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EDITORIALS

PFI hospitals bear the cost of Libor manipulation

A public inquiry is needed to determine the extent of the problem

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The fraudulent manipulation by Barclays Capital of the interbank lending rate (Libor) has real consequences for cash strapped NHS hospitals facing merger and service closure as a result of private finance initiative (PFI) debt repayments.[1] Libor, which is used by banks to set interest rates,[1] is linked to financial products known as derivatives that are widely used in PFI deals. By manipulating the Libor rate up or down banks can, at the expense of their clients, protect the profits they make from the trading of derivatives and mislead the market about the true cost of bank borrowing. South London Healthcare NHS Trust is in special administration, effectively bankrupt, because trust income is falling but PFI costs are rising,[2] partly because of reliance on derivative arrangements of the type marketed by Barclays Capital. The government has yet to examine PFI deals for fraud, although in the United States hospitals and local councils are considering suing banks for compensation, according to a BBC report.[3]

The derivatives industry, in which Barclays Capital is a major player, is fundamental to PFI. Derivatives are tradeable financial instruments used to protect lenders of long term debt from the risk of credit default (the risk that a loan is not repaid). According to the US regulator, the Commodity Futures Trading Commission, Barclays Capital traders manipulated the Libor rate by making "false, misleading or knowingly inaccurate [interest rate] submissions" to "benefit Barclays' derivatives trading positions."[4] Several other banks are being investigated by the European Union, including the Royal Bank of Scotland (RBS), which also has extensive PFI interests.

Derivatives are central to PFI because of the peculiar nature of this type of lending. In PFI deals, loans are secured not against assets but against hospitals' future revenue streams. Investment banks such as Barclays Capital that lend to PFI projects on this basis use derivatives known as "swaps" to protect the future revenue from which their loan is repaid. A swap is a derivative instrument used to insure (or hedge) against payment default in the event of adverse movements in interest or inflation rates. The Princess Royal University Hospital PFI in Bromley, which is a major contributor to the South London Healthcare NHS Trust deficit, was drawn up to include interest rate and inflation rate swaps. Interest rate swaps allow the PFI company to fix interest rates that would otherwise fluctuate in the money markets, locking the public sector into high interest rates when the cost of government borrowing is at a historic low. Inflation rate swaps involve passing the risks of inflation back to the public sector by indexing PFI payments to inflation even where PFI industry costs are not affected by inflation and interest rates already include a premium for anticipated inflation.[5] In Bromley, and many other NHS PFI schemes, the whole PFI debt repayment rises annually with the retail price index or a multiple of it.[5]

Derivatives' fees and profits are high. In the US industry it is estimated that fees for derivative arrangers, which in PFI deals are usually the lending banks themselves, account for 7-10% of total investment costs.[6] Profits from derivatives (known as the swap margin) are tied to Libor and, in the case of inflation swaps, are relatively unregulated and set by a small number of firms such as Barclays Capital. Inflation swaps and indexation, which are used to defer debt repayment, have such major cost implications that PFI has been described as a "pay for two get one hospital" policy.[7]

Treasury guidance acknowledges that inflation swaps are unlikely to offer value for money and advises against their use.[5] Nonetheless, swaps have been adopted in a succession of NHS hospital schemes and signed off by government because banks have consented to hospitals making lower PFI payments at the beginning of a contract secure in the knowledge that index linked payments will rise in the future. The arrangement has helped NHS trusts overcome initial affordability problems but created problems for the future.

In 2010, after the financial crash, Treasury guidance warned that the cost of derivatives had increased substantially,[8] but hospitals and local communities were left to bear the financial pain and service losses that inflated costs lead to. A public register of contracts and a major public inquiry are needed to determine the full extent to which the high interest rates, swap mechanisms, and swap margins fuelling the latest round of hospital and service closures are products of Libor manipulation and fraud.

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