

SECRET

FROM: M C SCHOLAR
DATE: 28 JULY 1988

1. SIR PETER MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Mr Anson
Sir Terence Burns
Mr Peretz
Mr Sedgwick or
Mr Hibberd
Miss O'Mara
Mr Potter
Miss Wheldon - Tsy Sol

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OK?
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*Supping so. But
if the bank
re Bank check
now, then
can be handled
St. James.*

Mr Scholar has done a good job in getting this letter into a sendable state. But it is still a pretty astonishing letter to be sending to the bank. Looking on the bright side, if the bank's view remains the same - as I suspect will - we shall be in a strong position. And I am pretty clear that the letter cannot be improved without a ministerial meeting with the Shadow General. *Em 29/7*

THE COMMUNITY CHARGE, THE RPI AND INDEXED-LINKED GILTS

At your meeting on 29 June it was agreed that we should return to the Law Officers, asking for new advice in the light of the changed situation, and seeking clearance of our draft reply to Mr George's letter of 22 June.

2. After some delay, because the economists' paper had to be reworked following Mr Ridley's announcement on local authority finance on 7 July, we now have the Solicitor General's advice (in the Attorney's absence), in the form of a revised draft of our reply to the Bank (flag A; please see, too, the attached earlier papers, including a further opinion from John Mummery).

3. Briefly, the Solicitor General's advice is that we can proceed as we proposed, but that we should invite the Bank particularly to consider the comparison with option 3 (RPI including the Community Charge) before reaching their view on whether option 2 (RPI without rates or Community Charge) would constitute a fundamental change in the RPI which would be materially detrimental to the interests of holders of indexed gilts. Our draft already made this point, but the Solicitor wanted us to make it with greater emphasis (see paragraph 4 at flag B); after some discussion with him he has agreed to a shorter, and better, version of this (paragraph 4 at flag A).

4. Are you content that I write to the Bank on these lines, enclosing this new version (flag C) of the economists' note, which also incorporates amendments from LG which they suggest in order to make the note wholly balanced?

MCS

M C SCHOLAR

A

FLAG A

cc Michael Scholar

405 7641 Ext.

Communications on this subject should be addressed to

THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

COVERING SECRET

Miss J. L. Wheldon,
Treasury Solicitor's Department,
Queen Anne's Chambers,
28 Broadway,
London,
SW1.

27 July 1988

Dear Sir

In my letter to you of 25 July I invited you to come back to us if there was any point in the draft enclosed with my letter which caused you concern. We have spoken about a number of such points, and I have discussed these with the Solicitor.

The Solicitor confirms the advice which was given to you in conference and which is largely incorporated in the draft. He is however content that the Treasury should send to the Bank the attached revised draft which includes amendments of style.

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E. S. WILMSHURST

COVERING SECRET

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SECRET -- MARKET SENSITIVE

INDEX LINKED GILTS AND THE RPI

1. Thank you for your letter of 22 June. There are three points on which it may be helpful to comment.

2. The first concerns the legal aspects covered in paragraphs 13-15 of your letter. Our own advice is that while the courts would not seek to second-guess the Bank's judgment as to the extent of the effect of the RPI, brought about by a `fundamental change`, which was necessary to constitute material detriment to stockholders, the exercise as^a whole is likely to be susceptible of judicial review. We are advised that by the exercise of its opinion-giving powers under paragraph 23 of the prospectuses, the Bank will directly affect the rights of many citizens i.e. as to whether they can redeem or not. The Bank is thus exercising a public duty in the sense that many members of the public will be affected by its exercise of power. It has been selected to perform that duty because of the special public position it occupies. It is the nature of the power rather than the source of the power which is important in this context. If the Bank were to abuse its power by misdirecting itself on the relevant law or by disregarding

procedural requirements or by arriving at an irrational opinion, the courts would not hesitate to grant an appropriate remedy by judicial review. I understand that even if the courts did not so hold and were to decline jurisdiction on an application for judicial review on the ground that in this context the Bank's source of power was contractual and that a challenge to its opinion was a matter of private law, then a disgruntled stockholder could sue the Bank in a private law action for declaratory relief, and if appropriate, for damages to negligence. The practical effect would therefore be very much the same.

3. We are also advised in the context of the meaning to be ascribed the words 'fundamental change' that paragraph 23 must be read as a whole. You suggest (paragraph 9 of your letter) that if a change to the RPI is not 'fundamental' the question of detriment does not strictly arise. We are not sure that this is right. In our view it is most unlikely that there could be a change in the coverage or calculation of the RPI which was materially detrimental to stockholders but not 'fundamental' for the purposes of the redemption clause.

4. Turning to paragraph 9 of your letter, we note your view that the continuing effect of the change involved in option 2 should be compared with the position had rates not been abolished. While we agree that this is a valid

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comparison we think a comparison with an RPI including the community charge, i.e. option 3, should also be considered. We appreciate that it is by no means easy to calculate the likely effect on the RPI if the community charge were included. But we believe that an investor might very well argue that the community charge, although in one sense and indeed perhaps the purest sense, a direct tax and not a price, nevertheless constituted a payment or charge for local services set locally by direct reference to the level of services provided; and argue, further, that this was the very way in which the community charge had been introduced and justified by Government. To take account of such an argument it might be wise to consider the likely effect on yield to stockholders of changes in the RPI caused by a range of variations in the community charge on the assumption that it was included in the Index. If the Bank thinks that a steep rise in the community charge would have a material effect on such an Index, and option 3 had not been taken as the comparator, this could provide the investor with ammunition in any court proceedings.

5. Finally, you asked if, before you deliver your definitive view on these issues, I would write to confirm that we had given you all the relevant material information on which to base your opinion. We have carefully considered what, if any, further material we should send to you, and I now enclose a note, prepared recently by our forecasters as

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an addition to their regular assessment of financial and economic prospects for the next few years - i.e. the early years of the new regime for local authority finance. I agree with you that the continuing effect on the RPI of the various options is to an extent `unknowable`, but I think that a court would require to be convinced that all reasonable possibilities had been considered.

6. We have undertaken a trawl, both within the Treasury and in the other relevant Departments, to see if there is any further analytical work of this sort which exists and which we ought to send to you. Our trawl has uncovered no further work beyond the note I am enclosing - although there may be other material - expressions of opinion, for example, about the buoyancy or otherwise of the community charge - on Departments' files which might be relevant to these issues, but which our trawl - which must necessarily not be well publicised, lest it leads to market destabilising leaks - has not uncovered.

E. A. J. George, Esq.,
Bank of England,
Threadneedle Street,
London, EC2

SECRET

FROM: A C S ALLAN
DATE: 1 August 1988

pup

MR SCHOLAR

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Peretz
Mr Sedgwick
Mr Hibberd
Miss O'Mara
Mr Potter
Miss Wheldon (TSol)

THE COMMUNITY CHARGE, THE RPI AND INDEXED-LINKED GILTS

The Chancellor was grateful for your minute of 28 July and the attached papers. He accepts in the circumstances that you should write to the Bank on the lines proposed, though he noted that it appears to give the Bank quite a strong steer towards changing their mind.

A handwritten signature in dark ink, appearing to read 'A C S Allan', with a long horizontal flourish underneath.

A C S ALLAN