BANK OF ENGLAND

Ben Broadbent
Deputy Governor Monetary Policy

Sir David Norgrove
Chair, UK Statistics Authority
1 Drummond Gate
London
SW1V 2QQ

4 March 2019

Dear Sir David

Thank you for your letter dated 18 February 2019, in which you set out a proposal for changing the basic calculation and coverage of the Retail prices index (RPI). The proposal described in your letter is to align the RPI with the CPIH, bringing the methods of CPIH into the RPI. If adopted, this would mean that, at least initially, the RPI would be identical to CPIH.

There is a very wide range of financial contracts linked in some way to RPI. As well as around £440bn of index linked debt, there are also substantial private sector liabilities linked to the index. In 2011, responses to the Debt Management Office consultation to issuing CPI-linked debt suggested that RPI-linked pension liabilities were 'likely to be in the region of around £650bn to £800bn'.[1]

As you noted, we have a specific responsibility for a small subset of these. Under Section 21 of the Statistics and Registration Service Act 2007 (the Act), the UK Statistics Authority (UKSA) must consult the Bank of England about the impact of a proposed change to the measurement of the RPI on particular index-linked gilts, the 2.5% 2020, the 2.5% 2024, and the 4.125% 2030. Specifically, the Bank must determine whether such a change is fundamental and whether it is materially detrimental for the owners of these gilts.

I would like to make it clear that nothing in this letter should be interpreted as expressing a view on the merits of the proposed change, which will necessarily depend on a broad range of considerations. This letter is concerned solely with the Bank of England's relatively narrow responsibilities under the Act.

This matter has been considered by a senior committee at the Bank, under my chairmanship, taking into account the advice of expert colleagues. The Bank's judgement is that the proposed change to the RPI would constitute a fundamental change to the basic calculation and coverage of the index and that it would be materially detrimental to the interests of the holders of relevant index-linked gilt-edged securities.

The proposal would result in a change to the elementary aggregation formula used in about a quarter of the RPI, altering the way the index is calculated at the most basic level. It would also involve a significant conceptual and computational change to the way that owner-occupiers' housing costs are captured within the index. Finally, there would be a number of changes to the RPI's weights and population coverage. For instance the inclusion within the RPI's reference population of the hitherto excluded 4% of households at the top of the income distribution, pensioner households dependent on income from state benefits, and foreign visitors to the UK.

Together, these represent a fundamental change to the basic calculation and coverage of the RPI. Moreover, the Bank considers it probable that the proposed change would cause the RPI to record lower rates of consumer price inflation on average than under the current methodology. Given the nature of the proposed change – fully aligning RPI to CPIH – there is a considerable amount of historical evidence on the behaviour of the two indices to suggest

[1] https://www.dmo.gov.uk/media/14572/cons20111129.pdf

that this effect is likely to be large when the change is implemented. Bank staff estimate that the proposals would be expected to reduce RPI inflation by around one percentage point on average. That is broadly consistent with the estimates of financial market participants gathered through the Bank's market intelligence function, as well as with published estimates of the average wedge over the future between RPI and CPI inflation published by the Office for Budget Responsibility.

A decline in the future path of RPI inflation of that magnitude would be expected to result in a material reduction in the cashflow return to holders of relevant index-linked gilts, and therefore a materially detrimental impact on the interests of the relevant bondholders.

The Bank's assessment that the proposed change would constitute a fundamental change that would be materially detrimental to the interests of the holders of the relevant securities applies to all three issues of relevant index-linked gilt-edged securities under consideration. We also note that in addition to these three securities where we have a formal role, there could also be a corresponding impact on other holders of RPI-linked instruments.

In writing this letter we have assumed that the move to aligning the RPI with CPIH is made imminently. The assessment could change if the alignment of RPI and CPIH were instead announced and then only implemented sufficiently long into the future.

I and my colleagues would be very happy to discuss any of these issues with you further.

A copy of this letter goes to John Pullinger and Jonathan Athow at ONS.

Yours sincerely

Ben Broadbent

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Deputy Governor, Monetary Policy