

PRIME MINISTERLOCAL AUTHORITY INTEREST RATE SWAPS

You will recall that the Hammersmith and Fulham interest rate swap case has now reached the House of Lords. Judgment is expected soon, possibly as early as next Monday.

Mr Patten has set out a line to take after the judgment in the attached letter. The matter is highly complex; it may be helpful if I attempt to summarise.

First, there are three possible outcomes. All interest rates swaps may be judged ultra vires; some may be judged ultra vires and some intra vires; or all may be deemed intra vires. The middle course is perhaps the most likely outcome - though the High court took the view that all should be ultra vires.

Second, the "professionals" view, shared by the City, the Bank, the Treasury, DoE, Audit commission and some local authority Treasurers, is that interest rate swaps should be an allowable financial instrument in the future. But three conditions would have to be met:

- a new practicable regulatory regime established;
- the banks will wish a safe harbour provision; and
- almost certainly, depending on the judgment, legislation will be required to give the banks the reassurance they will seek.

Mr Patten proposes to announce the intention to legislate. That seems sensible. But market revival must await the legislation.

Third, and more difficult, is what to do about the existing swap contracts involving 80 authorities in the past.

Mr Patten accepts that retrospective legislation to validate any deals found ultra vires is not acceptable. In the absence of such validation, therefore, there is the prospect of further

litigation between banks and local authorities about individual cases. There is a danger of litigation dragging on for years.

If some deals are pronounced ultra vires, it will be difficult for Government to give even a general statement.

Mr Patten seems to envisage Bank of England pressure on the one hand, and Audit Commission pressure on the other to settle out of court. But, either via legislation or out of court settlement, individual local authorities will face large bills.

On a worse case assumption, chargepayers in Hammersmith and Fulham could face an extra £2,000 bill each. Mr Patten does not want to give any direct financial assistance. But in recognition that this would be an intolerable burden on community charge payers, he proposes that local authorities might be given borrowing permissions ('credit approvals'), if necessary, to spread the burden over a period of years.

Accordingly, he proposes to say that credit approvals to cover such cases would be considered where appropriate.

Conclusion

The proposed line seems practicable and sensible. It avoids bailing out the banks, who have been careless in their dealings. It also avoids bailing out the local authorities - ensuring that their chargepayers face the burden but on a manageable basis over a period of years.

Yet it also recognises that interest rates swaps can be a sensible financial instrument; and, properly regulated, they have a future. That preserves the position of the City without doing too much damage to its overall reputation.

Though we have not yet seen a Treasury response, I understand they are broadly happy.

BHP
BARRY H POTTER
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Yes - but let us see the judgment before finalising the decision.
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We need to see the reasons as well as the results. not