PO/CH/NL/706
Part A

PO/CH/NL/706
Part A

Local Authority
Financial Assets

11.10.89

CC - SIR P MIDDLETON, MR ANSON
MR MONCK MR PHILLIPS C5
MR EDWARDS, MRS LOMAX
MR MACAUSLAN. MR RICHARDSON
MR POTTER, MR LAITE

CONFIDENTIAL

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Nicholas Ridley MP
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

28 March 1989

Dear Secretary of State,

STABILISATION MEASURES

Thank you for your letter of 17 March on this subject.

I remain much concerned about the present position. The Government is facing the prospect of a very large overspend in 1989-90 on local authority capital - it could easily be of the order of £1 billion. In England, there has been a 14% real increase in LA capital spending on main services (ELAB) over the last two years. A further real increase is in prospect next year - generated not by LAs wish to do more to meet the Government's economic and social objectives, but simply because of a change in the capital finance rules. We have to take action soon, if we are to avoid a huge claim on the Reserve for public expenditure that is likely to go largely on hastily-prepared, inefficient and low priority items.

The dangers of an overspend on net provision for LA capital in 1989-90 are well-known to you. There is the risk that the forecast inflow of capital receipts in 1989-90 may be a little ambitious. With the changing fortunes in the housing market capital receipts in 1989-90 could be less buoyant than our plans have assessed.

However my main concern is that gross provision for LA capital on the ELAB block will be substantially exceeded. According to estimates prepared by your officials last November, the likely overspend on gross provision in 1989-90 will be of the order of £700-900 million - far above the overspend I feared when we first discussed the problems during last year's Survey. That builds on forecast or actual overspends on gross provision for LA capital of £900m in 1988-89 and £350m in 1987-88.

The prospect of an overspend on LA capital of as much as £1 billion needs to be seen in the wider perspective of the Government's public expenditure plans for 1989-90. Local authority current budgets received to date indicate a claim on the Reserve of perhaps some £1.5 billion next year. Taken together, the prospective LA current and capital overspends would account for 70% of the Reserve. I accept that we can do very little to prevent the overspend on local authority current. But we can and must, in order to be fair to colleagues with other spending priorities, take action in order to reduce the overspend on local authority capital now in prospect.

I first raised this issue with you during last year's Survey and have written to you since on three occasions. Officials have had plenty to time to devise a satisfactory arrangement. I continue to favour the formulation I sent you on 10 February viz that each LA would be required to set aside for credit liabilities on 1 April 1990 whichever was the greater of:

a) 50% of non-housing and 75% of housing cash-backed receipts on 1 April 1990; or

b) X% of non-housing and Y% of housing cash-backed receipts on 1 April 1989.

X and Y would be some lower numbers than 50% and 75% respectively. I believe that provided X and Y were chosen judiciously a scheme of that type would be effective. Such a scheme would not be likely to hurt those authorities which behaved responsibly. But if you wish to include a qualification that will allow you to set aside the limits in deserving cases, I certainly would not object in principle. Indeed I would also be very pleased to consider alternative efficient schemes.

I recognise that we could not have taken the action I have in mind when you made your announcement to limit pre-funding schemes on 14 February. (To have done so would have been to invite an even higher overspend on gross local authority capital in 1988-89.) Any scheme to curb spending from capital receipts could not have been be announced until towards the very end of this financial year. But I do think we must be ready to make an announcement as soon as Parliament returns after the Easter recess.

We certainly cannot afford to wait for further evidence which - as your letter acknowledges - would inevitably be inconclusive. Contacts with LA Treasurers, the local authority associations and the Audit Commission have persuaded me that the opportunity and incentive to spend up in 1989-90 is only too well understood by local authorities throughout the country. We need to take early action not wait until we have the evidence to prove we should have acted before.

An announcement early next month will give local authorities plenty of time to make adjustments to their capital programmes to accommodate the new rules - just as they have had to do when faced with other in-year changes, in each of the last three years. As the third paragraph in your letter acknowledged, there is some expectation of Government action in any case.

Yours sincerely,

P. Warless

pp **JOHN MAJOR**
Approved by the Chief Secretary and signed in his absence.

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

Mr Potter
CX, Mr Anson, Mr Monck, Mr Phillips, Mr Lennox, Mr Edwards, Mr Price, Mr Devereaux, Mr Call

My ref

Your ref

CONFIDENTIAL

The Rt Hon John Major Esq MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
Whitehall
London SW1

25 May 1989

Dear Chief Secretary

STABILISATION MEASURES

Thank you for your letter of 28 March in which you pursued the question of action to limit capital expenditure in 1989-90 by local authorities. I am sorry not to have replied before now.

I had hoped that the budget returns from local authorities would have provided clear evidence of the way that things were going. Unfortunately, though we now have sufficient returns in for my officials to prepare forecasts of outturn in the current year, the figures do not in my view point conclusively to a particular solution.

My officials will be sending details of the figures to yours in the usual way. As usual, they are subject to the qaulification that the forecasts are subject to a good deal of uncertainty and that we have had to adjust the authorities own predictions in light of the experience of recent years that outturn expenditure is lower and outturn receipts are higher than those predictions would imply.

That said, our present judgement is that gross expenditure in cash terms is likely to be of the order of £7 billion or a little more and receipts of the order of £4.5 billion. That represents cash expenditure about £1.2 billion higher than gross provision for the year.

However, it does not represent a significant increase in the volume of capital spending by local authorities. There has been an increase in spending on preparation to implement the community charge (ie chiefly on office accommodation and computing) on which authorities are saying that they intend to spend about £100 million more than we have provided. Otherwise, we believe that the increases are to a large extent attributable to increases in the prices facing authorities rather than to increased activity. Expenditure on ELAB is actually 10% lower in volume terms than it was three years ago. That does not support your fear that spending is largely on hastily prepared and low priority items.

The figures are nevertheless not reassuring and it may be that we now have to consider taking some action. The difficulties in taking such action are, however, real, not least in the implications for our supporters and in the indiscriminate effect it would have on sensible capital planning. I would be reluctant to contemplate going to the House for yet another "midnight-tonight" measure to penalise authorities for using their receipts for expenditure which is perfectly legitimate under the law as it now stands. None of the legislative options so far identified seem to be both easy and effective.

I have asked my officials to look further at the possibilities and I will write to you again after the recess.

Yours sincerely

pp NICHOLAS RIDLEY

(Approved by the Secretary of State and signed in his absence) cst.ps/3jm25.5/drft

13/1/88

CONFIDENTIAL

cc:
Mr Anson
Mr Monck
Mr Phillips
Mr Edwards (LG)
Mrs Lomax (GEP)
Mr Potter (LG1)
Mr Pirie (FIM)
Mr Devereux (FIM)
Mr Laite (LG1)

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London
SW1P 3EB

25 May 1989

Dear Secretary of State

STABILISATION MEASURES

I wrote to you on 28 March, pressing once again for stabilisation measures to discourage excessive capital spending by local authorities in 1989-90, financed by a run-down of capital receipts.

We are agreed, I think, that such a surge in capital spending, much of it likely to be on ill-prepared, one-off projects, would, not only add to the pressures on public spending, the Reserve and the construction industry but also frustrate the intention of the new capital regime that the bulk of outstanding receipts should be used to redeem debt. The solution sketched in my letter had the useful property that, if an authority does not spend excessively from its receipts during this year, its debt repayment obligations in April 1990 will be unaffected.

This issue must, I believe, be resolved now, if we are to make an announcement that will affect local authorities' capital spending in 1989-90. I would be very grateful therefore if you could let me know your thinking on it as soon as possible. I do believe we must resolve the issue within the next week or so.

Yours sincerely,

P. Wanless

pp JOHN MAJOR
(Approved by the Chief Secretary
and signed in his absence)

JR303

D/ Ray Edwards please nip D Osborne?
A

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

CHIEF SECRETARY
REC 14 JUN 1989
Mr Porter
Mr Anson, Mr Phillips
Mr McInck, Mr Edwards
Mrs Lomax, Mr Pirie
Mr Devereux, Mr Laite

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1

13 June 1989

Dear Chief Secretary,

A LIMIT ON APPROVED INVESTMENTS

Thank you for your letter of 25 May proposing a limit on the amount of approved investments which local authorities may hold.

I agree that we do not want local authorities to act as financial intermediaries. But they have no powers to act in this way and the new system will not give them any such powers. We know that this is one of the things that local authority auditors keep very much in mind.

Nor will the new system provide any strong incentives for intermediation. The list of approved investments has yet to be finalised. But it is not our intention that it should contain any speculative or high-return securities. We should certainly resist City pressures for a wide range of "instruments" to be prescribed. It is unlikely that local authorities will be able to obtain a better return on approved investments than they would have to pay on their own borrowings in the market.

At 31 March 1989, the total investments of English local authorities amounted to approximately £8 billion, broken down as follows:-

	£bn
Bank deposits	5.4
Building society shares/deposits	1.3
Other financial institutions	0.5
Public corporations	0.1
Industrial and commercial companies	0.1
Gilts	0.1
Other	0.5
	8.0

Whatever one may think about the size of this portfolio, it is hard to criticise it on prudential grounds. Whilst a few authorities had been venturing into speculative investments such and equities, it is now clear that this had been effectively restrained by the measures which I took on 9 March last year.

The total rose by £2.5 billion during the preceding 12 months. That increase is clearly attributable to the surge in Right to Buy receipts last year, which will not have been allowed for when local authorities set their capital budgets for 1988-89 or when they made their borrowing arrangements for the year. It is perhaps significant that the total fell b £0.9 bn during the fourth quarter of 1988-89.

On the other side of the balance sheet are the following items, again as at 31 March 1989:-

	£bn	
Rate fund balance	1.6	Reserves
HRA balances	0.5	
Special fund balances	2.5	
Unapplied capital receipts	7.5	
	12.1	

That the actual total of investments was less than this by £4 billion suggests that local authorities are not, as you fear, acting as financial intermediaries. On the contrary, they are adopting the practice of "internal lending" under which balances are temporarily used to finance capital expenditure to hold down borrowing.

There appear to be two main reasons why the level of investments is as high as it is.

First, the existing capital control system permits local authorities to spend all their capital receipts over time but places restrictions on the rate at which they may do so. For the current financial year, what I might call the "non-prescribed" proportion of capital receipts amounts to no less than £1.8 billion, though much of this corresponds to receipts which are no longer cash-backed. ?

ie they're on deposit but can't spend on K bec outside [illegible] x 137

Secondly, most outstanding local authority debt is with the Public Works Loan Board. The terms on which PWLB fixed interest loans are repayable in practice preclude premature repayment at any time when interest rates are higher than they were when the loans were taken out. This is a matter on which many local authorities commented in response to last summer's consultation paper on the new capital system. We know that many authorities would have been happy to use capital receipts to redeem debt, if there had not been penalties.

The Local Government and Housing Bill will deal with the first of these. All receipts will either be usable or will have to be set aside as provision for credit liabilities.

As you recognise, action also needs to be taken to deal with the second. If a local authority with capital receipts have a PWLB loan carrying on 8% coupon and repayable in 10 years' time, it would be indefensible to require them immediately to redeem it other than on terms which reflect that its present value is significantly less than its nominal value.

If a solution to this second problem can be found, then I would expect a rapid reduction in the level of local authority investments once the new capital system comes into force. I do think that it is important to take prompt action on this point.

So, if we can remove the disincentive to early redemption of PWLB debt, I see no need for the measure you propose. Moreover, I have considerable reservations about the practicability of the actual proposal in your letter. A straightforward ratio such as you suggest would hardly be workable. It would have to cater for at least the following factors:-

i. some local authorities might wish to build up their usable capital receipts in order to carry out large projects. During the build-up, their investments would rise and to what might be regarded as a abnormal level;

ii. local authorities who are planning to finance capital programmes by long-term borrowing commonly borrow well in advance and place the monies on deposit. This can be very advantageous to them if interest rates subsequently rise. It also has direct benefits in terms of public expenditure and Exchequer contributions (such as housing subsidy on loan charges).

Art. 7?

36(2) Prudential borrowing of S.I. ... Group

Your officials will be aware of the difficulties that were encountered in the Working Group on Financial Prudence when it was proposed that limits should be placed on the level of local authority borrowing by reference to prudential ratios. I would expect the same problems to arise, namely that the limits would either be so high as to be meaningless or so low as to inhibit efficient debt-management. I would certainly not wish to announce that we were taking a power unless I were satisfied that it could effectively be implemented.

The Government does have one strong sanction against any local authority tempted to build up a debt-financed pool of investments. At present, local authorities have almost unrestricted access to PWLB funds. I understand that they are required when seeking loans to give assurances that they are not borrowing for the purposes of on-lending. But there is no substantive scrutiny as to whether the loan is needed, or whether other sources of finance such as capital receipts or investments are available. This is something which we should look at as a matter of urgency. I see no reason why PWLB funds should not be withheld from authorities who appeared to be maintaining a high level of investments. This would apply not merely to new borrowing but also to the rolling over of existing loans.

For these reasons, I am not attracted by your proposal. I would have no objection to further discussion between officials, but I would need to be persuaded that the regulation which you propose could be formulated in a way which did not inhibit efficient management both of debt portfolios and of capital programmes. And I believe that the problem is essentially a temporary one, arising from the inter-action between the present capital control legislation and the terms on which PWLB finance is available, which could and should be reformed.

Yours sincerely

pp NICHOLAS RIDLEY

(Approved by the Secretary of State
and Signed in his Absence)

lg.ph/AE/234

CONFIDENTIAL

pls type as final

DRAFT LETTER FROM THE CHANCELLOR TO:

The Rt Hon Nicholas Ridley AMICE, MP
Department of the Environment
2 Marsham Street
London SW1

LOCAL AUTHORITIES AND THE MONEY MARKETS

Having seen your letter of 13 June to John Major about a possible limit on approved investments by local authorities, I would like to explain our concerns a little more fully and to suggest a way ahead.

2. Our concern is that local authorities have in recent times increased their financial assets so much, and in particular their deposits with the banks, that they have in effect become large-scale financial intermediaries in their own right. I regard that as a thoroughly undesirable development. As you yourself have suggested in another context, local authorities have more important things to do. Furthermore, the rapid growth of local authorities' bank and building society deposits ~~has created~~ is creating problems for the Bank of England in its daily task of managing the money markets. We should not allow this state of affairs to continue.

3. The rise in local authority bank deposits over the last two years, though offset by a considerable reduction in the first quarter of this year, seems to have resulted from a number of factors, mostly mentioned in your letter:

i. the surge in right to buy receipts;

ii. the present capital control system, which requires local authorities to spread expenditure from capital receipts over a period of years;

iii. the downward sloping yield curve over the past year or so, which has made it profitable for local authorities to place funds on deposit rather than use them to repay long term debt or replace new borrowing; and

iv. the further disincentive to debt repayment which results from the existing PWLB rules on early repayment.

4. I appreciate that local authorities may reduce their deposits substantially next April so as to redeem debt in accordance with the Local Government and Housing Bill now before the House (you have promised an early response to John Major on the risk that they may spend heavily from these deposits in the meantime). But the present provisions in the Bill will not require authorities to do this. They may well choose to keep their accumulated receipts on deposit rather than repay debt or replace new borrowing, if the yield curve is such that this will be to their advantage. We cannot, in short, be sure that even a penny of debt will be repaid on 1 April 1990 or from subsequent capital receipts.

5. We have to consider against this background how best to stop local authorities from building up or maintaining large stocks of deposits rather than repaying debt or replacing new borrowing - how best to prevent them from playing a financial intermediary role and at the same time creating difficulties for money market management. Since the solution to this problem may necessitate some amendment of the Local Government and Housing Bill, we need to move quickly.

6. I have already decided that the PWLB rules should be amended so as to remove completely the present disincentive to early repayment of low interest PWLB debt. It should be possible to do this in July. Such a change will, as you imply, be helpful. It will not of itself however ensure that local authorities will repay debt or reduce new borrowing. They may still prefer to retain or increase their deposits.

7. We need in addition, therefore, to ask our officials to work up options for action in other areas. These should include:

   i. A limit on the approved investments which a local authority may hold, perhaps in relation to their annual revenue: this has been under discussion between officials for many months and more recently in the correspondence between you and John Major. How would such a limit best be framed? How effective would it be? What would be the legislative implications?"

CONFIDENTIAL

ii. Requiring local authorities (a) to use the 'reserved' proportions of their accumulated cash-backed capital receipts to repay debt on 1 April 1990 rather than leaving them the option (as in the present Bill) of setting the sums involved aside for debt repayment or replacement of borrowing after an unspecified and unlimited period of time; and (b) to use the reserved proportion of subsequent capital receipts for debt repayment or replacement of borrowing under credit approvals within a specified period of months.

iii. Amending the existing PWLB quota arrangements so as (at minimum) to limit the amounts that authorities with large amounts of liquid assets can borrow on normal terms from the PWLB, with a penal rate for borrowings in excess of that limit or quota.

8. These options are not, of course, mutually exclusive. I recognise your preference for option iii. over option i. In principle, each of these options should be feasible if the other is feasible. I ~~think~~ fear however that option iii. would carry greater risks of forestalling and be more subject to challenge in the Courts. Option ii. seems to me to merit serious consideration as well, especially now that the PWLB early repayment rules are to be changed.

9. If you agree, I suggest we should ask officials to report back as soon as possible on these matters, and in particular on the options which depend on inclusion of enabling clauses in the current Bill.

N — L

copy list as minute

M370

[redacted]..ps/4jm25.5/drfts

cc:
Mr Anson
Mr Monck
Mr Phillips
Mr Edwards (LG)
Mrs Lomax (GEP)
Mr Potter (LG1)
Mr Pirie (FIM)
Mr Devereux (FIM)
Mr Laite (LG1)

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London
SW1P 3EB

25 May 1989

Dear Secretary of State,

A LIMIT ON APPROVED INVESTMENTS

Our officials have been discussing for some months the idea of a prudential limit on the amount of approved investments held by a local authority, under the new capital finance regime. I am conscious that the matter needs to be brought to a head now, so that the necessary revisions can be made to the Local Government and Housing Bill.

A main aim of our new regime on local authority capital is that authorities should use the bulk of their outstanding and new capital receipts from asset sales to redeem debt. I accept of course that we must give them some flexibility: indeed it will sometimes be sensible for local authorities to leave some of their new receipts temporarily in approved investments instead of using them to repay debt. But we need to make sure that it is temporary and that the amounts are small. Most authorities have very large amounts of debts to be paid off. We want a system that requires them to repay the debts as soon as is practical.

I am concerned that without a prudential limit on the level of approved investments which an authority may hold, we could rapidly see the emergence of local authorities with simultaneously high debt and high approved investments. That would defeat our basic policy objectives. And it would have wider disadvantages.

i) We do not want local authorities acting as financial intermediaries. In particular, they should not be diverting their scarce financial management resources to optimising a high asset/high liability financial position from day to day but rather should confine financial activities to a subordinate role consistent with their service functions.

ii) The more local authorities are in a high asset/high liability position, the greater their scope for creative financing - and the more energy they will devote to it.

iii) The existence of high asset/high liability authorities makes money market management more difficult: if local authorities continue to borrow heavily from central government while building deposits with banks and building societies, this will reduce the money market shortages against which the authorities need to operate in order to retain control of interest rates.

I am aware that local authorities argue the present rules on Public Works Loan Board (PWLB) debt discourage them from redeeming their debts prematurely, thus making it sensible to hold investments. I accept that we cannot combine a policy which seeks early debt repayment with PWLB rules which discourage it, though of course the PWLB could not accept premature repayment on terms which resulted in a loss to the Exchequer. There is scope, however, for some relaxation in the premature repayment rules without compromising this principle, and officials here are considering how this should be done. With such a change of rules the case for requiring local authorities to redeem debt with their capital receipts rather than invest in gilts etc is all the more persuasive. Indeed, I see no reason why we should permit local authorities to have high approved investments for so long as they have outstanding debts.

I therefore propose that an enabling clause be inserted in Clause 35 of Part IV of the Bill to place a limit on approved investments, perhaps in the form of stated maximum ratios of approved investments to expenditure and/or outstanding debt. (The precise ratios would be specified by Order.) Provided that the proposed change in the PWLB rules is announced at the same time, I do not believe this new prudential limit would be resisted by the LAs. We would of course wish to discuss with the local authority associations how the limits might be set for different classes of authority.

Our officials have been unable to resolve this issue despite several discussions. I would be very grateful for your views. We shall need to move very quickly in order to change the Local Government and Housing Bill in the appropriate way.

Yours sincerely.

P. Walker

ff JOHN MAJOR
(Approved by the Chief Secretary
and signed in his absence)

lg.ph/AE/235

CONFIDENTIAL

CHANCELLOR

FROM : A J C EDWARDS (LG)
x4480
22 June 1989

cc **Chief Secretary**
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Pirie
Mr Potter
Mr Devereux
Mr Laite
Miss Wheldon T/Sol

Andrew: OK as marginally amended

Ch/ Content to write as drafted to Mr Ridley?

DIS

LOCAL AUTHORITIES AND THE MONEY MARKETS

You have said you are ready to write to Mr Ridley about limiting local authorities' scope for financial intermediation and the accumulation of short term financial assets. Mr Allan's note of 20 June and Mr Sparkes' record of your 20 June meeting refer.

2. The attached draft letter, which I have cleared with Mr Scholar and FIM colleagues, will in the main, I hope, be self-explanatory. There are however a few glosses which I should add.

3. First, the draft letter suggests that officials should not only work up urgently a blue-print for the proposed cap on "approved" investments (that is, investments in financial assets) but also look at the alternative possibility of requiring local authorities to use the bulk of their accumulated capital receipts on 1 April 1990, and their subsequent receipts, to repay debt instead of leaving them the option of keeping funds on deposit for as long as they wish, with a view to later debt repayment. This could be a more effective way of reducing local authorities' holdings of bank deposits, bearing in mind that they are due to "set aside" for debt repayment at a time of their own choosing perhaps some £6 billion of accumulated capital receipts on 1 April 1990. The idea would be similarly to require them to use the bulk of subsequent capital receipts (the so-called 'reserved proportions') to repay debt or substitute for new borrowing within (say) three months of the receipts becoming available.

CONFIDENTIAL

4. We have never been happy with the "setting aside" provisions of the present Bill. We had however to acknowledge DOE's point that one could not reasonably require local authorities to make early repayments of debt straight away when under the PWLB's present arrangements they would incur considerable financial penalties in many cases from doing so. Now that the PWLB's premature repayment arrangements are to be changed, we think it would be more reasonable to expect local authorities to use the specified proportions of their accumulated and on-going receipts to repay debt or substitute for new borrowing. Since the accumulated cash-backed receipts account for a large proportion of the total financial assets of local authorities, perhaps some £5 billion out of a total of some £9½ billion, we think this approach has considerable promise, though DOE will doubtless see difficulties in it.

5. Second, the draft letter refers back to earlier correspondence between the Chief Secretary and Mr Ridley (copies attached). The question of a possible cap on financial assets and the dangers of financial intermediation by local authorities have in fact been under discussion with DOE for a year now. Progress has however been much impeded in this as in other areas by DOE's inability to cope with the quantity of work on the LA capital side, including the Bill now before Parliament, the swaps and options saga, the new planning total and the new capital finance regime.

6. Finally, the draft letter does not comment on the idea of increasing the general level of PWLB charges, which does not affect the present Bill. Mr Scholar discusses this issue in his separate submission of today.

AJCE

A J C EDWARDS

chex.ps/ds2/146 **CONFIDENTIAL**

BF 11/87

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

26 June 1989

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Odling-Smee
Mr Peretz
Mr A J C Edwards
Mr Pirie
Mr Potter
Mr Devereux
Mr Laite

Miss Wheldon - T.Sol.

Rt Hon Nicholas Ridley MP
Secretary of State for the
Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

Dear Nick

LOCAL AUTHORITIES AND THE MONEY MARKETS

Having seen your letter of 13 June to John Major about a possible limit on approved investments by local authorities, I would like to explain our concerns a little more fully and to suggest a way ahead.

Our concern is that local authorities have in recent times increased their financial assets so much, and in particular their deposits with the banks, that they have in effect become large-scale financial intermediaries in their own right. I regard that as a thoroughly undesirable development. As you yourself have suggested in another context, local authorities have more important things to do. Furthermore, the rapid growth of local authorities' bank and building society deposits is creating problems for the Bank of England in its daily task of managing the money markets. We should not allow this state of affairs to continue.

The rise in local authority bank deposits over the last two years, though offset by a considerable reduction in the first quarter of this year, seems to have resulted from a number of factors, mostly mentioned in your letter:

(i) the surge in right to buy receipts;

(ii) the present capital control system, which requires local authorities to spread expenditure from capital receipts over a period of years;

(iii) the downward sloping yield curve over the past year or so, which has made it profitable for local authorities to place funds on deposit rather than use them to repay long term debt or replace new borrowing; and

(iv) the further disincentive to debt repayment which results from the existing PWLB rules on early repayment.

I appreciate that local authorities may reduce their deposits substantially next April so as to redeem debt in accordance with the Local Government and Housing Bill now before the House (you have promised an early response to John Major on the risk that they may spend heavily from these deposits in the meantime). But the present provisions in the Bill will not require authorities to do this. They may well choose to keep their accumulated receipts on deposit rather than repay debt or replace new borrowing, if the yield curve is such that this will be to their advantage. We cannot, in short, be sure that even a penny of debt will be repaid on 1 April 1990 or from subsequent capital receipts.

We have to consider against this background how best to stop local authorities from building up or maintaining large stocks of deposits rather than repaying debt or replacing new borrowing - how best to prevent them from playing a financial intermediary role and at the same time creating difficulties for money market management. Since the solution to this problem may necessitate some amendment of the Local Government and Housing Bill, we need to move quickly.

I have already decided that the PWLB rules should be amended so as to remove completely the present disincentive to early repayment of low interest PWLB debt. It should be possible to do this in July. Such a change will, as you imply, be helpful. It will not of itself however ensure that local authorities will repay debt or reduce new borrowing. They may still prefer to retain or increase their deposits.

We need in addition, therefore, to ask our officials to work up options for action in other areas. These should include:

(i) A limit on the approved investments which a local authority may hold, perhaps in relation to their annual revenue: this has been under discussion between officials for many months and more recently in the correspondence between you and John Major. How would such a limit best be framed? How effective would it be? What would be the legislative implications?"

(ii) Requiring local authorities (a) to use the 'reserved' proportions of their accumulated cash-backed capital receipts to <u>repay debt</u> on 1 April 1990 rather than leaving them the option (as in the present Bill) of setting the sums involved aside for debt repayment or replacement of borrowing after an unspecified and unlimited period of time; and (b) to use the reserved proportion of subsequent capital receipts for debt repayment or replacement of borrowing under credit approvals within a specified period of months.

(iii) Amending the existing PWLB quota arrangements so as (at minimum) to limit the amounts that authorities with large amounts of liquid assets can borrow on normal terms from the PWLB, with a penal rate for borrowings in excess of that limit or quota.

These options are not, of course, mutually exclusive. I recognise your preference for option (iii) over option (i). In principle, each of these options should be feasible if the other is feasible. I fear however that option (iii) would carry greater risks of forestalling and be more subject to challenge in the Courts. Option (ii) seems to me to merit serious consideration as well, especially now that the PWLB early repayment rules are to be changed.

If you agree, I suggest we should ask officials to report back as soon as possible on these matters, and in particular on the options which depend on inclusion of enabling clauses in the current Bill.

Yours
Nigel

NIGEL LAWSON

lg.ph/AE/275

Mike
Some of this strings is on safety net
S

CONFIDENTIAL

CHANCELLOR

FROM : A J C EDWARDS (LG)
x4480
7 July 1989

cc Chief Secretary
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Pirie
Mr Potter
Mr Devereux
Mr Laite
Miss Wheldon T/Sol

Ch/
Content to write as drafted?

LOCAL AUTHORITY FINANCIAL ASSETS

In response to your letter of 26 June, DOE officials have collaborated with us in examining various options for dealing with the problem of the high level of financial assets which local authorities hold and which they can in principle increase further from future capital receipts.

2. In the light of our exchanges with them, we believe the way is now open for you to follow up your earlier letter with a further letter enclosing the note which we have put together in the light of our discussions and specifying the new provisions which Mr Ridley needs now to authorise as a matter of urgency for the Local Government and Housing Bill.

3. We suggest you should take the opportunity to ask Mr Ridley to act at the same time to remove the incentives which local authorities have to maximise their capital spending this year (so as to reduce their debt redemption obligations on or after April 1990).

4. The attached draft letter and accompanying note by officials cover the above points. For the most part they will, I hope, be self-explanatory. But some commentary may be in order.

Financial assets

5. The draft letter presses Mr Ridley to take enabling powers in the Bill on the basis that the precise ways in which these powers would be implemented can be decided a little later. DOE officials

CONFIDENTIAL

are now much less hostile than previously to taking such powers. We understand that Mr Ridley is likely to agree to proceed broadly along the lines suggested in the draft letter, which calls for enabling powers to limit financial investments on the one hand and to require debt redemption from new capital receipts at least, and possibly accumulated receipts as well, on the other.

6. For technical reasons, it is much more difficult to define what levels of debt redemption local authorities should be obliged to make from their accumulated stock of capital receipts than from their future receipts (though the same problem arises in some degree on the existing provisions whereby they have to "set sums aside for credit liabilities"). We have not yet hit upon a technically sweet formula for debt redemption from accumulated receipts. The only practical way ahead is to take suitably framed enabling powers at this stage and work further on what form of action would be most appropriate.

7. We think it is quite possible in practice that, as a result of the other measures proposed, local authorities will run down the accumulated stock of receipts anyway in the early months of the next financial year. We may therefore be able to reserve judgment until about this time next year, when we see what authorities have actually done, on whether it is necessary to intervene so as to compel debt redemption from the accumulated receipts.

Expenditure from accumulated capital receipts

8. The other, related problem which the draft letter addresses is that local authorities have a great incentive to incur all the capital expenditure from receipts they possibly can this year before they are obliged to use substantial proportions of these receipts to redeem debt or "set sums aside for credit liabilities" in April of next year. Their budgets for the current year indicate an overspend on capital of no less than £1.3 billion.

9. Although this enhanced level of spending will doubtless partly substitute for capital expenditure next year, we fear that much of it will represent a permanent addition, or permanent bringing forward, of capital expenditure. We do not think the Government can simply turn a blind eye to this.

CONFIDENTIAL

10. The Chief Secretary first wrote to Mr Ridley about this in February, shortly after the extent of the problem had become clear from local authorities' budgets. After an initial, unsatisfactory exchange, he wrote again in March (letter of 28 March attached) urging the case for early action and suggesting a simple formula designed to remove the incentive to spend every available penny this year. Despite repeated reminders, Mr Ridley did not reply until 25 May (his letter crossing with a further letter of the same date from the Chief Secretary). Mr Ridley did not commit himself to any particular solution but promised to write again after the Whitsun Recess. In the event, despite more repeated reminders, he has again failed to do so.

11. In the meantime, the year is slipping away. We think it is better to act now, though late, than not to act at all. The natural time to announce the rather simple solution suggested by the Chief Secretary as long ago as 28 March (and reproduced in the draft letter below) would be alongside the provisions relating to capital receipts and financial investments discussed above. The draft letter therefore urges this.

12. We do not know how Mr Ridley will react on this point. His officials have been due to discuss the dossier with him on numerous occasions. For one reason or another, however, the discussions have simply not happened. One is bound to have great sympathy with Mr Ridley, who has been under enormous pressure on many fronts in recent months. We do not think, however, that it would be right to let this matter go by default.

AJCE

A J C EDWARDS

CONFIDENTIAL

DRAFT LETTER FROM THE CHANCELLOR TO:

pls type as final

The Rt Hon Nicholas Ridley AMICE, MP
Department of the Environment
2 Marsham Street
London SW1

LOCAL AUTHORITY FINANCIAL ASSETS

Further to my letter of 26 June, my officials have now with much help from yours put together the attached note identifying the options for action on local authority financial assets.

As the note makes clear, the urgent issue is what powers should be taken in the Local Government and Housing Bill. It seems to me that we need to take three powers, which are relatively simple in conception at least and would leave the Government with considerable flexibility. We need:

i. to expand Clause 42(2) or add a self-standing provision so as to empower you to provide by regulation that a local authority's approved investments should not exceed a stated percentage of its annual revenue or some other limit defined in the regulations (or possibly that an authority in excess of this limit should not be able to add to its external borrowing);

ii. to insert in the Bill, or in a regulation under Clause 42 of the Bill, a provision that a local authority may not borrow for the purpose of acquiring or retaining financial investments;

iii. to insert provisions or regulation-making powers enabling you to require debt redemption from cash-backed capital receipts set aside for credit liabilities, with the possibility of different provisions for accumulated and future receipts.

We can I believe take a little more time to resolve exactly how the enabling powers at i. and iii. should be used.

CONFIDENTIAL

Provisions i. and ii. would not only give the Government power to limit approved investments but also provide a statutory basis for the PWLB to ration its lending if appropriate. These provisions would thus open the way to adoption of options i. or iii. in the note by officials.

Provision iii. above would enable you to require that specified proportions of capital receipts, whether accumulated or on-going, should be used for debt redemption or substitution for new borrowing under credit approvals within a specified period of time. As the note makes clear, this seems a promising way of preventing local authorities from building up large stocks of financial assets in the future. Applying such a rule to the accumulated stock of capital receipts (as against new receipts) raises considerable problems which officials will need to consider further. It may not be necessary to take a final view on how to deal with this aspect until next year.

If we can proceed on the basis suggested above, that will take care of the intermediation and money markets problems which have been concerning me. We have still however to deal with the other problem arising from local authority's large accumulated holdings of capital receipts - the danger that they will spend them at a record rate over the remaining nine months of this year. Local authorities' budgets indicate the prospect of a very large overspend this year on capital, possibly of the order of £1.3 billion, on top of the real increase which has taken place on main services over the previous two years. The problem has arisen in large part because local authorities will see a strong incentive to spend their capital receipts this year rather than have to set large proportions of them aside for credit liabilities in April next year.

In present economic circumstances, we cannot turn a blind eye to this. John Major suggested as long ago as 28 March that the solution should be to provide by regulation that local authorities should be required to set aside for credit liabilities in April of next year whichever is the greater of:

a. 50 per cent of non-housing and 75 per cent of housing cash-backed receipts on 1 April 1990; or

CONFIDENTIAL

b. x per cent of non-housing and y per cent of housing cash-backed receipts on 1 April 1989,

where x and y would be numbers somewhat lower than 50 per cent and 75 per cent respectively. A provision of this kind would remove the incentive which local authorities now have to spend heavily during the current year.

John Major wrote again on 25 May urging action on this. In your own letter, also of 25 May, you promised an early proposal on the way ahead.

X

Time is running out. I must ask you therefore to announce something on the lines John ~~Major~~ has suggested simultaneously with announcing the amendments to the Bill on local authorities' financial assets and capital receipts discussed earlier in this letter.

I am copying this letter to John Major.

copy list as above minute.

CONFIDENTIAL

LOCAL AUTHORITIES AND THE MONEY MARKETS

This note examines the options set out in paragraph 7 of the Chancellor's letter of 26 June to Mr Ridley.

Objectives

2. The Chancellor's letter expressed concern that local authorities have in recent times increased their financial assets so much, and in particular their deposits with the banks, that they have become large-scale intermediaries in their own right, with a severe mismatch of assets and liabilities. Furthermore, the rapid growth of local authorities' bank and building society deposits is creating problems for the Bank of England and its daily task of managing the money markets.

3. We assume that, in the light of these concerns, the Government's objectives would be:

- to restrain local authorities from acting as financial intermediaries;

- to reduce the large stocks of financial assets which local authorities have accumulated over the past two years, mainly as a result of the surge in right to buy receipts; and

- to restrain any such build-up of financial assets in the future.

Context

3. We estimate that at end-March 1989 local authorities in England held some £8 billion of short term financial assets. Their annual revenues last year were of the order of £40 billion. The average ratio of financial assets to revenues was therefore around 20 per cent, compared with around 5 per cent five years ago.

4. During the current year, local authorities' financial assets could rise by up to £1 billion as a result of in-year inflows of capital receipts.

5. Under the Local Government and Housing Bill now before Parliament, English and Welsh local authorities will be obliged on 1 April 1990 to "set aside as provision to meet credit liabilities" the amounts equal to the "reserved parts" of their accumulated cash-backed capital receipts (75 per cent of their accumulated housing receipts and 50 per cent of their accumulated other receipts), estimated to amount to some £6 billion. They will not be obliged to repay debt with these "reserved" proportions but only to "set these amounts aside as provision to meet credit liabilities". They are unlikely to repay debt if the downward sloping yield curve or the PWLB's premature repayment rules make it financially unattractive to do so.

6. The Chancellor has already decided that the PWLB rules should be amended so as to remove the present disincentive to early repayment of low interest PWLB debt. It is hoped that this change can be made effective in July 1989. However, it will not of itself ensure that local authorities will repay debt or reduce new borrowing. They may still prefer to retain or increase their deposits.

Option i. :
Statutory limit on approved investments

7. Specification. The Local Government and Housing Bill now before Parliament would be amended at Lords Committee stage (in the last two weeks of July) so as to empower the Secretary of State to make regulations which would require a local authority's approved investments not to exceed a stated percentage of its annual revenue or some other limit specified in the regulations. ("Approved investments" are financial investments which local authorities are permitted to make without their encashment counting as a capital receipt.)

8. As noted above, the average percentage of financial assets to revenue in local authorities is now some 20 per cent. But this conceals wide disparities. Of the 447 authorities in England, 122 report having no financial investments, 57 have investments of less than 5% of their net rate fund expenditure, and a further 60 have investments between 5% and 15% of their net expenditure. In

general local authority investments appear to reflect the levels of capital receipts which they have obtained and continue to hold rather than levels of borrowing.

9. We consider that this option could be implemented either by a recasting of clause 42(2) of the Bill or by adding a suitable free-standing provision along the lines of paragraph 7 above.

10. Pros. This option would have the following advantages.

i. It would be clear.

ii. The amendment to the legislation would be relatively straight-forward.

iii. It would restrict local authorities whose asset holdings are far out of line with the average.

11. Cons. The disadvantages would be as follows:

i. Such a limit would be somewhat arbitrary. Individual local authorities have widely differing financial circumstances, in terms of capital receipts and capital expenditure programmes. Some of them, especially small authorities with lumpy expenditure, like to build up financial balances over a period beforehand when they have capital expenditure programmes to fulfil.

ii. The level of the limit would pose a dilemma. To have a significant impact on present levels of deposits, the limit would need to be set at a low level. The lower the limit is, however, the more it would tend to get in the way of sensible financial management.

iii. It would not encourage local authorities to minimise their holdings of financial assets below the limit.

iv. If the limit for each authority were adjusted so as to take account of receipts levels and capital expenditure plans, by deducting reserves, revenue balances and unreserved capital receipts from the financial assets total, the problems at i. and ii. above could be eased but the restrictions would become disagreeably complex.

12. If an option on these lines were pursued, local authorities below the financial assets limit would still in principle have the option of borrowing to increase their financial assets. Hence there would be a case for making regulations under clause 42 of the Bill to provide that a local authority may not borrow for the purpose of acquiring or retaining investments. Any authority which borrowed (even to "roll over" an existing loan) at a time when they had substantial investments would potentially have to justify their actions to their Auditor.

Option ii :
Require local authorities to repay debt rather than set sums aside

13. Specification. The Bill would be amended to provide that local authorities must use the "reserved proportions" of their new capital receipts arising on or after 1 April 1990 (75 per cent for housing, 50 per cent for other) to repay debt or substitute for borrowing under credit approvals rather than "set sums aside as provision to meet credit liabilities", within certain stated periods of time. We think that three months would be appropriate.

14. The Bill could also be amended to provide a regulation-making power under which it would be possible to apply a similar requirement to repay debt or substitute for credit approvals to the accumulated cash-backed capital receipts which local authorities hold on 31 March 1990. This is technically more troublesome and officials would need to work further on how such a regulation would best be framed.

15. Local authorities which have repaid all their debts would be required to use the reserved proportion of their new receipts in substitution for new borrowing under credit approvals while setting aside any remaining sums against future debt repayment.

16. Legislation. We think this option would require an additional one or two clauses in the Local Government and Housing Bill. These would provide that, when authorities have "set aside" sums to meet credit liabilities as in the current Bill, they must then repay debt or substitute for new borrowing under credit approvals within periods of time to be defined by Order. As

implied above, a provision on these lines in relation to new capital receipts would be much simpler than one related to the existing stock of receipts.

17. Pros. This option would have the following advantages.

i. It would be a signal to local authorities that the government wishes them to repay debt.

ii. It would restrain the main source of growth in local authority deposits thereafter.

iii. It would be easier to defend requiring local authorities to repay debt or substitute for new borrowing than setting an arbitrary limit on financial asset holdings.

iv. This option would be far more acceptable now that the PWLB early repayment terms are to be changed so as to remove the penalty element.

18. Cons. The main disadvantages of this option would be:

i. The changes to the Bill would probably be greater than those required for option i.

ii. Local authorities would still be able to use the unreserved proportion of their capital receipts to accumulate deposits. We think however that local authorities' financial assets would be reduced and then restrained without the Government having to impose unacceptable strait-jackets on them. As a general rule, moreover, we believe we can rely on the auditors to prevent local authorities from borrowing significantly in excess of need provided that this does not force authorities to sustain avoidable financial losses. It may be possible to improve the Audit Commission's codes of practice in this area and possibly the rules on aggregate credit limits and credit cover.

iii. It would be harsh to expect authorities to repay non-PWLB debt prematurely where they would incur penalty provisions. This problem would however be a limited one since local authority borrowing and lending from sources other than the PWLB is less than 8 per cent of the total. It might be possible to allow local authorities to set sums aside rather than repay debt in such cases.

iv. It would go against Mr Gummer's statement in the House, during Report stage, that local authorities would not be forced to pay off advantageous debt (though this problem is arguably mitigated, if not solved, by the proposed revision to the PWLB premature repayment arrangements).

Option iii :
Restrict PWLB borrowing by authorities with substantial financial assets or receipts

19. Specification. The PWLB quota arrangements would be amended so as to limit the amounts that authorities with large amounts of liquid assets or large capital receipts can borrow on normal terms from the PWLB, with a penal rate for borrowings in excess of that limit or quota. Since the PWLB acts as lender of last resort to local authorities, borrowing above quota would be permitted but would bear a penal rate of interest such as the existing 'non-quota B' rate which is designed to be above market rates.

20. The rule might be along the lines that an authority's PWLB quota would be equal to its credit approval for the year plus its debt repayment obligations less the reserved proportion of its capital receipts. We think that it would be easier to restrict access to normal PWLB funds on the basis of capital receipts than of financial assets. We would however face many of the same problems even so as under option i. above.

21. Legislation. None; but such an option would be much easier to implement if the Bill were amended to include the provisions envisaged under option i. above.

22. Pros. This option would have the following advantages.

i. It would not require legislation, though the legislative provisions for option i. would make it much more sustainable.

CONFIDENTIAL

ii. It would be easy to defend restricting access to the PWLB on normal terms for authorities which have large amounts of available receipts.

23. Cons. This option would have the following disadvantages.

i. It would not of itself prevent authorities from borrowing from the market in order to put sums on deposit (though the legislative provision mentioned in paragraph 12 would deal with that). With the present yield curve, that would still be profitable.

ii It would have no immediate effect on authorities with high levels of debts and investments, but no need for new borrowing, and would only affect the existing stock of financial assets over a period of years as debts fell due for repayment.

iii. There could be risks of legal challenge. These are being studied further.

iv. Forestalling: local authorities would be tempted to borrow heavily before introduction of such new rules unless they took effect from the date of announcement.

v. The PWLB as at present constituted is not equipped to differentiate between local authorities or police their behaviour in the way envisaged by this option: a statutory constraint policed by auditors would be likely to be more effective.

vi. the quota might be difficult to determine from day to day.

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

[A Edwards says is being dealt with; DoE to write in due course]

BF 31/7

11 July 1989

Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Scholar
Mr Odling-Smee
Mr A J C Edwards
Mr Peretz
Mr Pirie
Mr Potter
Mr Devereux
Mr Laite

Miss Wheldon - T.Sol.

Dear Nick

LOCAL AUTHORITY FINANCIAL ASSETS

Further to my letter of 26 June, my officials have now with much help from yours put together the attached note identifying the options for action on local authority financial assets.

As the note makes clear, the urgent issue is what powers should be taken in the Local Government and Housing Bill. It seems to me that we need to take three powers, which are relatively simple in conception at least and would leave the Government with considerable flexibility. We need:

(a) to expand Clause 42(2) or add a self-standing provision so as to empower you to provide by regulation that a local authority's approved investments should not exceed a stated percentage of its annual revenue or some other limit defined in the regulations (or possibly that an authority in excess of this limit should not be able to add to its external borrowing);

(b) to insert in the Bill, or in a regulation under Clause 42 of the Bill, a provision that a local authority may not borrow for the purpose of acquiring or retaining financial investments;

(c) to insert provisions or regulation-making powers enabling you to require debt redemption from cash-backed capital receipts set aside for credit liabilities, with the possibility of different provisions for accumulated and future receipts.

CHEX TO RIDLEY 11/7

We can I believe take a little more time to resolve exactly how the enabling powers at (a) and (c) should be used.

Provisions (a) and (b) would not only give the Government power to limit approved investments but also provide a statutory basis for the PWLB to ration its lending if appropriate. These provisions would thus open the way to adoption of options (i) or (iii) in the note by officials.

Provision (c) above would enable you to require that specified proportions of capital receipts, whether accumulated or on-going, should be used for debt redemption or substitution for new borrowing under credit approvals within a specified period of time. As the note makes clear, this seems a promising way of preventing local authorities from building up large stocks of financial assets in the future. Applying such a rule to the accumulated stock of capital receipts (as against new receipts) raises considerable problems which officials will need to consider further. It may not be necessary to take a final view on how to deal with this aspect until next year.

If we can proceed on the basis suggested above, that will take care of the intermediation and money market problems which have been concerning me. We have still however to deal with the other problem arising from local authority's large accumulated holdings of capital receipts - the danger that they will spend them at a record rate over the remaining nine months of this year. Local authorities' budgets indicate the prospect of a very large overspend this year on capital, possibly of the order of £1.3 billion, on top of the real increase which has taken place on main services over the previous two years. The problem has arisen in large part because local authorities will see a strong incentive to spend their capital receipts this year rather than have to set large proportions of them aside for credit liabilities in April next year.

In present economic circumstances, we cannot turn a blind eye to this. John Major suggested as long ago as 28 March that the solution should be to provide by regulation that local authorities should be required to set aside for credit liabilities in April of next year whichever is the greater of:

(d) 50 per cent of non-housing and 75 per cent of housing cash-backed receipts on 1 April 1990; or

(e) x per cent of non-housing and y per cent of housing cash-backed receipts on 1 April 1989,

where x and y would be numbers somewhat lower than 50 per cent and 75 per cent respectively. A provision of this kind would remove the incentive which local authorities now have to spend heavily during the current year.

John Major wrote again on 25 May urging action on this. In your own letter, also of 25 May, you promised an early proposal on the way ahead.

Time is running out. I must ask you therefore to announce something on the lines John has suggested simultaneously with announcing the amendments to the Bill on local authorities' financial assets and capital receipts discussed earlier in this letter.

I am copying this letter to John Major.

Yours ever
Nigel

NIGEL LAWSON

CONFIDENTIAL

CH/ In view of the fact that the LG&H Bill cannot be amended until October, we have time to continue to press DoE. But note the action on credit approvals Mr Ridley wants to announce this week. DIS

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref: 22528/89

Your ref :

CH/EXCHEQUER
REC. 21 JUL 1989
MR AJC EDWARDS ✓24/7
PS/CST PS/EST SIR P MIDDLETON
MR ANSON, SIR T BURNS
MR PHILLIPS, MR SCHOLAR
MR ODLING-SMEE, MR PERETZ
MR PIRIE, MR POTTER
MR DEVEREUX, MR LAITE
MISS WHELDON - T. SOL.

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
LONDON
SW1 3AG

21 July 1989

BF 28/7

Official advice urgently awaited

Dear Chancellor,

Thank you for your letter of 11 July about local authority financial assets. Your officials' note does not understate the difficulties of taking action and I myself would add three further caveats. First, we would need to be able to justify taking action now which was apparently not necessary 6 months ago when the Bill was introduced. During that period, the level of local authority approved investments has not been rising, though on account of last year's capital receipts it has been high by comparison with the recent past. Secondly, what is said in the note about the legislative feasibility of the options has not been considered by Counsel. Thirdly, the slightest hint that the Government were contemplating taking action to prevent the externalisation of balances would undoubtedly create precisely the consequences which we are anxious to avoid, namely an immediate surge in externalisation.

That said, I understand your concerns about money market management and intermediation and am ready to do what can practicably be done to help. But we must recognise that we are not starting from scratch and that the third of your proposals in particular would represent a very substantial departure from the policy which we agreed in E(LF) last year and which was then embodied in our consultation paper and has been repeatedly confirmed in response to enquiries by the Local Authority Associations and individual councils.

Malcolm Caithness expects Part IV of the Bill to be reached in Committee in the Lords on 26 July. In view of the other matters which the draftsman has on hand, there is no prospect of any amendments being made before Report stage in October.

I do not have a great deal of difficulty with the second of your proposals, namely that it should be provided that a local authority may not borrow for the purpose of acquiring or retaining financial investments. I have asked my officials to ascertain whether this would be possible under the Bill as it now stands. If not,

RIDLEY TO CHEX 21/7

CONFIDENTIAL

then subject to the views of the business managers and to the obtaining of drafting approval, I would be content for the Bill to be amended.

I am doubtful whether the first of your proposals would add very much to this. Your officials' note rightly draws attention to the difficulties of framing a limit in a way which would not hinder legitimate activity but would at the same time bring about an effective reduction in the overall level of investments.

Your third proposal would represent a very substantial change in the Government's stated policy and would in my judgement seriously jeopardise the prospects of acceptance of the new capital finance system. It would be seen by our friends in local government as yet another encroachment on their freedom of action. The councils concerned are preponderantly under the control of our supporters. Moreover the proposal would not fit easily within the structure of Part IV of the Bill.

I am far from persuaded that we need contemplate such drastic action when, as I pointed out in my letter of 13 June to John Major, we have in our hands the means to secure our objective by another means. That objective is to reduce by a substantial amount the net cash flow from the PWLB to local authorities and at the same time to reduce any incentive to intermediation. It seems to me that this could readily be done by introducing rules that would limit PWLB lending to cases where such lending was necessary to finance capital expenditure and where sums set aside as provision for credit liabilities or capital receipts were not available. I believe such rules could be formulated in such a way that they could be applied consistently and thus avoid the risk of legal challenge. They would provide a means of rationing PWLB lending which, because of its favourable terms, has been taken up by local authorities to a greater degree than would be justified by their capital programmes.

My proposal is set out in the attached note which my officials have prepared. They would be happy to explain to yours the detailed reasoning behind this proposal. In effect, it would prevent local authorities from borrowing to externalise internal lending except where usable capital receipts which had previously been internally lent were being applied to meet expenditure for capital purposes. In addition, those authorities holding approved investments and who also were required to make provision for credit liabilities exceeding their capital programmes would not be able to roll over PWLB loans.

I also have doubts about your proposal to prevent local authorities from spending their capital receipts this year. I remain extremely concerned about the prospective £1.2 billion divergence of forecast outturn from plans. But, as I explained in my letter of 25 May, this does not actually represent an increase in the volume of spending by local authorities. That makes it very difficult to justify measures which penalise authorities - in particular our own supporters - for using their receipts in a perfectly legitimate way. Any of the options we have considered would represent a significant change in

CONFIDENTIAL

our proposals. That flies in the face of sensible capital planning, which, we have claimed will be greatly improved under the new system.

Nevertheless, in view of the increase, I accept that we have to contemplate some action in addition to the significant measures we took in February. What I propose is this. In confirming the provisional assumptions about the baseline for credit approvals and receipts taken into account, we shall have to look again at the assumption about the availability of capital receipts to supplement spending from credit approvals. I propose that we should continue to assume that the receipts available to local authorities in 1990-91 will be the same as if local authority gross spending within ELAB had been in line with the Government's plans, ie £5.8bn. If local authorities overspend, they will have fewer receipts than we have assumed and will thus be able to spend less than we plan for next year.

That would produce an incentive for local authorities nationally to moderate their spending. But we need to supplement that by putting pressure on individual authorities. We can do that by basing the receipts taken into account (RTIA) for 1990-91 credit approvals on the receipts local authorities held in March 1989. Announcing it now should have a beneficial effect. Local authorities will know that if they spend all their receipts in 1989-90 they will have RTIA taken into account next year which they no longer have.

I accept that these measures may not have the same impact as the various legislative proposals we have considered. But for the reasons which I explained above I remain of the view that none of the proposals would be acceptable to our supporters. Neither would they themselves necessarily be effective. I hope that you can now agree to the measures I have outlined above and I attach a draft PQ by which I would propose to announce them next week.

I am sending copies of this letter to Peter Walker, John Wakeham, John Belstead, Sir Robin Butler, and First Parliamentary Counsel.

Yours sincerely

pp NICHOLAS RIDLEY

(Approved by the Secretary of State
and Signed in his Absence)

PWLB LENDING: A LIMITATION ON NEW LENDING/MINIMUM LEVEL OF REPAYMENT OF LOANS ROLLED OVER

For each financial year, there would be calculated (initially as an estimate) the following quantity:-

a. the use made by the authority in the year of their credit approval as authority to capitalise expenditure under clause 54(1)(a) of the Bill, minus

b. the total provision for credit liabilities made in respect of the year (including, in the case of 1990-91, the initial provision made out of 1980 Act receipts), plus

c. the usable capital receipts applied to meet expenditure incurred for capital purposes during the year, minus

d. usable capital receipts realised during the year, plus

e. the lesser of (i) the decrease (if any) during the year in the authority's revenue balances and (b) the excess, if any, at the start of the year of the authority's credit ceiling over the sum of their total external borrowing and the aggregate cost of their credit arrangements.

If the quantity so calculated were positive, it would be a limit on borrowing less repayments by the authority from or to the PWLB. If it were negative, the PWLB would only roll over existing loans if and to the extent that loans due for repayment exceeded it.

Not all of the quantities entering into the calculation would be known for certain until 6 months after the end of the financial year. Authorities would be free to borrow from the PWLB, and to roll over existing loans, but that up, until (say) 6 months after the end of the financial year concerned the loans would carry interest at a variable rate equivalent to the current rate on short-term loans (thus avoiding any incentive to intermediate). To the extent that loans made or rolled over were found to have exceeded the final figure, they would then have to be repaid. The balance (if any) would then carry interest at the appropriate long term rate.

To ask the Secretary of State for the Environment, what is the estimated level of local authority capital expenditure in the current financial year, and if he will make a statement.

Draft written answer

Local authority budget returns to my Department imply that gross capital expenditure by local authorities in England on services other than those covered by specific cash limits will be £7.5 billion, by comparison with the provision of £5.8 bn included in the most recent Public Expenditure White Paper (Cm 621). Capital receipts are forecast to be £0.2 bn above the estimate of £4.6 bn in Cm 621.

The overspend against provision for gross expenditure follows similar overspends in recent years and highlights the need for a new system to regulate local authority capital finance. The Local Government and Housing Bill provides for such a system. Meanwhile, I propose to take two measures to protect future community chargepayers from the adverse effects of further overspending this year.

First, in setting the national total for credit approvals in 1990-91, I propose to assume that local authorities have available to them the level of capital receipts that they would have had if gross spending in 1989-90 had been in line with the plans in Cm 621. If local authorities spend above those plans, they will have less spending power available in 1990-91.

Secondly, when setting local authorities' credit approvals for 1990-91, I propose to base the allowance made for their ability to finance expenditure from capital receipts on the receipts held by authorities on 31 March 1989.

JSP17D53

FROM: A J C EDWARDS (LG)
DATE: 26 July 1989
x4480

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr Walsh (FIM)
Mr Pirie (FIM)
Mr Potter (o.r) (LG1)
Mr Laite (LG1)

CW/ Adopting option B would not rule out keeping C as a fallback.

Yes.

Are you content to drop option A (if not, we need to move very quickly) and write as drafted, subject first to ensuring CST is happy?
DIS

LOCAL AUTHORITY FINANCIAL ASSETS

Mr Ridley's letter of 21 July gave his response to the concerns set out in your letter of 11 July about:

(i) local authorities' financial intermediary role: their large portfolios of borrowing on the one hand and financial assets on the other (the latter reflecting the surge in capital receipts over the last two or three years); and

(ii) their plans for high capital spending in the current year, financed from assets already held on deposit and in-year capital receipts, ahead of the new capital finance regime to be introduced on 1 April 1990.

In both cases, as you will recall from earlier submissions, Mr Ridley and DOE have dragged their feet for months despite repeated pressures from the former Chief Secretary and at official level. The offers now put forward in Mr Ridley's letter fall far short of what you suggested, and Mr Patten's instinct (and advice) will doubtless be to avoid making some not very popular announcements which Mr Ridley should have made some months ago.

AJCE TO CHEX 26/7

Intermediary Role

2. Mr Ridley's letter accepts the case for including in the Local Government and Housing Bill a provision to the effect that a local authority may not borrow for the purpose of acquiring or retaining financial assets. But it rejects your other proposals. It also notes that amendments to the Bill will have now to be tabled at Report Stage in October.

3. Now that the legislation timetable has slipped anyway, we should like to take a little more time to consider the best way ahead on the intermediary problem. We will submit further advice on this next week.

High Spending in Current Year

4. If something is to be done to restrain local authorities' capital spending this year, it should clearly be done as soon as possible (and should indeed have been done at the beginning of the year, as the former Chief Secretary requested). This is consequently the more urgent of the two issues.

5. Mr Ridley's response is, if anything, even more discouraging on this than on financial intermediation. He in effect rejects any substantive action to restrain the excessive capital expenditure financed from capital receipts which local authorities are planning to undertake this year. He offers nothing but smoke. The proposals on the final page of his letter may appear to be a step in our direction. In reality they represent no change whatever. As DOE officials know perfectly well, there can anyway be no question of changing the receipts assumption which underlay the calculation of baseline credit approvals earlier this year, and the figures for "receipts taken into account" have already been announced. The proposed PQ and A attached to Mr Ridley's letter would in our view do no good. It would indeed be positively counter-productive, from our point of view, in that it would make it more difficult for the Government to take effective action in this area in the Autumn.

6. Mr Ridley's unhelpful line is the more vexing in that we now have a strong impression that his earlier refusal to join battle over a protracted period reflected conscious planning rather than work overload or administrative hiccups as previously suggested. With the passage of time, DOE can now argue with some cogency that by this stage in the financial year local authorities will have entered into capital commitments corresponding to their plans so that any action to discourage spending is likely therefore to be ineffective. We for our part would not fully accept this argument. The scope for adjustment and phasing of capital programmes, even in-year, is much greater than Departments like to acknowledge.

7. In the meantime, the prospects for overspending by local authorities in the current year, compared with the last White Paper provision, have worsened further. On 11 July, when you wrote to Mr Ridley, the latest information suggested that local authorities in England were planning to spend £7 billion on capital projects in 1989-90 on the main local authority services (known as ELAB). This was £1.3 billion over gross provision. Since then DOE officials have revised the estimate for planned spending on ELAB programmes upwards to £7.55 billion. The excess over gross provision is now, therefore, some £1.8 billion, or over 30%. In principle, therefore, the case for action is stronger than ever.

8. All that being said, we have to recognise that this is a difficult nettle for a new Environment Secretary to grasp. Local authorities would undoubtedly criticise adjustments to the Government's proposals for the local authority finance regime, however unfairly, as being another case of changing the goal posts in mid-game.

Preferred Solution

9. As you will recall from earlier submissions, the problem arises from the incentive which local authorities have to spend every penny they can on capital projects this year. On

1 April 1990, they will be obliged to sterilise or "set aside for credit liabilities" 75% of their accumulated housing capital receipts and 50% of their accumulated other capital receipts (cash-backed or internally lent in both cases). Most local authorities with capital receipts will therefore be keen to spend them this year.

10. We continue to believe that the best solution to this problem is to remove the incentive to early spending by the means suggested in the former Chief Secretary's letter of 28 March and your letter of 11 July. Our proposal was that local authorities should be required to set aside for credit liabilities in April of next year whichever is the greater of:

(a) 50% of non-housing and 75% of housing cash-backed receipts on 1 April 1990, or

(b) X% of non-housing and Y% of housing cash-backed receipts on 1 April 1989,

where X and Y would be numbers somewhat lower than 50% and 75% respectively.

11. A provision of this kind would remove the incentive which local authorities now have to spend heavily during the current year. It would have the further merit that the Government could not be accused of <u>forcing</u> local authorities to cut back their planned capital programmes this year. If they proceed to implement these plans in full, however, they would have less to spend in future years.

<u>Alternative Solution</u>

12. The only alternative solution we have been able to identify would be to set credit approvals for 1990-91 at lower levels than otherwise, close to the Survey baseline. Low credit approvals for 1990-91 announced in October of this year might, just possibly, persuade some local authorities to temper their spending plans for this year and husband their available resources more prudently.

13. The problem with this solution, however, is that it will be extremely difficult, perhaps impossible, to deliver. Certainly the Chief Secretary would be able to argue the more strongly in the bilaterals that local authorities are planning to spend far too much in the current year and should be penalised next year. But he will be able to use an argument on these lines anyway, and it must be doubtful whether the outcome will be significantly different either way. Both the Departments who "sponsor" local authority capital programmes and DOE will argue strongly that the new capital finance system must "get off to a good start" and will resist proposals to set credit approvals at levels which look exceptionally low.

Line to Take with Mr Patten

14. As we see it, you have three main options in replying to Mr Patten. You could:

(a) press him to announce our preferred "either/or" formula within the next day or two, before the House rises; or

(b) press him to announce this formula in September: for example at the meeting of the Consultative Council on Local Government Finance fixed for 11 September; or

(c) drop any action along these lines but insist that the counterpart of this will have to be even greater restraint than would have been needed anyway on credit approvals next year.

15. Subject to your views, we would think it unreasonable to expect Mr Patten to make an immediate announcement, as in (a) above, in his first week as Secretary of State. In present economic circumstances, however, it would still seem wrong to concede defeat, and option (c) comes perilously close to that. If

you are willing, therefore, it would seem best to press for option (b). In commending this option you can point out that you are not pressing him to make the announcement immediately and that the proposed formula would remove perverse incentives rather than force local authorities to change their plans. A draft letter in this sense is attached.

AJCE

A J C EDWARDS

lg2.ds/edwards/drafts/3

pls type as final

CONFIDENTIAL

DRAFT LETTER FROM THE CHANCELLOR TO THE SECRETARY OF STATE FOR THE ENVIRONMENT

(+ as amended)

LOCAL AUTHORITY FINANCIAL ASSETS

You will doubtless have seen Nick Ridley's letter to me of 21 July on this subject. I regret to say that Nick's proposals do not deal effectively with the concerns expressed in my letter of 11 July.

On the financial intermediary issue, Nick's letter makes clear that no action can now be taken until the Report Stage of the Local Government and Housing Bill in October. That means we have a little time in hand. I will, however, write again shortly about this.

So far as local authorities' expenditure from capital receipts in the current year is concerned, we have to do what we can to avoid adding unnecessarily to the pressures on the economy and the construction industry at this time. That is why, in my letter of 11 July, I asked Nick to take a simple step, first suggested four months ago by John Major, to remove the perverse incentive which local authorities have as a result of the new capital finance system to spend every penny they can on capital expenditure this year.

Since Nick wrote, I understand that later information has become available to the effect that local authorities are planning to overspend the gross provision for capital expenditure in our last White Paper by a further £½ billion this year, on top of the £1.3 billion we foresaw earlier, making a total planned overspend of no less than £1.8 billion. This latest revision emphasises ~~underscores~~ the need for action.

Although an enhanced level of spending this year may substitute in part for capital expenditure next year, the fact is that much of it is likely to represent a permanent addition, or permanent bringing forward, of capital expenditure. The Government cannot simply turn a blind eye to this.

Nick's letter suggested that a better way ahead than John Major and I had suggested would be to announce in an arranged PQ and A that (a) the level of capital receipts assumed to be available to local authorities next year would not be reduced if authorities spent more of the receipts than assumed in the current year and (b) in distributing credit approvals between authorities receipts taken into account would continue to be based on the receipts available on 31 March 1989. I have to say, however, that this proposal does not seem to me to solve the problem at all. There can anyway be no question of changing the receipts assumption which underlay the calculation of baseline credit approvals earlier this year, and the level of ~~figures for~~ receipts taken into account has ~~have~~ already been announced in general terms.

Amendment made by Mr Edwards

The right solution remains to announce as soon as possible the simple "either/or" formula set out in the earlier letters from John Major and myself. In normal circumstances, I would have pressed you to announce this now, before the House rises. I would not think it reasonable in the circumstances to ask you to proceed with such haste. But I must ask you to announce it at the earliest opportunity in September. The meeting of the Consultative Council on Local Government Finance fixed for ~~11~~ 28 September would seem to offer a convenient opportunity. In preparation for that, I suggest that officials should advise us in good time on what the X and Y in the formula should be.

X

The formula which John Major and I have proposed will have the great merit, from the point of view of presentation to local authorities, that it will not oblige any of them to cut back their spending this year. It will simply remove the perverse incentives which they now have to spend every penny they can this year. My impression is that local authorities have been surprised that the Government has delayed so long before taking the action which is so obviously needed.

X

I am sending copies of this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

NIGEL LAWSON

Copy list as minute

chex.ps/ds/24 **CONFIDENTIAL**

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr A J C Edwards
Mr Walsh
Mr Pirie
Mr Potter
Mr Laithe

Treasury Chambers, Parliament Street,
01-270 3000

27 July 1989

Rt Hon Christopher Patten MP
Secretary of State for the
Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

BF 29/8

Dear Secretary of State,

LOCAL AUTHORITY FINANCIAL ASSETS

You will doubtless have seen Nick Ridley's letter to me of 21 July on this subject. I regret to say that Nick's proposals do not deal effectively with the concerns expressed in my letter of 11 July.

On the financial intermediary issue, Nick's letter makes clear that no action can now be taken until the Report Stage of the Local Government and Housing Bill in October. That means we have a little time in hand. I will, however, write again shortly about this.

So far as local authorities' expenditure from capital receipts in the current year is concerned, we have to do what we can to avoid adding unnecessarily to the pressures on the economy and the construction industry at this time. That is why, in my letter of 11 July, I asked Nick to take a simple step, first suggested four months ago by John Major, to remove the perverse incentive which local authorities have as a result of the new capital finance system to spend every penny they can on capital expenditure this year.

Since Nick wrote, I understand that later information has become available to the effect that local authorities are planning to overspend the gross provision for capital expenditure in our last White Paper by a further £½ billion this year, on top of the £1.3 billion we foresaw earlier, making a total planned overspend

CHEX TO PATTEN 27/7

of no less than £1.8 billion. This latest revision emphasises the need for action.

Although an enhanced level of spending this year may substitute in part for capital expenditure next year, the fact is that much of it is likely to represent a permanent addition, or permanent bringing forward, of capital expenditure. The Government cannot simply turn a blind eye to this.

Nick's letter suggested that a better way ahead than John Major and I had suggested would be to announce in an arranged PQ and A that (a) the level of capital receipts assumed to be available to local authorities next year would not be reduced if authorities spent more of the receipts than assumed in the current year and (b) in distributing credit approvals between authorities receipts taken into account would continue to be based on the receipts available on 31 March 1989. I have to say, however, that this proposal does not seem to me to solve the problem at all. There can anyway be no question of changing the receipts assumption which underlay the calculation of baseline credit approvals earlier this year, and level of receipts taken into account has already been announced in general terms.

The right solution remains to announce as soon as possible the simple "either/or" formula set out in the earlier letters from John Major and myself. In normal circumstances, I would have pressed you to announce this now, before the House rises. I would not think it reasonable in the circumstances to ask you to proceed with such haste. But I must ask you to announce it at the earliest opportunity in September. The meeting of the Consultative Council on Local Government Finance fixed for 28 September would seem to offer a convenient opportunity. In preparation for that, I suggest that officials should advise us in good time on what the X and Y in the formula should be.

The formula which John Major and I have proposed will have the great merit, from the point of view of presentation to local authorities, that it will not oblige any of them to cut back their spending this year. It will simply remove the perverse incentives which they now have to spend every penny they can this year. My impression is that local authorities have been surprised that the Government has delayed so long before taking the action which is so obviously needed.

I am sending copies of this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

Yours sincerely.

Duncan Sparkes

p.p. **NIGEL LAWSON**

[Approved by the Chancellor and signed on his behalf] lg1.va/potter/minutes/lafas

CONFIDENTIAL

Duncan
You may like to draft!

CHANCELLOR

The political difficulties of doing this now are v great. Nevertheless I am prepared to have a go @ Mr Potter, provided the letter is expressed to relate the proposals to the present position of Hammersmith & Fulham, this is the best case we can make. 18/8

content to write as proposals?

FROM: B H POTTER (LG1)
X4790
Date: 15 August 1989

cc: Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mr Edwards (LG)
Mr Gilholly (FP)
Mr Pirie (FIM)
Mr Devereux (FIM)
Mr Laite (LG1)
Miss Wheldon - T/Sol

LOCAL AUTHORITY FINANCIAL ASSETS

You wrote on 11 July to the previous Environment Secretary setting out three measures designed to reduce local authorities' intermediary role: their large portfolios of borrowing on the one hand and financial assets on the other. Each would require amendment to the Local Government and Housing Bill. They were:

(i) a power to cap local authorities' approved investments (ie holdings of financial assets);

(ii) a provision that a local authority could not borrow for the purpose of acquiring or retaining approved investments; and

(iii) a regulation-making power requiring sums set aside for debt redemption under the new capital regime (the "reserved part") to be used either to redeem debt directly or to be lent internally ie the reserved part could not be put on deposit.

POTTER TO CHEX 15/8

2. Treasury officials had envisaged proposals i) and iii) as <u>alternative</u> means of reducing or preventing intermediation, with iii) our preferred option. Proposal ii) is a general admonitory power designed to discourage intermediation. Though useful, it must be doubtful whether on its own it could prevent intermediation - because LA Treasurers would find ways around it through creative accounting.

3. Mr Ridley replied on 21 July. He casts doubt on proposal (i) above, on the grounds that it is unlikely to be workable; he accepts proposal (ii); and he vigorously rejects proposal (iii). His objections to this last proposal reflect the legislative and presentational difficulties involved - not doubts about the effectiveness of the measure.

4. However Mr Ridley also proposes a solution of his own: it is designed to decrease the net flow of funds from the PWLB, in the belief that local authorities would use more of their approved investments to finance their capital programmes and thus decrease amounts on deposit. This proposal has the attraction from the DOE's viewpoint that it could be undertaken by administrative action: but amendment to the Local Government and Housing Bill would still be needed for item (ii) above (which would, as discussed later, be a necessary part of any such approach).

5. This submission reviews DOE's objections to our preferred proposal (iii), concluding that they are not insurmountable; explains why Mr Ridley's alternative proposal would not solve the problem of intermediation; and offers a draft letter to Mr Patten asking him to reconsider our proposed approach.

Treasury Approach

6. The Treasury's preferred approach is essentially (iii). This would require local authorities to use the reserved part of capital receipts for debt redemption or internal lending. This would apply to post-1990-91 flows of capital receipts giving LAs a short period (say 3 months) in which to decide how the receipt would be used. The requirement could also be applied to the outstanding stock as of 1 April 1990 (but this may not be necessary).

7. The principle advantages are as follows:

(i) it is simple and straightforward to administer;

(ii) it achieves the underlying aim of the policy agreed at E(LF) 18 months ago, ie that local authorities should be required to use the reserved part of their receipts to redeem outstanding debt - not be allowed to build up stocks of financial assets, while retaining high borrowings;

(iii) it attacks the problem of intermediation directly: local authorities will be prevented from using the reserved part of their receipts to take a turn on the back of the yield curve. Authorities would however still be able to apply the other 'useable' part (to the extent that it was not spent) in this way. But the bulk of receipts would have been dealt with.

8. In DOE's view there are three main disadvantages to this approach. First DOE officials argue that it would require a substantial recasting of the existing provisions in Part IV of the Local Government and Housing Bill. As you know Part IV is built around three potential uses for the reserved part of local authority capital receipts - internal lending; repayment of debt; and putting money on deposit. To change that now, say DOE officials, would complicate the whole shape of this part of the Bill.

9. We have pressed DOE to demonstrate how substantial the changes actually are. We have had no reply. Our own, admittedly uninformed and inexpert assessment, is that the problem is not insuperable. Depending upon the manner in which Counsel chose to approach his task, it would require amendment of up to eight or ten clauses of the Bill.

10. Secondly, and no doubt driving the opposition within DOE, is the concern that this looks like a substantial and late change in policy. DOE argue that it would affect detrimentally the response to the new capital finance regime. Clearly any move to restrict local authorities' freedom to play the financial market will be unpopular. But DOE themselves have now effectively conceded that some such action is necessary. In our view the criterion should be less trying to avoid speculative degrees of unpopularity, than how effective the arrangements are in discouraging intermediation.

11. Thirdly, DOE say the Government has given unequivocal commitments that local authorities will be allowed to put their money on deposit. We have checked. Our assessment is at Annex A. In short we do not believe that what has been said so far constitutes an insuperable obstacle to the changes.

DOE Approach

12. The DOE approach is to restrict local authorities' borrowing from the PWLB by administrative rules; because this would act on PWLB lending only, it needs to be accompanied by the general power (ii).

13. From DOE's viewpoint the principal advantages are:

(i) it is an administrative not a legislative solution: by acting via the PWLB, it would divert criticism from DOE and on to the PWLB (and by extension the Treasury);

(ii) it leaves the original concept of the capital regime and the proposals in the Bill intact; it can therefore be presented as a less fundamental attack on the existing proposals; and

(iii) it will be effective in reining back the indirect flow of PWLB borrowing into deposits in financial markets.

14. Our main concern is that this approach will simply not achieve our twin objectives: it will not force LAs to reduce outstanding debt and it will not therefore prevent intermediation.

15. Nothing in the DOE proposals would prevent local councils from putting the reserved part of their capital receipts on deposit rather than using them to redeem debt. Any shortage of funds for financing the capital programme (or rolling over debt) could be met by borrowing from non-PWLB sources. The issue is only whether they would think it worthwhile borrowing ie undertaking such intermediation in those circumstances.

16. Intermediation is attractive to authorities because of the gap between long and short rates. But this gap would still exist even if all PWLB lending were at market rates (a more restrictive position than Mr Ridley's suggestion of a quota on concessional funds). Long term PWLB rates are currently under 10 per cent; short term rates are at 14 per cent. So even if PWLB long lending rates were raised to 11 per cent there would still be a significant gap for those authorities ready to mismatch their assets and liabilities.

17. This being the case, it would not matter if the PWLB lending was restricted in quantity: authorities might simply borrow from the market with the same (apparent) gain from intermediation.

18. Of course, a rise in PWLB rates (or a greater dependence on market borrowing) reduces the initial gain from intermediation. But only when the yield curve is virtually flat will the present differential between PWLB and market rates be the <u>only</u> cause for intermediation.

<u>Recommendations</u>

19. It remains our view that our approach is the better. It is a sure means of preventing intermediation; and crucially, it would ensure that the reserved part of receipts go to reducing LAs outstanding debt, as E(LF) intended.

20. The big problem is political: whether Mr Patten will be prepared to take what will undoubtedly be seen as a further restriction on local authorities' financial freedom. It is reasonable to give local authorities about three months in which to decide whether to pay off debt or lend the money internally. We can point out that the only purpose for leaving this money on deposit beyond that would be to play the financial markets. We, and privately the Audit Commission, do not believe that is an appropriate role for local authorities.

21. DOE still do not like this approach but have been unable to come up with anything against it apart from the (admittedly considerable) presentational and legislative difficulties. At official level, there have been hints that they might agree to the power being taken on a reserve basis. It would be made clear to local authorities that the present levels of debt and approved investments are too high and would be closely monitored. If both remained high then the power would be implemented. The expectation must be that a reserve power would be less effective than full implementation; nonetheless it could substantially rein back the levels of approved investments held in the future.

22. Ultimately this may be the compromise solution. But there is no need to concede any ground for the present: it should be up to DOE to make any such offer.

Other approaches

23. We see the Treasury approach (full or reserve power) as the main runner. We and DOE have concluded that the other idea of a cap - proposal (i) - though attractive in principle, will be difficult to achieve in practice. But we have also considered other possible mechanisms.

24. One technical possibility would be to introduce a financial disincentive to intermediation. DOE suggested this might be achieved by taxing local authorities' income from approved investments, beyond some allowance to enable precautionary balances to be held. Providing the rate of tax could be sufficient to cover the likely gap between borrowing long and depositing short, that would effectively stop local authorities putting money on short term deposit. This could be introduced by means of next year's Finance Bill.

25. We are opposed to this. Creating a new tax is unattractive in principle and in this case it would be less effective than the Treasury approach outlined above, unless the tax were set at a punitively high rate. Moreover, local authorities are not taxed. Their resistance to having intermediation interfered with would be compounded with what they would allege was a major "constitutional" change.

Conclusion

26. Because of the need for changes to the Bill, we need to keep the pressure on DOE. I recommend that you write now to Mr Patten reviewing the position and inviting him to reconsider the Treasury approach. You can point out that Mr Ridley's proposal would not affect intermediation significantly even if you went further than Mr Ridley proposed and set all PWLB lending at market rates. You can say that you are considering this possibility seriously (because it would encourage local authorities into the market, making them subject to market discipline); but even so, DOE will have to take further action - as we have suggested - to counter intermediation.

27. FIM and FP agree.

Barry H. Potter

BARRY H POTTER

CONFIDENTIAL

DRAFT LETTER TO SECRETARY OF STATE FOR ENVIRONMENT

LOCAL AUTHORITY FINANCIAL ASSETS

Nick Ridley and I have been in correspondence for some weeks on the question of the financial assets held by local authorities. Specifically we were anxious that local councils should not be active in borrowing long, particularly from the Public Works Loan Board (PWLB), while at the same time retaining, and indeed building up, short term assets on deposit. Such intermediation is undesirable from the point of view of local authorities own balance sheets; it creates problems for money market management; and it threatens to frustrate a key element of the new capital regime - that LAs should use part of their receipts to reduce their high levels of outstanding debt.

The issue is how best to prevent such intermediation, bearing in mind that amendments are likely to be needed to the Local Government and Housing Bill and will have to be drafted soon for inclusion in the Bill in October.

I have considered Nick's latest proposal very carefully. The aim of the scheme he had in mind would be to limit the net flow of funds from the PWLB to individual local authorities. I can see merit in this idea: but the attractions lie in the encouragement it gives local authorities to borrow from the market, rather than from the PWLB, and thus be more subject to market disciplines. That is an important policy issue in its own right which we need to discuss soon. But even if we were to go as far as charging all PWLB lending at market rate - a proposal I am seriously considering - I doubt very much whether this would affect intermediation.

The problem with Nick's proposals is this: there would still be scope for local authorities to ride on the back of the yield curve even if they undertook <u>all</u> their borrowing from the market rather than the PWLB. The higher borrowing costs they would incur would reduce the apparent gain from intermediation. But only in a few cases (when the yield curve was fairly flat) would this remove the incentive to intermediate for those authorities prepared to mismatch their assets and liabilities. For example, at present long PWLB rates are under 10 per cent: even if long market rates were 1 per cent higher than the PWLB rate, there would still be an attraction in retaining deposits earning of the order of 14 per cent.

Consequently I still regard the more straightforward power set out as proposal (iii) in my letter of 11 July, to prevent local authorities using the reserved part of their receipts to put on deposit as the best way forward. It is a simple, direct and effective way of achieving the original aim of our policy agreed by E(LF) - that local authorities should be required to use part of the proceeds from the sale of assets to reduce the large amounts of outstanding debt they have built up.

Moreover, the objections in Nick's letter to that proposal are about the potential legal difficulties and presentational considerations - not about its effectiveness in achieving our agreed policy objective and in preventing intermediation. I do not underestimate the legal difficulties and my officials would be happy to consider with yours how the necessary changes could be made on the basis which would least disrupt the present draft of Part IV of the Bill. On presentation, I accept that local authorities will not like any move which aims to restrict their financial freedom of action: but we do need to bear in mind that continuing to allow LAs to put money on deposit permanently rather than pay off their debts would only serve to give local authorities the ability to play the financial markets. This is not a legitimate activity for them in my view or that of the Audit Commission.

I would therefore ask you to reconsider the position.

I am copying this letter to ~~the other members of E(LF)~~ and ~~to~~ Sir Robin Butler.

[N.L]

ANNEX A

MINISTERIAL STATEMENTS ON DEBT REDEMPTION

E(LF)87 22 MAY 1987

SoS for the Environment said, "Local authorities would be required to pay 50 per cent of cash-backed receipts into a redemption fund."

Prime Minister said, "The requirement to pay 50 per cent of cash-backed capital receipts into a debt redemption fund could well prove controversial, and could limit incentives to dispose of assets. This aspect of the proposals would require careful handling when the proposals were made public."

CAPITAL EXPENDITURE AND FINANCE: A CONSULTATION PAPER DOE/WELSH OFFICE 7 JULY 1988

Paragraph 25: "the remainder (of capital receipts) would be applied to debt redemption...."

Paragraph A33: "capital receipts should be applied to debt redemption."

Paragraph A34: 'The government is of the opinion that local authorities should, out of the proceeds of asset sales, set aside prudent provisions for the redemption of external debt and for the meeting of future liabilities."

LOCAL GOVERNMENT AND HOUSING BILL: HOUSE OF COMMONS REPORT STAGE HANSARD 13 JUNE 1989

Mr Gummer said: "..no one is being forced to pay off advantageous loans of the 6 per cent variety. But where local authorities realise capital, they must apply a substantial part of the resources thus realised to debt repayment - either by discharging such debts or by establishing a fund as a contra to them. Provided that local authorities build up such a fund and use the interest from it for other purposes they do not have to pay off advantageous debts."

LOCAL GOVERNMENT AND HOUSING BILL: HOUSE OF LORDS COMMITTEE STAGE HANSARD OFFICIAL REPORT 26 JULY 1989

The Earl of Caithness said"...when local authorities dispose of capital assets they should make provision for debt redemption."

CONFIDENTIAL

DRAFT LETTER TO SECRETARY OF STATE FOR ENVIRONMENT

Redraft by Mr Edwards

LOCAL AUTHORITY FINANCIAL ASSETS

Nick Ridley and I have been in correspondence for some weeks on the question of the financial assets held by local authorities. Specifically we have been considering how local councils may be prevented or discouraged from being active in borrowing long, particularly from the Public Works Loan Board (PWLB), while at the same time retaining, and indeed building up, short term assets on deposit.

It has, I think, been common ground between us that such intermediation is undesirable from the point of view of local authorities' own balance sheets; it creates problems for money market management; and it threatens to frustrate a key element of the new capital regime - that LAs should use part of their receipts to reduce their high levels of outstanding debt.

The problem is that the Local Government and Housing Bill, as currently drafted, would continue to permit local authorities to put the unspent proportions of their large capital receipts into deposits and other short-term financial assets rather than repay debt. The effect would be that local authorities would continue to be able to play the financial markets. In my view, and I believe that of the Audit Commission, that is not a legitimate activity for them. To prevent continuing intermediation, some amendments will be needed to the Bill, and these will need to go beyond the addition, which Nick agreed in principle, of a general provision whereby a local authority may not borrow for the purpose of acquiring or retaining financial investments. Such amendments will clearly need to be drafted soon for inclusion in the Bill in October.

I have considered Nick's latest proposal very carefully. The aim of the scheme he had in mind would be to limit the net flow of funds from the PWLB to individual local authorities. I can see merit in this idea: but the attractions lie in the encouragement it gives local authorities to borrow from the market, rather than from the PWLB, and thus be more subject to market disciplines. That is an important policy issue in its own right which we need to discuss soon. But even if we were to go as far as charging all PWLB lending at market rate - a proposal I am seriously considering - I doubt very much whether this would affect intermediation.

The problem with Nick's proposals is this: there would still be scope for local authorities to ride on the back of the yield curve even if they undertook <u>all</u> their borrowing from the market rather than the PWLB. The higher borrowing costs they would incur would reduce the apparent gain from intermediation. But only in a few cases (when the yield curve was fairly flat) would this remove the incentive to intermediate for those authorities prepared to mismatch their assets and liabilities. For example, at present long PWLB rates are under 10 per cent: even if long market rates were 1 per cent higher than the PWLB rate, there would still be an attraction in retaining deposits earning of the order of 14 per cent.

CONFIDENTIAL

Consequently I still regard the more straightforward power set out as proposal (iii) in my letter of 11 July, to prevent local authorities using the reserved part of their receipts to put on deposit, as the best way forward. It is a simple, direct and effective way of achieving the original aim of our policy agreed by E(LF) - that local authorities should be required to use part of the proceeds from the sale of assets to reduce the large amounts of outstanding debt they have built up. I would envisage taking such a power in such a way as to require minimum change to the existing Bill.

The objections in Nick's letter to that proposal are about the potential legal difficulties and presentational considerations - not about its effectiveness in achieving our agreed policy objective and in preventing intermediation. My officials would be happy to consider with yours how the necessary changes could be made on a basis which would least disrupt the present draft of Part IV of the Bill. On presentation, I accept that local authorities will not like any move which aims to restrict their financial freedom of action: but we do need to bear in mind that continuing to allow LAs to put money on deposit indefinitely rather than pay off their debts would (as I said earlier) <u>only</u> serve to give local authorities the ability to play the financial markets, and that this cannot be a legitimate activity for them.

I suggest that we should take the opportunity of our meeting next week on the safety-net to discuss this issue and the related issues of this year's massive overspend on LA capital as well.

I am copying this letter to Geoffrey Howe, Peter Walker, ~~John Wakeham~~, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

[N.L]

chex.dc/ds/33

CONFIDENTIAL

cc: PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mr Potter
Mr Edwards
Mr Gilhooly
Mr Pirie
Mr Devereux
Mr Laite
Miss Wheldon - T/Sol

Treasury Chambers, Parliament Street, SW1P 3
01-270 3000

29 August 1989
[sent out on 4 Sept]

Rt Hon Christopher Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

BF 18/9
[news?]

CHEX TO PATTEN 29/8

Dear Chris

LOCAL AUTHORITY FINANCIAL ASSETS

Nick Ridley and I have been in correspondence for some weeks on the question of the financial assets held by local authorities. Specifically we have been considering how local councils may be prevented or discouraged from being active in borrowing long, particularly from the Public Works Loan Board (PWLB), while at the same time retaining, and indeed building up, short term assets on deposit.

It has, I think, been common ground between us that such intermediation is undesirable from the point of view of local authorities' own balance sheets; it creates problems for money market management; and it threatens to frustrate a key element of the new capital regime - that LAs should use part of their receipts to reduce their high levels of outstanding debt.

The problem is that the Local Government and Housing Bill, as currently drafted, would continue to permit local authorities to put the unspent proportions of their large capital receipts into deposits and other short-term financial assets rather than repay debt. The effect would be that local authorities would continue to be able to play the financial markets. In my view, and I believe that of the Audit Commission, that is not a legitimate activity for them. To prevent continuing intermediation, some amendments will be needed to the Bill, and these will need to go beyond the addition, which Nick agreed in principle, of a general provision whereby a local authority may not borrow for the purpose of acquiring or retaining financial investments. Such amendments will clearly need to be drafted soon for inclusion in the Bill in October.

I have considered Nick's latest proposal very carefully. The aim of the scheme he had in mind would be to limit the net flow of funds from the PWLB to individual local authorities. I can see merit in this idea: but the attractions lie in the encouragement it gives local authorities to borrow from the market, rather than from the PWLB, and thus be more subject to market disciplines. That is an important policy issue in its own right which we need to discuss soon. But even if we were to go as far as charging all PWLB lending at market rate - a proposal I am seriously considering - I doubt very much whether this would affect intermediation.

The problem with Nick's proposals is this: there would still be scope for local authorities to ride on the back of the yield curve even if they undertook <u>all</u> their borrowing from the market rather than the PWLB. The higher borrowing costs they would incur would reduce the apparent gain from intermediation. But only in a few cases (when the yield curve was fairly flat) would this remove the incentive to intermediate for those authorities prepared to mismatch their assets and liabilities. For example, at present long PWLB rates are under 10 per cent: even if long market rates were 1 per cent higher than the PWLB rate, there would still be an attraction in retaining deposits earning of the order of 14 per cent.

Consequently I still regard the more straightforward power set out as proposal (iii) in my letter of 11 July, to prevent local authorities using the reserved part of their receipts to put on deposit, as the best way forward. It is a simple, direct and effective way of achieving the original aim of our policy agreed by E(LF) - that local authorities should be required to use part of the proceeds from the sale of assets to reduce the large amounts of outstanding debt they have built up. I would envisage taking such a power in such a way as to require minimum change to the existing Bill.

The objections in Nick's letter to that proposal are about the potential legal difficulties and presentational considerations - not about its effectiveness in achieving our agreed policy objective and in preventing intermediation. My officials would be happy to consider with yours how the necessary changes could be made on a basis which would least disrupt the present draft of Part IV of the Bill. On presentation, I accept that local authorities will not like any move which aims to restrict their financial freedom of action: but we do need to bear in mind that continuing to allow LAs to put money on deposit indefinitely rather than pay off their debts would (as I said earlier) <u>only</u> serve to give local authorities the ability to play the financial markets, and that this cannot be a legitimate activity for them.

I suggest that we should take the opportunity of our meeting next week on the safety-net to discuss this issue and the related issues of this year's massive overspend on LA capital as well.

I am copying this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

Yours ever
Nigel

[N.L]

CONFIDENTIAL

Y SWYDDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switsfwrdd)
01-270 0538 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switchboard)
01-270 0538 (Direct Line)
From The Secretary of State for Wales

The Rt Hon Peter Walker MBE MP

CH/EXCHEQUER
REC. 5 SEP 1989
ACTION MR AJC EDWARDS 5/9
COPIES TO PS/EST, PS/EST, SIR P MIDDLETON, MR ANSON, SIR T BURNS, MR PHILLIPS, MR SCHOLAR, MR ODLING-SMEE, MR PERETZ, MR PIRIE, MR POTTER, MR DEVEREUX, MR LAITE, MISS WHELDON - T/SOL

CT/6209/89

BF 18/9

31 August 1989

WALKER TO CHEX 31/8

Dear Nigel

Nicholas Ridley copied to me his letter of 21 July about local authority financial assets. As a result I became aware of the correspondence between you, he and the Chief Secretary which had been underway since our 14 February announcement. I have subsequently also seen your letter of 27 July. Your suggestions for amending the post 1990 system might in the normal course of events be expected to apply equally to Wales and so I thought it might be helpful if I gave my preliminary views.

Like you I see no reason why authorities should borrow solely so that they may hold approved investments and I would be quite content to see the Bill amended to block that.

I am less convinced about the attractiveness of limiting authorities' investments, under either your or Nicholas' suggested approaches. My fear is that to deliver even a crude and indiscriminate control would call for a complexity of legislation and a degree of central government prescription which would outweigh any advantage.

It is your third suggestion, however - that we should effectively control <u>when</u> authorities apply the reserved portion of their receipts to credit liabilities - which I find most difficult. This would be quite at odds with the line we have taken (and which has been well received) throughout consultation and throughout the legislative process so far. I do not see how we could with any credibility move away at this late stage from the position that individual authorities best know how to manage their own debt and must be allowed the freedom to do so.

/ Copies of this letter go to Geoffrey Howe, Chris Patten, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

Peter

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

CONFIDENTIAL

CHANCELLOR

FROM : A J C EDWARDS (LG)
x4480
5 September 1989

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr Walsh
Mr Peretz
Miss Noble
Mr Potter
Mr Devereux
Mr Laite
Mrs Chaplin

LOCAL AUTHORITY CAPITAL OVERSPEND AND FINANCIAL ASSETS

BRIEF FOR MEETING WITH MR PATTEN, 7 SEPTEMBER

Your letter of 29 August to Mr Patten suggests that you should discuss with him on Thursday, in addition to the safety net, the massive overspend in prospect on LA capital this year and the accumulation of financial assets by LAs.

2. As you will recall, these two issues remain unresolved after months of fruitless exchanges, or non-exchanges, with Mr Ridley, who apparently took a conscious decision to employ against us the same delay and battle-declining tactics which Quintus Fabius Maximus Cunctator used to such good effect against Hannibal some years ago.

Main papers

3. The most recent papers, which will I think be in your folder, are:

11 July	NL to NR	Overspend and financial assets
21 July	NR to NL	Overspend and financial assets
27 July	NL to CP	Overspend
29 August	NL to CP	Financial assets

CONFIDENTIAL

Background : overspend

4. The overspend and the accumulation of financial assets are, as you will recall, two distinct but related problems. On the overspend, the problem is that local authorities' budgets for this year reveal an intention to spend no less than £1.8 billion gross on capital more than the provision made in the last Autumn Statement and Public Expenditure White Paper. This and the expected overspend on current, taken together, are projected to use up almost all of the current year's Reserve.

5. While an overspend on capital is quite normal, the magnitude of this year's figure reflects the forthcoming introduction of the new capital finance system for local authorities. Authorities will be obliged on 1 April next year to 'set aside for credit liabilities' (that is, debt redemption or substitution for new borrowing at some future time), and hence not to spend, large proportions of their accumulated cash-backed capital receipts (75 per cent for housing receipts and 50 per cent for other receipts). Most authorities like spending more than debt repayment. Hence they have a perverse incentive to spend every penny they can this year, before the 1 April day of judgment, and to time payments and prepare accounts so as to minimise their obligation to set sums aside.

6. You and the former Chief Secretary have both argued since March (and before) that the correct solution is to remove the perverse incentive described above by making the set-aside requirement an 'either/or' formula under which local authorities would be obliged on 1 April next year to set aside whichever is the greater of:

a. 50 per cent of non-housing and 75 per cent of housing cash-backed capital receipts on 1 April 1990, and

b. x per cent of non-housing and y per cent of housing cash-backed capital receipts on 1 April 1989,

where x and y would be somewhat lower than 50 per cent and 70 per cent, respectively. This formula would be incorporated in an Order. No amendment to primary legislation would be necessary,.

7. It would clearly have been better to announce this formula soon after the beginning of this financial year (so that authorities would not have had time to frustrate the Government's intentions by overspending last year but would have had maximum time to adjust this year) - even though full budget figures for the current year were not available until July. Introducing the formula now, well after the main plans for the year have been laid, will be much less effective. It could however still have some effect, from two points of view:

i. spending this year: the scope for varying capital expenditure in-year is greater than is sometimes suggested, especially on small projects of low priority and on the timing of inception and rate of progress of larger projects; and

ii. creative accounting: local authorities appear to have scope for paying bills sooner rather than later and for classifying as capital rather than current expenditure large amounts of road maintenance expenditure (perhaps £½ billion in the current year), thus reducing their obligation to set sums aside for credit liabilities at 1 April.

Background : financial assets

8. The other problem relates to the size of the financial assets which local authorities have built up over the last two to three years. We estimate that at end-March 1989 local authorities in England held some £8 billion of short term assets, equivalent to about 20 per cent of annual revenues and a slightly lower percentage of outstanding borrowing. These holdings could rise by up to £1 billion this year as a result of in-year inflows of capital receipts.

9. We have had two main concerns about this liquidity. First, there are prudential concerns arising from local authorities' financial intermediary role. Second, the large increase in LA holdings of bank deposits has caused problems for money market management, and looks set to do so again in future, at times of seasonal money market surplus, unless the process can be halted or, ideally, put into reverse.

CONFIDENTIAL

10. The high levels of LA deposits and short term financial assets have arisen for two reasons above all - the unexpectedly high inflow of RTB receipts (some £3 billion last year) and the downward sloping yield curve. Because of the latter, local authorities have had no incentive in the short term to use receipts to repay long term debt. It has been more profitable to keep funds on deposit.

11. Mr Ridley agreed in July to introduce into the Local Government and Housing Bill a new provision to the effect that local authorities may not borrow for the purpose of acquiring or retaining financial investments. But he rejected further steps and in particular the idea, revived in your latest letter, of requiring local authorities to repay debt (or substitute for new borrowing) from capital receipts rather than giving them the option of holding sums indefinitely on deposit.

Strategy for meeting

12. It is important to resolve these matters now, or at least to make provision for their early resolution.

13. The best outcome from the Treasury's point of view would be to obtain agreement to:

i. early announcement of the 'either/or' formula so as to restrain in some degree the current year's overspend and the incentive for creative accounting;

ii. amendment of the LGH Bill to require local authorities to use the reserved proportions of their new capital receipts to repay debt or substitute for new borrowing, while reserving considerable discretion to the Secretary of State, rather than put them indefinitely on deposit.

It will however be difficult to win both points - still less, both points plus the safety net argument as well. Hence you will wish to consider priorities.

14. Earlier in the year, the 'either/or' formula on overspending was probably the more important objective from the Treasury's point of view. It would still help to sustain the level of sums set aside for debt repayment next April. And it does not require

primary legislation. With the passage of time, however, its effectiveness in containing spending will inevitably be much reduced, and it is probably also the less attainable of the two objectives. Mr Patten will doubtless resist taking any action on the overspend. He will feel that such a move would be unpopular with local authorities and would now have a certain air of retrospection. He may instead revive Mr Ridley's earlier offer of a statement to the effect that, the more LAs overspend this year, the less they will have available next year. There is very little for us in this.

15. You may well judge that you cannot insist on the 'either/or' formula if (as expected) Mr Patten puts up a stalwart resistance. We suggest however you should at least probe Mr Patten's defences sufficiently to leave him in no doubt how serious a view the Treasury has to take on LA as well as other overspends. Your fallback should be to say that the Treasury will have to compensate for this year's overspend by an exceptionally tough line on credit approvals for next year (though realistically the settlements reached on 1990-91 credit approvals, programme by programme, are not likely to be much affected one way or the other).

16. On financial assets (objective ii.), DOE have convinced us that we cannot realistically insist that local authorities use the 50/75 per cent reserved proportions of the accumulated stock of capital receipts at 1 April next to repay debt. There are two main considerations:

- First, the accumulated capital receipts are a balance sheet entry. Many authorities have used the associated cash long since, notably for internal lending, and the accumulated receipts do not necessarily have any counterpart in deposits or other assets held. Hence local authorities would probably have in many cases to take out new borrowing in order to meet their debt repayment obligations. The net reduction in deposits and financial assets from applying this more stringent requirement to the accumulted stock could well therefore be only a fraction of the total stock.

CONFIDENTIAL

- Second, DOE maintain that applying the more stringent debt repayment requirement to accumulated receipts as well as new receipts would require substantial changes to many clauses throughout the Bill. They are already in deep trouble over the number of amendments to the Bill which they will need to table in the Lords.

17. Against this background, we are clear that the requirement to repay debt/substitute for new borrowing (and not to put sums on deposit) should be applied to future receipts rather than the existing stock. Action to prevent deposit building from future receipts is certainly worth having and is probably more achievable than action on the current year's overspend.* So far as local authorities' existing financial assets are concerned, their behaviour is at least reasonably predictable. They will repay little debt while the yield curve makes this unattractive in the short term and a great deal as soon as a 'normal' yield curve returns.

18. We would hope that Mr Patten might agree to an additional clause along these lines, requiring authorities to repay debt/ substitute for new borrowing from future receipts. If Mr Patten should refuse to budge, however, and you judge that he has good reasons, there are some reasonably respectable fallback positions. Mr Ridley's earlier agreement to introduce a general clause about not borrowing to raise or retain financial assets is helpful. Mr Patten might be invited to consider the possibility of consultations with local authority associations and the Audit Commission with a view to refining codes of practice in this area. We would of course retain the option of returning to the charge on this in later years.

---

*Mr Walker has now written saying that LAs must be allowed freedom to manage their own debt. One might, however, regard the limitation of the proposed change to <u>new</u> receipts as meeting this point, in part at least.

CONFIDENTIAL

19. You will wish to test Mr Patten's defences in both these areas and decide in the light of that what deal to strike. If you should feel it necessary to give Mr Patten much of what he wants on the capital issues, you might be able to take some credit for that in the safety net context. Whether there can be any direct trade-off, however, seems doubtful. The safety net will doubtless be resolved as an issue in its own right, and the Prime Minister's views will clearly be crucial.

Line to take

20. If you are content with the above approach, you may like to draw on the speaking notes attached.

AJCE

A J C EDWARDS

CONFIDENTIAL

ANNEX

LINE TO TAKE

Capital overspend, 1989-90

- Very serious matter. £1.8 billion gross overspend on capital and normal overspend on current threaten between them to use up almost whole of Reserve this year.

- Massive overspend arises largely because local authorities have perverse incentive to undertake all the capital spending they can before end of this year because of requirement to 'set aside' 50/75 per cent of their accumulated cash-backed capital receipts on 1 April next.

- Simple way to remove this incentive: define amounts to be set aside by Order as 50/75 per cent of 1 April 1990 accumulated receipts or x/y per cent of 1 April 1989 receipts, whichever is greater, while reserving to you some discretion over difficult cases.

- Would clearly have been far better to do this earlier, in March or April. But may still be worth doing. LAs have more scope for pacing their capital programmes than usually acknowledged and for making payments as early as possible, thus reducing their set-aside obligations next year.

- Recognise that LAs will dislike. But they are probably surprised we have done nothing about this so far.

Fallback (if necessary)

- [WAY OUT] So be it. But must warn that Treasury will have to compensate for gross overspend this year by exceptionally tough line on credit approvals next year.

CONFIDENTIAL

Financial assets

- Troublesome problems of financial prudence/money market management associated with large increase in local authority holdings of financial assets, especially bank deposits, over past two to three years, to a level of some £8 billion (20 per cent of annual revenues).

- Nick Ridley already agreed to add provision to Bill to effect that a LA may not borrow for purpose of acquiring or retaining financial investments. Useful beginning.

- But problem remains that such a provision will not deal with problem that LAs will tend to add to their deposits in unpredictable ways as large and unpredictable flows of capital receipts come in.

- Fundamental problem is that LGH Bill provides for local authorities with capital receipts to 'set them aside for credit liabilities' rather than apply them straight away to repaying debt or substituting for new borrowing. This will enable LAs to accumulate and retain deposits indefinitely, with fluctuations in line with high and fluctuating levels of receipts.

- Way to deal with this is to add clause to Bill which would make clear that reserved proportions of new capital receipts, after April 1990, must be applied to debt redemption or substitute for new borrowing and not be placed on deposit or in other short term financial assets. Worth tabling an extra clause for this.

- Would have liked to apply same rule to reserved stock of accumulated capital receipts. But accept that accounting/ technical/legal difficulties prevent us from applying same rule to these. LAs' portfolio decisions on existing stock of deposits are anyway more predictable. Will depend above all on yield curve.

Fallback (only if necessary)

- Must go ahead with provision Nick Ridley has already agreed. Please consider whether we can reinforce this by consulting local authority associations and Audit Commission with a view to strengthening codes of practice on financial asset holdings.

chex.jp/jg/5 **CONFIDENTIAL**

PLP

FROM: JOHN GIEVE
DATE: 8 SEPTEMBER 1989

MR A J C EDWARDS (LG)

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr Walsh
Mr Peretz
Miss Noble
Mr Potter
Mr Devereux
Mr Laite
Mrs Chaplin

LOCAL AUTHORITY CAPITAL OVERSPEND AND FINANCIAL ASSETS

The Chancellor and Chief Secretary did not have time to discuss these subjects substantively at their meeting with Mr Patten although the Chancellor emphasised that the issues were important and urgent. It was agreed that Mr Patten should write setting out his views (and he promised a new proposal on at least one of the issues). The matter could then be discussed in the margins of the Environment Bilateral.

JG

JOHN GIEVE

CONFIDENTIAL

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

01-276 3000

My ref:

Your ref :

CH/EXCHEQUER
REC. 13SEP1989
ACTION MR AJC EDWARDS ✓14/9
COPIES TO PS/CST, PS/EST
SIR P MIDDLETON
MR ANSON, SIR T BURNS
MR PHILLIPS, MR SCHOLAR
MR ODLING-SMEE
MR PERETZ, MR PIRIE
MR POTTER, MR DESERELLA
MR LAITE, MS WHELDON - T/SOL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

13 September 1989

Ch/ Much as expected - it's too late to do much beyond Mr Ridley's empty gesture (at end of letter of 21/7). Perhaps all we can do is ask Mr Patten to exhort LAs, pointing out that a capital overspend this year will mean less money available next year. DLS

Dear Chancellor

Thank you for your letter of 27 July about the level of local authority capital expenditure in the current financial year.

That the level of gross local authority capital expenditure is substantially higher in cash terms than had been planned, but that the level of receipts is not, appears to be fact. Whether this is a response to the prospect of compulsory debt-redemption as from 1 April 1990 or whether it represents a desire by local authorities to maintain their capital programmes in volume terms, recent increases in construction prices notwithstanding, are questions which we could debate unprofitably at length. There is anecdotal evidence to support the former view whilst the figures are consistent with the latter. There had been overspends on gross provision of between £0.6 bn and £1.2 bn in each of the last 4 years, so the fact of an overspend this year will hardly have been unexpected; the difference this year is that no countervailing additional receipts are expected.

I would prefer to concentrate on the practicalities of your proposal.

Local authorities will by now largely be committed to their capital programmes for the current financial year. Even where contracts have not been let, expectations will have been aroused. In particular, insofar as capital receipts were to be applied to capitalised maintenance of council housing, the people living in the housing will be looking forward to the resulting improvement in these homes. In consequence, local authorities will in general be under the strongest pressure not to cut back their expenditure this year but rather to suffer the penalties next year, whilst blaming the Government for them. The proposal would thus not be effective in achieving your objective of reducing spending in the current year.

CONFIDENTIAL

CONFIDENTIAL

Some local authorities, however, would have no option but to cancel planned works or even to seek to renegotiate contracts. These are the authorities who, for whatever reason, had receipts at 31 March 1989 but plan to have used them all by 31 March 1990. Some authorities will be in this position for reasons which have nothing to do with the advent of the new capital finance system. It would be necessary to incorporate some form of safety valve to accommodate them. But the operation of a safety valve would provide every scope for challenge.

Even if it had been announced in July, this proposal would constitute retrospective legislation. I would see great difficulty in justifying this in the House of Lords where any amendment would have to be introduced.

The consequences of this proposal for relations between central and local government are not such as to be contemplated. Once again the Government would be seen to be penalising responsible councils for having taken decisions which were perfectly proper and prudent at the time that they were taken. I can think of no arguments that I could deploy to justify penalising Conservative councils who, for whatever reason, had reduced their receipts during 1989-90 whilst doing nothing about Labour councils whose practice has been to use all their receipts as soon as they are realised. The Consultative Council in September would certainly not be a suitable forum.

My conclusion is that it is now too late to reopen the decision that were taken collectively before the Local Government and Housing Bill was introduced and that the remedy you propose would be unlikely substantially to reduce expenditure in the current year but would add significantly to the problems we face in our relations with local government. I hope that on reconsideration you will not wish to press your proposal. I remain ready to take the steps proposed by Nicholas Ridley in his letter of 21 July.

I am sending copies of this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler, and First Parliamentary Counsel.

Yours sincerely

R Bright

pp CHRIS PATTEN

(approved by the Secretary of State and signed in his absence)

CONFIDENTIAL

CONFIDENTIAL

CH/EXCHEQUER	
REC.	13 SEP 1989
ACTION	MR AJC EDWARDS ✓14/9
COPIES TO	PS/CST, PS/EST SIR P MIDDLETON MR ANSON, SIR T BURNS MR PHILLIPS, MR SCHOLAR MR ODLING-SMEE MR PERETZ, MR PIRIE MR POTTER, MR DEVEREUX MR LAITE, MS WHELDON - T/Sol

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

I await advice. This Bill has run into serious Parly problems (not our fault) and would be v. diff to further amend [illegible] grave. If there is legislative change [illegible] should be by Order, [illegible] this matter.

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

13 September 1989

Ch/ Mr Patten's code of practice may be the best we can do, but we ought certainly to remind him that Mr Ridley agreed in principle that the Bill should include a power to bar LAs from borrowing expressly to acquire financial assets.

See also Mr Patten's other letter, behind.

DIS

Dear Chancellor

LOCAL AUTHORITY FINANCIAL ASSETS

Thank you for your letter of 29 August about local authority financial assets. I have also seen your earlier exchange of letters with Nicholas Ridley.

Like Nicholas, I find it easier to agree that there is a problem and that something needs to be done than to sign up to the solution which your officials have proposed.

Our starting point must be last Summer's consultation paper on local authority capital expenditure and finance. That paper, which was agreed by all the departments concerned, including the Treasury, set out our diagnosis of the problems and our proposed solution. That solution was a control on net indebtedness. It was made quite clear that capital receipts set aside as provision for credit liabilities would not have to be applied immediately to the redemption of debt. It is a point on which many local authorities have sought specific confirmation. During proceedings on the Bill in Parliament, both John Gummer and Malcolm Caithness made clear that the reserved part of capital receipts had to be set aside but did not have to be used to pay off debts prematurely. Rightly or wrongly, the Government's stated policy is a policy based on controlling net indebtedness.

That is not to say that we should not change the policy, but if we do so we should do it in a proper manner by setting out our proposals, and the reasons for them, and indicating our willingness to consider representations before giving effect to changes. Otherwise, the Government will once again be laying itself open to accusations of bad faith, reduction of local discretion, and so on. Such accusations would be particularly hard to rebut because, as far as the informed public is concerned, there is no perception that there is a problem. Nothing has happened since the Bill was published in February which we could point to as justification for what would be seen as a significant change in policy. Furthermore,

CONFIDENTIAL

I understand that the Public Works Loan Board's view is that there is no evidence that local authorities have in the last 18 months been borrowing for the purpose of building up their investments. I also understand that officials have examined the returns submitted by individual authorities and established that with only a very few apparent exceptions the investments of individual authorities are less than their revenue and capital balances and their usable capital receipts. Thus the investments preponderantly represent temporarily surplus funds.

I have to say in any case that, regardless of the policy considerations, I would be very reluctant to make legislative changes at this stage of the Bill.

I am already extremely concerned about the number of amendments I have before me for Lords Report. The Business Managers are pressing me to minimise them, and I have every sympathy with them. We must have regard to the number of amendments to be considered by the Commons on a Bill which is not guillotined and will not return from the Lords until the beginning of November. In any case, I should in general like to resist the growing tendency to introduce important new material at a late stage. Since the changes would be fundamental, we should be laying ourselves open to the accusation that we really do not know what policy we want and there must be a very considerable danger that we should produce defective legislation. That is precisely what Part IV is designed to replace.

The proposals you have put forward would require substantial redrafting of the Bill, since Part IV is designed as an integrated system based on control of net indebtedness. That applies equally to your suggestion of an enabling power. To make changes radically altering a foundation stone of the Part at this late stage seems to me most unwise. My officials will be happy to discuss further with yours the technicalities involved.

I conclude that we need to consider alternative means to meet your concerns.

There is a precedent.

In the early 1970's, there was concern that local authorities were borrowing short term to finance their capital programmes and were vulnerable to interest rate movements. I am told that they were warned of the possibility of amendments to the Control of Borrowing Order and as a result agreed to negotiate a code of practice on maturity periods which has subsequently led to a steady increase in the average term of their borrowings.

I suggest that the Chief Secretary and I should jointly put a paper to Consultative Council on Local Government Finance which would:-

a. draw attention to the growth in local authority investments in recent years;

b. refer to the problems that are being caused for money market management and to the risks inherent in unmatched assets and liabilities;

c. point out that although the new capital finance system is intended to allow local authorities flexibility to manage their cash sensibly, the Government would in normal circumstances not expect individual authorities' investments to be more than their spendable revenue and capital reserves on a long term basis;

d. refer to the precedent of the code of practice on maturity periods for dealing with a not totally dissimilar problem;

e. propose discussions between officials and officers to draw up a statement of objectives or code of practice which would bring about an acceptable level of investments;

f. express the hope that such a statement or code would make it unnecessary for the Government to take legislative action.

Such a paper would also take credit for the change in the terms on which PWLB loans can be repaid, which I understand is to be announced shortly.

I realise you would prefer a legislative solution. But I hope you will understand the very real presentational and legislative difficulties I have outlined and can agree that the approach I have proposed is the best way forward at this stage.

Copies of this letter go to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

Yours sincerely

R Bright

pp CHRIS PATTEN

(approved by the Secretary of State and signed in his absence).

FROM: D I SPARKES
DATE: 15 SEPTEMBER 1989

MR A J C EDWARDS

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr Walsh
Mr Peretz
Miss Noble
Mr Potter
Mr Devereux
Mr Laite
Mrs Chaplin

BF ~~20~~ 27/9

LOCAL AUTHORITY CAPITAL OVERSPEND AND FINANCIAL ASSETS

The Chancellor has seen Mr Patten's two letters dated 13 September on which he awaits advice. He commented that the Local Government and Housing Bill has now become a major Parliamentary problem (not our fault) as a result of which further amendments will be very difficult to secure. If there is any legislative change that could be secured by Order, that would be a different matter.

D.I.S.

DUNCAN SPARKES

lg.ph/AE/417

CONFIDENTIAL

CHIEF SECRETARY

FROM : A J C EDWARDS (LG)
x4480
21 September 1989

cc Chancellor o/r
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Walsh
Miss Noble
Mr Potter
Mr Devereux
Mr Laite
Mrs Chaplin

LOCAL AUTHORITY CAPITAL OVERSPEND AND FINANCIAL ASSETS

As time runs out for amendments to the Local Government and Housing Bill, an early reply is needed to Mr Patten's letter of 13 September in response to the Chancellor's letters of 27 July and 29 August.

2. The Chancellor underlined to Mr Patten earlier this month the serious view the Treasury took of the problems of LAs' capital overspend this year and their financial assets mountain. In subsequent discussion with us, the Chancellor confirmed that he accepted it was too late to deal with the former problem this year by changing the rules on accumulated capital receipts to be set aside for debt redemption next April.

3. The Chancellor also noted the problem which the business managers face as a result of the enormous number of proposed Government amendments to the Local Government and Housing Bill and asked us to keep in close touch with the exercise for pruning the list of amendments. This we are doing.

4. We have delayed submitting advice on Mr Patten's letters partly to see whether we could reach an understanding with DOE officials about the best way ahead but also because of a new development. Having taken further legal advice, DOE now say that Mr Patten will have to withdraw Mr Ridley's earlier offer to include a provision in the Bill to the effect that local authorities may not borrow for the purposes of adding to or

CONFIDENTIAL

retaining financial investments. What would be practicable, they believe, is to make statutory provision for the Secretary of State to issue codes of practice about local authority borrowing and financial assets.

5. In the light of this, DOE officials have agreed informally that, in response to a request from Treasury Ministers, they would be prepared to commend to Mr Patten a package on the following lines:

i. on financial assets, they would insert a short provision in the Bill enabling the Secretary of State to promulgate codes of practice on local authority borrowing and financial assets. Such codes would not be enforceable through penalties but would give authorities and their auditors clear guidance on acceptable levels of financial asset holdings which would be extremely difficult, if not impossible, to lay down in regulations; and

ii. on the capital overspend in the current year, the Secretary of State would take an early opportunity (possibly at the forthcoming Consultative Council meeting followed by a letter to local authorities) to remind authorities that they will not receive more credit approvals next year if they spend heavily from receipts this year and that authorities which overspend their prescribed expenditure limits in the current year will have corresponding deductions made from their credit approvals next year.

6. This package seems to us to provide as good a way ahead as is practicable in the circumstances. If you are content, therefore, I suggest that you should reply on the Chancellor's behalf to Mr Patten along the lines of the attached draft.

AJCE

A J C EDWARDS

lg.ph/AE/416

CONFIDENTIAL

DRAFT LETTER FROM THE CHIEF SECRETARY TO:

Rt Hon Christopher Patten MP

LOCAL AUTHORITY FINANCIAL ASSETS AND CAPITAL OVERSPEND

In the Chancellor's absence I am replying to your two letters of 13 September. I have also seen Peter Walker's letter of 31 August.

On financial assets, I understand that there has been a further development since you wrote. Your officials have told mine that, after further consideration and discussion with the lawyers, they do not now think it will be practicable to include in the Bill a simple amendment along the lines envisaged in Nick Ridley's letter of 21 July to the effect that a local authority may not borrow for the purpose of acquiring or retaining financial investments. What they would see as practicable, with minimum amendment to the Bill, would be to insert a simple provision empowering you to promulgate codes of practice governing local authority borrowing and financial assets. This would enable you, after consultation with the local authority associations and others concerned, to issue a code of practice for the guidance of local authorities and their auditors which would provide that local authorities -

a. should not hold approved investments in excess of their usable capital receipts, provision for credit liabilities and need for financial reserves, and

b. should apply sums set aside for credit liabilities to debt repayment or substitution for external borrowing in as short a period as is reasonable.

CONFIDENTIAL

This approach seems to me to offer the best available way at this stage of dealing with what has been a troublesome problem from the standpoint of money market management, with minimum disturbance to the Bill, and I suggest we should proceed accordingly.

On the capital overspend in the current year, our concerns are in no way diminished. I understand, however, that the legal advice is that further amendment of the Bill would be required to remove the perverse incentives to spend before the end of March, and the Chancellor and I both appreciate the difficulties of announcing such a change now that so much of the year has elapsed.

I agree, therefore, that the best way ahead will be to proceed in accordance with the spirit of Nick Ridley's 21 July letter and the penultimate paragraph of your own 13 September letter. You would take an early opportunity to remind local authorities that, although the allocation of credit approvals between authorities will in general take account of receipts available to them, individual authorities will not receive more credit approvals next year if they spend heavily from receipts this year. Moreover, as provided in schedule 3, part 1 of the Bill, individual authorities which overspend their prescribed expenditure limits in the current year will have corresponding deductions made from their credit approvals next year.

I am copying this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

CONFIDENTIAL

LORD PRESIDENT OF THE COUNCIL

CH/EXCHEQUER

REC. 25SEP1989

ACTION MR AJC EDWARDS ✓28/9

COPIES TO PS/CST, PS/EST
SIR P MIDDLETON
MR ANSON, SIR T BURNS
MR PHILLIPS, MR SCHOLAR
MR ODLING-SMEE
MR PERETZ, MR PIRIE
MR POTTER, MR DEVEREUX
MR LAITE, MS WHEELDON - T/Sol

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

25 September 1989

Dear Nigel

LOCAL AUTHORITY FINANCIAL ASSETS

I have seen the recent correspondence between you and Chris Patten about local authority financial assets, and the question whether the relevant provisions of the Local Government and Housing Bill should be amended.

Although I would not wish to comment on the substance of the policy arguments, I must endorse very strongly Chris's comments about adding to the number of amendments which remain to be made to the Bill. He is already engaged in a process of pruning which will lead to the postponement of a number of desirable amendments to the Bill. Part IV had its Committee Stage in the Lords before the Recess. To make fundamental changes to any provision at Lords Report stage is in principle undesirable. A major revision of the capital provisions would, in the circumstances, significantly increase our already grave difficulties in completing the Bill and this Session's programme on time.

I am copying this letter to Chris Patten, Peter Walker, John Belstead, Sir Robin Butler and First Parliamentary Counsel.

Yours ever
Geoffrey

GEOFFREY HOWE

The Rt Hon Nigel Lawson MP

CONFIDENTIAL

cst.ps/6n125.9/lets

CONFIDENTIAL

Ch/ To note that in your absence CST has replied to Mr Patten as advised by Mr Edwards in submission behind.
DIS

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street SW1P

cc:
Chancellor
Sir Peter Middleton
Mr Anson
Mr Phillips
Mr A J C Edwards
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Walsh
Miss Noble
Mr Potter
Mr Devereux
Mr Laite
Mrs Chaplin

The Rt Hon Christopher Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London
SW1P 3EB

PMP

26 September 1989

Dear Secretary of State

LOCAL AUTHORITY FINANCIAL ASSETS AND CAPITAL OVERSPEND

In the Chancellor's absence I am replying to your two letters of 13 September. I have also seen Peter Walker's letter of 31 August.

On financial assets, I understand that there has been a further development since you wrote. Your officials have told mine that, after further consideration and discussion with the lawyers, they do not now think it will be practicable to include in the Bill a simple amendment along the lines envisaged in Nick Ridley's letter of 21 July to the effect that a local authority may not borrow for the purpose of acquiring or retaining financial investments. What they would see as practicable, with minimum amendment to the Bill, would be to insert a simple provision empowering you to promulgate codes of practice governing local authority borrowing and financial assets. This would enable you, after consultation with the local authority associations and others concerned, to issue a code of practice for the guidance of local authorities and their auditors which would provide that local authorities -

a. should not hold approved investments in excess of their usual capital receipts, provision for credit liabilities and need for financial reserves, and

b. should apply sums set aside for credit liabilities to debt repayment or substitution for external borrowing in as short a period as is reasonable.

This approach seems to me to offer the best available way at this stage of dealing with what has been a troublesome problem from the standpoint of money market managements, with minimum disturbance to the Bill, and I suggest we should proceed accordingly.

On the capital overspend in the current year, our concerns are in no way diminished. I understand, however, that the legal advice is that further amendment of the Bill would be required to remove the perverse incentives to spend before the end of March, and the Chancellor and I both appreciate the difficulties of announcing such a change now that so much of the year has elapsed.

I agree, therefore, that the best way ahead will be to proceed in accordance with the spirit of Nick Ridley's 21 July letter and the penultimate paragraph of your own 13 September letter. You would take an early opportunity to remind local authorities that, although the allocation of credit approvals between authorities will in general take account of receipts available to them, individual authorities will not receive more credit approvals next year if they spend heavily from receipts this year. Moreover, as provided in schedule 3 part 1 of the Bill, individual authorities which overspend their prescribed expenditure limits in the current year will have corresponding deductions made from their credit approvals next year.

I am copying this letter to Geoffrey Howe, Peter Walker, John Belstead, Sir Robin Butler, and First Parliamentary Counsel.

Yours sincerely

Carys Evans

NORMAN LAMONT

approved by the Chief Secretary and signed in his absence mp

Bank of England
London EC2R 8AH

The Governor

Copies to The Chancellor of the Exchequer
The Secretary of State for the Environment

18 October 1989

CH/EXCHEQUER
REC. 19 OCT 1989
ACTION MR SCHOLAR 19/10
COPIES TO CST, FST, PMG, EST
SIR P MIDDLETON, MR ANSON
MR WICKS, MR PHILLIPS
MR A J C EDWARDS, MR WALSH
MR PERETZ, MR GRICE, MR PIRIE
MR POTTER, MR DEVEREUX
MR LAITE, MRS CHAPLIN, MR TYRIE
MR LIGHTFOOT, MS WHELDON - T.SOL

P J Wrangham Esq
Chairman
The British Overseas and Commonwealth Banks Association
99 Bishopsgate
London
EC2P 2LA

Dear Mr. Wrangham,

LOCAL AUTHORITY SWAP AND RELATED TRANSACTIONS

Thank you for your letter of 11 October expressing the concerns of the British Overseas and Commonwealth Banks Association about the local authority swaps affair.

You will understand that it is not within the Bank's power to effect a solution to the current situation. It is for the courts to issue a definitive legal interpretation of the present statutory powers for local authorities to undertake off-balance sheet transactions; and it is for Government to determine whether that interpretation coincides with its policy intentions.

I am however conscious of the potential ramifications of the affair and in particular the intangible but nevertheless real damage which might be caused to London's reputation as an international finance centre. As a result we have made appropriate representations to Government, urging that action be taken to allow payments to be resumed on existing contracts entered into in good faith by both sides. The ability of local authorities to engage in further such contracts in future is a rather different question, and one which officials are currently considering.

I have noted your reference to building societies and suggest that the best course would be for you to pursue your points directly with the Building Societies Commission.

I am copying your letter and this reply to the Chancellor of the Exchequer and the Secretary of State for the Environment.

Yours sincerely,

R. Leigh-Pemberton

THE BRITISH OVERSEAS AND COMMONWEALTH BANKS ASSOCIATION

HON. SECRETARY & TREASURER
K. H. G. Coales
The Hongkong and Shanghai Banking Corporation
Telephone: 01-638 2366

99 BISHOPSGATE
LONDON EC2P 2LA

11 October 1989

Rt. Hon. Robin Leigh-Pemberton,
Governor,
The Bank of England,
Threadneedle Street,
LONDON EC2R 8AH.

Dear Governor.

LOCAL AUTHORITIES

I have been asked by our Committee to write to you expressing our concerns regarding the alleged ultra vires dealings of certain Local Authorities. Irrespective of the outcome of the Hammersmith and Fulham court case, action should be taken to rectify the current situation in order for member banks of our Association to undertake interest rate swaps and other transactions with Authorities in the full knowledge that dealings will be legally binding on both sides. The problems resulting from the swap transactions of Local Authorities have led to serious questions as to whether swaps and other position covering transactions undertaken by Building Societies and other Mutual Societies are intra vires; this has led to some banks no longer wishing to deal with these institutions.

Treasurers in Local Authorities are given wide discretion in the day-to-day financing of council services and long term borrowing, although under S.19(1) of the 1982 Local Government Finance Act they are effectively personally liable should they stray beyond rather undefined boundaries. Given the numbers involved, of course, this clause is rather meaningless. While S114 of the 1988 Local Government Finance Act has attempted to restrict creative accounting by Authorities, such book-keeping creativity is often a matter of opinion. Local Authorities have traditionally been regarded by banks as undoubted counterparties and credit risks; indeed it is less than a year ago that the Bank of England issued a notice regarding the implementation of the Basle Agreement under which Local Authorities' on-balance-sheet risk weighting was advised to be 20% (or indeed only 10% if eligible local authority bills are used as security for loans to discount houses).

Since swaps and most other capital market products tend to be somewhat instantaneous transactions, it is impossible for bank counterparties to know whether the swaps they are entering into with Local Authorities are in any way speculative rather than position covering and therefore we have now reached an impasse in that bank counterparties can no longer enter into transactions with Local Authorities for fear of them in any way being declared ultra vires. It must be remembered, however, that swaps are used in financial markets as excellent instruments for companies and Local Authorities to hedge their exposure to movements in interest rates and to help to reduce risk and the current situation not only leaves banks without direction for knowing whether or not they can deal with Authorities but also prevents Authorities being able properly to cover positions that arise in the normal course of their business; not taking cover for a position can in itself of course be regarded as taking an exposure.

The dilemma facing banks in respect of Local Authorities had led to problems for transactions with building societies and other entities not falling under the Companies Act, despite the fact that Societies are governed by tight regulations of their own and closely overseen by the Building Societies Commission, who believe they would spot any speculative and ultra vires dealing any society would make. Nevertheless, there is no question that should a society have acted ultra vires this would only be spotted after the event, when they would probably be unable to honour the obligation if they wanted to. Although we understand no new building society legislation is due for five or six years, there is obviously a genuine need for the legality of transactions with them to be defined before then so that societies and banks can undertake deals without concern of any legal risk.

Whatever the outcome of the current Hammersmith and Fulham court case, it appears that legislation will be required to amend the present state of affairs. If the decision is that the transactions are intra vires, the Government will undoubtedly wish legislation to prevent Local Authorities continuing in engaging in such transactions, while an ultra vires decision will require legislation to allow repayment by the Authorities if their undoubted credit status is to be maintained. Non-payment will, no doubt, lead to an extremely costly and unnecessary exercise for accountants to stipulate which transactions are intra and which ultra-vires. Additionally an ultra vires decision will almost inevitably result in banks suing Authorities for default, which in turn would trigger default in all their other borrowings.

It is obvious that a default by an Authority will affect most adversly a large number of entities that wish London to remain the leading financial centre of the world. As the leading financial centre, it is here that new financial products are first developed, thus for swaps, we should also read options, swaptions, FRAs and other products which can be used for exposure covering or position taking situations. It would appear therefore to be in everyone's interest for a legislative solution to the current impasse we have in respect of Local Authorities (and building societies and mutual societies) erasing any thoughts that such entities could not honour their contractual obligations.

As we have now reached the stage that payments by the Authority concerned can only occur with the permission of the Secretary of State for the Environment, I have sent a similar letter to him so that he realises the very deep concern of this Association to the current situation, the required solution and the adverse impact on London as a financial centre should the present problems not be resolved quickly.

We appreciate that you will have received many similar letters and that you will be fully aware of the concerns we have expressed. These are however very real and any assistance which you personally can give in helping to achieve a correct and equitable solution to the problem will, we believe, be of considerable value to the Banking industry and indeed the entire financial sector in the United Kingdom.

Yours sincerely,

P. J. WRANGHAM
CHAIRMAN