CC BUP

PRIME MINISTER

LOCAL AUTHORITY SWAPS: HAMMERSMITH AND FULHAM

The Bank of England has been consistently pressing for the Government to take some action to ease the position of the banks who stand to lose as a result of the Court ruling on the Hammersmith and Fulham and other similar cases.

Both Nigel Lawson and the present Chancellor have been unsympathetic to this pressure. They have taken the view, which I think you share, that this is an issue for the courts to resolve; and if, as a result, the banks lose out because they were unwise enough to have entered into transactions now judged to have been illegal then so be it.

The Governor has, however, now sent the Chancellor the further attached letter and, for the first time, copied it to you. You will see he is proposing that the Bank should act as mediator to bring about a financial solution whereby:

- the local authorities should make some ex gratia payment to the banks. What he means, though he does not say it, is that this part of the bill should fall on Community Charge payers;

- the banks should also make a contribution;

- if need be the Bank of England itself would also chip in;

The Governor sees some sort of package of that sort as necessary to uphold the good name of the City.

My impression is that the Chancellor continues to be unimpressed by these arguments, as I assume are you. But the Chancellor will I think want to mention this to you briefly at your bilateral next week.

PAUL GRAY

1 December 1989

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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 6 DECEMBER

I have agreed with the Chancellor's office three main items for tomorrow's agenda:

i) Local Authority SWAPS You did not have a chance over the weekend to see the papers at Flag A. I assume you will want to support the Chancellor in his continuing resistance to the Governor's proposal that the authorities should play a role in bringing about a financial settlement of the Hammersmith and Fulham and related cases.

ii) Bank of England appointments You saw the latest note from the Chancellor about the proposed appointment of Mr. Coleby in last night's box.

Temporarily retained 25/1/16

iii) Markets You will want to have the usual round-up discussion with the Chancellor. Next week we move into the busy period of the month for new economic figures with for example:

- retail sales and producer prices, both for November, on Monday;
- unemployment/earnings and the quarterly balance of payments figures on Thursday;
- the RPI on Friday.

PG.

(PAUL GRAY)

5 December 1989

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cc Policy Unit

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 December 1989

LOCAL AUTHORITY SWAPS

The Prime Minister has now had the opportunity to consider the points raised in the Governor's letter of 28 November to the Chancellor. She considers that this is a matter to be settled by the courts. If the present court judgement is upheld on appeal, she does not consider it would be appropriate to try to arrange a financial solution along the lines set out in the Governor's letter or for the Government to take the measures set out on page 3 of his letter.

I am sending copies of this letter to John Gieve (HM Treasury) and Roger Bright (Department of the Environment).

PAUL GRAY

Paul Tucker, Esq.,
Bank of England.

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

21 December 1989

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

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Dear Robin,

When we met on the 7 December we talked briefly about your letter of 28 November about local authority swaps. You will since have seen Paul Gray's letter recording the Prime Minister's views with which I wholly agree.

I cannot see that it would be sensible for the Bank to get involved in administering the outstanding contracts, far less contributing towards the costs. This is not a mess of the Government's making, far less the Bank of England's, and the losses, though highly unwelcome to the individual banks, cannot possibly be said to represent a systemic risk to the banking system. We have worked hard to get the banking system to understand that they cannot, and must not rely on the Bank of England to bail them out if they get into difficulties; and we have also tried to get the markets to understand that we do not stand behind the local authorities. I cannot see how we could reconcile either of those with your stepping in now.

As I indicated to you, I have less difficulty with your suggestion of a review of existing legislation to see whether anything needs to be done to achieve greater certainty in future for banks dealing with counterparties not covered by Section 35 of the Companies Act or by the Local Government Act, where clarification is now being provided by the courts. As I told you, I doubt if there is major problem - or indeed, any at all of

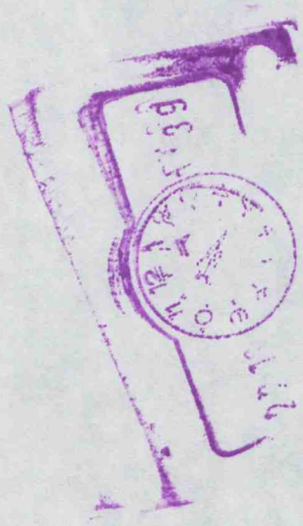
substance - beyond the local authorities. And I am not yet convinced that the solution is necessarily a comprehensive "safe harbour" provision. In some cases it may be better simply to confirm that the body has no need to, and cannot enter into swaps. But I am content for my officials to go through this with yours. My officials will be in touch with yours to discuss, but strictly on a basis of "no commitment". I would not wish these discussions to be made public at this stage, since it may only stimulate wholly unjustified expectations.

Copies of this letter go to the Prime Minister and Chris Patten.

Yours Ever,

John

JOHN MAJOR



Copies to The Prime Minister
The Secretary of State
for the Environment

CC BUP.

Bank of England
London EC2R 8AH

The Governor

28 November 1989

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Dear John,

I regret having to come back to you on the matter of local authority swaps, but I feel I must because the implications of the judgment in the Hammersmith and Fulham case for the City and for the financial system are so serious.

Since we spoke I have received the strongest representations from my central bank colleagues at our last meeting in Basle. More generally, the Bank is coming under increasing pressure to make its views known; and, more immediately, I have received the enclosed letter from Sir Jeremy Morse as President of the British Bankers Association to which I have had to reply by making it clear that I am continuing to urge the Government to review urgently the question of "safe harbour" protection for counterparties in relation to entities not covered by the Companies Act, and by advising that, until this question has been resolved, banks would be unwise to enter into contracts unless they can be sure that those contracts are legally valid and enforceable.

The problem is not simply that the Hammersmith judgment is seen as unjust in that it rewards the authority which has been found to have acted outside the law. The more fundamental problem, as I explained in my letter of 28 June to your predecessor, is the doubt raised about how far a contract entered into in good faith in London can now be relied upon. It is in this sense that the integrity of the City is seen to be impugned even though none of the City institutions involved have been shown to have conducted themselves irresponsibly; indeed they appear to have done all that they could to establish the validity of the contracts by making proper enquiries and relying on legal advice, including the Henderson opinion obtained and circulated by the Audit Commission. Against that background it is the Government's unwillingness to help resolve the situation in the light of this fundamental concern that so astonishes overseas banks and their authorities. We are already aware that some foreign banks operating here have received instruction from their head offices not to engage in any transactions with local authorities or other unincorporated bodies where doubt arises as to their ability to fulfil contractual obligations; and one French bank has approached us for a loan facility to help it to hedge its uncertain exposure to local authorities.

I can understand that it is difficult for the Government to legislate now to legitimise retrospectively the transactions which the Courts have just declared illegal. We have therefore been considering whether there is another possible approach.

One possible alternative, if the judgment is upheld on appeal, would be to try to arrange a financial solution. This might involve the following -

(i) persuading the local authorities involved that, to protect their name, they should agree to pay on an ex-gratia basis a proportion of the cost involved in servicing the outstanding contracts to maturity;

(ii) persuading the bank counterparties to contribute to a solution by accepting reduced servicing on the outstanding contracts.

A shared contribution of this kind by the contracting parties would be seen as a gesture towards upholding the principle of the enforceability of contracts in London. In addition, the Bank could make its own contribution by -

(a) taking over if necessary the administration of the outstanding contracts; and

(b) if necessary, in the last resort if the local authorities and bank counterparties could not come to an agreement which covered the full amounts outstanding, by ourselves contributing something to the settlement.

It is likely in any event to be quite impracticable to reverse all the matured contracts and service payments already made under existing contracts up to the point at which servicing was interrupted, not least because some of the counterparties may no longer exist. These payments would therefore have to be let lie. If the Courts were to insist that they had to be unwound it would presumably be necessary to legislate to clear up the mess.

Any such initiative would have to be blessed by the Government. It would still need to agree -

(1) to sanction by the Secretary of State under Section 19(1) of the Local Government Finance Act 1982, with the effect that neither the Government itself nor the District Auditor would pursue the local authorities or their officers for making or receiving payments under the arrangements;

(2) to undertake to introduce if necessary legislation legitimising the ex-gratia payments (which may be easier than the swap transactions themselves) if those payments were to be challenged in the Courts (for example by chargepayers); and, crucially,

(3) to undertake to review existing legislation (across the board, covering all unincorporated entities such as building societies, friendly societies, mutuals and pension funds as well as local authorities and other public sector bodies) with

the aim of ensuring that any contract entered into in good faith, and covered by a warranty as to its legality, would be enforceable even if it subsequently transpired that the contract was ultra vires.

The Government might present these undertakings as a reflection of its concern that the principle of the sanctity of contracts should be reinforced and that unincorporated bodies, like companies, should be answerable for their actions.

Because of the importance I attach to these issues, I am copying this letter to the Prime Minister and to Chris Patten.

Yours ever,

Robin

Bank of England
London EC2R 8AH

The Governor

21 November 1989

Sir Jeremy Morse
President
British Bankers' Association
10 Lombard Street
London
EC3V 9EL

Dear Jeremy,

Thank you for your letter of 16 November about the implications of the judgment in the case against Hammersmith and Fulham.

I am indeed aware of the concerns which you describe, and I am continuing to press upon the Government the extreme importance of finding a resolution of both the problems the judgment causes in the case of swap transactions with local authorities and of the wider problem of "safe harbour" protection for counterparties in relation to entities not covered by the Companies Act.

In the meantime it cannot be for me to interpret the law, but recent events emphasise that it must be unwise for a bank to enter into a contract where it cannot be sure that that contract is legally valid and consequently enforceable.

Yours ever,

Robin

LOCAL GNT - Rels pr 87

BRITISH BANKERS' ASSOCIATION

10 LOMBARD STREET LONDON EC3V 9EL

PRESIDENT

TELEPHONE: 01-623 4001
TELEX: 888364

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

16 November 1989

Dear Robin,

I sent to you, on 3 November, copies of my letters to the Chancellor of the Exchequer and the Secretary of State for the Environment drawing attention to the deep unhappiness and concern felt by members of the British Bankers' Association as a result of the Judgment in the Hammersmith and Fulham case.

You are, I know, aware that these concerns extend well beyond local authorities and swaps, because the Judgment has far reaching implications for transactions of a non-lending nature with all unincorporated bodies not covered by the Companies Act.

It is perhaps indicative of the severe jolt to confidence suffered in the London markets that many banks have been considering urgently the status of non-lending contracts entered into with building societies, mutual societies, friendly societies, pension funds and the like. The absence of a "safe-harbour" protection for counterparties - such as is provided for companies under Section 35 of the 1985 Act - is causing banks to question whether it is wise for them to continue to deal with such bodies while there remains a legal risk, however remote, that contracts freely entered into in good faith by both sides might be declared at some future time to be ultra vires.

I have been asked to seek the Bank's guidance as to whether these fears may be misplaced and, if not, whether prudence should dictate that banks would be unwise to continue to transact non-lending business with unincorporated bodies. Any comfort you might be able to give to our members would be greatly appreciated.

Yours,