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PRIME MINISTER

**COMMUNITY CHARGE AND THE RPI : INDEXED GILTS**

As you know, following Norman Fowler's letter of 28 July it has been agreed that the RPI Advisory Committee should be convened to consider the implications for the Retail Prices Index of the abolition of domestic rates. A series of meetings is being arranged over the next few months.

- Review PG

Although we must wait for advice from the Advisory Committee before making a decision, it may nevertheless be useful at this stage to consider what outcome we would prefer to see.

Nick Ridley in his letter of 12 August and John Moore in his letter of 3 October have stated the case for including the Community Charge in the RPI. On the other hand, the arguments for exclusion set out in paragraphs 2(a) and (b) in the paper by officials, of 22 July, are strong ones.

However, in considering this issue I have had a particular concern which my officials have been discussing with the Bank of England. This is the possible implication for index-linked gilts (IGs), given the standard clause in IG prospectuses that gives investors the right to require HMG to redeem stock at "indexed par" (ie the current redemption value) "if any change should be made to the coverage or basic calculation of the Index which, in the opinion

SECRET  
AND MARKET SENSITIVE



of the Bank of England, constitutes a fundamental change in the Index which would be materially detrimental to the interests of policy holders". All IGs at present stand below their current redemption value in the market, and if we were required to redeem and refinance them with new stock there would be a cost to the Government of some £3 billion.

Officials have therefore been considering with the Bank whether any of the options set out in the paper by officials circulated with Norman's letter of 28 July would be likely to trigger this clause. Although the key to this is "the opinion" reached by the Bank of England, we have been mindful that the Bank's decision could be open to challenge in the Courts, and have taken extensive legal advice, consulting the Law Officers.

The Bank has considered the three Options set out in paragraph 14 of the paper by officials. The Bank's view, in summary, is as follows :

- Option A, which produces a 4% step downward change in the level of the RPI, would represent a fundamental change to the RPI that would be materially detrimental to IG stockholders, thereby requiring stock to be redeemed. I believe this option in any case to be politically unacceptable.
- Option B, under which rates drop out from the RPI as they are abolished but without producing a major discontinuity, is not a fundamental change in the Index, and even if it were, there are no firm grounds for concluding that it would be materially detrimental to the interests of stockholders.



- Option C, under which rates are replaced in the Index by the Community Charge, is a fundamental change in the Index, since payments such as the Community Charge which are statistically classified as direct taxes have hitherto been excluded, but there are no firm grounds for concluding that it would be materially detrimental to the interests of stockholders.

At this stage these can only be provisional conclusions. The Bank cannot give a definitive opinion until the decision on the RPI has been made. At that stage the Bank would need, for example, to take account of any comments made by the RPI Advisory Committee and any other relevant information known to Government.

In reaching these conclusions the Bank has considered the evidence of relative growth of rates and other elements in the RPI in the past; and it has been shown such assessments as have been made within Government of the likely future growth of the Community Charge.

While these are the Bank of England's provisional conclusions, based on its own legal advice, I have also to weigh the risks of the matter being subsequently brought to the courts, and the courts taking a different view. Given the amount of money potentially at stake we need to take a careful look at the risks.

I am advised that the Bank might face a challenge in court that it should have triggered the redemption if Option B were chosen. The Solicitor General's advice is that a court might well take the view that in judging Option B the proper comparison for the Bank to have made is not with what the RPI would have been, had rates

SECRET  
AND MARKET SENSITIVE



not been abolished, but with Option C, that is the replacement of rates in the Index by the Community Charge. Although the Bank believes this not to be a proper comparison to make, it also advises that judged on this basis there would probably be detriment and that the level of detriment could be significant.

I have therefore reached the conclusion that there is a significantly greater risk under Option B than under Option C so far as Indexed Gilts are concerned.

To summarise, while I can see strong arguments for Option B, given the risks for IGs I should on balance prefer to see Option C as the outcome. I should add that I do of course accept that the RPIAC must be consulted and their views be taken fully into account before the Government reaches a decision on the matter. Indeed I understand that the Government might be judicially reviewable if the normal procedures were not followed. I hope however that you and our colleagues will agree that in putting the Government view to the RPIAC we can suggest that Option C is, on balance, preferable.

Finally, there could be undesirable market consequences if there were any suggestion in public that Option A, with a 4% fall in the RPI, were being seriously considered. To reduce uncertainty I therefore hope that in putting the matter to the RPIAC we can make it clear that this is not an option favoured by the Government.

Given the general market sensitivity I am sending copies of this note only to Norman Fowler and Nick Lyell. I am writing to Norman and other colleagues separately, summarising my views.

A handwritten signature in dark ink, appearing to be 'N.L.' with a flourish.

N.L.