

Our ref 001/PSA/M04885246/2015-16

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Dear Mr Cardin

Wirral Council: Objection to audit of the accounts 2015-16 – Decision and Statement of Reasons

- 1 We write regarding your objection to the accounts of Wirral Council (the 'Council') for the financial year ended 31 March 2016. This document sets out our decision and Statement of Reasons in relation to this objection. Please accept our apologies for the time taken to determine this objection.
- 2 You have requested that we prepare a report in the public interest and also seek a declaration from the High Court under section 28 of the Local Audit and Accountability Act 2014. You will however see from the rest of this document that our view is that it is not appropriate to prepare a public interest report nor to seek a declaration from the Court. We set out in detail our reasons for this provisional view.

The objection

- 3 The objection was made in your email dated 10 August 2016.
- 4 The objection relates to the Council's Lender Option Borrower Option ('LOBO') borrowing portfolio. Specifically, the objection relates to assertions that:
 - i The term 'unlawful' applies in this context, I believe, because the decision to sign up to so many (19) LOBO loans was unreasonable and irrational.
 - ii The potential costs and derivatives risks of the LOBO loan contracts were not, and could not, be fully understood by council officers, and the type and volume of borrowing carries such a high risk as to be prejudicial to the interests of Wirral Council taxpayers.
 - iii Due to the complexity and 'optionality' of the contracts, the overall interest rate of the loans would have been impossible to price over the long term, without sophisticated pricing tools that the majority of Local Authorities do not have direct access to.
 - iv LOBO loans contain derivatives, which in some cases have similar properties to interest rate swaps declared ultra-vires or illegal for use by UK local government following the landmark 1989 Hammersmith and Fulham case. The legality of LOBO loans remains untested in a UK court of law.
 - v Making such a large borrowing commitment under the conditions that the banks imposed, without benchmarking and recording the decisions against comparable PWLB loans amounts to 'irrational' conduct. Wirral Council's LOBO loan borrowing accounts for approximately three quarters of the council's long term borrowing, contravening the explicit advice of Cipfa that Council's should not hold more than 30% of their long term debt in LOBO loans. (see Treasury Management Bulletin - April 2015)

The Council is now effectively locked into expensive LOBO loans with interest rates ranging from 4.4% to 8%.

- vi The loan signed on 15 August 2005 with Hypothekenbank, is particularly problematic, as not only could the Council now refinance at much lower rates were it not locked into the LOBO loan by high 'breakage fees', but even at the time the loan was signed in August 2005 PWLB rates (4.6% interest) were more favourable than the so-called 'teaser rate' on the LOBO (6.25% interest), ensuring this loan was never taken out in the public interest.

Work carried out

- 5 In the course of our inquiries we have considered:
 - i the written notice of objection of 10 August 2016;
 - ii the Council's records regarding its treasury management activities including its portfolio of LOBO borrowing;
 - iii information from meetings with Council officers to discuss the Council's LOBO borrowing; and
 - iv email correspondence received by us from Council officers.

Background

- 6 'LOBO' arrangements are forms of borrowing that include option dates, which occur at regular and prescribed intervals during their life. On the option dates, lenders may request new terms for loans and if these terms are unacceptable the borrower may repay the LOBO loan without penalty.
- 7 As at 31 March 2016, the Council was party to 19 LOBO loans, which the Council entered into over an 8 year period between January 2001 and January 2008. The principal outstanding on these 19 loans, as at 31 March 2016, was £137 million. Subject to change events (the exercise of lender and borrower options), the maturity dates of these loans range from January 2066 to July 2077.
- 8 In addition to these loans, Wirral Council is also the administering authority for 4 LOBO loans associated with the Merseyside Residual Debt Fund. The loans have a total value at 31 March 2016 of £18 million and were taken out between March 1999 and September 2004. The loans have similar characteristics to the 19 directly associated with the Council, but are not within the scope of this objection.
- 9 The Council's LOBO loans were entered into between 11 and 18 years ago, and a number of the officers party to these borrowing decisions are no longer employed by the Council. Given the age of the loans (and the normal deletion/retention policies of the Council), it is perhaps unsurprising that not all contemporaneous documentation is available setting out the Council's decision making and what was taken into account. As a result, our approach has been guided by the following. We have considered first whether, on the basis of the information that has been located, what is known about the prevailing financial and economic circumstances, both nationally and at the Council at the time and taking into account the applicable statutory and Council financial guidance, there is anything to indicate that entering into a long term loan on the LOBO terms would be considered irrational or in some other way outside the Council's powers. We have also taken into account our understanding of interest rates at the relevant time and subsequently in considering whether the Council's decisions appear to have been rational decisions.

The law, regulations, proper practice and guidance – borrowing powers

10 The specific statutory powers for local authorities to borrow were replaced during the period relevant to your objection. For the earlier LOBOs (those taken out prior to 1 April 2004), Section 43 of the Local Government and Housing Act 1989 (“the LGHA 1989”) empowered local authorities, subject to certain provisions, and as part of the proper management of their affairs, to:

‘borrow money for any purpose relevant to their functions under any enactment’.

11 Each local authority’s total borrowing was limited, under section 44(1) of the LGHA by its Aggregate Credit Limit set under section 62, which is the sum of the authority’s temporary and long-term borrowing limits, taking into account ‘credit approvals’ issued by the Secretary of State under schedule 3 of LGHA 1989.

12 Under section 45 of the LGHA 1989, local authorities were required to determine, for each financial year:

(a) an amount of money (in this Part referred to as ‘the overall borrowing limit’) which is for the time being the maximum amount which the authority may have outstanding by way of borrowing

(b) an amount of money (in this Part referred to as ‘the short-term borrowing limit’), being part of the overall borrowing limit, which is for the time being the maximum amount which the authority may have outstanding by way of short-term borrowing; and

(c) a limit on the proportion of the total amount of interest payable by the authority which is at a rate or rates which can be varied by the person to whom it is payable or which vary by reference to any external factors’

13 Section 46 of the LGHA required that:

‘every local authority shall maintain a register giving particulars of all the loans in respect of which loan instruments are issued by or to the local authority on or after 1st April 1990’

14 The Local Authorities (Borrowing) Regulations 1990 (amended 1991) and Local Authorities (Capital Finance) Regulations 1997 were issued pursuant to the powers conferred on the Secretary of State by the LGHA.

15 The Chartered Institute of Public Finance and Accountancy (CIPFA) issued, from time to time, Codes of Practice for Treasury Management in the Public Sector and in Local Authorities.

16 For those LOBOs entered into on or after 1 April 2004, Section 1 of the Local Government Act 2003 (the ‘LGA 2003’) empowers local authorities to 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’.

17 Section 3(1) of the LGA 2003 requires a local authority to *‘determine and keep under review how much money it can afford to borrow.’*

18 Section 15 of the LGA 2003 requires local authorities:

‘to have regard (a) to such guidance as the Secretary of State may issue and (b) to such other guidance as the Secretary of State may by regulations specify.’

The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require local authorities to have regard to CIPFA’s ‘Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes’ as amended or reissued from time to time.

19 This Code identifies three key principles:

'public service organisations should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities'

'their policies and practices should make clear that the effective management and control of risk are the prime objectives of their treasury management activities and that responsibility for these lies clearly within their organisations. Their appetite for risk should form part of their annual strategy...'

'they should acknowledge that the pursuit of value for money in treasury management, and the use of suitable performance measures, are valid and important tools for responsible organisations to employ in support of their business and service objectives; and that within the context of effective risk management, their treasury management policies and practices should reflect this. In framing recommendations, CIPFA acknowledges the difficulties of striving for effective risk management and control, whilst at the same time pursuing value for money. The Code does not seek to be prescriptive about how this issue should be handled...'

- 20 The Code recommends that organisations manage exposure to fluctuations in interest rates with a view to containing interest costs in accordance with the amounts provided in budgetary arrangements, by the prudent use of their approved instruments, methods and techniques, primarily to create stability and certainty of costs but at the same time retaining a sufficient degree of flexibility to take advantage of unexpected, potentially advantageous changes in the level or structure of interest rates.
- 21 CIPFA has set out minimum requirements for the process to be followed and the standards of governance to be met in setting, revising and monitoring the prudential indicators specified in 'The Prudential Code for Capital Finance in Local Authorities' in the five main areas of affordability, prudence, capital expenditure, external debt and treasury management. The adoption of these prudential indicators has effectively superseded the previous statutory annual limits on local authority borrowing set under s46 of LGHA 1989.
- 22 Of particular relevance to consideration of this objection are the following prudential indicators:
- Affordability** – ratio of financing costs to net revenue stream
 - Prudence** – gross debt as a proportion of the capital financing requirement
 - External debt** – the authorised limit and operational boundary
 - Treasury management** – upper limit for fixed interest rate and variable interest rate exposure.

Relevant case law / authorities

- 23 You have raised the House of Lords judgment against the London Borough of Hammersmith and Fulham with us, arguing that LOBO loans contain derivatives with similar properties to the interest rate swaps declared ultra-vires or illegal for use by UK local government. The Hammersmith and Fulham case was finally settled in January 1991, following an appeal to the House of Lords. The House of Lords held that substantial financial transactions of a speculative nature, based on the level of interest rates, were ultra vires and unlawful for councils, and that it could not be said that such transactions were lawful by virtue of the subsidiary powers of local authorities provided for in s111 of the LGA 1972.
- 24 Our review of documentation and information relating to the Council's portfolio of LOBO loans has not found any evidence of loans containing derivatives with similar properties to interest rate swaps, or any evidence that loans were entered into on a speculative basis. In addition we have not identified any evidence that the scale of the borrowing undertaken by the Council is unreasonable or is not linked to the provision of the Council's functions. We comment in paragraphs 41 to 50 on the refinancing risks associated with the LOBO loans.
- 25 For these reasons view we do not consider the Hammersmith and Fulham case to be relevant to this objection.

Financing of local authority capital investment

- 26 Local authorities have available to them a number of ways of financing traditionally procured capital investment. In all cases, cash will be paid over. The term 'financing' does not refer to the payment of cash but the resources that are applied to ensure that any underlying amount arising from capital payments is dealt with absolutely, whether at the point of spend, or over the longer term.
- 27 A number of financing options that are available to local authorities involve resourcing the investment at the time that it is incurred. These are:
- The application of useable capital receipts
 - A direct charge to revenue for the capital expenditure
 - The application of a capital grant
 - Securing an up-front contribution from another party towards the cost of a project.
- 28 Capital expenditure that is not financed up front by one of the above methods will increase the 'Capital Financing Requirement' of the authority.
- 29 Local authorities will not, and should not, associate borrowing with particular items of expenditure (unless required to under statute). Local authorities will, at any point in time, have a number of cash flows both positive and negative and manage the position in terms of their borrowings and investments in accordance with treasury management strategies and practices.
- 30 In measuring external debt, the Prudential Code encompasses all borrowing, whether for capital or revenue purposes. In day-to-day cash management, no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all a local authority's financial transactions and not simply those arising from capital spending. It includes other long-term liabilities associated with credit arrangements, such as Private Finance Initiatives or finance leases.
- 31 The 'Capital Financing Requirement' reflects a local authority's underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. (Source: CIPFA Prudential Code for Capital Finance 2011 Appendix – Capital Financing Requirement).
- 32 Local authorities set, for the forthcoming year and the two following financial years, an 'authorised limit' for their total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. The limit takes into account authorities' plans for capital expenditure and financing, and their treasury management policies and practices. Authorities need to assure themselves that their plans are affordable and prudent. (Source: CIPFA Prudential Code for Capital Finance 2011 – External debt pp22-23).

Findings

- 33 The next section of this document seeks to consider in turn each of the specific matters which you have raised in your objection, along with our views on each one.
- The term 'unlawful' applies in this context, I believe, because the decision to sign up to so many (19) LOBO loans was unreasonable and irrational.**
- 34 The Council is one of the largest local authorities in the North West of England with a resident population in excess of 320,000. As at 31 March 2016, the Council's property, plant, equipment, and investment property balances were in excess of £663 million and £12 million respectively. As at 31 March 2016 the Council's closing 'Capital Financing Requirement' was £335.4 million and the principal outstanding on the Council's LOBO borrowing totalled £137m.
- 35 The Council has explained to us that the majority of the LOBO loans that it entered into involved the rescheduling of more expensive non-LOBO debt and that the LOBOs carried lower rates of interest and avoided or minimised early repayment penalties.

Our review of contemporary reports to the Council's Cabinet supports the Council's position that the majority of LOBO loans entered into involved the rescheduling of non-LOBO debt. We found that these referred to private sector loans being arranged, generally at rates fixed for an initial period, but which the lender may vary at a future date. The reports also refer to the restructuring of the Council's loan portfolio, and an overall strategy of assessing interest rates by comparing those available from the market and PWLB.

- 36 We note that Barclays Bank wrote to Wirral Council in June 2016 setting out that the bank had taken a decision to waive their right to change the applicable interest rate of the LOBO loans that the Council held with the bank. As a result of this action, the Council LOBO loans held with Barclays effectively became fixed rate loans to remain at interest rates current at the time. The Council has 4 loans with Barclays Bank with a value of £38.5 million.
- 37 In our view, for a local authority of Wirral Council's size, the decision to enter into 19 LOBO loans over an 8 year period was neither unreasonable nor irrational. We explore this issue further in responding to some of your specific points below.

The potential costs and derivatives risks of the LOBO loan contracts were not, and could not, be fully understood by council officers, and the type and volume of borrowing carries such a high risk as to be prejudicial to the interests of Wirral Council taxpayers.

Due to the complexity and 'optionality' of the contracts, the overall interest rate of the loans would have been impossible to price over the long term, without sophisticated pricing tools that the majority of Local Authorities do not have direct access to

- 38 It is inherently difficult to determine with precision the extent to which potential costs and risks were understood by relevant Council officers due to the age of the LOBOs and the fact that a number of the officers concerned are no longer employed by the Council.
- 39 In entering into LOBO loans the Council exposed itself to risks, some of which were risks inherent in relation to any external borrowings, and some were risks associated with the options contained within the specific LOBO arrangements.
- 40 The banks' options to request new terms give rise to refinancing risks for the Council. That is, depending on the length of notice and the availability of other finance, that the Council would not be able to exercise its option to repay, even if it considered it to be in its interest to do so, or that it would only be able to do so at a cost that is greater than it would have been had it been able to anticipate the need to raise the finance.
- 41 We note that the Council manages its overall borrowing portfolio to achieve a spread of maturity dates across the short, medium and long terms as a partial mitigation of the refinancing risks to which it is subject. The Council has complied with its statutory duty to set aside a prudent amount of its revenues each year as a provision for the repayment of borrowing and credit arrangements associated with capital expenditure. This provides a further partial mitigation of the refinancing risks.
- 42 We note that the Council now has access to professional external treasury management advice, including forward interest rate forecasts, such that relevant Council officers are able to form reasonable expectations of whether lenders are likely to exercise their options to increase interest rates, in advance of option dates. The Council has confirmed that treasury advisers were not employed throughout the period that LOBO loans were taken out.
- 43 Reports provided to us by the Council relating to the financial years 2001/02 to 2007/08 confirm that the decisions to enter into the LOBO loans were made by officers based on information available at the time with regard to the CIPFA Treasury Management Code and in compliance with the Treasury Management strategy in place at the time. All of the LOBO loans were taken out prior to the introduction of the Prudential Code.
- 44 We further note that the Council is able to borrow from the Public Works Loan Board (PWLB) and its powers to raise revenue mean it is able to access borrowing via the financial markets under normal trading conditions.

- 45 Local authority borrowing often accrues interest at a rate that is fixed for the duration of the borrowing ('fixed rate borrowing') or at a rate that may vary during the term ('variable rate borrowing').
- 46 Fixed rate borrowing provides certainty of the interest rate burden and the protection against rises in market interest rates over the term of the loan. However, fixed rate borrowing also exposes the borrower to the risk of paying a rate of interest that is high relative to prevailing rates should interest rates fall during the term of the loan.
- 47 Variable rate borrowing provides the ability to benefit from falls in market interest rates. However, variable rate borrowing does not provide the borrower with certainty as to the interest rate burden, and exposes the borrower to increases in interest payable should interest rates rise during the term of the loan.
- 48 LOBO loans carry fixed rates of interest, albeit for an indefinite, but nevertheless ultimately finite, term. The existence of lender options, and the inherent uncertainty as to future interest rate movements, means that the borrower has certainty over interest rates, but for an uncertain period of time.
- 49 We note that a significant proportion of the Council's LOBO portfolio comprises 'stepped' loans. These loans featured a lower initial interest rate for a period ranging from 6 months to 10 years, stepping up to a higher rate at the end of the initial period, and then subject to lender and borrower options. We comment below in paragraphs 73 to 78 on interest rates prevailing on fixed rate PWLB loans at the time of inception of the Council's LOBO loans.
- 50 Whether any borrowing would be prudent is inevitably a matter of judgement which it is for the Council to exercise. A court considering a challenge to the legality of the Council's LOBO borrowing based on unreasonableness would only interfere if the Council's borrowing was outside the broad range of reasonable borrowing that authorities might enter into, or if the Council had acted irrationally through failing to take account of relevant considerations or taking account of irrelevant considerations. It is not therefore for us to substitute our subjective view as to the reasonableness of LOBO borrowing terms, but rather to consider whether they are broadly reasonable, or put another way, not wholly unreasonable (i.e. *Wednesbury* unreasonable).
- 51 In the context which we have outlined above, in our view we have no reason to believe that the transactions were not fully understood, or that the degree of risk involved was prejudicial to the interests of the Council's taxpayers. It is also our view that the Council's overall use of LOBOs is not outside the broad range of reasonable borrowing that an authority might enter into and does not appear to be 'wholly unreasonable'.

LOBO loans contain derivatives, which in some cases have similar properties to interest rate swaps declared ultra-vires or illegal for use by UK local government following the landmark 1989 Hammersmith and Fulham case.

- 52 As we note at paragraph 24, our review of documentation relating to the Council's portfolio of LOBO loans has not found any evidence of loans containing derivatives with similar properties to interest rate swaps. We have not identified any breaches of the Council's Prudential Indicators, including treasury management limits. We have commented above on the refinancing risk that is associated with loans that contain options for lenders to change interest rates. We do not consider the refinancing risks associated with LOBO loans to be so great as to mean the Council was acting outside its borrowing powers, which we comment on further below.
- 53 Under section 43 of the LGHA 1989 a local authority could, as part of the proper management of its affairs:
- 'borrow money for any purpose relevant to their functions under any enactment'*
- 54 Under section 1 of the Local Government Finance Act 2003:
- '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'.

- 55 Whether any borrowing entered into would in fact be prudent in terms of the management of an authority's financial affairs is, subject to certain matters, inevitably a matter of judgement which it is for the authority to exercise. We have not seen any evidence to suggest that the funds raised through LOBO borrowing were applied to any purposes outside of the Council's borrowing powers.
- 56 To be lawful, however, any such borrowings must:
- (i) comply with certain limitations
 - (ii) only be undertaken having had regard to certain matters
 - (iii) be such that a reasonable authority could undertake in the circumstances
 - (iv) be properly authorised.
- 57 As at 31 March 2016, the principal outstanding on the Council's LOBO borrowing totalled £137m, of which some £44 million was entered into under LGHA 1989 powers, the remaining £93 million under LGFA 2003 powers.
- 58 A local authority is required to determine and keep under review how much money it can afford to borrow, having regard to CIPFA's 'Prudential Code for Capital Finance for Local Authorities', and it may not borrow money if doing so would result in a breach of any limit it thus determines. The amount of the principal borrowed under any LOBO must not involve the breach of any limit for how much money the authority can afford to borrow that it has determined having had regard to the Prudential Code.
- 59 The Council has operated within its authorised treasury management limits throughout the period (since 2004) for which the Prudential Code and associated indicators have been in place.
- 60 In exercising the power it has to borrow, a local authority must have regard to (a) matters it is required to have regard by enactment and (b) matters that no reasonable authority would fail to consider in the circumstances. In carrying out its functions with respect to borrowing, a local authority is also required to have regard to CIPFA's 'Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes'.
- 61 The Treasury Management Code states that an authority should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities. It is concerned with both interest rate risk (the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden against which the authority has failed to protect itself adequately) and refinancing risk (the risk that borrowing cannot be refinanced on terms that reflect the provisions made to do so or on terms inconsistent with prevailing market conditions at the time).
- 62 The Council has adopted CIPFA's Code of Practice for Treasury Management in the Public Services, has set out its objectives within annual treasury management strategies and associated limits as part of its annual budget setting process, and has established systems and processes for the control of its treasury management activity and for the reporting of that activity.
- 63 In relation to acting reasonably, CIPFA has stated 'organisations need to consider carefully whether they are equipped with the skills and experience to evaluate and control the risks and advantages associated with using the instruments available to them in their approved list, even if they are legally permitted to do so'.
- 64 The Council engaged Arlingclose to provide treasury management advice and interest rate forecasts between November 2007 and March 2016. Arlingclose is a recognised provider of treasury management advice. Prior to November 2007 the Council did not engage any treasury management advisers.

65 We have taken into account the following contemporaneous reports that set out and confirm that the Council's overall borrowings were within the limits set and provide a brief summary of the financial implications considered by the Council ahead of entering into LOBO transactions:

- Report to the Cabinet of 1 February 2001 concerning the borrowing limits of the Council in 2001-2002 in respect of existing loan debt, capital expenditure and revenue borrowings. The report refers to a number of private sector loans having been arranged, enabling debt restructuring generally at rates fixed for initial periods but which the lenders may vary at future dates.
- The Council's Treasury Management Annual Report 2001-2002 reported to the Cabinet 19 September 2002
- Report to the Cabinet of 31 January 2002 concerning the borrowing limits of the Council in 2002-2003
- The Council's Treasury Management Annual Report 2002-2003 reported to the Cabinet 18 September 2003
- Report to the Cabinet of 17 February 2003 concerning the borrowing limits of the Council in 2003-2004
- The Council's Treasury Management Annual Report 2003-2004 reported to the Cabinet 22 July 2004
- Report to the Cabinet of 17 March 2004 setting out the Treasury Management policy of the Council for 2004-2005. The report refers to the Council's overall strategy of assessing interest rates, comparing those available from the market and PWLB.
- The Council's Treasury Management Annual Report 2004-2005 reported to the Cabinet 30 June 2005
- Report to the Cabinet of 13 January 2005 setting out the Capital Financing/Treasury Management policy of the Council for 2005-2006.
- The Council's Treasury Management Annual Report 2005-2006 reported to the Cabinet 28 June 2006
- Report to the Cabinet of 15 March 2007 setting out the Treasury Management policy and strategy of the Council for 2007-2008. The report refers to the Council's overall strategy always embracing an assessment of interest rates, by comparing those available from the market and PWLB
- The Council's Treasury Management Annual Report 2007-2008 reported to the Cabinet 26 June 2008.

Our review of all of this available documentation did not indicate that the Council had taken into account irrelevant factors or failed to take account of relevant factors in its decision-making.

66 The decision to enter any LOBO must also have been made by a person having the authority delegated to him to do so.

67 Under the Council's Constitution, the section 151 officer is responsible for 'arranging the borrowing and investments of the Council in accordance with the CIPFA "Code of Practice on Treasury Management" and the Council's Treasury Management Policy Statement and Strategy'. The LOBO loan agreements we have reviewed were all approved at inception by either the section 151 Officer or an officer acting under appropriate delegated authority.

Making such a large borrowing commitment under the conditions, which the banks imposed, without benchmarking and recording the decisions against comparable PWLB loans amounts to "irrational" conduct. Wirral Council's LOBO loan borrowing accounts for approximately three quarters of the council's long term borrowing, contravening the explicit advice of CIPFA that Council's should not hold more than 30% of their long term debt in LOBO loans. (See

Treasury Management Bulletin - April 2015) The Council is now effectively locked into expensive LOBO loans with interest rates ranging from 4.4% to 8%.

- 68 The scale of the Council's borrowing commitment needs to be viewed in the context of the size of the Council, and the nature of its operations. It should also be noted that the Council is in an 'internally borrowed' position, meaning that its Capital Financing Requirement exceeds the aggregate of its external debt and credit arrangements for capital purposes. This effectively means the Council is using some of its cash-backed reserves in place of additional external borrowings, to reduce its interest rate burden.
- 69 The conditions associated with amounts borrowed were subject to consideration by the Council's Treasury Management officers, and subject to approval of the Council's section 151 officer. Our view is that the Council did not act under compulsion in entering into borrowing commitments, not least as the Council had access to alternate sources of borrowing, including from the Public Works Loan Board.
- 70 We note CIPFA's April 2015 Treasury and Capital Management Panel Bulletin, and that this document was issued over seven years after the Council entered its most recent LOBO loan. We are not aware of any earlier guidance relating to the proportion of LOBO borrowing within a local authority's overall debt portfolio.
- 71 As explained above, the Council understandably does not hold all of the documentation recording the basis of its decisions to enter into LOBOs. We cannot therefore reach a conclusion as to the full extent to which benchmarking was carried out in order to support rational decision-making, although it is clear from the available evidence (see para 65) that some benchmarking was carried out. To provide an indicator as to the rationality of the decisions, we have reviewed available information in support of the Council's LOBO portfolio.
- 72 Our review confirms that 11 of the 19 LOBO loans were 'stepped loans'. For four of these 11 'stepped' loans, the initial interest rates were lower than prevailing PWLB fixed rate loans with a comparable loan repayment dates at initiation, and the higher subsequent LOBO rates were also less than or equal to the PWLB rate at initiation.
- 73 For a further 4 of the 11 'stepped' loans, the initial interest rates were lower than prevailing PWLB fixed rate loans with a comparable loan repayment dates at initiation, although the higher subsequent LOBO rates were higher than the PWLB rate at initiation. The 'stepped' rates on these loans were 0.07% to 0.4% higher than the PWLB rate at initiation.
- 74 For the remaining 3 stepped loans, the initial rates were higher than prevailing PWLB fixed rate loans with a comparable loan repayment dates at initiation. The initial LOBO rates were 0.325% to 1.8% higher than PWLB rates at initiation with the 'stepped' rates on these loans 1.875% to 3.55% higher than the PWLB rate at initiation.
- 75 The Council's LOBO portfolio also contains 8 'vanilla' (non-stepped) LOBO loans. One of these loans, which replaced an earlier loan, was entered into at a rate equal to the prevailing PWLB fixed rate for a loan with a comparable loan repayment date. The interest rates on the remaining 7 'vanilla' LOBO loans were between 0.34% and 2.48% higher than prevailing PWLB fixed rate loans with comparable loan repayment dates at initiation.
- 76 We have discussed the 10 LOBO loans, referred to in paragraphs 75 and 76, on which the initial rates were higher than prevailing PWLB fixed rate loans with a comparable loan repayment dates at initiation, with Council officers. As noted at paragraph 36, the Council has indicated to us that the majority of the LOBO loans that it entered into involved the rescheduling of more expensive non-LOBO debt and that the LOBOs carried lower rates of interest and avoided or minimised early repayment penalties. The Council has further advised that it no longer holds documentation relating to the loans that were replaced by the 10 'new' LOBO loans. This is consistent with the Council's document retention policy which indicates that loans files are destroyed 7 years after loans have been repaid.
- 77 In the absence of documentation relating to the repaid and replaced loans we are unable to retrospectively assess the decision-making process.

- 78 Taking the LOBO portfolio as a whole, our discussions with Council officers and our review of contemporary reports to the Council's Cabinet, we do not consider that there is evidence to indicate that the Council acted irrationally or unreasonably (and therefore unlawfully) in entering into LOBO loans.
- 79 Historically, the Council has maintained a long-term debt portfolio that has comprised both Public Works Loan Board and market loans. The ratio of PWLB to money market loans has varied over the years as the Council has sought to obtain the most favourable long-term borrowing rates available.
- 80 As at 31 March 2001 PWLB debt accounted for 70.1% of the Council's long-term debt and market debt accounted for the remaining 29.9%. Over the years that followed annual treasury management reports presented to the Council set out that
- 'historically the PWLB has offered the lowest interest rates available. However, the last 2 years have seen the private sector offering specialist deals known as Lender Option Borrower Option (LOBO) arrangements and they offer the Authority considerably lower interest rates for a fixed number of years after which the rate becomes variable'*
- and we note that the Council sought to restructure its debt by repaying high interest PWLB debt and replacing it with LOBO debt.
- 81 During 2004/05 the Council transferred its housing stock to a registered social landlord as part of its strategy to achieve the Decent Homes Standard. At the point of the transfers a proportion of the Council's debt with the PWLB was written off by the government. The cumulative amount written off during this period was £107.7 million.
- 82 As a consequence of the stock transfer and the implementation of prior and post transfer treasury management strategies the Council has a long-term borrowing portfolio as at 31 March 2016 whereby PWLB debt accounted for 20.2% of the Council's long-term debt and market debt accounted for the remaining 79.8%.
- 83 In our view, while the initial interest rates on these loans were higher than the PWLB equivalents, there is no evidence to suggest the Council acted irrationally or unreasonably in entering into the LOBO loans. Furthermore, even if we believed it was irrational, we would still not seek a declaration from the Court to this effect because:
- The costs of such action would be high and with limited prospect of success given the lack of contemporaneous evidence
 - The consequences of such action being successful are uncertain, given the passage of time since the loans were entered into and the fact that the lenders appear to have acted in good faith in entering into the agreements.
 - Officers involved in the transactions have moved on from the Council and there would only be very limited learning from the Council from any such finding.

The loan signed on 15 August 2005 with Hypothekenbank, is particularly problematic, as not only could the Council now refinance at much lower rates were it not locked into the LOBO loan by high 'breakage fees', but even at the time the loan was signed in August 2005 PWLB rates (4.6% interest) were more favourable than the so-called 'teaser rate' on the LOBO (6.25% interest), ensuring this loan was never taken out in the public interest.

- 84 The loan with Hypothekenbank was advanced on 15 August 2005 at an initial interest rate of 6.25%. We understand that this particular LOBO loan was taken out to replace an existing £8.5 million private sector loan held by the Council at an interest rate of 9.25%. For this particular loan the Council provided us with their analysis setting out that it was cheaper in the long term to take out the LOBO loan, at a higher rate than a new PWLB loan that involved no rescheduling (4.45%), rather than repaying the loan early and refinancing from PWLB. We understand that the interest rate for this loan reflects the premium payable by the Council to redeem the earlier private sector loan. The Council's calculations set out an annual cost of £891k to repay the earlier loan early and replace it

with a PWLB loan, compared to an annual interest cost of £680k for the loan with Hypothekenbank, and £786k per annum for the original loan.

85 The Council has provided us with a clear explanation of the factors that it is considered at the time in taking out this LOBO to replace a loan that it had at a higher rate. It is clear, as stated in the notice of Objection, that given the movement in interest rates, the Council is now prevented from refinancing this loan at lower rates, other than at a significant cost to the Council. That however is a retrospective judgement and reflects the risk that is inherent in any fixed rate borrowing. The information that we have reviewed does not provide any evidence the Council acted recklessly or unreasonably in taking out this LOBO loan in 2005.

Overall Conclusions

86 As you will be aware, only a court may decide definitively on the way in which statute is to be interpreted and in the absence of previously decided case law we cannot pronounce definitively on the correct application of the law.

87 We have considered whether it is appropriate for us to exercise any of the formal audit powers under the Local Audit and Accountability Act 2014. These include the power to issue a public interest report under section 27 and the power to apply to the High Court for a declaration under section 28 that an item of account is unlawful.

Application to Court

88 If an item of account appears to us to be contrary to law, it is at our discretion as to whether we apply to the Courts for a declaration under Section 28 of the 2014 Act to that effect. It should be noted that this discretion only arises insofar as we are clear that there is an item of account which is contrary to law – where there is doubt this discretion does not arise. It is not the role of the auditor to seek the clarification of the Court where there is legal doubt.

89 Relevant factors which we take into account in deciding whether to exercise our discretion to apply to the Court for a declaration include:

- The significance of the issue concerned;
- The amount of the item of account involved;
- The expense of an application
- The practical consequences of any declaration;
- Whether the Council agrees or not with my view on the lawfulness of items in question; and the prospects of success.

90 In this case, having considered the matter carefully, and having taken all representations into account, we have decided that we should not exercise our discretion to seek a declaration under Section 28 of the 2014 Act. Our reasons for this view are as follows:

- The Council had broad borrowing powers under Section 43 of the Local Government and Housing Act 1989 and Section 1 of the Local Government Finance Act 2003;
- The Council has acted in compliance with recognised guidance, including CIPFA's Code of Practice on Treasury Management in the Public Services and in particular has published treasury management strategies and adhered to its treasury limits;
- We have found no evidence to suggest that the Council acted unreasonably recklessly in entering into LOBO loans.

91 For the reasons outlined above, we do not believe that an application under section 28 to the Court would be warranted in our view. Therefore, we do not intend to take any such action in this respect.

Public Interest Report

92 It is a matter for us in the exercise of our discretion whether to issue a report in the public interest under section 27 of the Local Audit and Accountability Act. Relevant factors which we take into account in deciding whether to exercise our discretion to issue a report in the public interest include:

- The extent, if any, of unlawful items of account or loss;
- Whether there were significant failings in governance;
- Whether the matters that might be the subject of a report are ongoing;
- Whether there has been significant publicity in respect of the issues; and
- Whether the auditor believes that his independent view should be expressed in public.

93 For this objection the matters do not appear to us to justify such a report. We rely on those matters set out in paragraph 90 above.

Right of Appeal

94 You have a statutory right of appeal against our decision not to make an application to the Court for a declaration that an item of account is contrary to law. Any appeal must be issued at Court within the period of 21 days. We suggest that anyone considering an appeal should take their own legal advice.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Gregory', written over a horizontal line.

John Gregory
Director

for Grant Thornton UK LLP