

## **Reform of Investment Organisation in Australia's Local Government Sector**

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### **Abstract**

The losses reported from the so-called sub-prime category, and the collateral damage suffered by some councils, has brought renewed scrutiny of their financial viability and the investment practices which are employed across the local government sector. The diversity of prudential investment standards which currently apply in Australia also suggests that the investment policies expected to deliver optimal economic outcomes for ratepayers require reform. In conjunction with the moves to address the financial sustainability of the sector, this paper argues that reforms are needed to standardise investment powers, empower councils to develop appropriate investment objectives, and to centralise funds management.

## Introduction

The losses reported in credit markets and write downs of local government investments have highlighted important and fundamental issues facing the financial viability of Australia's local government sector. The diminution in the values of collateralised debt obligations (CDO) and other securitised investments has threatened service provision at what is arguably the most politically-sensitive level of government.

*Prima facie*, investment losses suggest “proof” of poor governance structures; however, these events are symptomatic of the increasing financial pressures affecting the local government sector. This phenomenon has intensified as Commonwealth and State governments have increasingly devolved responsibility for service provision, engaged in cost-shifting, and increased statutory obligations, without compensation.<sup>1</sup> The vulnerability of the sector has been exacerbated because informal or “pegged” rate rises have constrained councils from increasing revenue from ratepayers and restricted broadening of own-source revenues. In this environment, councils have deferred capital expenditures and sought higher returns on their investment portfolios to support recurrent expenditures whilst being subject to varying prudential investment standards.

The recent volatility in financial markets provides a useful backdrop for analysing fundamental matters. This requires an understanding of the investment constraints imposed upon councils which provides insights into why some councils had a seemingly insatiable appetite for high-yielding credit instruments. The CDO debacle has also

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<sup>1</sup> Examples of cost shifting include the requirement to provide pensioner rebates and concessions, the costs associated with the upkeep of roads and airport assets previously transferred from other tiers of government ownership, and non-indexation of fees and charges (despite rising costs and inflation).

reiterated evergreen concerns regarding the use credit ratings as an investment tool, queried the adequacy of investment advice that councils as “sophisticated investors” have received, and highlighted potential or actual conflicts of interest existing between service providers within the funds industry food chain.<sup>2</sup>

The first part of this article briefly surveys research into Australia’s local government sector, especially focusing on the salient issues of investment management (as distinct from total asset management/physical infrastructure). The second part discusses the origins and background of the “prudent investor rule” which applies in Australia’s local government sector and the mainstream fiduciary finance industry. The third part provides a comparative assessment of the regulatory constraints imposed upon the local government sector with regard to their investing activities in Australia. The fourth part proposes options for reform of local government investment operations to accord with best practice standards. Finally, a summary is provided.

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<sup>2</sup> It is important to note that most of these issues have been subject to continuous and comprehensive reform within retail financial services/intermediation markets since the late 1990s which have enforced greater disclosure for customers.

## Previous research into local government finances and investments

The concerns regarding the “financial sustainability” of the local government sector have been well documented at state and national levels since 2005. Inquiries and studies into financial sustainability were published for South Australia, New South Wales and Western Australia; all of which were undertaken by Access Economics.<sup>3</sup> The Municipal Association of Victoria (MAV) has also analysed trends in the efficiency and long-term sustainability of local government finances in Victoria.

The principal metrics typically used to define “financial sustainability” are backlogs in infrastructure spending, underspending on current infrastructure, operating performance and liquidity.<sup>4</sup> The MAV developed a “viability index” which incorporated unfunded superannuation liabilities in addition to the conventional financial data for borrowings and infrastructure backlogs.

In 2006, the Australian Local Government Association (ALGA) commissioned PricewaterhouseCoopers (PwC) to complete a national study on the financial sustainability of local government. This research used the results of the previous state-based studies supplemented by a financial ratio analysis of 100 Australian councils to extrapolate a national position of long-term financial sustainability.

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<sup>3</sup> See further: House of Representatives, Standing Committee on Economics, Finance and Public Administration (SCEFPA) (2003); Access Economics (2005; 2006a; 2006b; 2007); Independent Inquiry into Financial Sustainability of NSW Local Government (2005; 2006).

<sup>4</sup> See further PwC(2005)

The results of the PwC analysis were reported in November 2006. The median data presented for five separate sustainability metrics showed that overall the sector generated an operating surplus of 10 per cent (i.e. revenues exceeding expenses), rates coverage of 40 per cent, a “sustainability” ratio (capital expenditure divided by depreciation) of 1.8 times, and a current ratio (current assets divided by current liabilities) of 2.6 times.

Disaggregating these national numbers, however, significant disparities existed especially within rural and remote councils. Overall, PwC concluded that up to 30 per cent of local government councils might be regarded as “unsustainable” (PwC, 2006: 12).<sup>5</sup> As shown in table 1, the national median data reported across the sustainability benchmarks obscured widespread evidence of operating deficits, declining own-sourced revenues, capital shortfalls even to fund existing infrastructure, and heightened risk of insolvency.

**Table 1: Financial sustainability benchmarks and performance**

| <i>Area</i>      | <i>KPI</i>                | <i>Description</i>   | <i>Benchmark</i>                    | <i>% of councils below benchmark</i> |
|------------------|---------------------------|--|-------------------------------------|--------------------------------------|
| <i>Operating</i> | Operating surplus/deficit | Total operating revenue less total operating expenses, divided by total revenue  | operating deficit < 10% of revenues | 16                                   |
|                  | Rates coverage            | Total rates divided by total costs   | 40.0%                               | 40                                   |
| <i>Capital</i>   | Sustainability ratio      | Capital expenditure divided by depreciation expense                              | 1.0                                 | 8                                    |
| <i>Liquidity</i> | Current ratio             | Total current assets divided by total current liabilities                        | 1.0                                 | 21                                   |
|                  | Interest coverage         | Operating surplus less non-cash items e.g. depreciation, divided by net interest | <3.0                                | 36                                   |

Source: PwC (2006), p.117

<sup>5</sup> PwC noted that its findings were more positive than the state-based studies completed by Access Economics, however it included important caveats relating to the omission of Tasmanian and Queensland councils and concerns regarding the quality and comparability of data presented under varying accounting treatments (see further: PwC 2006: 9-10).

Overall, PwC noted that the total infrastructure spending backlog in Australia's local government sector was \$14.5 billion with an annual underspend on renewals of \$1.1 billion creating a funding gap to clear the backlog and correct the underspend of \$2.2 billion per annum (PwC, 2006: 113).

To address the concerns regarding financial sustainability, the PwC report recommended that councils be allowed to expand own-source revenues, the removal of rate pegging, reform of intergovernmental structural funding arrangements, continued attention to extracting operating efficiencies, and the establishment of a dedicated "infrastructure renewals fund".

This report did not explicitly deal with investment policies and operations across the local government sector, although it noted that in other countries that investment income was a more important source of overall revenue.<sup>6</sup> In the United Kingdom, Canada and New Zealand, it was noted that councils were given considerable autonomy with regard to own-source revenue-raising and decision-making, however, they were required to long-term (e.g. 10-year) planning cycles and provide standardised and comprehensive data on service provision and financial performance.

Data which quantifies investment portfolios of the local government sector is not currently published on an aggregated basis by the Australian Bureau of Statistics, although councils are required under the relevant legislation to report on their portfolios

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<sup>6</sup> For example, in New Zealand investment income was approximately 6.5% of total local government revenue.

individually. The Productivity Commission analysed the revenue raising capacity of councils and found that in real terms, increases in all components of revenue per person were achieved, however, investment income derived from interest and dividends, remained relatively constant (between 2-3 per cent) between 1998 and 2006 (Productivity Commission, 2007: 25). In its submission to the Productivity Commission's inquiry into local government funding, however, the ALGA noted that the contribution of investment revenue was \$591 million (or about 2.75%) of total government revenues of \$21,459 million in 2004-5 (ALGA, 2007).

In terms of understanding investment practices, the NSW Local Government Accounting Advisory Group (LGAAG) surveyed council investments using data provided by councils in their 2004/05 financial returns. Its survey found that 83 per cent of 135 councils surveyed had a formal investment policy: of these, 87 per cent were adopted under council resolution; 57 per cent reviewed their policies annually; 12.5 per cent reviewed them between 2 and 5 years; 5 councils reviewed them as required and 2 never reviewed them; 131 councils modeled their investment policy according to the statutory investment order. In terms of investment practices, the survey found that 42 (31 per cent) of councils invested through a third party although not all councils used full funds managers, preferring instead to obtain separate investment advice which was independent of funds managers (LGAAG, 2006).

Even before the concerns became more obvious in credit markets, the NSW Department of Local Government (DLG) released circulars reminding councils of their obligations in relation to investments, reiterating that investments should be made in accordance with the relevant regulations, and on appropriate grounds, with ‘...the onus for investments...to be on preservation of capital rather than the rate of return’ (NSW DLG, 2006, 1).

A subsequent circular specifically reminded councils to be ‘...cautious when investing with a third party fund manager where there is a perceived or actual conflict of interest’ (NSW DLG, 2007a). In September 2007, in the midst of the unfolding CDO crisis, it was announced that a comprehensive review of councils’ exposures in NSW would be undertaken in conjunction with Treasury (NSW DLG, 2007b) to clarify the CDO exposures of councils.

The investment activities of councils, financial advisers and fund managers, have all been subjected to considerable scrutiny within the financial media (e.g. Barrett and Gray, 2007; Barrett, 2007). Councils in their quest for high returns have been described as “yield pigs” (Gray and Barrett, 2007: 44).

## Background to prudential investment standards

Before examining the prudential standards and investment governance structures in the local government sector, it is instructive to re-visit the origins of prudential investment standards (especially the so-called “prudent investor” rule). These standards are derived from the common law and supplement the statutory duties of care, skill and diligence imposed upon fund sponsors, trustees and fund managers (Ali, Stapledon and Gold 2003: 78-94).

Until prudent investor rule was “modernised” the latter part of the twentieth century, financial fiduciaries such as trustees were generally only permitted to invest in government-backed investments. Corporate bonds, mortgages, and common stocks were generally deemed imprudent and prohibited investments. The conservatism of trustee investments can be attributed to the traditional rationale of trusts which favoured preservation of capital, and the financial disasters of trust investments in the eighteenth century, which ruined thousands of investors and prompted the British Government to enact the Bubble Act in 1719.

Traditionally, family trusts were established to ensure that the grantor’s estate was preserved on behalf of successive generations of beneficiaries. The trustee’s priority, therefore, was to avoid risks to the trust’s capital, with a secondary emphasis on generating current income. Family trusts were typically used to preserve capital (including purchasing power of principal), to provide “satisfactory” current income. More

recently, as noted by Haskell (1990), these legal structures have been used to minimise the economic burdens imposed by taxes.

The main shortcoming of traditional formulation of the prudent investor rule was its inability to provide objective standards for investment. This resulted in inconsistencies and absurdities which were subject to legal challenges in the US in the late nineteenth and early twentieth centuries. The traditional formulation of the prudent investor rule enshrined conservatism: it required the prioritisation of risk avoidance and a “line-by-line” assessment of the individual securities in isolation from the overall portfolio. Under this formulation, only “safe” investments – primarily government guaranteed bonds – exhibiting low risks to capital could be held however this approach was problematic because these securities would necessarily provide only low returns.

Early court cases therefore considered the trade-off between “high current income yield” and “safety of capital”: one court ruled that *all* common stocks were imprudent, although legislators circumvented this blanket prohibition by publishing lists of “approved investments” (although these generally precluded common stocks in favour of bonds). In another case, under the prevailing line-by-line assessment of portfolio choices, a fiduciary was sued for making a loss on a single investment, despite the fact that the portfolio was profitable overall. Further, several court cases examined what constituted “appropriate diversification” and whether “young”, “growth companies”, convertible debentures and real estate investment trusts, were considered speculative (Haskell, 1990: 94-100).

The important effect of the modernisation of the prudent investor rule was to endorse a “whole-of-portfolio” approach to investment selection; this emphasises the management of a diversified portfolio on an integrated basis to maximise returns overall. This approach removed the onus on fiduciaries to select only “safe” investments which would protect against loss of capital: an approach which had previously precluded potentially profitable opportunities from higher returning assets (and those which could also offer an effective hedge against the deleterious effects on capital values from inflation).<sup>7</sup>

The modernisation of the prudent investor rule endorsed the key modern portfolio theory principle espoused by Markowitz (1953, 1959): that the *total return* of the portfolio has primacy over the income yield or expected capital appreciation of individual securities.

Within a diversified portfolio, therefore, it was both possible and *essential* for financial fiduciaries to invest in innovative securities and financial instruments which would otherwise be considered risky or speculative in isolation, but could provide meaningful diversification and incremental returns for a portfolio.

Whereas the “traditional” formulation of the prudent investor rule demanded active management, the consensus of available empirical evidence has reinforced the view that the majority of professional fund managers cannot beat the broad market reliably. Thus, the process of modernising prudential investment standards has effectively endorsed index-tracking schemes (Gold, 2007: 68).

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<sup>7</sup> This is particularly interesting given the recent directions provided by the NSW DLG to councils enjoining against risking capital.

So the question remaining is what is a “prudent” investment approach? As noted by Australian scholars (Ali, Stapledon and Gold 2003; Gold, 2007) standards of prudential investment remain in a disjointed state. Although Markowitz’s “whole-of-portfolio” approach is accepted as “best practice” in both scholarly and professional circles, a gamut of approaches is currently applied across jurisdictions and fiduciary finance applications.

This diversity in prudential standards is not peculiar to the local government sector: even within the regulations governing the mainstream managed investments industry (investment funds and superannuation funds) there are differences. The *Superannuation Industry (Supervision) Act 1993* (Cth) which regulates superannuation funds codifies a modern portfolio theory approach, however, the *Corporations Act 2001* (Cth) which governs managed investments (such as unit trusts) and Australian state and territory Trustee Acts, do not uniformly or explicitly acknowledge portfolio theory precepts.<sup>8</sup>

In fact, Ali, Stapledon and Gold (2003) have noted that

...the investment duties of the trustees and investment fiduciaries of managed funds other than superannuation funds remains wedded to the traditional formulation of the prudent investor rule, despite its obvious flaws...and the weight of judicial authority in Australia supports conservative loss-avoidance approach articulated in the traditional formulation of the prudent investor rule (p. 85-6).

Given the passage of time and evolution of “scientific” investing standards which has occurred in industry and the academy, it is interesting that Shiller (2002) notes that prudence is judged according to conformance with conventional wisdom:

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<sup>8</sup> However, in practice, it is common that these financial products are typically managed using this approach: i.e. the Product Disclosure Statement will usually present an “economic bargain” to the investor which includes a total return approach.

[T]he prudent person is someone who does what most of us think is sensible. Ultimately, it must refer to conventional wisdom...the prudent investor standard tells fiduciaries to follow conventional wisdom. The problem with the rule is, of course, that it makes fiduciaries interpreters of conventional wisdom rather than investment professionals. They cannot take action unless they can show that it is conventional...Fiduciary duties mean that investors are obliged to invest in a way that is generally regarded as prudent. Conforming with conventional wisdom – the truths that a person repeatedly hears – is a natural thing to do. As the prudent person standard has evolved, it has become clear that the rule does not mean the prudent man is pathologically risk averse or someone who lived 100 years ago – rather it refers to someone who does what most of us think is sensible – it must refer to conventional wisdom (p. 22).

In terms of formulating local government prudential investment standards, it is apparent that if they are to be consistent with the trends within the domain of fiduciary investments, that greater reliance will need to be placed upon relative comparisons of portfolio selections and investment outcomes (i.e. hindsight measures) across the sector.

#### Comparative prudential investment standards in the local government sector

In Australia, municipal councils can only make investments which comply with statutory provisions.<sup>9</sup> As shown in table 2 below, varying approaches are adopted across the states. For example, in Queensland a “traditional trustee” model is used which employs a prescribed list of approved investments and centralised funds management. In Western Australia, a “modern fiduciary” model is used which does not employ a prescribed list but instead rests significant duties on council officers to invest prudently with cognisance of the purposes of the investments they are making.

Table 2: Investment governance models in Australia

| <b><i>Prudential investment model:</i></b> | <b><i>Traditional trustee</i></b><br><i>(Prescribed list)</i> | <b><i>Hybrid</i></b> | <b><i>Modern fiduciary</i></b><br><i>(No prescribed list)</i> |
|--|---|----------------------|---|
| Jurisdictions:                             | Queensland  | Victoria<br>NSW      | Western Australia,<br>South Australia,<br>Tasmania            |

<sup>9</sup> A list of relevant legislation, regulations and orders is shown in appendix 1.

In New South Wales, the Treasurer approves investments and a list is published in the NSW Government Gazette: investments are “acceptable” if they comply with a Ministerial order under section 625(2) of the *Local Government Act 1993*. In addition, under these regulations, councils must provide written reports of their investment activities including a Certification that these comply with the Act and the council’s investment policies.

Overall, the investment governance models employed in Australia reflect differing prudential standards. What they have in common, however, is an emphasis on conservative portfolio selections. For example, in South Australia, which can be regarded as operating a modern fiduciary model, expressly prohibits councils from investing directly in ordinary shares (although equity investment via unit trusts and managed funds are permitted). There are also blanket prohibitions on investing in derivatives (although again, when these form part of a managed fund they are deemed to be acceptable) and portfolio leveraging through borrowing.

A notable feature of investment policies which apply in the local government sector (e.g. in Victoria and NSW) is the use credit ratings to develop approved lists for short and long term debt issues. Perhaps catching up with the awareness of investment professionals, the CDO crisis has brought the specific nature of these opinions into sharp focus: credit ratings agencies have long disclaimed their opinions as relating to *creditworthiness* rather than *investment values* or *recommendations*.

## Reforming funds management operations in the local government sector

In the section above it was observed that there was currently a disparity in the investment methodologies and associated constraints imposed on councils across Australia. Fundamentally, from the perspective of economic efficiency, there does not appear to be any rationale for not applying a “modern” approach to portfolio management uniformly across the sector.

The fact that a diversity of approaches in the local government sector exists is most likely to be the result of historical differences in the trustee acts of the states and territories which were promulgated in the 1920s and 1950s, and have provided the regulatory imprimatur for conservative investment policies ever since. The recent election of the Rudd Labor government which makes the prospect of cooperative federalism now more likely, appears to provide an opportunity for long-overdue reform of the trustee acts and local government regulations to embrace a total return approach to portfolio management.

Whilst restructuring of funds management operations for local government which accords with the accepted wisdom of industry professionals and academics would appear a necessary outcome, more fundamental reforms are needed and questions asked regarding the processes by which investment funds come into the hands of local governments in the first place.

Any reform of investment powers in the local government sector must therefore be undertaken as part of a holistic approach which acknowledges that the financial sustainability of the local government sector in its principal service delivery functions is

principally dependent upon improving revenues. Leaving to one side the complex and necessary structural reforms to correct this issue, the sector is not an “investment centre” *per se*, as the Productivity Commission data has revealed. However, this realisation does not diminish the imperative of improving the efficiency and effectiveness of investment operations.

In effect, there are two interrelated steps. Firstly, as the estimates in shortfalls for infrastructure spending has been quantified and governments must consider how this can be addressed, councils should encouraged to identify their true investment objectives. Secondly, consideration must be given to how the best available investment technology can be employed to provide optimal outcomes.

With regard to the first step, it is generally accepted that the establishment and operation of a “successful” portfolio management operations requires the investor to formulate appropriate objectives from which investment strategies can be devised which are based on meeting their stated needs and prerogatives. Therefore, renewed focus must be given to understanding the idiosyncratic requirements of councils.

The current decentralised system and strong notion of self-government which operates in Australia’s local government sector provides councils with substantial autonomy with regard to the use of funds.<sup>10</sup>This self-government approach reflects the reality that local

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<sup>10</sup> In November 2007, this autonomy has come under direct attack in NSW with the Department of Planning moving to retain control over developer contributions, ostensibly to reduce the costs of development. Under the changes it would retain developer contributions in the Treasury on behalf of councils which could then

government has operational responsibility for deploying capital and service provision, and is best placed to gauge community needs. Reform of investment policies implies that a “bottom up” approach to the setting of investment strategies is needed rather than a “top down” approach currently used and incorporated in the legislation.

This process of articulating investment objectives is a complex one which can only be achieved with the input of individual councils. While the intense scrutiny of financial sustainability in the sector has usefully identified funding backlogs and underinvestment in infrastructure, it is essential that councils incorporate long-term planning which more clearly identifies the expected demands on finances. What is required, therefore, is for councils to adopt a far more rigorous and holistic approach to the monitoring of all assets (including financial asset holdings), liquidity needs and capital management.

To achieve this, councils should be required to categorise their best estimates of liabilities (i.e. demands on funds) according to a standardised framework so that appropriate investment strategies can be implemented (i.e. to acquire and invest financial assets which can provide appropriate returns). In other words, from existing capital budgeting and risk management processes, each council would need to devise a “liability” profile and then funds (independently of the decision as to how these are sourced) could then be invested appropriately to achieve “liability hypothecation”.

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“reclaim” funds as needed (see NSW Department of Planning, 2007: 2). Arguably, this is evidence of a trend to centralise financial management.

By adopting a liability-driven investing approach, councils could determine what proportion of their financial asset holdings should be invested to meet their liquidity needs (which could be invested in “income” assets such as money market and bonds) with the balance invested more appropriately in assets of longer duration (for example, in diversified pools of “growth” assets such as equities). Once portfolio assets are constructed according to the true investment objectives of councils, they would be able to demonstrate a prudent and holistic approach to their funds management operations.

This approach would be likely to produce significantly different investment portfolios to meet the needs of the local government sector. Given that a large proportion of expenditures will be required to address the long-term infrastructure shortfalls, it would be expected that liability-driven investing would create significantly higher portfolio exposures to growth assets. This contrasts with the current situation where council portfolios are predominantly invested in short-term, income producing assets.

The above discussion advocates a holistic funds management approach which incorporates true investment objectives (and thus potentially ignores conventional market benchmarks) and attempts to remove fundamental disconnects occurring between sponsors' needs and financial portfolios. The remaining and related issue is to determine the best way of managing funds to provide optimal outcomes. In this regard, it would appear logical and fiscally responsible for a local government “investing system” to employ as its centrepiece, a centralised funds management structure.

The notion of councils ceding responsibility for funds management would not affect in any way their “sovereignty”: any proposal to centralise funds management deals simply with fungible [rather than unique] financial assets which have no intrinsic differentiation across jurisdictions in Australia.

Anecdotally, there appear to be diametrically opposed views to the centralisation of funds management. On one hand, councils may wish to retain responsibility for funds management as it is the “interesting” part of the financial management function and there is a strong conviction that the financial resources “belong” to the ratepayers. On the other hand, some councils may willingly surrender responsibility (and accountability) for investment performance outcomes to state and territory governments, provided these are accompanied by profound changes to address the financial sustainability of the sector.

The process of centralising funds management would be relatively straightforward. Operationally, councils would transfer financial asset holdings to the relevant agency which would establish individual accounts for them. Councils would periodically draw down capital from financial investments and/or invest additional funds which would be clearly designated according to the type of expenditures they represent (e.g. specific infrastructure items, new capital works etc).

In many states and territories, centralised funds management agencies already exist to serve the asset and liability management requirements of government. Employing these agencies to manage funds of the local government sector would enable councils to

harness cost efficiencies and superior portfolio outcomes, whilst devolving responsibilities from what is essentially a “non-core” activity for the sector.

As is the case even *within* fund complexes (e.g. various branded managed funds offered by a single fund manager), significant scale efficiencies can be achieved by lowering incremental investment costs (including funds management staff, dealing, brokerage, custody and registry).

A further significant benefit arising from a centralised funds management model from a financial governance perspective, is that it would provide stakeholders with a more robust and effective system for monitoring financial holdings and portfolio exposures. This is a feature apparently lacking in the current decentralised system.

## Conclusion

Recent losses on council investments, and continued concerns regarding the financial sustainability of local government sector, *should* provide the focus for scrutinising investment operations in Australia’s local government sector.

This article has noted that different models of prudential investment apply in Australia’s states and territories, however, all are seeking to deal with the same issue: how to manage financial assets more efficiently and to optimize returns for the ratepayers. Given the consensus of available research, the mixture of investment approaches used is ultimately unsatisfactory. Councils chasing high yields, and suffering adverse consequences, is symptomatic of outdated investment governance.

It has been argued that fundamental reform of governance for financial asset portfolios (i.e. investing rules) is essential. In this regard, the continued application of outdated trustee investment models (which have their genesis in the early twentieth century) are economically sub-optimal, and indeed, when judged relative to other fiduciary finance applications, arguably *imprudent*. In particular, the fixation on avoiding capital loss which is enshrined in the traditional trustee model has been discredited by modern portfolio theory, as it is likely to deliver less optimal returns.

The urgency for reforming funds management models employed within the local government sector has been obscured by the imperative for broader structural reforms to improve financial sustainability. However, introducing uniform and modernised investment powers across Australia seems to be a logical and essential step in improving outcomes for stakeholders.

Councils should be encouraged to operate according to genuinely long-term investment horizons as the previous inquiries regarding financial sustainability have highlighted. Councils would be required to provide considerable thought and input into the development of liability-based investment objectives and strategies. Provided that clear objectives and suitable strategies are agreed at the outset, there are economic benefits to be reaped from operating a centralised funds management model which is well-accepted as the best practice for investment management in other fiduciary finance contexts.

## Appendix 1 – Comparative prudential investment standards in Australia

| State             | Instruments   | Investment methodology  |
|-------------------|---|---|
| Queensland        | Statutory Bodies Financial Arrangements Act (1982) and accompanying regulation (1997)             | Traditional trustee model with centralised financial management. Schedule 7 of regulations provides a list of Queensland Investment Corporation and Queensland Treasury Corporation products unless exempted  |
| Victoria          | Local Government Act 1989 (s143) and Prudential Statement – Investment Powers for Councils (1998) | Hybrid model. Must consider specific objectives and invest in a prescriptive list which includes Commonwealth and State government guaranteed securities and approved depository institutions, and trusts managed by VFMC or external funds managers. Minimum credit ratings apply for short and long term debt securities. |
| New South Wales   | Local Government Act (1993) and Minister for Local Government Investment Order (2005)             | Hybrid model. Legislated requirement for councils to consider specific objectives prior to investing such as risk/return, liquidity, diversification, etc. plus a prescriptive list with minimum credit ratings for short and long term debt securities.  |
| South Australia   | Local Government Act 1999 (s139)  | Modern fiduciary model. Reliance on council responsibility as prudent funds manager. Councils must avoid hazardous or speculative investments; stocks are not permitted.  |
| Tasmania          | Local Government Act 1993 (s75) and Trustee Amendment Act (1997)                                  | Modern fiduciary model. Reliance on council responsibility as prudent funds manager. Councils may invest in any manner in which a trustee is authorised by law to invest trust funds and in any investment the Treasurer approves.  |
| Western Australia | Local Government Act (1995) and Trustee Amendment Act (1997)                                      | Modern fiduciary model. Reliance on council responsibility as prudent funds manager and State Trustee Act requirements.   |

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