'Carpetbaggers' Cost Councils Millions

Lauren Wilson and John Lyons | *September 20, 2008*

WINGECARRIBEE Council, nestled in the southern highlands an hour's drive south of Sydney, sent out expressions of interest inOctober 2006 seeking an independent investment adviser.

The Australian arm of US investment bank Lehman Brothers lost no time in responding, promising high levels of transparency and claiming a record in local government that was "pre-eminent and sustainable".

And the clincher: a financial return one percentage point higher than the major banks could offer.

Today, the ratepayers of this leafy district are $29 million poorer as a result of the crash of Lehman Brothers this week.

How a bank such as Lehmans could act as an independent financial adviser while selling financial products has become a major issue.

Wingecarribee Shire commenced an action in the Federal Court last month alleging Lehmans did not provide independent advice because it had a conflict of interest in the sale of financial products to earn fees.

But following the collapse of Lehmans, who does the council sue? And will there be any money if they win?

Wingecarribee includes some of the most popular day trips from Sydney. About 1.2 million people a year visit the area, which includes Bowral, Mittagong, Moss Vale and Robertson.

Theo Onisforou is a local who knows his way around business. He was chief investment manager for Kerry Packer's Consolidated Press Holdings in the late 1980s and 90s. "Mind-blowingly stupid" is how Onisforou describes the council's decision to chase the higher returns from collateralised debt obligations, or CDOs.

Onisforou ran for last weekend's council elections on a platform of financial responsibility, but was unsuccessful.

The council's decision "is beyond my wildest dreams of stupidity", he said.

"This was other people's money, and you have a moral responsibility to be careful with other people's money.

"While I don't doubt the presentations would have been slick and smooth, you'd think most people would think these guys are carpetbaggers."

Wingecarribee Council general manager Mike Hyde was reluctant to comment on the investment decision as it was now the subject of court proceedings, saying only: "We believe they (Lehmans) lied; that's why we're taking them to court."

Councils around the nation are now nervously checking their portfolios to see if they have products from the US banks.

Another major NSW council, Gosford, ended its financial advisory arrangement with Lehmans late last year because, according to director of corporate services Nic Pasternatsky, the council became concerned about Lehmans managing its portfolio at the same time it was selling the council its financial products.

NSW councils were advised this week to determine their exposure to Lehmans as a matter of urgency and to notify the state Government as to "the effect it may have on council's activities".

In other words, work out which facilities or services need to be cut. Or as Onisforou jokes: "There is some good news: our local council can't go broke. All they'll do is put up the rates."

Lehman Brothers set out to win over councils in Australia. To Wingecarribee Council, they uttered soothing words.

The council claims Lehmans guaranteed to buy back investments if the council wanted its capital. No one from Lehmans could be contacted yesterday.

The complexity of the products became obvious last year when Lehmans sent the council a confirmation about a strangely named investment, "Corsair (Cayman Islands) No 4 Series 5 Torquay", which contained a reference to the investment being a "floating rate CDO".

The council's financial services manager, Doug Neville, sent back an email: "Are these CDOs? In our discussions it was quite clear we were only going to invest in floating rate notes where the capital is 100 per cent guaranteed if the investment is held to maturity. I am sure this is the case, but due to our lack of experience with these products I just need to confirm this."

The council's difficulty in understanding the product was not unique. It's as if the global financial system is detoxing derivatives, which are so complex few people seem able to understand them. One of the wiliest investors of all, US legend Warren Buffett, warned some years ago that such products were "weapons of mass financial destruction".

And in July last year, Reserve Bank governor Glenn Stevens cautioned: "The real question is whether some bits of risk are being given to people who are unaware of what they're doing, and I suppose the favourite anecdote there would be the local government authorities in Australia holding CDOs."

A report commissioned by the NSW Government in April found councils across the state had $590million invested in CDOs at the end of the previous financial year. Even then, these CDOs had already suffered estimated losses of $200 million.

Some councils, including Parkes in the state's central west, were found to have invested more than 60 per cent of their portfolios in CDOs.

Parkes Council's director of corporate services, Les Finn, said the problem facing councils with CDOs was "there is no secondary market to sell them into".

The government report found almost half of Gosford Council's $136 million investment portfolio was made up of CDOs. Neighbouring Newcastle Council had $36 million in CDOs at the end of last financial year.

And in Sydney's south, Hurstville Council had $20 million in CDOs, accounting for two-thirds of its investment portfolio.

The NSW Government opened the door for councils to invest in CDOs in 2000, by allowing for the acquisition of such securities, providing they had a credit rating above an A level. The Lehman Brothers Federation CDO, which exposed at least 24 NSW councils to the sub-prime mortgage market in the US, was initially given a AAA rating by the Standard and Poor's agency.

After the April report showed the high level of exposure to CDOs, the Government last month prohibited councils from investing in CDOs.

But NSW Minister for Local Government Barbara Perry said investment decisions were matters for councils alone.

Onisforou said: "I believe everybody with any level of financial experience would understand that where you are pursuing a higher return, there is a higher risk. While it was obviously legal to do so, if you asked ratepayers, they would have said no."

He described the investment banks as "fee factories".

"For a less than 1 per cent extra return, it is mind-blowingly stupid to have gone for these investments rather than 90-day or 12-month bank bills with the big banks," Onisforou said. "What has happened in America has cost our shire $29 million."