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ANNEX
A

E.A.J. GEORGE
EXECUTIVE DIRECTOR

22 June 1988

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Dear Michael,

INDEX-LINKED GILTS AND THE RPI

- 1 In your letter of 19 May you outlined three options for adjustments to the RPI to reflect the change from rates to Community Charge, and asked to have an indication of the view we would be likely to take of the implication of the three options for the provision for early redemption of the index-linked stocks.
- 2 What follows is our provisional view, based at this stage on the summary information in your letter and the working papers you sent us with your letter of 15 June. We may of course need to revise our view in the light of any subsequent information.
- 3 For each of the three options in your paper we have found it helpful to consider the effect of the change under two heads - the one-off impact effect on the level of the RPI and the continuing effect thereafter on the future rate of growth of the RPI.

4 In the first option, rates (apart from Northern Ireland rates) would be progressively removed from the RPI and the Community Charge would not be included in replacement. You indicate in your letter that the impact effect of the first option would be a series of step reductions in the RPI, cumulatively totalling something in excess of 3 1/2%. The continuing effect, as compared with a situation in which rates were not being abolished, would hinge on the relative rate of growth of rates as compared with other components of the RPI: for the future this is unknowable; in the past rates have tended to grow faster than the other components of the RPI, but in this instance the past may not necessarily be a useful guide to the future.

5 The prospectus requirement is that early redemption must be offered "if any change should be made to the coverage or the basic calculation of the Index which, in the opinion of the Bank of England, constitutes a fundamental change in the Index which would be materially detrimental to the interests of stockholders". This requires a view on a series of related questions - whether there is a change in coverage or basic calculation, whether that change is fundamental, whether it would be detrimental, and whether the detriment would be material - the last three of these being for the Bank to decide.

6 We think that the first option would constitute a change in the coverage of the RPI, since rates are to be abolished. What is more difficult to determine is whether it would be a fundamental change. We have considered a number of tests which bear on whether a change could be considered fundamental:

- (i) whether the change in components is of such a kind as to change fundamentally the basket from which the RPI is derived; or
- (ii) whether, even if the basket is not fundamentally changed, the change in components nonetheless introduces a new element which alters fundamentally the character of the RPI; or
- (iii) whether the change produces a result which fundamentally departs from the existing purpose and use of the RPI.

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We do not feel that removing rates is ipso facto fundamental on any of these three tests. But a series of step changes on the scale indicated in your letter does seem to us arguably to be fundamental in the sense of the third test above. Moreover, since the step changes would be reductions in the RPI, they would clearly be detrimental to the interests of index-linked stockholders; and, given the magnitude indicated in your letter, we take the view that they would be materially so. We see no grounds for supposing that the continuing effect would offset this material detriment arising from the impact effects. We thus conclude that the first option would require stockholders to be offered early redemption, on the grounds that the change was both fundamental and materially detrimental.

7 In the second option in your letter, rates would be progressively removed and the Community Charge not substituted, as in the first option, but adjustments would be made to the weights attaching to the rates component as rates were progressively abolished to "avoid major discontinuities" in the level of the RPI.

8 If the adjustments do in practice remove any step change - and this is something we would need to check when we see the detail of what is proposed - the impact effect of this option would involve no change in the level of the RPI, and the continuing effect would be as for the first option. On that basis, there does seem to us to be, as in the first option, a change in the coverage of the RPI, since rates are to be removed; and possibly this option also entails a change in basic calculation, given the adjustments being made to avoid discontinuities. But after careful consideration we have reached the view that neither change would in our opinion be a fundamental one. As regards the change in coverage, we do not consider that removing rates is ipso facto fundamental, as indicated above in relation to the first option; and as regards the possible change in basic calculation, we do not feel that an adjustment (or series of adjustments) designed to avoid discontinuity arising from the removal of rates would on that account alone constitute a fundamental change - subject as above to our checking when we see the detail of what is proposed - since adjustments of that nature are made when there are changes in the quantities of the constituents of the RPI basket. In reaching this view, we have again considered the three tests in paragraph 6

above of whether a change is fundamental; it seems to us that none of the three tests is fulfilled in the case of the second option.

9 If the change is not fundamental, the question of detrimentality does not strictly arise. But in any case we can find no firm grounds on which to conclude that the change would be detrimental to the interests of stockholders; and still less to conclude that it would be materially detrimental. The impact effect, if step changes are avoided, would be nil; and the continuing effect would, as indicated above, hinge on whether the RPI would be likely to grow faster if rates were not being abolished. Past experience (see Annex) indicates that over the period 1970-1987 the average annual increase in rates* was 13.6% p.a. against 10.4% p.a. for the RPI, ie, rates grew on average faster than the RPI by 3.2 percentage points p.a. Over the shorter period since 1982, when index-linked gilts were first introduced, the average annual increases were 9.6% p.a. for rates* and 5.3% p.a. for the RPI, ie, rates grew on average faster than the RPI by 4.3 percentage points p.a. This means that the RPI excluding rates* would have been on average 0.112 percentage points p.a. lower over the whole period 1970-87 and 0.185 percentage points p.a. lower over the shorter period 1982-87. This evidence cannot be conclusive, since as indicated we do not feel that in this area the past is necessarily a useful guide to the future. But having considered the evidence, we do not feel that we can reasonably conclude that the continuing effect of the change would be materially detrimental in future years. We thus conclude that this second option would not require stockholders to be offered early redemption, on the grounds that the change is not fundamental and that in any case there are no firm grounds for concluding that it would be materially detrimental.

10 The third option would entail progressively replacing rates with the Community Charge. In your letter you indicate that the impact effect would be likely to raise the level of the RPI somewhat; and the continuing effect would hinge on the extent to which the Community Charge rose faster or slower than rates would have risen had they been retained (not, we think, on the extent to which the Community Charge rose faster or slower than the rest of the Index, as suggested in your letter).

* including water charges: see Annex

11 This, as in the other options, would seem to us to constitute a change in the coverage of the RPI: and we consider that it would be a fundamental change in the sense of test (ii) in paragraph 6 above, since the Community Charge is a direct tax, not related to the consumption of a specific service, and such payments have hitherto been excluded from the RPI for the conceptual and practical reasons set out in paragraph 2(iv) of your letter. But we see no firm grounds for concluding that the change would be materially detrimental to the interests of stockholders, since we agree with your assessment that the impact effect would be likely to be beneficial, and the continuing effect is unknowable (and there is not even, as in the case of the second option, any historical experience on which to base an assessment of the future effect).

12 Thus our provisional view, based on the information you have supplied, is that the first option would require the offer of early redemption, but the second and third options would not.

13 We have also considered with our legal advisers to what extent our opinion might be challenged in the Courts by aggrieved stockholders. It seems unlikely that judicial review would arise, since the matters in question are not in the area of public law but stem from contractual obligations arising from the terms and conditions of the prospectus, in which the Bank is acting in the capacity of an expert rather than an arbitrator.

14 On the basis of contract, there appear to be two avenues that an aggrieved stockholder might pursue:

- (i) in an action against HMG in contract, a stockholder might seek to show that our conclusion was so palpably misconceived that the Court ought to override it. But we are advised that, since the contract under which the stockholder acquired his rights does explicitly leave the question of offering early redemption to the opinion of the Bank, the Courts would be unlikely to override our opinion unless our judgment could be shown to be wildly off-beam;

(ii) in an action in tort against the Bank, a stockholder could attempt to show that we had been negligent in discharging our function, on the basis that we had a duty of care, which we had failed to discharge, and that the stockholder had suffered damage as a result. Again, we are advised that this would be a difficult case to mount. One obvious danger is that, in discharging our responsibilities, we might inadvertently omit to consider some obviously relevant factor because we were unaware of it. It would therefore be helpful if, before we deliver our definitive opinion, you could write and confirm for the record that you have given us all the relevant material information on which to base our opinion.

15 On this basis no challenge in the Courts appears likely in the circumstances to arise under the third option in your letter. It is, however, more likely that we would be challenged under your second option, but we think our position should be defensible.

16 I hope this is helpful in clarifying our provisional views. We would be glad to discuss this assessment with you further, if that would be helpful, and as indicated we may in any case need to review it in the light of detailed study of any further working papers.

Yours sincerely,

R. d. l. e.

GROWTH IN RPI AND RATES AND WATER SUB-INDEX: 1970-87

Average % increase unless specified

	<u>RPI</u>	<u>Rates and water charges*</u>	<u>Rates & water increases less RPI increases</u>	<u>Weight of sub-component (% of RPI)</u>	<u>Contribution of rates and water to RPI increase</u>
1970-87	10.4	13.6	3.2	3.5%	0.112
1982-87	5.3	9.6	4.3	4.3%	0.185

* Rates only in 1987

Note

Except for 1987 these figures include water charges in the figures for rates, since that is the basis on which data for the RPI are published. Water charges are, however, of considerably less importance than rates in the RPI, with a current weight, for example, of 0.7% against 4.2% for rates.