d@dlg.nsw.gov.au the closing date for comments is 16 January 1999. Any queries should also be directed to Mr Lewis by phone on (02) 9793 0625.

Garry Payne
Director General

REVIEW OF FORMS OF INVESTMENT FOR COUNCILS

A CONSULTATION DOCUMENT BY THE DEPARTMENT OF LOCAL GOVERNMENT

INTRODUCTION:

Council circular 98/38 (Forms of Investment – Minister’s Order) foreshadowed the need to examine the provisions of the Local Government Act 1993 relating to investment powers of councils.

The review is necessary following the proclamation in March 1998 of the Trustee Amendment (Discretionary Investments) Act 1997 that amended the Trustee Act 1925 by removing the list of authorised securities and in its place requiring that all trustees invest in a prudent manner (the “prudent person rule”).

Under the “prudent person” approach councils would not be linked to a list of “authorised” investments, but would be required to invest funds in a “prudent manner”.

The current legislative and administrative arrangements applying to councils are influenced by a number of historical factors that include; the 1919 Local Government Act; the 1983 recommendations of the Royal Commission of Inquiry into the Nugan Hand Group and various amendments to the Trustee Act 1925 to increase the range of investments available to trustees in NSW.

The existing controls on councils are largely a result of the recommendations of the Royal Commission. The findings of the Hon Mr Justice D.G. Stewart highlight what can happen given poor local decision making when organisations and classes of investment thought previously to be reputable and safe have proved to be otherwise.

However, investment in a listed security is not a guarantee against loss or failure of an investment, nor does it relieve a trustee of their duty to invest funds in a prudent manner.

Accordingly the Department has prepared the following consultation document and is seeking the views of councils regarding the current policies and procedures applying to the investment powers of councils.

Councils’ comments including any suggestions for change should be sent to the Department of Local Government by 16 January 1999.

CURRENT LEGISLATION:

Section 625(2) of the Local Government Act 1993 provides that “Money may be invested only: (a) in any security authorised by the Trustee Act 1925; or (b) in a form of investment notified by order of the Minister published in the Gazette”.

The Minister’s Order provides that a council must invest, or maintain an investment in any security authorised by section 14A (2) of the Trustee Act as in force immediately before the commencement of Schedule 1 (2) to the Trustee Amendment (Discretionary Investments) Act 1997.

In addition, the Order notifies forms of approved investment with the Local Government Investment Service; the banks; the Treasurer and accredited Funds Managers.

The Local Government (Financial Regulation) 1993 (Part 4, Cl.19) provides that the responsible accounting officer must report monthly to the council setting out details of all the money council has invested and certification that the investment has been made in accordance with the Act, the regulations and the council's investment policies.

OPTIONS:

1. THE PRUDENT PERSON APPROACH:

Since 1995, Australian states have been progressively amending Trustee legislation to introduce the "prudent person" principle.

The "prudent person" approach leaves the question of investment entirely to the discretion of the trustee. That discretion, however, must be exercised in accordance with the rule which was laid down in 1830 in Harvard College v Amory 26 Mass (9Pick) 446 which states:

"All that can be required of a trustee is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to permanent disposition of their funds, considering the probable outcome, as well as the probable safety of the capital to be invested."

The trustee is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would. The trustee must, at least once in each year, review the performance (individually and as a whole) of trust investments.

Local councils would not be expected to achieve maximum yields, but the reasonable yields otherwise expected from normal management by prudent people; a balance between earnings and risk.

Section 14C of the Trustee Amendment (Discretionary Investments) Act 1997 prescribes 15 matters that a trustee must take into account when exercising the power of investment. The list includes for example, that the trustee must have regard to "the desirability of diversifying trust investments" and have regard to "the risk of capital or income loss or depreciation".

The 15 matters are not an exhaustive list. Trustees may take into account relevant things additional to the 15 prescribed matters. Section 14C also empowers trustees to seek out and obtain independent and impartial advice from people who are competent to give such advice.

Proponents of the "prudent person" approach argue that it allows greater flexibility for trustees, avoids moral hazard for governments and the need for constant review of listed investments by governments.

2. THE CURRENT ARRANGEMENTS:

This would involve maintaining the list authorised by section 14A (2) of the Trustee Act as in force immediately before the commencement of Schedule 1 (2) to the Trustee Amendment (Discretionary Investments) Act 1997.

In keeping with existing arrangements it would be the responsibility of each individual council to determine if its investments were authorised in terms of the

listed securities.

It is argued that there is a wide range of investments currently available and that it is not considered necessary for councils to invest in other forms of securities.

Critics of authorised lists argue that there are inherent difficulties in a list of authorised investments as the possibilities are too diverse. In addition, the market is constantly developing new investment products and variations of existing products.

3. THE PUBLIC AUTHORITIES (Financial Arrangements) APPROACH:

Another option is to link councils to the financial rules relating to public authorities that are covered in the “Public Authorities (Financial Arrangements) (PAFA Act) 1987.

Authorities have gradated investment powers ranging from “Part1” (the most basic), through to “Part 4” (the broadest). The category into which an organisation fits depends on the nature of investments generally under management and the investment skills, expertise and resources possessed by the organisation.

The most basic (Part1) provide access to a range of investment opportunities through deposits with banks and the Treasury Corporation, through to the Hour-Glass investment facility of the Treasury Corporation. Investments of any kind are authorised for any authority, which may exercise Part 4 investment powers.

In 1990 Cabinet agreed that authorities should report on investment performance on their statutory annual reports and that investment returns obtained by Hour Glass Investment facilities should be used as a benchmark.

Informal advice from the NSW Treasury is that there are no proposals to change the existing arrangements in terms of the investment powers of authorities. That is, the “prudent person rule” does not apply.

At the same time, investment in a listed security is not a guarantee against loss or failure of an investment, nor does it relieve a trustee of his or her duty to invest funds in a prudent manner. Government does not guarantee authorised investments.

Councils have traditionally been excluded from the investment power restrictions under the Public Authorities (Financial Arrangements) (PAFA) legislation. It is understood that councils did not want to be included in recognition of the day to day autonomy and identity of local government.

OTHER CONSIDERATIONS:

A. AUTHORISED FUNDS MANAGERS:

In addition to the current authorised list of securities prescribed in section 14 A (2) of the Trustee Act 1925 the Minister has made an Order that authorises a list of fund managers (similar to the minimum credit rating requirement based on clause 54 of the Public Authorities (Financial Arrangements) Regulation 1995).

Money with an authorised funds manager must be re-invested by the funds manager in a security authorised by section 14 A (2) of the Trustee Act. To become an authorised funds manager, proof must be provided that the funds manager or its controlled parent entity (immediate or ultimate) has a satisfactory credit rating given by Standard and Poor’s of A, or by Moody’s of A2.

Recent concern has been expressed as to the practicality of withdrawing investments in the event of a funds manager or its controlling entity falling below the required minimum or investing in a security that ceases to comply with section 14 A (2) of the Trustee Act.

In addition it is argued that the ratings of the entities may be dated or that by simply keeping a list the Government may be seen as endorsing the Fund Manager.

An alternative approach is to have the individual investment product rated, on the basis that, for example, a separate unit trust fund's specific rating is the relevant determining factor in relation to the security of the assets.

B. TENDERING ARRANGEMENTS:

If there is any change to existing arrangements councils may need to consider the implications of the local government tendering regulations when engaging the services of investment advisers if the potential fees payable are likely to be more than \$100,000. Similar consideration may be necessary in relation to the fees payable to professional fund managers.

Tendering would provide councils with the opportunity to appraise the services of those competent people available to provide independent and impartial financial advice.

C. CODE OF PRACTICE:

As with the current arrangements, members of councils and staff must avoid investments (and other business activities) in which it might reasonably be perceived that there is a conflict of interest, a pecuniary interest or confidential information. Full disclosure must be made whenever such issues arise.

D. NATIONAL COMPETITION POLICY:

It is unlikely that if a council manages its own investment strategy that it would be regarded as a business activity, even if, as expected the activity will generate revenue. However, if a council were to tender for investment services from other councils or clients, then council's activities are likely to be defined in business terms and as such NCP guidelines would apply.

E. OTHER STATES:

A survey of other States arrangements shows that:

- Queensland includes its councils with its statutory authorities legislation, similar to the PAFA;
- South Australia is considering moving to the "prudent person" approach" once the legislation to replace the current Local Government Act is passed."
- Victoria prescribes a list of authorised investments in its local government legislation.
- Western Australia adopted the "prudent person" approach in June 1997.
- Tasmania adopted the "prudent person" approach in April 1998.

Advice from New Zealand is that since the late 1980's the prudent person rule has applied but that as from the 1 July 1998 councils will need to publish an investment

policy as part of their Annual Plan.

F. ISSUES:

In considering the best approach for councils in New South Wales the following issues need to be considered:

- the concept of stewardship of entrusted public funds, particularly those raised through rating;
- the responsibility of maximising returns on investment within prudential guidelines;
- the community attitudes towards acceptable and unacceptable risk;
- the skills required to manage funds in relation to risk and return;
- the need to have liquidity when required;
- the accounting; reporting and accountability requirements;
- the efficiency administration costs incurred as opposed to the benefits received;
- the possibility of insolvency arising from poor investments.

Appendix 12.4:-Ministers Order:-Investment Guidelines Mar 2000



Department of Local Government Circular to Councils

Circular No: 00/18
Date: 28/3/00
File No: FF97/0218
Contact: Derek Lewis
(02) 9793 0625
lewis.d@dlg.nsw.gov.au

FORMS OF INVESTMENT - MINISTER'S ORDER and INVESTMENT GUIDELINES

Attached is a copy of an Order of the Minister notifying forms of investment for the purposes of section 625 (2) (b) of the Local Government Act 1993. The Order is published in the Government Gazette on 24 March 2000 and takes effect on and from that date. The Order replaces the previous Order published in the Government Gazette of 15 May 1998.

The new Order notifies the authorised investment powers of councils following the introduction of the Trustee Amendment (Discretionary Investments) Act 1997 that amended the Trustee Act 1925 to delete the authorised list of investments.

The list of authorised investments as authorised by section 14 A (2) of the Trustee Act 1925 as in force immediately before the commencement of the new Act has been revised and forms the basis of the new Order. As well, new Investment Guidelines for councils have been prepared (see attached).

In keeping with existing arrangements it is the responsibility of each individual council to determine that its investments are authorised in terms of the listed securities.

In addition, councils should be aware that, following a review of the legislation, section 625 of the Local Government Act 1993 will be amended to delete the reference to the Trustee Act 1925.

Garry Payne
Director General

LOCAL GOVERNMENT ACT 1993 – ORDER

(Relating to investments by councils)

I, HARRY WOODS, 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, with effect on and from the 17 March 2000 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;

Appendices

(k) any securities which are issued by a company or body 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".

(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";

(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.

Harry Woods

Dated this 17 day of March 2000 **HARRY WOODS, MP**

Minister for Local Government

Investment Guidelines

- Councils must comply with clause 16 of the Local Government (Financial Management) Regulation 1999 that provides for reporting on council investments by the responsible accounting officer.
- The revised Code of Accounting Practice and Financial Reporting will require councils to maintain a separate record of money it has invested under section 625 of the Act. The record must specify:
 - the source and the amount of money invested; and
 - particulars of the security or form of investment in which the money is invested; and
 - if appropriate, the rate of interest to be paid, and the amount of money that
 - the council has earned, in respect to the money invested.
- The revised Code of Accounting Practice and Financial Reporting will also require a council to maintain a separate record of all quotations that the council has obtained before making such an investment (similar to clause 19 of the Local Government (Financial Management) Regulation 1993).
- A council or entity acting on its behalf should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. A prudent person is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would. (Ref: Trustee Amendment Discretionary Investments) Act 1997 section 14 A (2)).
- A council should develop an investment strategy as part of its overall financial plan. The strategy should, as a minimum consider the desirability of diversifying investments and the nature and risks associated with the investments. (For guidance see: Trustee Amendment (Discretionary Investments) Act 1997 section 14 c (1) “matters to which trustee is to have regard when exercising power of investment”).
- A council should at least once in each year, review the performance (individually and as a whole) of council investments and review its investment strategy.
- An investment adviser or investment dealer acting on behalf of a council, should be licensed by the Australian Securities and Investment Commission. Ref: www.asic.gov.au
- Where a council invests in banks; building societies and credit unions it should know that these institutions are regulated as authorised deposit taking institutions by the Australian Prudential Regulation Authority (APRA) under the Banking Act 1959 Ref. www.isc.gov.au Note, however, that whilst APRA has power to require financial institutions to observe prudential standards (such as appropriate capitalisation, liquidity and governance) and to intercede if it believes that depositors’, policyholders’ or members’ interests are at risk, it provides no guarantee of the performance of the financial institution.
- Credit ratings are a guide or standard for an investor, which indicate the ability of a debt issuer or debt issue to meet the obligations of repayment of interest and principal. Credit rating agencies such as Moody’s and Standard

and Poor's make these independent assessments based on a certain set of market and non-market information. 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. Even given this challenge, ratings provide the best independent information available.

- In the event that a credit rating of a security or the credit rating of the company or body issuing the security falls below the required minimum, as set out in the Minister's Order, a council must make all the necessary arrangements to withdraw the deposit as soon as practicable.
- Note that in choosing a NSW Treasury Corporation hour-glass investment the choice of the facility should be based on the nature of the underlying commitments for which the council is holding funds. For example, funds required in the short term must be invested with a short-term profile rather than with exposure to more volatile asset classes such as property and shares.

Appendix 12.5: Ministers Order:-Investment Guidelines Nov 2000



Circular No: 00/71
Date: 29/11/00
File No: FF97/0218
Contact: Derek Lewis
(02) 9793 0625
lewis.d@dlg.nsw.gov.au

FORMS OF INVESTMENT - MINISTER'S ORDER

Attached is a copy of an Order of the Minister notifying forms of investment for the purposes of section 625 (2) of the Local Government Act 1993. The Order is published in the Government Gazette on 24 November 2000 and takes effect on and from that date. The Order replaces the previous Order published in the Government Gazette of 24 March 2000.

The new Order notifies two changes to the authorised investment powers of councils compared with the previous Order. Item (p) has been added to allow investments in "shares in the Inland Marketing Corporation Limited" and a minor addition to part (k) of the Order that includes the words "or controlled parent entity, either immediate or ultimate" after the words "body or company".

Councils should also be aware that the amendment to the Local Government Act 1993 to delete the reference to the Trustee Act 1925 was contained in the Statute Law (Miscellaneous Provisions) Act 2000 and commenced on 29 June 2000. Section 625 (2) provides that "Money may be invested only in a form of investment notified by order of the Minister published in the Gazette".

In addition, Councils attention is drawn to Update 8 of the Code of Accounting Practice and Financial Reporting that contains a policy direction that states "councils must maintain an investment policy". That investment policy must comply with the legislation and investment guidelines.

In keeping with existing arrangements it is the responsibility of each individual council to determine that its investments are authorised in terms of the listed securities. Note that the Guidelines issued with the previous Order remain unchanged.

Garry Payne
Director General

New South Wales Department of Local Government
66-72 Rickard Road, Bankstown NSW 2200 Locked Bag 1500, Bankstown NSW 2200
Tel: (02) 9793 0793 Fax: (02) 9793 0799 TTY: (02) 9707 2508
Email: dlg@dlg.nsw.gov.au Web: <http://www.dlg.nsw.gov.au>

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

I, HARRY WOODS, 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, with effect on and from the 16 November 2000 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''.
- (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'';
- (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.
- (p) shares in the Inland Marketing Corporation Limited.

Dated this day of 16 November 2000

HARRY WOODS, MP
Minister for Local Government

INVESTMENT GUIDELINES

- Councils must comply with clause 16 of the Local Government (Financial Management) Regulation 1999 that provides for reporting on council investments by the responsible accounting officer.
- The revised Code of Accounting Practice and Financial Reporting will require councils to maintain a separate record of money it has invested under section 625 of the Act. The record must specify:
 - (a) the source and the amount of money invested; and
 - (b) particulars of the security or form of investment in which the money is invested; and
 - (c) if appropriate, the rate of interest to be paid, and the amount of money that the council has earned, in respect to the money invested.
- The revised Code of Accounting Practice and Financial Reporting will also require a council to maintain a separate record of all quotations that the council has obtained before making such an investment (similar to clause 19 of the Local Government (Financial Management) Regulation 1993).
- A council or entity acting on its behalf should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. A prudent person is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would. (Ref: Trustee Amendment (Discretionary Investments) Act 1997 section 14 A (2)).
- A council should develop an investment strategy as part of its overall financial plan. The strategy should, as a minimum consider the desirability of diversifying investments and the nature and risks associated with the investments. (For guidance see: Trustee Amendment (Discretionary Investments) Act 1997 section 14 c (1) "matters to which trustee is to have regard when exercising power of investment").
- A council should at least once in each year, review the performance (individually and as a whole) of council investments and review its investment strategy.
- An investment adviser or investment dealer acting on behalf of a council, should be licensed by the Australian Securities and Investment Commission. Ref: www.asic.gov.au
- Where a council invests in banks; building societies and credit unions it should know that these institutions are regulated as authorised deposit taking institutions by the Australian Prudential Regulation Authority (APRA) under the Banking Act 1959 Ref. www.apra.gov.au Note, however, that whilst APRA has power to require financial institutions to observe prudential standards (such as appropriate capitalisation, liquidity and governance) and to intercede if it believes that depositors', policyholders' or members' interests are at risk, it provides no guarantee of the performance of the financial institution.
- Credit ratings are a guide or standard for an investor, which indicate the ability of a debt issuer or debt issue to meet the obligations of repayment of interest and principal. Credit rating agencies such as Moody's and Standard and Poor's make these independent assessments based on a certain set of market and non-market information. 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. Even given this challenge, ratings provide the best independent information available.
- In the event that a credit rating of a security or the credit rating of the company or body issuing the security falls below the required minimum, as set out in the Minister's Order, a council must make all the necessary arrangements to withdraw the deposit as soon as practicable.
- Note that in choosing a NSW Treasury Corporation hour-glass investment the choice of the facility should be based on the nature of the underlying commitments for which the council is holding funds. For example, funds required in the short term must be invested with a short-term profile rather than with exposure to more volatile asset classes such as property and shares.

Appendix 12.6:-Circular:-Forms of Investments Sept 2005



Circular No. 05-53
Date 23 September 2005
Doc ID. A29843

Contact Sonja Hammond
02 4428 4143
sonja.hammond@dlg.nsw.gov.au

FORMS OF INVESTMENT - MINISTER'S ORDER

Attached is a copy of an Order of the Minister notifying forms of investment for the purposes of section 625 (2) of the *Local Government Act 1993*. The Order was published in the Government Gazette on 29 July 2005 and takes effect on and from that date. The Order replaces the previous Order published in the Government Gazette of 24 November 2000.

The new Order notifies three changes to the investment powers of councils compared with the previous Order. Items (k) and (l) have been amended to include Fitch Ratings as a prescribed rating agency. Item (p) Shares in the Inland Marketing Corporation Limited has been removed.

In addition, council's attention is drawn to Update 13 of the Code of Accounting Practice and Financial Reporting that contains a policy direction that states, "councils must maintain an investment policy". That investment policy must comply with the legislation and investment guidelines.

In keeping with existing arrangements it is the responsibility of each individual council to determine that its investments are authorised in terms of the listed securities.

Garry Payne
Director General

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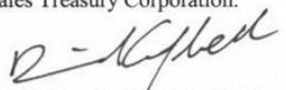
LOCAL GOVERNMENT ACT 1993 – INVESTMENT ORDER

(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 day of 15TH JULY 2005


Hon DAVID CAMPBELL MP
Acting Minister for Local Government

Appendix 12.7:-Circular:-Investment Requirements Nov 2006



Circular No. 06-70
Date 27 November 2006
Doc ID. A73775

Contact Sarah Gubb
02 4428 4142
sarah.gubb@dlg.nsw.gov.au

INVESTMENT REQUIREMENTS FOR NSW COUNCILS

Following a recent survey it is apparent that some councils are not adhering to the current Ministerial Investment Order regarding the investment of funds. As a consequence, this circular replaces Circular 00/71 and should be read in conjunction with Circular 05/53 to further remind councils of their responsibilities.

Councils must comply with the Ministerial Investment Order, section 625 of the *Local Government Act 1993* and clause 212 of the Local Government (General) Regulation 2005. Clause 212 of the Regulation provides for reporting on council investments by the responsible accounting officer, while section 625 of the Act describes how councils may invest.

Councils must consider the following when considering an investment:

- the purpose of the investment
- the desirability of investment diversification
- the nature and risks associated with the investments
- the likely income return and timing of any income return
- the length of the proposed investment
- the costs involved in making the investment
- other matters as appropriate.

Under section 625 of the *Local Government Act 1993*, councils must maintain a separate record of the money they have invested. The record must specify:

- the source and the amount of money invested
- particulars of the security or form of investment in which the money is invested 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.

Councils need to be aware of their obligation to be transparent when reporting changes of value in investments. The onus for investments is to be on preservation of capital rather than the rate of return.

As part of its overall financial plan, each council should develop and maintain an investment strategy/policy. The strategy/policy should, as a minimum, consider the desirability of diversifying investments and the nature and risk associated with the investments.

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Appendices

An analysis of NSW councils at 30 June 2005 revealed that a large percentage of councils have an investment policy that had been adopted under council resolution. However, many councils with an investment policy indicated that they did not review the policy on a regular basis. Councils should, at least once in each year, review the performance of council investments (individually and as a whole) and review their investment strategy/policy.

Third Party Investments

It has also been brought to the department's attention that a number of councils are investing through third parties. It is of concern that some third party investments may be outside the Ministerial Order. When investing through third parties a council, or entity acting on behalf of a council, should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. An investment adviser or dealer acting on behalf of a council should be licensed by the Australian Securities and Investment Commission (ASIC) (www.asic.gov.au).

Where council invests through a third party, the Fund Manager should be provided with strict investment guidelines that meet the legislative requirements. As councils remain responsible for investments meeting legislative requirements, they need to ensure that Fund Managers are delivering appropriately and complying with council's requirements, including the Ministerial Investment Order. The Responsible Accounting Officer should obtain regular assurance from Fund Managers that third party investments comply with council's requirements. Clause 212 of the Local Government (General) Regulation 2005 states:

The responsible accounting officer of a council:

- (a) must provide council with a written report (setting out details of all money that the council has invested under section 625 of the Act)
- (b) must include in the report a certificate as to whether or not the investment has been made in accordance with the Act, the regulations and the council's investment policies.

Based on this, it is suggested that councils obtain assurance from Fund Managers on a monthly basis.

Additionally, the General Manager, Mayor and Responsible Accounting Officer are also required to certify that the annual financial statements are in accordance with the Act and regulations. This would include compliance with investment requirements.

Credit Ratings

Credit ratings are a guide or standard for an investor, which indicate the ability of a debt issuer or debt issue to meet the obligations of repayment of interest and principal. Credit rating agencies such as Moody's, Standard and Poor's and Fitch Rating make these independent assessments based on a certain set of market and non-market information. Ratings in no way guarantee the investment or protect an investor against loss. Councils should not misinterpret prescribed ratings as an

implicit guarantee of investments or entities that have such ratings. Even given this challenge, ratings provide the best independent information available.

It should be noted that **in the event that a credit rating of a security or the credit rating of the company or body issuing the security falls below the required minimum**, as set out in the Ministerial Investment Order, a council must make all necessary arrangements to withdraw the invested funds as soon as practicable.

Note that in choosing NSW Treasury Corporation hour-glass investment, the choice of the facility should be based on the nature of the underlying commitments for which the council is holding funds. For example, funds required in the short term must be invested with a short term profile rather than with exposure to more volatile asset classes such as property and shares.

The Local Government Finance Professionals have produced a Best Practice Guide for Investments to assist councils. This can be obtained by contacting the Finance Professionals at <http://lgfp.lgmansw.com.au>.

Garry Payne

Director General

Appendix 12.8:- Circular:-Investments Aug 2007



Circular No. 07-38
Date 17 August 2007
Doc ID. A111061

Contact Grahame Gibbs
02 4428 4130
grahame.gibbs@dlg.nsw.gov.au

COUNCIL INVESTMENTS

Councils are reminded of their responsibility to ensure that investments comply with the forms of investment made by order of the Minister under section 625(2) of the *Local Government Act 1993*. The current Ministerial Order was issued under Council Circular 05-53 on 23 September 2005.

Councils are also reminded of the investment reporting requirements in Clause 212 of the Local Government (General) Regulation 2005. This requires the responsible accounting officer to provide council with a written report on the money that council has invested under section 625. The report must include a certificate as to whether or not the investments comply with the Act (ie, the Minister's Order) and the council's investment policies.

Your attention is also drawn to Circular 06-70, which was issued on 27 November 2006. The Circular draws particular attention to the need for Councils to exercise prudential care when making investment decisions through third parties. Councils are reminded that all investment products, in whole or in part, need to comply with the Ministerial Investment Order. When obtaining investment advice councils should be sure that the advice provided is through a licensed independent adviser. Councils should also be cautious when investing with a third party fund manager where there is a perceived or actual conflict of interest.

A handwritten signature in blue ink, appearing to read 'Garry Payne'.

Garry Payne AM
Director General

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Appendix 12.9:- Circular:-Investments and Cole Enquiry April 2008



Circular No. 08-10
Date 2 April 2008
Doc ID. A137391

Contact Chris Duff
02 4428 4133
chris.duff@dlg.nsw.gov.au

COUNCIL INVESTED FUNDS AND THE COLE INQUIRY REPORT

The Review of NSW Local Government Investments report has now been issued. The Review investigated the impact on councils that invested in structured financial products. The NSW Government has adopted all the recommendations from the report.

The recommendations include:

- Amendments to the Ministerial Investment Order
- Grandfathering existing investments that are excluded by the proposed changes to the Ministerial Investment Order
- Excluding the manufacturers and distributors of investment products from acting as investment advisors to councils
- Suspending investments with specific credit ratings until December 2009
- Ensuring councils are more fully aware of their obligations under the *Local Government Act 1993* and the *NSW Trustee Act 1925* and
- Issuing investment policy guidelines for councils.

A copy of the report can be accessed from the Department of Local Government's website at: www.dlg.nsw.gov.au.

The Department is currently working on the following to implement the recommendations from the Review:

- Amending the Ministerial Investment Order:
 - to include both principal and investment income in a definition of investment instruments
 - to suspend investments with specific credit ratings specified in section (k) and (l) until 31 December 2009, subject to further review
 - to exclude subordinate obligations under section (m)
 - to restrict mortgages over land to first mortgages with a Loan to Value ratio of no greater than 60% under section (f)
 - to exclude investments in ASX listed property trust investments under section (g).

The amended Ministerial Investment Order will be issued as soon as practicable.

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Appendices

Preparing investment guidelines for all councils. The investment guidelines will include issues raised in the Report relating to:

conflict of interest such as product manufacturers and distributors being appointed as investment advisors

councils' fiduciary responsibilities in relation to investment activities under the *Local Government Act 1993*

councils' obligations under the NSW *Trustee Act 1925*.

The guidelines will be prepared with industry consultation.

Councils may continue to hold to maturity, redeem or sell investments that comply with the existing order, but any new investments must comply with the revised Ministerial Investment Order. Similarly, when councils restructure or replace non-complying investments with new investment products, the new products must comply with the revised Ministerial Investment Order.

When considering selling or restructuring current investments that fall below the requirements of the Ministerial Investment Order (see circular 06-70), councils should exercise due care and diligence. Councils should not solely rely on advice from the issuer of the investment and should seek independent financial advice. An investment adviser or dealer acting on behalf of a council should be licensed by the Australian Securities and Investment Commission (ASIC) (www.asic.gov.au).

When determining the most practicable time to withdraw the funds, councils should consider, but not be limited by, the following factors:

- whether the downgrade of the rating is a short-term market fluctuation or long-term market correction
- the likelihood of the rating of the security changing
- the maturity date of the investment
- the preservation of capital if the investment was held to maturity
- the assessment of independent quotes for the market value of the investment
- the effect on interest received from the investment, and
- the capital loss incurred if the investment was sold.

Subject to changes to the Ministerial Investment Order already outlined and the introduction of Investment Guidelines by the Department and councils abiding by their fiduciary responsibilities, the current partial deregulation model operating in NSW will be retained.

Garry Payne AM

Director General

Appendix 12.10:- Investment Order July 2008

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.

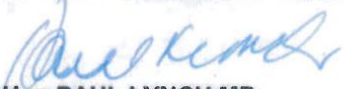
All investment instruments (excluding short term discount instruments) referred to above include both principal and investment income.

Transitional Arrangements

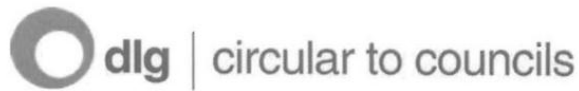
- (i) Subject to paragraph (ii) nothing in this Order affects any investment made before the date of this Order which was made in compliance with the previous Ministerial Order dated 15 July 2005, and such investments are taken to be in compliance with this Order.
- (ii) Paragraph (i) only applies to 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 31st day of July

2008


Hon PAUL LYNCH MP
Minister for Local Government

Appendix 12.11:- Circular:-Release Ministerial Investment Order Aug 2008



Circular No. 08-48
Date 18 August 2008
Doc ID. A153888

Contact Chris Duff
02 4428 4133
chris.duff@dlg.nsw.gov.au

REVISED MINISTERIAL INVESTMENT ORDER

The recent Review of NSW Local Government Investments ("the Cole Report") investigated the impact on councils that invested in structured financial products. The NSW Government adopted all the recommendations from the report.

The Minister for Local Government has now issued a revised Order pursuant to section 625 of the *Local Government Act 1993*. The Minister signed the amended Order on 31 July 2008 and it was gazetted on Friday 15 August 2008. It replaces the Order dated 15 July 2005. The revised Order is attached to this circular.

The changes to the Order include:

- 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. This decision will be reviewed after 31 December 2009
- 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 Department is preparing guidelines aimed at assisting councils in developing a comprehensive investment policy. The process will incorporate consultation with stakeholders. The guidelines will include 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.

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When considering selling current investments that fall below the requirements of the revised Ministerial Investment Order (see Circular 06-70), councils should exercise due care and diligence. Councils should not solely rely on advice from the issuer of the investment and should seek independent financial advice. An investment adviser or dealer acting on behalf of a council should be licensed by the Australian Securities and Investment Commission (ASIC) (www.asic.gov.au).

A handwritten signature in black ink, appearing to be 'Garry Payne', with a stylized, flowing script.

Garry Payne AM
Director General

Appendix 12.12:- Circular:-Draft Investment Policy May 2009



Circular No. 09-20
Date 25 May 2009
Doc ID. A135292

Contact Finance Policy Section
02 4428 4100
investmentpolicy@dlg.nsw.gov.au

DRAFT INVESTMENT POLICY GUIDELINES FOR CONSULTATION

The Department is releasing the draft investment policy guidelines for consultation. The draft guidelines have been developed to provide assistance to councils with the preparation of an investment policy and the prudent and appropriate management of council's surplus funds. The draft guidelines include discussion about diversification of investments, independent financial advice and capital protection.

The Department has previously provided guidance to councils in regard to investments. On 27 November 2006 Council Circular 06-70 *Investment Requirements for NSW Councils* was issued in response to concerns that a number of councils held investments with credit ratings which were below the investment order. There were also concerns that a number of councils did not have an investment policy or a policy which had not been reviewed annually. The Circular also advised that councils, or entities acting on behalf of a council, should exercise the care, diligence and skill that a prudent person would exercise in investing council funds when investing through third parties.

On 17 August 2007 Council Circular 07-38 *Council Investments* was released to remind councils of Circular 06-70 and to draw particular attention to the need for councils to exercise prudential care when making investment decisions through third parties.

Circular to Councils 08-10 advised that investment policy guidelines would be prepared with industry consultation. Draft guidelines have now been completed and are located on the 'Publication's page of the Department's website at www.dlg.nsw.gov.au.

The Department is also examining the need for legislative change to clarify that investment decisions made by a General Manager under delegated authority are made only within the council's adopted investment policy and that variations to that policy cannot be delegated.

Councils are invited to provide comment on the draft Investment Policy Guidelines by Friday 3 July 2009 via email to investmentpolicy@dlg.nsw.gov.au.

A handwritten signature in blue ink, appearing to read 'Ross Woodward'.

Ross Woodward
Acting Director General

Department of Local Government
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Appendix 12.13:- Circular:-Release Investment Policy May 2010



Circular No. 10-11
Date 25 May 2010
Doc ID. A198213

Contact Chris Duff
02 4428 4133
chris.duff@dlg.nsw.gov.au

RELEASE OF INVESTMENT POLICY GUIDELINES

On 25 May 2009, draft Investment Policy Guidelines were released for consultation. The final Investment Policy Guidelines have now been released after considering feedback from councils.

The Guidelines have been developed to assist councils with the preparation of an investment policy and the prudent and appropriate management of council's surplus funds.

As a result of the feedback received, the main changes to the Investment Policy Guidelines include:

- o clarification on the role of independent financial advisors
- o removal of the term 'investment strategy'
- o guidance to councils following a breach of the council's investment policy
- o a greater emphasis on councils maintaining legal title of their investments.

The Investment Policy Guidelines are available from the 'Publications' page of the Division's website at www.dlg.nsw.gov.au.

Ross Woodward
Chief Executive, Local Government
A Division of the Department of Premier and Cabinet

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Appendix 12.14:- Circular:-Revised Ministerial Order Feb 2011



Circular No. 11-01
Date 17 February 2011
Doc ID. A232163

Contact Finance Policy Section
02 4428 4100
dlg@dlg.nsw.gov.au

REVISED MINISTERIAL INVESTMENT ORDER

A revised Investment Order pursuant to section 625 of the *Local Government Act 1993* has been issued. The Minister for Local Government signed the revised Order on 12 January 2011 and it was published in the NSW Government Gazette on 11 February 2011. It replaces the Order dated 31 July 2008. The revised Order is attached to this circular.

Changes to the Investment Order include:

- the removal of the ability to invest in the mortgage of land (part (c) of the Investment Order dated 31 July 2008)
- the removal of the ability to make a deposit with the Local Government Financial Services Pty Ltd (part (f) of the order dated 31 July 2008)
- the addition of "Key Considerations" in the revised Investment Order, which includes a comment that a council's General Manager, or any other staff, with delegated authority by a council to invest in funds on behalf of the council must do so in accordance with the council's adopted investment policy.

Councils are reminded that on 25 May 2010 the Division of Local Government issued Investment Policy Guidelines (Circular to Councils 10-11 refers). It is expected that all councils will by now have adopted an Investment Policy in accordance with the Guidelines.

Ross Woodward
Chief Executive, Local Government
A Division of the Department of Premier and Cabinet

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Appendix 12.15:- Investment Order Jan 2011

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.

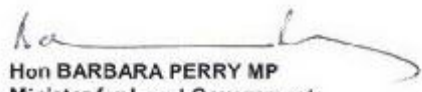
All councils should by resolution adopt an investment policy that is consistent with this Order and any guidelines issued by the Chief Executive (Local Government), Department of Premier and Cabinet, from time to time.

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.

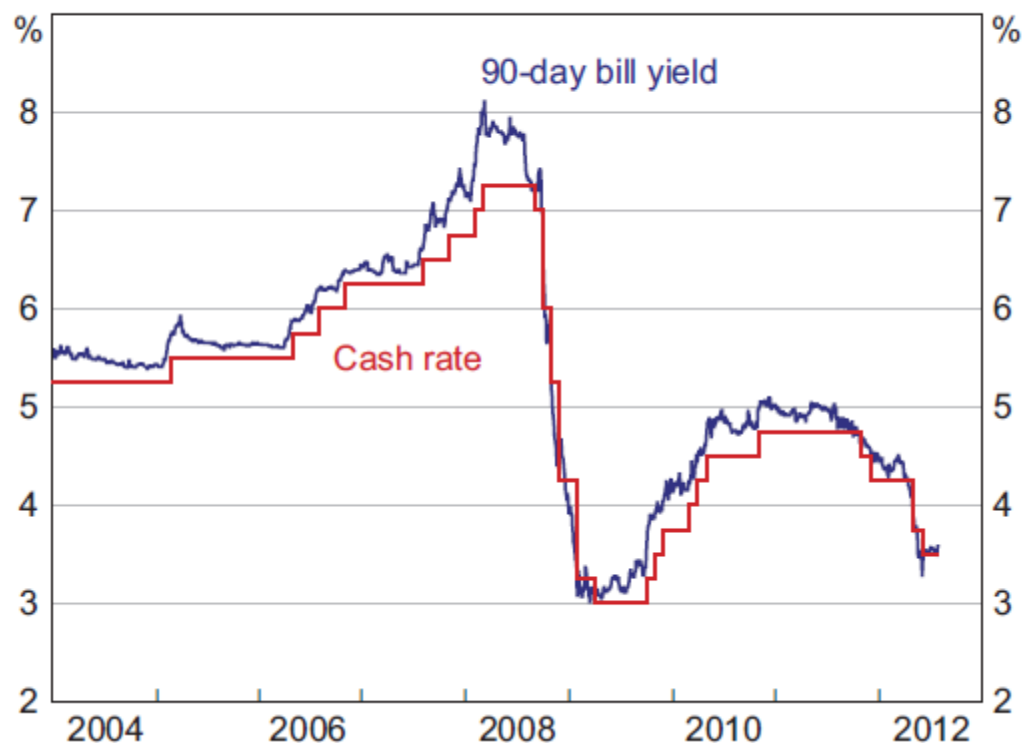
When exercising the power of investment councils should consider, but not be limited by, the risk of capital or income loss or depreciation, the likely income return and the timing of income return, the length of the term of the proposed investment, the liquidity and marketability of the proposed investment, 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

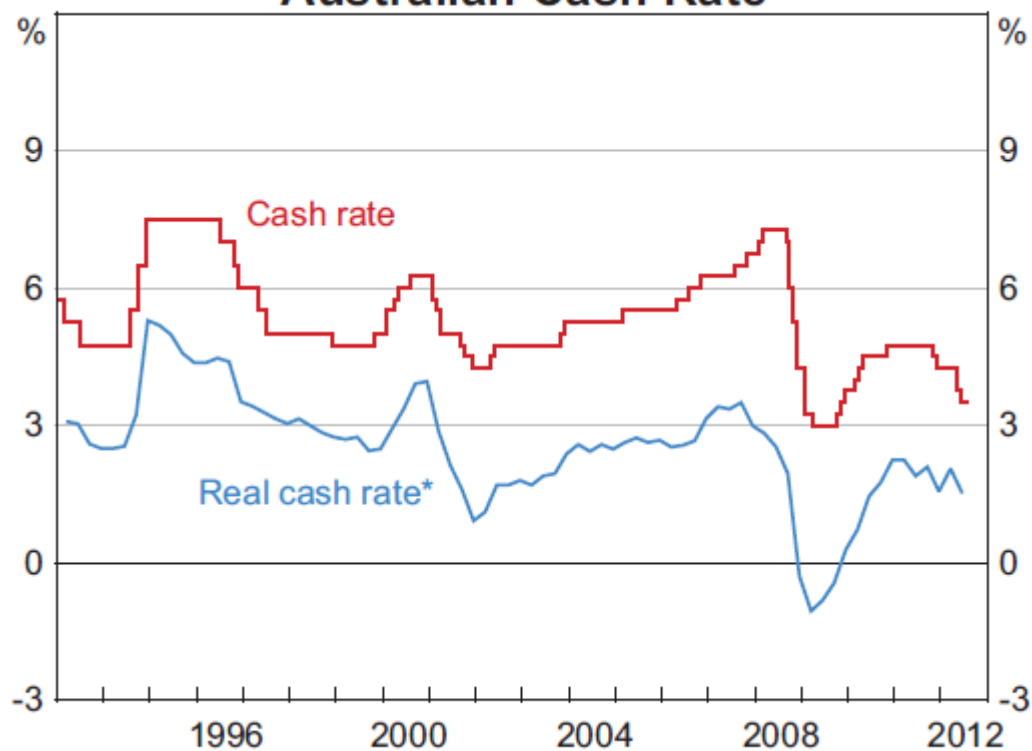

Hon BARBARA PERRY MP
Minister for Local Government

Appendix 13: Investment returns and interest rates 2000-2010

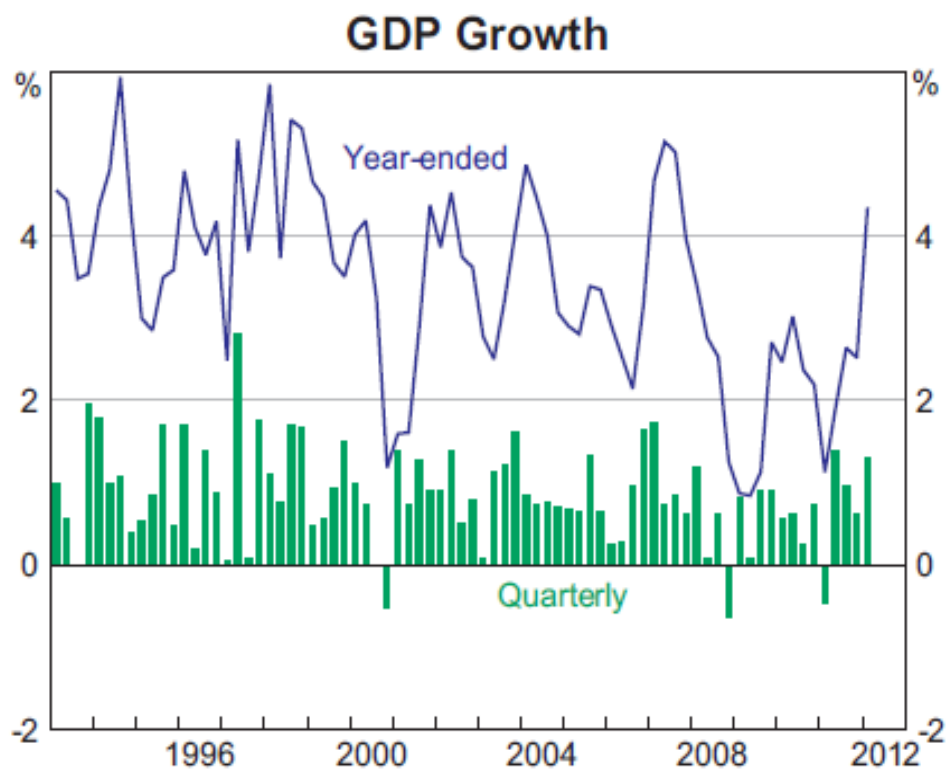
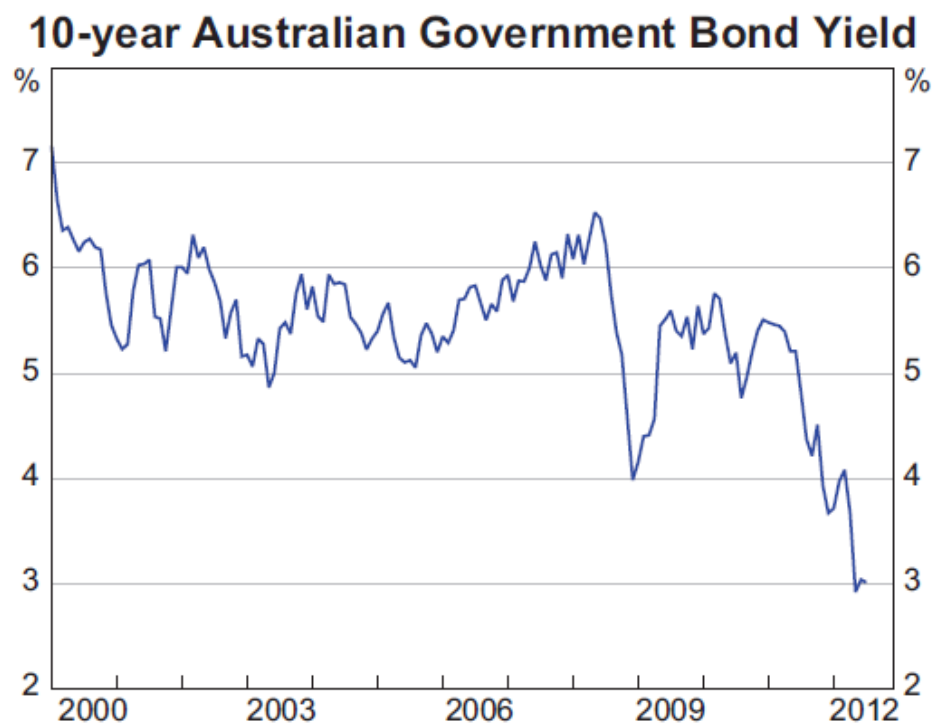
Australian Cash Rate and 90-day Bill Yield



Australian Cash Rate

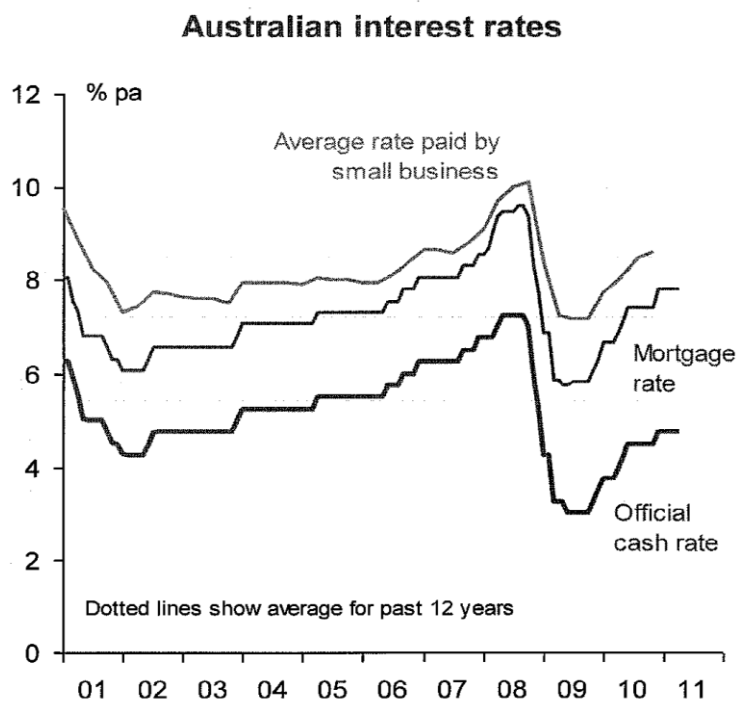


* Calculated using average of weighted median and trimmed mean inflation

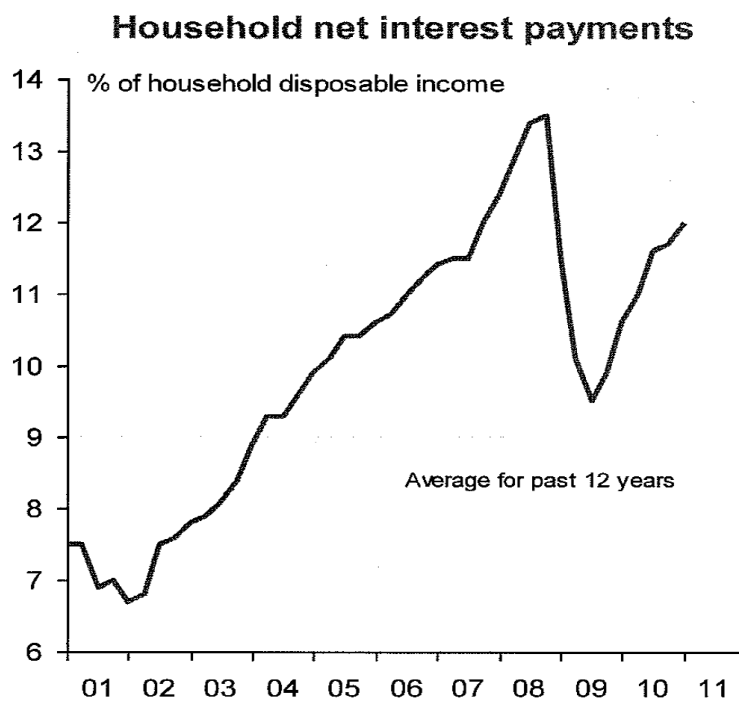


(Source RBA, 20120)

Appendix 14: Interest rates and returns 2000-2011



(Eslake, 2011a)



(Eslake, 2011a)