

By Email to: joanne.lees@kpmg.co.uk cc to kevin.foster@eastsussex.gov.uk

5 July 2017

Notice of Formal Objection:

RE: East Sussex County Council's 2016/17 Annual Accounts on LOBO Loan borrowing

As an elector of East Sussex County Council (ESCC), I wish to lodge an [objection to the accounts prepared for public inspection by the Council for the year 2016-2017](#). I request that you prepare a public interest report and apply to the courts for a declaration that items of the accounts, namely "*Lender Option, Borrower Option*" (LOBO) loan borrowing (aka "Non PWLB Debt" pg 59), is unlawful.

The term 'unlawful' applies in this context, I believe, because the decision to sign up to so many [\(4\) LOBO loans](#) was unreasonable and irrational on the part of those in various positions of public trust.

Nowhere in the ESCC accounts are LOBO or *Lender Option, Borrower Option* loans named on pages 9, 27 and 59, [despite ESCC borrowing £35,900,000 via Eurohypo, Barclays and RBS between 2005 - 2010](#).

In July 2015, LOBO loan borrowing was subject to a Channel 4 Dispatches documentary: "[How Councils Blow Your Millions](#)", is the subject of a [Parliamentary Inquiry by the Communities and Local Government Committee](#) and an [investigation by the Treasury Select Committee](#).

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 East Sussex County 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.

As ex-Barclays' Capital employee Rob Carver stated: ["You just need a Bermudan swaption pricer to know the relevant volatility surface, some kind of interest rate model calibrated to the](#)

[appropriate processes and the full forward and spot curve.](#)”- not the things the average council finance department has to hand.

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 court of law.

East Sussex County Council borrowed approximately [£35.9 million in LOBO loans from Barclays, RBS and Eurohypo](#).

Additionally, East Sussex County Council were advised on its LOBO borrowing by [Treasury Management Advisors - Butlers \(refer to 7.\)](#) a subsidiary of brokerage firm ICAP run by Conservative Party donor Michael Spencer, who are known to have received at least [£27,000 in kickbacks](#) from the banks and ICAP, for each loan councils borrowed - [producing a conflict of interest](#) with the TMA’s contractual requirement to provide financial advice in the best interest of their local authority client.

Making such a large borrowing commitment under the conditions which the banks and advisors recommended and imposed, without benchmarking and recording the decisions against comparable PWLB loans, amounts to “irrational” conduct.

LOBO (**Lender Option Borrower Option**) loans are typically very long-term loans [\(50-60 years in the case of East Sussex County Council\)](#).

The initial interest rate is usually a fixed “teaser” rate, but the **lender** has the “**option**” to propose or impose, on predetermined future dates a new fixed rate. The **borrower** has the only “**option**” to either accept the new rate or repay the entire loan. [In the case of East County Council some LOBOs have option dates every 6 months, some every 5 years.](#)

In the current low interest rate climate, it is very unlikely that the lender will call it’s “option” as it would be disadvantageous to them.

That “lenders options” on LOBO loans are unlikely to be called by the banks was confirmed by [Barclays, which cancelled the lender’s option on vanilla LOBOs \(announced June 2016\)](#) converting outstanding LOBO loans to a fixed rate.

LOBO's are not identified in East Sussex County Councils accounts, and no attempt to price the fair value or breakage costs of exiting these 50-60 year duration loans, required under new IFRS rules has been made.

Council are now locked into risky expensive loans with high [\(3.6 - 4.39%\)](#) interest rates and large "breakage costs", for the next 50 years in a climate where ESCC could be borrowing at much lower rates.

With the current contracts, should the local authority choose to repay the loan (for example to access a cheaper rate loans elsewhere) without waiting for the lender to exercise their "option", it would need to pay a "break penalty" to exit the loan, which given the pricing of derivatives in the contracts can cost multiples of the original loan principal.

This is partially reflected in the fair value of the loans as set out on page 59 of the accounts, but cannot be defined precisely, as the final "break cost" would be determined through a negotiation process with the bank. In any case, East Sussex have falsely applied PWLB breakage costs to LOBO loans, when breakage costs for LOBOs are known to be almost three times higher ([refer Q: 12 - breakage cost = 90% of face value for LOBOs vs 38% for PWLB](#)).

Due to the complexity and "optionality" of the contracts, the overall cost over the long term of LOBOs loans to the Council would have been extremely difficult to benchmark to equivalent PWLB loans.

The decision to sign these contracts was a gamble and an irrational and unlawful decision by the Council.

I would therefore be grateful for you, under the *Local Audit and Accountability Act 2014*, to apply to the courts for a declaration that East Sussex County Council's LOBO loan borrowing as referenced in the 2016-2017 accounts is unlawful, and request that you prepare a public interest report on this matter.

Nicholas Wilson