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LIVERPOOL AND LOCAL AUTHORITY CREDITWORTHINESS

Note by HF

An earlier note by HF (submitted with Mr Culpin's submission of 28 February) described the likely effect on the creditworthiness of local authorities generally if Liverpool defaults on its debt. This note offers an updated assessment and considers in greater detail the options available to Ministers. The note takes into account discussions at a meeting we held yesterday - at their request - with Maurice Stonefrost, Chairman of the local government side of the Local Authority Borrowing Committee and Noel Hepworth, the President of CIPFA. The Bank and DOE were also present.

Background

2. Alone amongst local authorities, Liverpool has so far made no rate for 1984/85. The Council should have set a rate sufficient to balance the budget in the light of other income by the end of March. Instead, it attempted to adopt an unbalanced, and therefore illegal, budget. However, defections from the Labour camp resulted in this proposal being blocked.

3. The Council are to discuss the budget again on 25 April, but it is probable that no decisions will be taken. Most probably, decisions will now be deferred until after the local elections on 3 May. It is likely that Labour will be re-elected with an increased majority, and that an unbalanced budget could be adopted by the Council by mid-May. If so, an immediate challenge is likely in the courts, leading to the rate probably being declared illegal in June.

Liverpool's own debts

4. Liverpool's outstanding debt amounts to about £700 million (2 per cent of total local authority debt), of which £384 million is debt due to the PWLB; the rest, just over £300 million, is due to the private sector. Of the latter, about £210 million is owed to financial institutions, mainly banks. As much as £150 million of private sector debt may be subject to cross default, so that it

could be withdrawn immediately if Liverpool defaulted on another lender. About £90 million is short maturity borrowing.

5. £130 million of existing debt has to be refinanced by early June. This includes a £10 million stock redemtption and £5 million repayable to the PWLB on 15 May.

6. As far as we can tell, the market is no longer lending to Liverpool. This could be because Liverpool is not actively trying to borrow and thus is avoiding testing the market; but it seems more probable that, if they were to try to do so now, they would not succeeed - at least not until there is a reasonable expection of a legal budget.

7. Liverpool still does have access to PWLB funds - for example, during the last week on the advice of the Treasury Solicitor the PWLB have approved two loans of £6 million; and the National Debt Office and the Bank of England are possible sources of temporary funds. By also running down their reserves, it might thus be possible for Liverpool to carry on meeting its debts for a while. But the availability of public sector funds also depends crucially on whether Liverpool adopts a legal budget. If it does not very soon after the 3 May election, continued PWLB and other public sector lending will be ruled out on grounds of legality/propriety - quite apart from any other considerations.

8. Thus, if Liverpool makes an illegal rate or fails to make a rate, it will almost certainly default on its debts. If this happens, creditors will have recourse to the courts. DOE's legal advice is that creditors would have a first charge on Liverpool's revenues, including RSG if that continued to be paid - as we think, on legal grounds, it would have to be. But it is highly uncertain how quickly the creditors would be paid out. Until or unless commissioners were sent in, Liverpool would presumably refuse to pay up and the creditors would then attempt to attach Liverpool's assets. That would be a very unattractive prospect. Even after commissioners arrived, it might take a little time for claims to be settled.

9. Precisely when Liverpool would default is uncertain: it could be very shortly after they make an illegal rate; it could be later in the summer if they are able to draw down reserves etc.

Wider effects of default

10. Mr Stonefrost and Mr Hepworth both emphasised the damage which would be done to the credit standing of local authorities generally if Liverpool default.

11. In the short run, they argued, some authorities would probably be unable to borrow at all - particularly those likely to be on DOE's rate capping list. Interest rates for all authorities would almost certainly rise at least temporarily. Over the longer term, there would be a tiering of rates, which would raise the average cost of local authority borrowing even if "best" authorities were able to borrow at fine rates once again. And by making local authority borrowing "non-homogeneous", this would change the whole nature of the market. Because of the need for individual credit assessments and in some cases possibly enhanced security, the process of borrowing would become much more complicated and less efficient. Mr Stonefrost said it would take years for the market to get over a default, and that the change in the nature of the market would probably be irreversible.

12. But he also spoke strongly against HMG artificially propping up Liverpool by lending in support of revenue expenditure. The structure of local authority credit depended upon the clear legal duty of authorities to set a proper rate. If one authority was artificially sustained, others might be enticed to follow Liverpool's example; and this would cause great uncertainty in the market.

13. HF and the Bank broadly agree with this assessment. There are in addition some further points:

(i) the Government's credit standing, and hence gilts rates, might be affected in the short run by a Liverpool default - particularly if there was uncertainty about whether commissioners would be sent in.

(ii) Borrowing by local authorities from the non bank private sector in the form of yearling bonds and other short term paper could - at least in the short term - be at risk. If this market dried up altogether for say a month, we might need to sell up to £1 billion more Central Government debt to keep £M3 on track. This is against the background of a short term monetary prospect that already looks uncomfortable, because of heavy front end loading of the PSBR.

(iii) A switch in local authorities borrowing from banks to Central Government would not affect £M3 but it would add to money market surpluses over the next few months. This would enable the Bank to run off its holdings of bills more rapidly. With the bill mountain now at over £12 billion, this would, in principle, be positively helpful. But excessive surpluses could cause problems for market management, especially if we needed to raise short term interest rates for general monetary reasons.

(iv) We would not want local authorities to become entirely dependent upon the PWLB - and nor would they - because of the greater flexibility of bank borrowing, and because at some point in the future we might want the banks to play a bigger role at the expense of PWLB financing.

(iv) tiering of rates might look attractive insofaras it might bring greater pressure to bear on high-spending authorities. But the disadvantages - particularly the higher average cost of local authority borrowing - in our view significantly outweighs this.

14. It is not possible to quantify the effects outlined above. But we believe they would be serious and that action should, if possible, be taken to minimise them or to prevent Liverpool's default in the first place.

Possible courses of action

15. There appear to be 3 principal options:

(i) make a general statement seeking to distance Liverpool from all other local authorities who have behaved properly and to whom the PWLB stands ready to lend and clarifying again the legal position of creditors.

(ii) announce at an appropriate time the intention to legislate and send in commissioners.

(iii) legislate to protect Liverpool's creditors.

Any one of these might be coupled with the announcement of a new short term PWLB facility, which would be designed to strengthen the market's perception of the PWLB as "lender of last resort" and thus provide additional comfort to creditors. (At present, PWLB loans are available for a minimum maturity of 3 years. The idea, which we are exploring with the PWLB and the Bank, would be to offer temporarily a 3-month facility).

16 Option (i). This is the minimalist "hands off" approach, which would enable the Government to stand back from Liverpool as long as possible. The purpose would be to put a "ring fence" around Liverpool.

17. A general statement of the kind proposed - a Treasury/DOE draft is attached - might help to steady the market if it deteriorated in advance of Liverpool declaring an illegal budget. But we should not count on this working. And once Liverpool defaults, it seems extremely unlikely that a general statement - even if accompanied by a short term PWLB facility - would prevent the worst effects outlined in the previous section from occurring. It would become all too clear that Liverpool's creditors' only recourse would be to the courts - with all the uncertainties that that would involve; and there would be little to mitigate the fact that for the first time a local authority had intentionally defaulted.

18. Option (ii). As soon as commissioners are appointed there would be no risk of default - though there might be a short delay in meeting payments while they made the necessary budget decisions. In terms of Liverpool's creditors and the market more generally, the ideal solution would be for commissioner legislation to be announced as soon as there is a serious deterioration in the LA market - ie if necessary, before the Council makes its budget. The introduction of legislation would be conditional on the rate being found illegal by the court. In practice, even if legislation were quickly introduced, the commissioners could not actually be appointed - because of the way the legislation is drafted as approved by L Committee - until the breakdown of services or until Liverpool fails to meet its obligations. This might still leave a short interregnum before creditors received their money. But provided it was made absolutely clear that:

(i) legislation would be quickly introduced,

(ii) there was a strong expectation that before long commissioners would be going in,

(iii) the commissioners would ensure early payment of any debt arrears,

then we believe that should be sufficient to largely prevent the "ripple" effects from occurring.

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19. The main disadvantage of this approach is that the Government might have to announce the legislation, albeit conditionally, considerably earlier than hitherto thought desirable on other grounds. Holding off accentuates pressure on the Council to act responsibly. Too early an announcement gives the extremists the chance to seize martyrdom. If it was thought politically impossible to make such an announcement before the Council's budget-making, then a fallback in the event of the market deteriorating in advance would be to make a general statement (ie option (i)) to be followed by option (ii) later.

20. The above assumes that Liverpool makes some kind of budget. The announcement about commissioner legislation would presumably have to say that, if they failed to make any budget at all by say the end of May, legislation would then be introduced.

21. Option (iii). This could take one of two forms. HMG could take over Liverpool's debt - ie debt incurred up to the date of an illegal budget; or we could hypothecate Liverpool's RSG so that it would be used first of all to meet Liverpool's debts. Both would require legislation. Unless in the form of a general power (which other authorities would find highly objectionable), the legislation would be hybrid and therefore might take considerable time to enact.

22. Taking over Liverpool's debts looks very unattractive. The creditors would be paid out and this might steady the LA market. But it would look like a victory for Liverpool's high-spending and a major concession by government. It would presumably add to public expenditure, and when the implication that the Government might possibly do the same for other local authorities had sunk in, this would undermine one of the foundations of the local authority market (ie the point made by Mr Stonefrost) and be highly damaging for the Government's credibility.

23. DOE are giving further consideration to the idea of hypothecating RSG. At first sight, this looks quite attractive. But

there are at least two objections:

(i) there might be administrative problems; there would also be delay until the legislation was enacted.

(ii) more importantly, while the creditors might be protected, Liverpool would almost certainly still be making an illegal budget: with a lower RSG, after hypothecation, the chances of an illegal budget might be that much greater. So commissioner legislation would sooner or later also be necessary. The prospect of two pieces of legislation directed against Liverpool seems sufficient to rule this option out.

Conclusion

24. Liverpool now seems likely to set an illegal budget - or possibly no budget at all. In that case, new lending to Liverpool will wholly dry up and Liverpool will almost certainly default on its debts. That would be very damaging for the local authority market generally, and could well have adverse monetary implications, especially in the short-run.

25. The immediate announcement of commissioner legislation as soon as there is a serious deterioration in the LA market would seem the best option available. This would ensure that Liverpool's creditors are paid out, and although any delay in appointing commissioners might be a slight cause for concern, the wider effects of an illegal budget should be largely contained.

26. If the market deteriorates before there is an illegal budget, and if it is not thought feasible to announce commissioner legislation before there is such a budget, then a general statement on the lines of option (i), followed by an announcement about commissioner legislation later, would be worth having.

DRAFT STATEMENT ON CREDITWORTHINESS (LIVERPOOL)

Local authorities have always enjoyed a very high credit standing, for the practical reasons that the financial viability of authorities is secured at every turn. First, strict requirements of good housekeeping are enjoined on them by law: to borrow prudently and within limits; to make adequate provision for the servicing of debts; to balance their budgets and so on. They may not budget for a deficit and discharge of these legal requirements is scrutinised each year by an independent auditor.

2. Secondly, if in the ordinary course of business a tranche of an authority's long-term debt fell due and it experienced difficulty in refinancing that debt in the market, it can turn to the Public Works Loan Board with its range of facilities, not least the capacity to operate as lender of last resort.

3. Third, if despite these safeguards an authority found itself without adequate funds to cover all its liabilities, then all loans - principal and interest - rank equally ahead of all other liabilities as a charge on the available revenues. But no local authority in Britain has ever been known to default on its market debt and there is no reason for them to start to do so now.

4. What has happened in Liverpool does not alter these safeguards. Liverpool's failure to set a rate at the first attempt is not novel and is not in itself an illegal act. Pending a decision on the rate, Liverpool will have revenue from rents and charges; it will be able to use any balances and investments it may have; and it will continue to receive, as usual, direct financial assistance from the Exchequer in the form of rate support grant and specific grants. In Liverpool's case, rates account for only about ¼ of its gross revenue expenditure. Despite the extremely regrettable failure to set a rate, and the irresponsible proposals from the majority Group to set a rate which would be inadequate and therefore illegal, the City Council has a breathing space in which it can set and begin to collect an adequate rate. Hopefully commonsense will prevail. The Government will continue to monitor the position in Liverpool closely.

5. Meanwhile, lenders to local authorities may be concerned about whether Liverpool's behaviour implies that local authorities generally should not enjoy the same credit rating as at present. Nothing has changed in that respect. Let me stress that every authority in the country other than Liverpool has taken the usual steps to set a sufficient and proper rate for the next financial year at the right time. The safeguards which I have outlined for lenders will apply in the normal way. Liverpool's behaviour should

not adversely affect other authorities. Lenders should not be deterred from their previous practice of placing absolutely confidence in the ability and intention of local authorities to meet payment on debt at the due time.

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