

REPORT

Panel TREASURY MANAGEMENT PANEL

Date 15 October 2007

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Subject Background Paper on Councils Use of Interest Rate Swaps in the Mid 1990s.

1. At its last meeting the Panel discussed the use of derivatives by local authorities. A number of Panel members expressed a desire to better understand the legal issues arising from interest rate swaps in the early nineties, especially the Hammersmith and Fulham Case. This paper provides the Panel with background information on those cases.
2. Under an interest rate swap, one party (the fixed rate payer) agrees to pay the other over a certain period interest at a fixed rate on a notional capital sum; and the other party (the floating rate payer) agrees to pay to the former over the same period interest on the same notional sum at a market rate determined in accordance with a certain formula. Interest rate swaps can fulfil many purposes, ranging from pure speculation to more useful purposes such as the hedging of liabilities. They are in law wagers, but they are not void as such because they are excluded from the regime of the Gaming Acts by section 63 of the Financial Services Act 1986.
3. One form of interest rate swap involves what is called an upfront payment, i.e. a capital sum paid by one party to the other, which will be balanced by an adjustment of the parties' respective liabilities. The fixed rate payer may make an upfront payment to the floating rate payer, and in consequence the rate of interest payable by the fixed rate payer is reduced to a rate lower than the rate which would otherwise have been payable by him. It was this feature which, in particular, attracted local authorities to enter into transactions of this kind, since they enabled local authorities subject to rate-capping to obtain upfront payments uninhibited by the relevant statutory controls.
4. Local authorities began to enter into transactions of this kind soon after they came into use in the early 1980s. At that time, there was thought to be no risk involved

in entering into such transactions with local authorities. Financially, they were regarded as secure; and it was assumed that such transactions were within their powers. This changed as a result of *Hazell v. Hammersmith and Fulham London Borough Council* [1992] when the House of Lords held that such transactions were ultra vires for the local authorities who had entered into them.

5. During the fiscal years 1987-1988 and 1988-1989 Hammersmith and Fulham had entered into substantial transactions through a capital market fund in the name of the council with a view to making a profit. The capital market fund was established without a specific resolution of the council and the council members received no report on the transactions. For the year 1987-88 the council resolved, on the recommendation of its financial and administration committee, to borrow to meet its capital and revenue payments during the year, and authorised the director of finance to arrange and administer the council's borrowing on its behalf.
6. By January 1988, the finance and administration committee had received a report that the director of finance had continued to arrange transactions in the London Money and Capital Market in order to maximise gains on favourable interest rate movements. No details in writing of the transactions were given. On 24 February 1988 the council resolved to authorise the director of finance to arrange transactions in the London Money and Capital Market in order to take advantage of favourable interest rate movements. By 31 July 1988, the council had entered into a number of transactions of which the majority were ones in which the council would benefit if interest rates fell and lose if interest rates rose.
7. The auditor questioned the legality of the transactions with the result that the council's director of finance closed all the transactions save those where the council would incur a loss if he did so. From August 1988 to 23 February 1989, the council continued to carry out transactions but as part of an "interim strategy" designed to reduce the extent of the council's exposure to loss which arose from a rise in interest rates.
8. The council obtained its own legal opinion in which it was advised that if the transactions were undertaken as part of the proper management of the council's funds, they would be intra vires under section 111 of the Local Government Act 1972, but if the council was carrying on a business in transactions it would be ultra vires. The council was not advised however as to what action it should take at that stage and at a meeting on 22 February 1989 the auditor advised the director of finance that the council had to desist from further activity unless supported by legal opinion. Later that day, the council was advised by counsel that the scale of the

transactions was outside acceptable parameters and was therefore unlawful. After 23 February, the council was involved in only seven such transactions

9. The auditor applied, under section 19 of the Local Government Finance Act 1982, for a declaration that the items of account appearing in the capital market fund for the financial years 1987-1988 and 1988-1989 were contrary to law, and an order for rectification of the accounts.
10. The Divisional Court granted the auditor a declaration that the items of account appearing within the capital markets fund account of the first respondent for the financial years beginning on 1 April 1987 and 1 April 1988 were contrary to law and ordered that the accounts of the first respondent for those financial years be rectified with liberty to the parties to apply if what was required to rectify those accounts was not agreed.
11. On appeal by the banks, the Court of Appeal ordered that the declaration made by the Divisional Court should stand save in so far as it related to transactions entered into in, on or after 25 July 1988 and that there should be no order for rectification. It was further ordered that questions relating to the enforceability of the transactions reflected in the accounts should not be decided in those proceedings. There was also an appeal by the council in respect of the variation made by the Court of Appeal to the declarations made by the Divisional Court. The two appeals were conjoined.
12. The House of Lords in *Hazell v. Hammersmith and Fulham London Borough Council* [1992] held that such transactions were ultra vires for the local authorities who had entered into them. The key legal argument discussed during the case was that whilst there was no express statutory power entitling the council to enter into financial transactions, it had an implied power under section 111 of the Local Government Act 1972 to do anything which was ancillary to the discharge of any of its functions, which included borrowing. However, having regard to the provisions and limitations of the Act of 1972, in particular Part I of Schedule 13, it could not be said that the transactions were calculated to facilitate, or were conducive or incidental to the discharge of, the council's function of borrowing within the meaning of section 111, and, therefore, the transactions were ultra vires and unlawful.
13. In his judgment Lord Ackner concluded that:

“The purpose and function of swap transactions is not to facilitate, to help, or to make more easy the discharge by the local authority of its function of borrowing. The original underlying debt or debts continue in existence and are all unaffected by

the swap transactions. In many cases the swap transactions are entered into long after the underlying borrowing and were not even in contemplation when such borrowing took place. The function and purpose of swap transactions is to alleviate the consequences of borrowing by the local authority purchasing what has been conveniently called 'a stream of income' or a 'cash flow' which will enable it to reduce the net cost of its borrowing."

14. This judgement caused grave concern among financial institutions, and especially foreign banks, which had entered into such transactions with local authorities in good faith, not necessarily contemplating that the ultra vires doctrine might undermine what they saw as a perfectly legitimate commercial transaction.
15. There then followed litigation in which banks and other financial institutions concerned sought to recover from the local authorities with which they had dealt the balance of the money paid by them, together with interest. Out of the many actions so commenced, two were selected as test cases. These were *Westdeutsche Landesbank Girozentrale v. Islington Borough Council* [1994], and *Kleinwort Benson Ltd. v. Sandwell Borough Council* [1994]. In a powerful judgment it was determined that the banks were only entitled to recover from the councils the net balance outstanding on the transaction between the parties, i.e. the difference between the upfront payment paid by the bank to the council and the total of interest payments paid by the council to the bank. It was decided that the bank's right to restitution at common law arose from the fact that the payment made by the bank to the council was made under a purported contract which, unknown to both parties, was ultra vires for the council and so void.
16. The reliance on section 111 of the Local Government Act 1972 for borrowing powers has been removed by the Local Government Act 2003 in England and Wales. Section 1 determines that:

"A local authority may borrow money—

 - (a) for any purpose relevant to its functions under any enactment, or
 - (b) for the purposes of the prudent management of its financial affairs. "

Section 9 Gives protection to lenders:

"A person lending money to a local authority shall not be bound to enquire whether the authority has power to borrow the money and shall not be prejudiced by the absence of any such power."