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Closing the Swap Shop, 1988–91

The Hammersmith and Fulham swaps affair began like the plot of a Raymond Chandler thriller, with a telephone call to the controller's office in Vincent Square, late on a hot June afternoon in 1988. It was from a woman working for Goldman Sachs, the US investment bank. Davies asked his secretary to put the call through to Mike Barnes, who was head of technical support. Half an hour later, a sombre-looking Barnes appeared at Davies's door. 'I think you'd better talk to them', he said.[1]

Davies duly returned the call. The banker happily explained again the reason for it. She was an American, newly arrived in the London office. She worked on the swaps desk at Goldman and had been familiarizing herself with the book of the bank's existing positions. She'd been intrigued, she said, 'by this guy Hammersmith'. Finding him (she persisted with the joke) on the other side of several Goldman contracts, and not knowing the name, she had made some inquiries. 'And I find this guy's real big in the market. In fact, he's on the other side of everything. He's in for billions and *all on the same side* of the market! Anyway, I've asked about him and people have explained the Audit Commission is responsible for him. So I thought I'd call you up and let you know. This guy's exposure is *absolutely massive*.'

Davies made two more calls within the hour. The first was to the accountancy firm Deloitte, Haskins & Sells, where one of the partners, Tony Hazell, was assigned as the auditor to Hammersmith. Hazell said he had no idea what the lady from Goldman was talking about. Then Davies rang the chief executive of the council. He explained his concern. The chief executive tried to make light of the matter. He could confirm that Hammersmith was involved in the swaps market, he said, but didn't think it was much of a player. Davies knew better than to suppose that a bank like Goldman might have rung him on a whim. 'Would you mind just inquiring,' he persisted, 'and see what you think the position is?' It was early in the evening when the chief executive called back. Yes, he said, the council did indeed have a lot of swap positions – and the treasurer saw it as a nice little earner. 'I really wouldn't worry about this, Howard. Anyway, everybody knows that interest rates are going to fall.'

With this, of course, the clock struck thirteen. Davies responded accordingly: 'So I said, are you telling me all of your positions are geared to interest rates going down? He was. Right, I said, I'm sending in the auditor and I'm sending a team from here as well.'

While detailed figures would take months to unravel, it was clear within days that something extraordinary had been happening at Hammersmith. It was a borough with bank borrowings of £308 million as of 1 April 1988 and a capital expenditure budget of £44.6 million for 1988–89. Yet in the books of its treasury department was a 'capital markets fund account' recording literally hundreds of derivatives contracts signed with banks from all over the world. Just as Goldman had said, the capital amounts covered by these contracts ran into many billions of pounds.

Hammersmith town hall was an unlikely hotbed of financial rocket science. In fact, it was one of London's loonier left-wing councils. (After a lunch with Deloitte's audit team a year earlier, Howard Davies had noted: 'They are clearly now getting to grips with a difficult authority in Hammersmith and Fulham where they are not allowed to refer to 'members', because that is regarded as sexist terminology.')[2] It had apparently made a profit on its derivatives activities to date, which was unsurprising given that it had been collecting premiums on contracts with contingent liabilities that only lay in the future. But what might its exposure eventually be? And how would it be affected by any unforetold *rise* in interest rates?

SWAPS AND THE LEGAL OPTIONS

As Tony Hazell and his colleagues from Deloitte began grappling with the paperwork, the Audit Commission had to take stock of its own position. It had been concerned over the use of complex derivatives by local authorities since the earliest days of creative accounting: the minutes of the members' monthly meetings record a string of anxious references to the subject. Perhaps, with hindsight, it is surprising that more assertive action had not been taken by the Commission already. Now, all district auditors were asked to report back on how many of their client councils were currently active in the market. Back came the answer within days: 137 of them. The Commission had urged caution on several occasions, but nothing more. Clearly this was no longer enough.

There were just three basic options. Either derivatives trading was lawful. Or trades relating to the hedge of an underlying loan were lawful, but no others. Or all such trading was unlawful, and based on an erroneous reading of what the 1972 Local Government Act empowered councils to do in the financial markets. A joint legal opinion was urgently sought from a leading counsel, Roger Henderson QC, and a junior counsel, John Howell. What they handed to the Commission early in July, however, were three opinions. In one, both agreed that derivatives contracts were generally beyond the powers (*ultra vires*) of local authorities. The QC opined, separately, that hedging derivatives related to an underlying portfolio ('parallel contracts') could be legitimate. His junior advised, in a third opinion, that all derivatives were unlawful.

Davies and Cliff Nicholson, mindful of the sensible ways in which swaps could evidently be used to reduce a council's exposure to interest rate movements, opted for Henderson's opinion – the hybrid option. In a memo that went out on 13 July, they alerted the auditors to the legal advice that had been received. The only swaps to be accepted as legitimate, they advised, were those used to hedge individual loans – and even here, trading such swaps would be unlawful. Other derivatives were not to be accepted.

They had pondered hard over the Howell opinion. It had the attraction of being a simpler response, but was it really practical? It would have entailed a huge setback for the capital markets and the unwinding of hundreds of contracts all across local government. Davies could see no justification for that. On the contrary, he and Nicholson urged auditors to be pragmatic and use their common sense. 'Where authorities have engaged in swap transactions beyond the limited scope accepted as legitimate [but] the response is one of agreement to limit any future activity to hedging individual loans, there is no need to take action on previous activity. The transactions cannot be unravelled and the authorities should be discouraged from seeking to do so.'[3]

Back in Hammersmith town hall, Tony Hazell duly extracted a promise from the council that it would suspend swap transactions from 1 August. But its response to the auditor was curmudgeonly at best. The officer responsible for the capital markets fund account took exception to the joint opinion from the Commission's counsel, of which the council had been given a copy. It was 'too narrow and ignored cash and investment management considerations'.[4] The finance director warned that swap activities could only be halted 'temporarily' and would not preclude further selective trades as 'the most prudent response to the present uncertain position . . .'[5]

Over the following six months, Hammersmith compounded the managerial ineptitude that had already brought it to the brink of disaster. As an illustration of just how badly a local authority could be run, it might almost have been designed to accompany the first two of the Commission's Management Papers. Neither the leader of the council nor any of its elected members had any idea what was happening in their finance department. Indeed, in view of the massive potential exposure so rapidly accumulated, it was questionable whether even the finance officers really understood what they were doing. (The Commission's in-house lawyer, Tony Child, thought not.) None of them had sought any outside legal advice over derivatives, though they had been in the market since December 1983 and had been deep into speculative contracts since April 1987. The council's own director of legal services was not asked for his views until February 1989. Letters from the auditor to the chief executive generally drew replies from the finance director (or, just as often, his deputy). And all of them seemed to be in a collective state of denial over the time-bomb ticking in their treasury. It was not until the end of October that leading counsel was even instructed.

Anthony Scrivener QC's opinion for the council took six weeks to complete and was received a few days before Christmas 1988. Another three weeks elapsed before a copy of it was sent to the auditor. In a covering letter, the council officers explained why in their view the opinion allowed them 'a wider range of powers' than counsel to the Commission had deemed legitimate. Accordingly, and with breathtaking defiance in the circumstances, the letter said 'the council is considering what action it should take, if necessary, in conjunction with other local authorities'.[6]

By mid-January 1989, though, the Commission's patience was wearing very thin. Even more astonishing than Hammersmith's dilatory handling of the crisis was the sheer financial scale of it, which by now was becoming horribly apparent. Back in April 1987, the council had been a party to deals with a notional principal sum of just £135 million. The equivalent figure for August 1988 was £4.2 billion. This guy Hammersmith, as the lady banker had put it, was accounting for a half of one per cent of the entire global market in derivatives! At one point, its contracts had represented roughly 10 per cent of the sterling sector of the market. Under an 'interim strategy' adopted from that August, the council had continued – true to the weasel words in their response to Tony Hazell – to strike fresh deals in the market. It seemed all too likely, though, that these were just digging the hole deeper. (Later records would show that, between April 1987 and April 1989, the council executed a staggering 613 deals, involving a notional principal sum of £6,208.5 million – equivalent to more than one contract for every working day, with an average principal sum of about £12 million.)[7] Meanwhile, there was one unambiguous change since August 1988. The level of sterling interest rates had almost doubled, from around 8 per cent to 15 per cent. As of February 1989, Hammersmith's treasury had lost its reckless one-way bet in spectacular style. By one estimate, the cost of closing out all of its derivative contracts was now around £300 million – or roughly an eye-popping £4,000 from every ratepayer in the borough.

The Commission had to tread extremely warily. It had no *direct* statutory responsibility for tackling Hammersmith's predicament.

That was down to the auditor. (The subtlety of this distinction, given the Commission's statutory responsibility for appointing all auditors and prescribing the code of practice that governed their fulfilment of their duties, would be a source of confusion to many third parties.) Nor was the Commission's advisory role entirely straightforward: Tony Child conferred closely with Cliff Nicholson but was formally engaged (in line with his usual practice) as solicitor to the auditor with the statutory burden. Yet of course it was the Commission that had to take the heat from the City. This mounted steadily through the autumn of 1988 as the banks grew increasingly exasperated over the auditor's failure to produce a clear-cut ruling. By early 1989 there existed a tense stand-off, which remarkably had still to be picked up by the media.

If Hammersmith's contracts were to be declared illegal, the banks would face substantial losses. Leading City law firms, led by Clifford Chance and Linklaters & Paines, put two arguments to the Commission. First, it was unconscionable that anyone could think of nullifying contracts freely entered into by the council. (Some colourful doomsday scenarios were lined up in support of this view.) And second, according to a precedent in the private sector, any legitimacy for parallel contracts – that is to say, contracts entered into as a hedge against market risks incurred on underlying borrowings by the council – would mean the openly speculative trades had been unlawful only because the council did too many of them or executed them for the wrong purpose. That would not preclude the banks from enforcing these latter contracts. (This was known as 'the *Rolled Steel* argument', a reference to the commercial precedent.)

This second line of argument from the banks proved counter-productive. Tony Child had been certain from the start that Hammersmith's capital markets fund had been unlawful: 'it was completely unrelated to treasury management in any way'.[8] But the banks' stance made him more acutely aware than ever of the different consequences that would flow, depending on whether it was the scale and nature of the transactions that made them unlawful or the fact that there was no power to trade like that at all. 'If there was no power, it protected authorities for the future. If we didn't win on the "no power" point, the banks were going to say: "You've got a pyrrhic victory and we can still enforce these deals."' Child himself did not accept the Rolled Steel argument – but he was determined to close the door on it, just in case.

Accordingly, at the end of January, he exercised his duty as solicitor to the auditor and bravely advised him that he should disregard Roger Henderson's advice on parallel contracts – which was still broadly espoused by the Commission itself – and be guided instead by the opinion written by John Howell, the junior counsel. In other words, the auditor should argue that *all* trading in derivatives was *ultra vires* for local authorities. And he should apply to the High Court for a Section 19 declaration by the judge to this effect – meaning that all of the capital markets fund's actions in 1987–88 and 1988–89 would be deemed illegal. Hazell accepted Child's advice.

There was now an awkward difference of view between the Commission on the one hand and its auditor on the other. Davies and Nicholson had no choice but to back the auditor in public, of course – and to hope that a way would turn up in due course of reconciling Child's uncompromising legal strategy with a practical agenda for cautious councils using swaps to hedge their loans books.

FROM COUNTING HOUSE TO COURTROOM

The controller and his deputy hosted a conference in Vincent Square late on the afternoon of 8 February 1989 that for the first time brought together all of the key players. For the council, the leader and some of his committee chairmen attended along with the finance officers and their external counsel, Anthony Scrivener. From Deloitte, Tony Hazell came with his main partner on the audit, Michael Roberts. Tony Child and his assistant, Judy Libovitch, sat alongside Mike Barnes and Harry Wilkinson. No record of the discussion survives but presumably, given Child's advice to Hazell, the full implications of the Howell opinion must have been spelt out. After so many months of investigation, some degree of consensus on the way forward might have been expected. There seems to have been none.

At least, though, the conference energized the members and officers of the council. A torrid schedule of meetings now ensued in the town hall. But while the auditor struggled to administer the last rites to all their fantasy finances, the members and officers spent most of the next two weeks vehemently reassuring themselves that all was well. Seemingly unaware of the enormity of its potential liabilities, the members and officers of the council continued to insist on the legality of its activities. 'Treasurers sought to reassure members that the potential exposure (which they feared at the time could be as high as £2.5 billion) was notional rather than real money. The clear impression given to elected representatives was that the authority had played the markets and won.'[9]

The capital markets fund was a corpse that wouldn't lie down. But several nails now went into the coffin in quick succession. News of the crisis finally broke in the media, with a scoop by the *Independent* newspaper on 25 February. Two days later, Tony Hazell issued a Public Interest Report warning that court action was imminent. And the morning after that, a letter was delivered to the council from the Department of the Environment. Hammersmith's finance director had written to Nicholas Ridley on the 24th asking him to sanction further trades in the capital markets and to indemnify councillors and officers against any penalties for handling them. Ridley declined to do so. This brought squawks of indignation from the council, but a white flag too. It issued a press release explaining that it wished to honour any and all payment obligations incumbent on the capital markets fund. 'However, further payment made in these circumstances without the sanction of the Secretary of State would render those authorising the payments liable to surcharge.'[10]

On 6 March, having had confirmation from the auditor that he was proceeding with a Section 19 application to the courts for all of the fund's activities since April 1987 to be declared *ultra vires*, the council passed a formal resolution to suspend all its capital market activities.

Thus far, the Audit Commission had handled the crisis with considerable skill. It had positioned itself (and accommodated a subtle repositioning) adroitly on the legal fundamentals of the case. It had complied with the procedural niceties of the situation since June 1988 with patience and sensitivity, while providing vital support and encouragement to the auditor. And it had coped well with the intermittent involvement of interested third parties. But it still had two vital contributions to make.

The first, in American football parlance, consisted of some defensive blocking. Once the full import of the auditor's position was clear, there was intense pressure on both Deloitte and the Commission to ditch the case, not least from other local authorities. If Hazell's Section 19 application was granted, it would of course put an end to derivatives trading by all councils, as the Commission itself was all too well aware. Existing contracts would need to be rescinded – and putative gains would have to be surrendered. Tony Child recalled: 'Many people in local government were saying "Back off, don't get involved! Hammersmith have dug this pit for themselves. Why should the rest of us suffer, if we've been doing it for perfectly proper reasons? And if some of us have made money out of it, why should we have to give it back?"'[11]

But of course it was the bankers who leaned hardest on the Commission. Doubtless their regard for the sanctity of contract would have prompted fierce opposition even had Hammersmith council been in line for a huge net windfall. The fact that it wasn't, and that the banks together stood to forfeit a net gain of several hundred million pounds, may just have added to their distress. Some of them took an extraordinarily aggressive stance towards the Commission. On one occasion, Davies was visited in Vincent Square by a senior executive who warned that his bank was considering legal action not just against the Commission, but against the controller in person, too.

The banks with the most to lose included two of the British clearers, Midland Bank and Barclays Bank, plus Security Pacific National Bank and Chemical Bank of the US and Mitsubishi Finance International, the City subsidiary of a Japanese bank. They formed a steering group to fight the action. And while their legal advisers prepared to contest it in the courts, the banks began to canvas for appropriate retrospective legislation in the ugly event that Hammersmith's trades were eventually to be declared *ultra vires*. They won support for this cause from the British Bankers' Association – and at first, too, from the Bank of England.

The Bank had been very concerned indeed for some time about the impact of the case on the markets, and had initially tried to persuade the Commission to back off. But the Bank official in charge of the brief was Eddie George, who had been Howard Davies's counterpart at the Bank when Davies was working in the Treasury. George, a future governor of the Bank and widely known as Steady Eddie for the sureness of his touch, contacted the controller and the two of them talked through the issues at some length. George quickly appreciated the Commission's dilemma: he was soon taking an active role in explaining its position to the banks, while looking for ways to resolve the problems he could see ahead.

Meanwhile, Davies and Nicholson stood their ground. The auditor was fully entitled to make up his own mind on the Hammersmith case. He had decided to take a more radical stance than the Commission itself on the law governing swaps. That was his prerogative. It in no way diminished the Commission's support for his action. Rumours swirled all through the DAS about the pressures on the controller. There was scurrilous talk of private investigators, paid by City financiers to dig up dirt on the controller and his team. Suspicious individuals were said to be loitering in the corners of Vincent Square. Meanwhile, more plausibly, the banks' PR people were working overtime to win support in the financial press. Would not success for the auditor, after all, be the end of an era for the City of London?

Faced with their overt opposition, Tony Child named the five lead banks as third party respondents in the district auditor's application. This allowed their interests to be represented in court. But it helped to concentrate minds in Hammersmith town hall, too. By the time the application was lodged, on 31 May, most of the councillors were more than happy to acknowledge the auditor as the prospective saviour he really was.

The banks were soon disabused of any notion that Whitehall might see their defeat as a blow to the City of London's reputation. When Davies and his chairman sat down to talk about the case with Ridley at the DoE, late in June 1989, he told them the Bank had tried this line with No. 11 – 'but the chancellor had responded "robustly" to these arguments'. Ridley himself thought retrospective legislation to validate selected trades was simply out of the question. He saw 'some advantages' if the banks ended up getting their come-uppance. In fact, it would be rough justice. 'The government had spent a lot of time and energy attempting to close off loopholes but the banks had persisted in doing business with local authorities contrary to the spirit and sometimes the letter of the legislation.'[12]

Tracking down the letter of the legislation and relating it specifically to what exactly Hammersmith council had been doing since 1987, was going to be a gruesomely complicated business. On this score, at least, the banks and their City lawyers must have supposed themselves at a significant advantage to any local government auditor. Surprisingly, the opposite proved true. This was the second of the Commission's vital contributions. In Tony Child, they fielded a solicitor with an unsurpassed knowledge of local government law *and* a readiness to immerse himself in the financial minutiae of the derivatives' market until he could describe its activities with a rare lucidity. As for his willingness to be his own man and to scrap hard against any odds, there was never much doubt about that.

Child, Hazell and their two assistants met together at the start of March to begin their work on the district auditor's affidavit. Child himself never went to Hammersmith (though he and Judy Libovitch did visit the City offices of the council's solicitor, Herbert Smith, to copy documents lodged there). Instead, with the help of innumerable shopping expeditions by the auditor, dozens of box files were brought from the town hall to the Commission's offices in Vincent Square. There, over the next eight weeks or so, Child and his assistant – together with Hazell's counsel, John Howell – pored over hundreds of contracts to reconstruct a detailed narrative of the key events in the case.

The crisis hinged, in common parlance, round Hammersmith's swaps – but in reality, of course, the capital markets fund had gorged itself on every dish in the derivatives diner. For days on end, the team at Vincent Square waded through the documentation for swaps and options, caps, floors and collars. They produced succinct illustrations of everything from simple straddles to exotic 'mandatory cash exercise strangle options'. And the end result was a 140-page affidavit that won the auditor's case a credibility and authority in the courtroom that none of the respondents ever matched.

UP THE LEGAL LADDER

Proceedings began in Crypt Court 2 of the Royal Courts on 1 October 1989, before Lord Justice Woolf and Mr Justice French. They lasted ten and a half days. Right at the outset, there was a clash of views between Hammersmith's lead counsel and the bench. The council, said Tony Scrivener, wished to argue *both* that parallel contracts could be lawful *and* that all swaps could be deemed *ultra vires*. Lord Justice Woolf thought this impermissible. It had to be one argument or the other. Scrivener refused to concede the point, though it was quite clear to Child that the lawyers at Herbert Smith were strongly committed to the *ultra vires* view.

Next morning (and thereafter), Scrivener failed to appear. Junior counsel stood to say that Hammersmith accepted all swaps were *ultra vires*. From that point on, the citing of the council as a respondent in the case was a pure technicality. The Commission continued to insist in public that it was a dispute between the auditor and his client council. But in truth it was essentially the Commission and its auditor versus the banks.

The High Court ruled for the auditor. Everything turned on its judgment on Section 111 (1) of the 1972 Local Government Act. This empowered local authorities to do anything 'which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions'. The High Court decided that swaps did not facilitate a function, but rather the *consequence* of a function. They were therefore beyond the legitimate powers of a council.[13] The banks, not unreasonably pointing out that swaps had been undertaken by council treasurers for many years without anyone publicly impugning their legitimacy, turned to the Court of Appeal. The council, having flipped its case over in the High Court, now joined the auditor against the banks.

Privately, Davies and his colleagues had their own worries about the practical consequences of the High Court ruling. After all, it threatened precisely the problems that they had sought to duck at the outset in opting for the Henderson opinion. In December 1989, Davies went with the chairman, David Cooksey, to see Chris Patten, who had succeeded Nicholas Ridley at the DoE. The visit was not expressly arranged to talk about the swaps case. They covered a broad agenda of other matters – and Patten made it clear that he could say nothing about it while the appeal was pending. But inevitably the discussion turned to the Hammersmith case.

The permanent secretary, Terry Heiser, made it clear he was fiercely opposed to the idea of any retrospective legislation, as Ridley had been. All that Cooksey and Davies could do was point out the difficulties that might lie ahead. 'The chairman said that the Commission would on balance hope that the secretary of state might do something to allow councils who undertook debt-management type deals in the past in good faith to honour their obligations.' Patten said he noted this view.[14]

The appeal by the banks was heard in February 1990, and was presided over by the president of the Family Division. This expediency was reportedly forced on the Court of Appeal by the huge workload with which it was struggling at the time. The proceedings lasted just over fifteen days. On the day of the ruling, it was a measure of the intense interest in the case that something highly unusual happened. 'For the only time in my life, at a Court of Appeal judgment,' remembered Child, 'they locked the doors. So once you were in, you were not going to be let out again until all the details of the judgment had been delivered, in case it affected the markets.'[15]

The Appeal judges ruled, in effect, that wherever they enabled a council to manage the interest rate risk on its loan portfolio, swaps were facilitating a function and were therefore legitimate. Where they were traded in pursuit of a profit, they were not. In the case of Hammersmith specifically, contracts before the auditor's intervention should be seen as speculative and unlawful. Subsequent swaps could be seen as part of an attempt to reduce the council's portfolio risk and were therefore to be honoured. The media generally welcomed the judgment. In the *Financial Times*, the Lex Column observed: 'overseas financial institutions can feel more confident that City deals will not be sabotaged by arcane UK laws. The integrity of the markets has been preserved, without allowing the banks to escape the consequences of their foolishness in over-trading with Hammersmith and Fulham.'[16]

The banks themselves wasted no time in issuing writs to enforce payments of more than £3 million outstanding on the post-July 1988 contracts. The Appeal ruling meant there was no immediate need to invoke the Rolled Steel argument for these. However, there was little doubt in legal circles that the banks would in due course turn their attention to building a case for further payments. This was a widespread expectation for a good reason: many senior lawyers thought the Appeal Court's ruling had in several respects been rather bizarre. Indeed, it was considered so unsatisfactory that Cooksey was privately urged by many powerful figures at the Bar to ensure that matters did not rest there.[17] The final decision, as ever, had to lie with the auditor. But all eyes, inevitably, were on the Commission. How would it react?

It was a dilemma for the Commission. At their next monthly meeting, on 1 March, the members were told that Hazell was considering an appeal. In the meantime, the controller had turned back to Roger Henderson QC for further legal advice on the implications of the case. A conference with him would follow a week later. It was agreed that the chairman should subsequently call for a special meeting if he thought it appropriate – and David Cooksey had no doubt this was needed. And so, on the afternoon of 13 March 1990, for the first time since the Commission's launch in 1983, the members met for an extraordinary meeting. It was attended also by an independent solicitor – they were now well past the point where Tony Child could advise both the Commission and the auditor. The members fully appreciated that the Commission and the auditor were separate parties, and that the appeal decision was down to the auditor alone. It was Henderson's advice that Hazell's primary duty related to the ratepayers of Hammersmith and Fulham – but he was also entitled to take into consideration the effects of the case on local government generally, and on this score it was legitimate for the Commission to offer its own advice. But what should that advice be? It was a long discussion.

There was plenty to be said for the Appeal Court ruling. It had much in common, after all, with the original July 1988 opinion from Henderson 'which the Commission had consistently supported'. If accepting the ruling meant sacrificing the immediate interests of the Hammersmith community-charge payers in the wider interest of councils across the country – well, a case could certainly be made for doing just that. And they needed to acknowledge that any appeal to the House of Lords was always fraught with risk and the possibility of huge additional legal costs. Cooksey recalled: an unsuccessful appeal 'would have risked bankrupting the Commission but for our ability to put up our charges'.[18]

On the other hand, the Appeal ruling had plenty of disadvantages, too. It cast the definition of legitimate swaps much more widely than Henderson had done, which prompted some unease over the dodgy dealing that might arise in future. And, from a technical standpoint, there were several unclear aspects of the ruling that seemed likely to cause trouble even over Hammersmith. It was also a minor concern that the Appeal Court had reached a most unsatisfactory conclusion on costs, leaving the Commission with substantial expenses that members thought should be met from the ill-fated capital markets fund.

Reaching a decision proved a tortuous process. It was agreed that the auditor would not be criticized by the Commission if he chose not to appeal. Then it was agreed he would be fully supported if he did. But what should be the Commission's recommendation? Finally, and for the only time during his chairmanship, Cooksey decided that they would have to take a vote round the table. Even then, the outcome that was recorded in the minutes read like a truly Delphic utterance: 'on balance, the wider implications of the Court of Appeal judgment for local authority auditors and audit law generally were such as to suggest that an appeal to the House of Lords could be of value'.[19]

Tony Child's advice to the auditor was never made public but was almost certainly a great deal more forthright. There is no reason to suppose that he had changed his mind. He was ready to oppose the banks' writs. He was also ready to fight them in the ditches over applications of the *Rolled Steel* argument, which he feared might now regain some traction. But wouldn't it just be much simpler and therefore of greater assistance to local authorities everywhere if the House of Lords could be persuaded to back a blanket prohibition on swaps? Tony Hazell decided to appeal.

Whatever the verdict in the Lords, it was apparent that many local authorities were soon going to face some difficult meetings with their bankers. The Commission needed to be able to assist in this process, which meant some fence-mending of its own in the City might be no bad thing. Davies set up a string of meetings with the banks – and indeed with representatives from the Bank of England – through the early summer. 'Although it had not been possible to avoid the [Hammersmith] case going to the Lords, the meetings had helped to explain the Commission's position and had improved relationships with the banks,' as he later explained to the commissioners.[20]

By the autumn, the Commission was exploring with the British Bankers' Association how councils might best handle a post-verdict settlement. The BBA was optimistic enough to start work on an 'interest rate swaps code of practice' and asked for the Commission's comments on a first draft. Nothing was expected from the Lords much before the end of 1990 at the earliest.

Early on the evening of 31 October, the controller was the last person left in the office at Vincent Square. At about 7 p.m., the fax machine outside his door whirred into life. On the sheet of paper that slid gently into its in-tray was a letter addressed to the Commission solicitor. It was from the House of Lords Committee considering the Hammersmith and Fulham case. Their Lordships had provisionally decided, it said, to find against the banks on point 1A. In plain English, it had provisionally decided that councils had no power to engage in *any* swap transactions. Their Lordships had agreed with John Howell's opinion. Child had backed the winner. Davies put the letter in his pocket and went home. Next morning, he came in a little late, calculating that Tony Child and his assistant would arrive as punctually as usual. He stepped into Child's office and handed the two of them the letter. They read it together. Then, as Child recalled, 'we started jumping up and down in celebration'.[21]

Whether Davies actually jumped up and down with them is unrecorded. No doubt he felt mightily relieved that the court action was finally over. It had been a long haul since Mike Barnes had taken that first telephone call from Goldman Sachs in June 1988. And for all the reasons aired at the extraordinary meeting, it was a ruling he could welcome. Celebrations, though, were probably left to the lawyers. Davies would not have regarded a Lords ruling in favour of the Appeal Court as a disaster for the Commission. Nor did he see this ruling against the banks as a triumph. The truth was that he and

Nicholson had worked hard to insulate the Commission's credibility as an institution from the outcome of the legal action. A ruling in favour of the Appeal Court ought therefore to have been manageable. That was in many ways a better measure of their success over the past two and a half years than any specific ruling from the Lords. The Commission had properly fulfilled its role by stepping forward to halt an evident abuse of derivatives trading. How exactly such an abuse should be prevented from recurring in the future was a matter for the lawyers to decide. Davies, as ever with Nicholson's help, had held the ring for them to do so. He had shrewdly protected the reputation of the Commission throughout the process, and in so doing had greatly enhanced his own reputation as a cool head in a crisis.

He had also done local government a signal favour. For the Lords' ruling was not just a get-out-of-gaol card on existing derivatives-linked liabilities. It also marked a pre-emptive strike against the strong likelihood of a broader and more damaging crisis arising in the future. As the best detailed study of the episode concluded in 1998: 'For British local authorities, the House of Lords' ruling severely curtailed their capital markets activities, but effectively fireproofed them from the derivative debacles that came to be a recurring feature for US authorities, notably Orange County, during the 1990s.'[22]

By chance, the members were convening for their next monthly meeting on that same 1 November that had Child jumping in his office. It was business as usual in the boardroom. The provisional decision from the Lords went into the minutes simply as an event with some especially onerous housekeeping implications. 'Accounting Practice would consider what advice to give auditors to enable them to help local authorities in complying with the judgment. Discussions would take place with the banks and others to try to reach a constructive solution.' The threat posed by the court action had long since closed the capital markets to all local authorities. The unwinding of all their derivative trades, though, still seemed almost as daunting a task as it had appeared at the outset. Harry Wilkinson and the Accounting Practice directorate set to work almost immediately on the technical guidelines that would be needed by the auditors.

The formal judgment emerged from the House of Lords in January 1991. In addition to the ruling on the illegality of council activities in the swaps market, there was a welcome finding on the costs of the case. (Indeed, this proved rather a windfall. The court calculated a post-tax reimbursement based on gross costs in line with City fees. Because the Commission had relied so heavily on its own, rather less expensive in-house lawyers for most of the case, the final payout proved to be extremely generous: the income statement for 1991–92 showed costs of £31,000 and recoveries of £441,000.) But the judgment was by no means the last act of the drama. The great unravelling of contracts took several years to complete. The banks wrote off an estimated £600 million, though fears for the standing of the City of London proved to have been grossly overblown. The lawyers prospered as the banks and their former council clients squabbled over the restitution payments. The final curtain did not fall until May 1996, when the House of Lords ruled that such payments needed only to be accompanied by simple rather than compound interest.

As for the councils themselves, and their ratepayers, those facing sizeable losses on their trading books could count themselves fortunate indeed to see the losses cancelled – and there were a good few, though none in Hammersmith's league. Those confident of making a real return were less pleased to see their putative profits forgone, though few of them made much fuss. One exception was Westminster City Council, which sent its treasurer to appear before the House of Lords in 1990 and give evidence on behalf of the banks against the district auditor. Westminster's big day in the Lords, though, was yet to come.