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SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury Parliament Street
LONDON SW1

24 October 1990.

Dear Chancellor,

LOCAL AUTHORITY INTEREST RATE SWAPS

The Hammersmith and Fulham interest rate swap case has now reached the House of Lords and a judgement is expected soon. Our officials have been considering the issues. I am now writing to seek your agreement and that of colleagues to the line that I would like to take when the judgement becomes available.

This is complicated by the uncertainty as to when the judgement will be and what line it will take on the central question of the powers of local authorities to engage in swaps and similar transactions.

Ideally, it would be highly desirable to make a statement within a day or two of the judgement becoming available, although we will obviously need to reserve our position to some extent until we have considered the judgement in detail.

I see two key advantages in an early statement. First it will appear decisive; this case has now been running for more than a year and a half and the Government will be expected to have made up its mind on the main issues. Secondly, once the judgement is available we will no doubt be subject to intense lobbying from both the banks and the local authorities seeking action on the treatment of past transactions. An early statement would help to put the lid on such pressure before expectations could build up.

As regards the line we should take in a statement, the issues can conveniently be divided into two: for the future what ability, if any, do we think local authorities should have to enter into swaps; for the past what, if anything, should we do to unravel the consequences of local authority swaps so as to mitigate the potentially very serious effects on financial institutions or community chargepayers.

On the future, I am satisfied that in principle there is a reasonable case for local authorities being allowed to use swaps and similar instruments for the purposes of interest rate management, provided that a practicable regulatory regime can be devised and put in place to ensure that we do not see a repeat of the Hammersmith and Fulham affair. If the House of Lords were to say that swaps for the purposes of interest rate management are intra vires, I would therefore want to invite the local authority associations and other interested parties to put forward proposals urgently for a framework under which local authorities could continue to operate in this market. But I would not want to promise legislation to cover this.

So if the market was to revive, it would have to do so in the first instance without the protection of a safe harbour provision for the banks. It remains to be seen whether that would happen; the banks" present line is that it would not. If that were the case, it need not bother us too much. I might be prepared to consider legislation for a safe harbour in the longer term. But I would probably want it linked to a regulatory framework, so that the counterparties only enjoyed protection if they had made best endeavours to ensure that authorities ~~was~~ were operating within the framework.

If the House of Lords rules all swaps ultra vires, as did the High Court, then the position would be different. The market could not restart without legislation to permit swaps. A statement would make clear that saw no prospect of early legislation and that in any case I would only want local authorities to be allowed to use swaps if a suitable regulatory framework could be devised. Again I would invite interested parties to put forward proposals for such a framework, but there would be no question of the Government's taking the ~~led~~ lead on this or giving priority to finding space for legislation on it.

As regards the past, we will be under a great deal of pressure form the banks to legislate to validate ultra vires deals retrospectively. (Obviously, that pressure would be all the greater if the House of Lords finds all transactions have been ultra vires.) Local authorities would then have to pay up. Despite the banks' lobbying, however, I do not believe that they now widely expect such ~~actin~~ action. Nor do think it is desirable. It would undermine our line that we do not stand behind local authority debt and would also have serious consequences for public expenditure. I propose to make clear therefore that we do not intend to legislate retrospectively to interfere with the House of Lords' decision.

In the absence of such validation, and especially if the House of Lords decides that some kinds of deal are legal and some are not, there will be the prospect of such further litigation between the banks and authorities to establish the liabilities in particular cases. Even if all deals are held to be ultra vires the argument will be that the arrangements should be honoured because on both sides they were entered in good faith. In both sets of

circumstance such litigation will be costly, will maintain the profile of the whole affair, and may further damage London's financial reputation. We would have to be very cautious about issuing even general advice to local authorities as to what action they might take in cases which might still be subject to litigation. But it would be desirable all round for authorities and institutions to settle out of court wherever that was sensible. The attitude of auditors and the Audit Commission is crucial here and my officials are speaking to the Commission about the line they propose to take. The Bank of England may also have a role here in encouraging banks to act pragmatically and our officials are discussing this with them. Whether individual authorities consider it would on balance be in the interests of their chargepayers to take part in such a settlement would depend on the precise terms and their assessment of the prospects of being required by the Courts to make larger payments than envisaged under the proposed out of court settlement.

As you will know, the sums involved in local authority swaps are very large. The figures are uncertain but we estimate that the potential losses faced by the 80 or so authorities involved are about £500 million, of which about half is accounted for by Hammersmith and Fulham. So to the extent that authorities do end up having to make payments, there will be serious effects on the chargepayers in some areas. We believe that on a worst case assumption the cost in Hammersmith and Fulham could be £2,000 per chargepayer. That is unlikely but cannot be ruled out. Even on more optimistic assumptions it could be of the order of £100 per chargepayer each year for a number of years. That figure might apply in Brent too. But it will be much less in the vast majority of authorities.

I would want to rule out at the outset any cash help for these authorities. Once again such help would undermine our firm line that we do not stand behind local authority debt. And ruling it out would encourage authorities to take an objective view of whether to make an out of court settlement or take their chance in litigation. But the scale of the figures is such that we must consider allowing authorities to spread the payments over a number of years. This is likely to require credit approvals and officials are considering how such help should be given. The precise losses faced by authorities are not likely to become clear until some time after the Lords' judgement. For the purpose of my statement I would propose simply to say that when any losses become known we will consider whether in extreme cases it would be appropriate to allow local authorities to spread them over a number of years.

I would be grateful to know if you and colleagues are content for me to make a statement on appropriate lines as indicated above, as soon as possible after the Lords' judgement. We would obviously circulate the terms of the statement in advance for approval.

I am copying this letter to the Prime Minister, David Hunt, the Governor of the Bank of England, and Sir Robin Butler.

Yours sincerely

CHRIS PATTEN
Approved by the Secretary of State
and signed in his absence