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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

21 February, 1989.

SUBJECT CC MASTER

LOCAL AUTHORITY SWAPS AND OPTIONS: HAMMERSMITH AND FULHAM

The Prime Minister discussed this evening with your Secretary of State and the Chief Secretary the paper attached to your letter to me of today's date.

I should be grateful if you and Carys Evans, to whom I am copying this letter, would ensure that it is seen only by named individuals on a strict need to know.

Your Secretary of State explained that the level of the Council's exposure had arisen from active trading in futures. Some 200 agreements had been entered into, which were now falling due at the rate of one or two each week. He understood that this evening the Director of Finance, having been advised by the auditor that an agreement falling due today was illegal, had reneged on a payment. News of this was likely to come out quickly; in any event, members of the Council were being advised of the position tomorrow.

Continuing, your Secretary of State said that future developments depended on the formal action the auditor decided to take. He faced three options:

- (i) To exercise the new "stop power" to prevent the Council from proceeding with payments falling due under the Agreements.
- (ii) To apply for judicial review.
- (iii) To seek a declaration from the courts that the transactions under the Agreements were illegal.

If either of the last two options were adopted, the position would fall to be settled in the courts. But if the auditor decided to use the swap power, the only body who could appeal to the courts for the power to be removed was the local authority itself, and they were most unlikely to do this. In that case the financial institutions and traders who were the counter-party to the agreements would be likely to start actions for damages.

Your Secretary of State said that he had concluded that it would not be appropriate to take the action open to him under Section 19 of the Local Government Finance Act 1982 (Option 2 in the paper). Any action taken under this section would have the effect of prejudging on whom the financial burden should fall. This would be wrong, and it should be left to the auditor and the courts to resolve the legal position.

The Chief Secretary said that careful consideration had been given to the market implications of the Government delaying any action (Option 4 in the paper). The conclusion was that some disruption would result, but this would be bearable in market management terms, and would be unlikely to spread beyond the swaps and options market. Your Secretary of State added that the Council was in a strong financial position, with balances of some £65 million, and so Option 4 would not precipitate a financial crisis for the Council.

In further discussion it was agreed that another advantage of the Government not intervening at this stage was that all concerned in the financial transactions would be obliged to face up to the consequences of their actions.

Summing up the discussion, the Prime Minister said it was agreed that the Government should take no action at this stage. It would be for consideration whether any subsequent action would be appropriate in the light of the position reached in the courts.

I am copying this letter to Carys Evans (Office of the Chief Secretary, HM Treasury).

Paul Gray

Roger Bright, Esq.,
Department of the Environment.