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6 September 1988

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CC: EAJG o/r  
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*Dear David,*

INDEX LINKED GILTS AND THE RPI

1 Michael Scholar's letter to Eddie George of 1 August raised three points about the provisional views which we expressed in our letter of 22 June. We have considered these points carefully with our legal advisers but we have concluded that they do not lead us to change our views.

2 The first point was the question of whether the Bank's determination would be susceptible to judicial review. We would agree that the nature of the power exercised (and not just its source) may be relevant, but we are advised that, in this context, the Bank would not be exercising a public law function. We do not think that it is correct to say that, since our decision will affect the rights of many individuals, it is on that account a public law decision. The view we take, based on the advice we have received, is that the critical feature is that the Bank's decision will not affect the rights of individuals as members of the general public, but rather as stockholders in accordance with the terms of their contracts with H M Treasury and that, in performing this role, the Bank will be acting as an independent expert. Our authority to act in this respect derives not from statute or subordinate legislation but from the terms of the gilts prospectuses. As Michael Scholar's letter says, the Bank was "selected" for this role - we could not have been compelled to accept it. Indeed, if the Bank had been chosen to perform a similar role in a non-Governmental issue, it seems doubtful whether similar arguments would have arisen.

3 As Eddie George mentioned in his letter of 22 June, this is not to say that aggrieved stockholders would be deprived of all remedy. However, our advice leads us to disagree with the assertion that the practical effect of action under private law would be very much the same as under judicial review. It seems to us that the difficulties in the way of an aggrieved stockholder being able to mount a successful action under private law would be

considerable and the remedies available in such circumstances would not necessarily be the same as they would be in an action for judicial review.

4 The second point raised is the meaning of "fundamental change". We are advised that if there were a danger of ambiguity in the language of the gilts prospectuses it would be right to consider the provision as a whole, but that in this case, on a proper construction, the language would appear to be plain. Thus the three constituent elements must be examined in logical order, viz (i) a change in coverage or basic calculation, (ii) which is fundamental; and (iii) if those elements are present, which would be materially detrimental to the interests of stockholders. Whilst it may be correct to say that it is unlikely that there could be a change in the coverage or constitution of the RPI which was materially detrimental to stockholders, but not fundamental, the interpretation posited in Michael Scholar's letter does not seem to us the proper way to interpret the clause, confusing as it does the "conceptual" issue of whether the nature of the change is such as to constitute a fundamental change, and the question of the "effect" of the change.

5 The third point raised is whether, in reaching our determination, we should compare the second option (without the community charge included in the RPI) with the third option (an RPI including the community charge). As I understand it, your view is that an investor might seek to use an argument based on the effects of the third option in support of a challenge to the Bank's determination in respect of the effects of the second. You are concerned that not comparing the second and third options could provide ammunition in any challenge of the Bank's determination. We feel, and our legal advisers agree, that once the decision as to the treatment of rates and the community charge in the RPI has been made, the proper course of action is for us to analyse each option independently in the manner described in paragraph 4 above and make a determination accordingly. To reach a determination on the basis of having compared the effects of one option with the effects of another would in our view result in a determination based on "comparative effect", but using for the purposes of the comparison something different from that required by the relevant paragraph in the prospectus. We remain of the view that what is required is a comparison of the position prior to the change with that applicable after it, rather than with alternatives other than that actually implemented.

6 We are grateful for the additional material enclosed with Michael Scholar's letter. As I know you appreciate, it is important that we take account of all relevant material information, including any recommendations or views expressed by the RPI Advisory Committee and any government departments, up to the time we are actually called upon to make our determination in definitive terms. It would therefore be helpful if you could keep us up-to-date with developments on this question.

7 I am copying this letter to Michael Scholar and Margaret O'Mara.

*Yours sincerely,*

*John Phillips*

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13 September 1988

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SW1P 3AG*Dear David,*INDEX-LINKED GILTS AND THE RPI *not copied to us.*

1 In your letter of 12 September you asked us, in the context of current consideration of how the Community Charge should be treated in relation to the RPI, to consider the differential effect of the second option described in Michael Scholar's letter of 19 May as compared with the third option in that letter.

2 In trying to respond to your question, I should stress at the outset that, so far as concerns our function under the prospectuses relating to index-linked gilts, we do not consider that a comparison of that kind would be a relevant factor in reaching the determination required of us under the index-linked prospectuses and we would not think it appropriate to take it into account for that purpose. We remain of the view that what is required in relation to any particular option is a comparison of the position prior to the change with that applicable after it, rather than with alternatives other than that actually implemented. You indicated in your letter, however, that your legal advice on the interpretation of what is required under the prospectuses is different from our own. That there should be a divergence of views on so significant a question is a serious matter that we believe we need to address. We therefore think that we need to consult Counsel in order to obtain a third opinion.

3 In the meantime, we have endeavoured to make what comparison we can of the two options in question. The second option would, as Michael Scholar's letter describes it, provide for rates (apart from Northern Ireland rates) to be progressively removed from the RPI, with the Community Charge not substituted, but with adjustments being made to the weights attaching to the components

of the index as rates were progressively abolished to "avoid major discontinuities" in the level of the RPI. Under the third option, as we understand it, rates would similarly be progressively removed from the RPI, but they would in the process be replaced by the Community Charge.

4 It is helpful to consider differences in the effect of these two options 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.

5 Differential impact effects could arise in a number of ways and we would need to study the details of precisely how any such change was to be implemented before we could reach a firm view. But one of which we are aware from Michael Scholar's letter of 19 May is that progressive inclusion of the Community Charge as rates were removed from the RPI (the third option) would be likely at that point to raise the level of the RPI above the level produced by the second option because "index households" - which do not include the richest 4% of households and certain pensioners - are, we understand, likely to pay a relatively higher proportion of the Community Charge than of domestic rates. In the papers we have seen, the scale of this effect is put at around 1/4 percentage point, once-for-all.

6 The difference in continuing effect between the two options would depend on the extent to which the Community Charge rose faster or slower than the rest of the RPI. This is unknowable; and the historical performance of rates, which as you know we have already considered in our letter to you of 22 June, does not seem to us likely to be a useful guide to the future performance of the Community Charge.

7 The impact effect identified above does not in itself appear likely to be substantial, though it would be disadvantageous to the interests of stockholders and we would need to satisfy ourselves as to whether there were other impact effects. On the continuing effect, we are conscious that it is very difficult to reach any considered view, because there are so many unknown quantities. We are aware of a view expressed by some commentators, and noted in the Treasury's paper of 14 July on "Prospects for local authority finances", that local authorities may "see the new system as an opportunity to raise expenditure (and the Community Charge) in the belief that the level of the Community Charge will be seen as a government responsibility". We also note from the Department of Employment's paper of 22 July on "Treatment of rates and the Community Charge in the RPI" that future uprating of business rates will be limited to an amount not greater than the increase in the RPI, so that excluding the Community Charge from the RPI "could be seen as a means of further depressing the non-domestic contribution to local authority costs and increasing the burden on Community Charge payers". We are, of course, aware of the Government's view, expressed in the Treasury paper noted above, that "over time the greater accountability of local authorities resulting from the Community Charge system will reduce expenditure compared to what it might otherwise be, reducing the Community Charge for any given level of business rate income and grant receipts". On the Treasury's own projections in that paper, the Community Charge does not look likely to grow substantially in 1990-91, but the projections

suggest that it could rise more sizeably in 1991-92; and we have seen no projections for the years beyond.

8 On these considerations the second option would appear likely to be disadvantageous to stockholders as compared with the third option. But we do not at this stage feel able to make an assessment of the scale of the disadvantage.

Yours sincerely,

