

**Consultation on the Measurement of
Mortgage Interest Payments
within the Retail Prices Index**

October 2009

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Introduction

1. The Office for National Statistics welcomes views on a proposed change to the measurement of Mortgage Interest Payments (MIPs) within the Retail Prices Index (RPI). This change was endorsed by the UK Statistics Authority in October 2009.
2. The consultation document contains the report on the change from the Consumer Prices Advisory Committee (CPAC). The Annexes are for background information and contain analysis on how the two different measures have performed historically. Following standard practice, no revisions will be made to the RPI for previous periods following the introduction of any new methodology. For more information see paragraph 11 of the main document.

Open consultation

3. You may wish to consider the following questions:
 - i. Does the alternative measure better reflect the expenditure of households on Mortgage Interest Payments?
 - ii. Should the change be made with the next RPI basket update which will be introduced in March 2010?
4. The consultation period begins with the publication of this document and will run for 12 weeks. Please ensure that your response reaches us by 22 January 2010.
5. Responses to the consultation should be sent to:

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Room 1227
Office for National Statistics
Government Buildings
Cardiff Road
Newport
NP10 8XG

Phone: +44 (0)1633 455 896

Alternatively, responses can be sent by email to: cpi@ons.gov.uk

6. This document can also be found on the Office for National Statistics website at <http://www.ons.gov.uk/about/consultations/>. The consultation is conducted in line with the UK Statistics Authority Code of Practice. <http://www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html>

7. When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled.

Terms of reference of the Consumer Prices Advisory Committee

Section 21 of the Statistics and Registration Service Act 2007 requires the Statistics Authority to compile and maintain the RPI and publish it every month. It further requires that before making any change to the coverage or the basic calculation of the index, the Authority must consult the Bank of England as to whether the change constitutes a fundamental change in the index which would be materially detrimental to the interests of the holders of relevant index-linked gilt edged securities. If the Bank of England considers that that change is a fundamental change in the index which would be materially detrimental to the holders of index-linked gilts, the Authority may not make the change without the consent of the Chancellor of the Exchequer.

Any methodological changes to the RPI therefore require the approval of the Authority before being referred to the Bank of England. To facilitate this, the Authority established a body to advise it on proposals for change to the RPI. This body is called the Consumer Prices Advisory Committee and it has three distinct roles:

1. To advise the UK Statistics Authority on the implication for the Retail Prices Index (RPI) of the improvements to this index recommended by the Office for National Statistics (ONS).
2. To provide the UK Statistics Authority with advice on RPI methodological issues.
3. To advise the UK Statistics Authority on improvements to the UK Consumer Prices Index (CPI) recommended by the ONS.

Membership of the Consumer Prices Advisory Committee

Members

Ms Jil Matheson	National Statistician (Chair) - from September 2009
Dame Karen Dunnell	National Statistician (Chair) - to August 2009
Mr Partha Dasgupta	UK Statistics Authority
Mrs Pam Davies	Office for National Statistics
Ms Stephanie Flanders	British Broadcasting Corporation
Mr Chris Giles	Financial Times
Mr Neal Hatch	Bank of England
Mr Adam Lent	Trades Union Congress
Professor Stephen Nickell	UK Statistics Authority
Mr David Ramsden	H. M. Treasury
Mr Dennis Roberts	Office for National Statistics
Professor James Sefton	Imperial College London
Mr Prashant Vaze	Consumer Focus
Dr Martin Weale	National Institute of Economic and Social Research

Secretariat

Mr Lewis Conn	Office for National Statistics
Ms Tracy Jones	Office for National Statistics

Consumer Prices Advisory Committee: Mortgage Interest Payment in the Retail Prices Index

Introduction

1. The Committee reviewed the present treatment of Mortgage Interest Payments (MIPs) in the Retail Prices Index (RPI) in September 2009. The committee has several recommendations for the UK Statistics Authority's consideration with the view to the changes to be implemented in March 2010 for the February 2010 RPI.

Recommendations

2. The Committee recommends that:
 - a. The Office for National Statistics changes the interest rate measure used in the calculation of mortgage interest payments in the RPI from the Standard Variable Rate (SVR) to an Average Effective Rate (AER) and that the choice of rate should be kept under review in future and changed, if necessary, at the annual RPI reweighting.
 - b. The AER should be introduced into the published RPI in March 2010, at the same time as the annual update of the basket of goods and services that underpin the RPI (and CPI).

Measuring Mortgage Interest Payments

3. The measure of MIPs currently included in the RPI is based on the Standard Variable Rate (SVR) of interest from the main bank and building society providers using data supplied by the Bank of England. The committee noted the two main concerns with this approach:
 - i. the SVR does not reflect the average rate borrowers are paying;
 - ii. the weight given to MIPs in the RPI has been overstated in recent years.
4. Both concerns surround the take up of fixed rate, discount and tracker mortgages which are not covered in the calculations. Data from the Bank of England indicate that fewer than 5 per cent of customers take out SVR mortgages and approximately only 10 per cent of mortgages in stock are on SVR rates.

Alternative measure of interest – the Average Effective Rate

5. The Committee reviewed an alternative measure of interest, the Average Effective Rate (AER), which has been developed jointly by the Office for National Statistics and the Bank of England. The AER is more representative of mortgage rates available, covering around 90 per cent of bank and building society mortgage lending.

6. The AER is calculated using the same data as the Bank of England's published effective rate¹, which includes various mortgage rates weighted together based on market share. For the RPI, these rates are weighted by the relevant stock of mortgages each January. (For the calculation of the 'effective rate', the Bank reweights the index each month.) The AER is in line with the RPI concept of a fixed basket with fixed weights within each year. The final MIPs series then reflects both new and existing mortgages.
7. Annex A shows how the RPI would have changed over recent years had the AER been included rather than the SVR.
8. The AER for any month cannot currently be compiled in time to be included directly in that month's RPI. However, the Bank of England forecast the average effective rate for the current month using the latest available data and this can be readily extended to produce a forecast AER. Such an approach would be consistent with the current methodology used to estimate the change in house prices within the existing MIPs series.
9. The effect of the forecasting error in the AER over 2005 to June 2009 is outlined in Annex B. The Committee noted that the effect on the all items RPI rate was very small. This forecast error is considered to be acceptable given the improved quality from the use of the AER.
10. The Committee noted that the proposed AER is based on average rates over the whole of a month rather than on a fixed date. This is out of line with current RPI methodology of collecting prices on a single day around the centre of the month. The divergence from current policy cannot be quantified but was considered by the Committee to be minor against the current limitations of using a MIPs series based solely on the SVR. The general issue of timing of collection will be reviewed further by the committee at a later date.

Implementation

11. Following standard practice, no revisions will be made to the RPI for previous periods following the introduction of any new methodology. The AER based series would be linked on to the existing MIPs series in January as part of and using the same methodology as the standard annual update of the basket of goods and services used in compiling the index. In effect monthly movements into January would depend on the SVR and monthly movements beyond January would depend on the AER. The 12 month percentage change over the year the change is introduced would be based partly on SVR and AER monthly movements.
12. The Committee preferred to move to the AER as soon as possible as the AER is more representative of mortgage interest rates that consumers are paying. However, the Committee also noted that the impact of incorporating this change going forward will depend on the relationship

¹ Bank of England (2009). *Effective interest rates*, Bankstats table G1.4, available at: <http://www.bankofengland.co.uk/statistics/ms/current/index.htm>

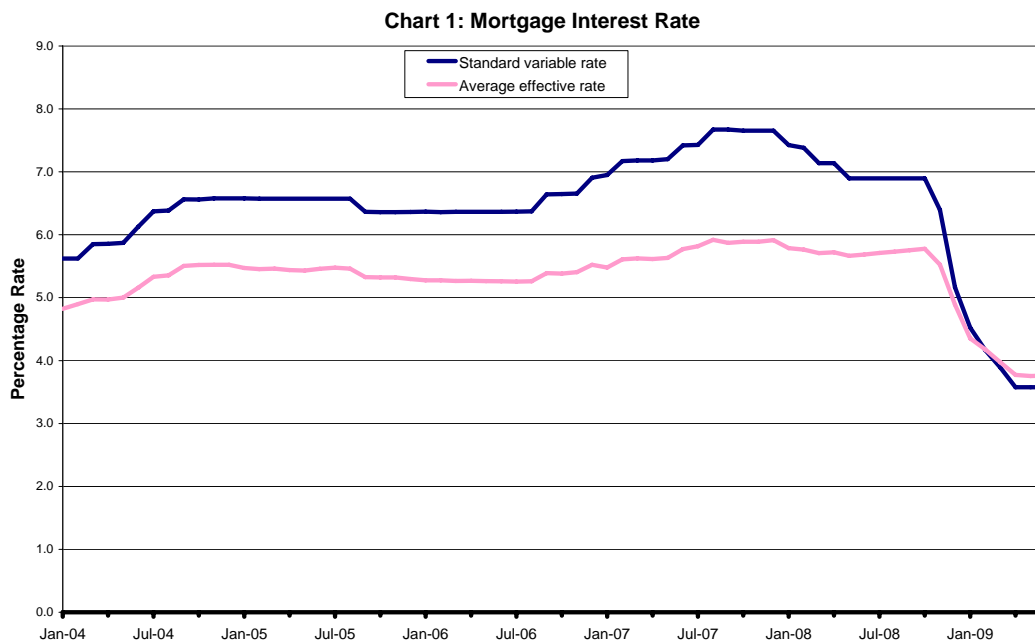
between the AER and the SVR from the point of implementation. Further, to implement the AER series in the monthly production of the RPI requires further work to be undertaken by the ONS and the Bank of England. The Committee noted that postponing implementation would allow a longer time series of data to be available to study the impact of the change in practice.

13. Changes to the RPI are best made with the standard annual update of the index in March so the first opportunity to incorporate the AER into the published index is for February 2010, to be published in March 2010.

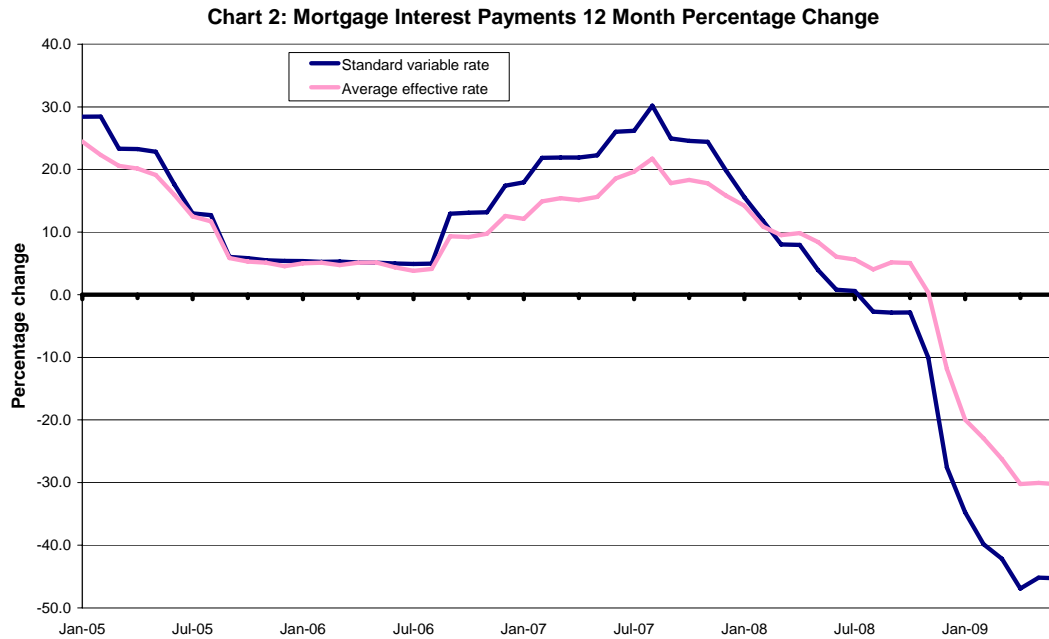
Annex A

Effect of using the Average Effective Rate in the Retail Prices Index

1. This annex illustrates the effect the proposed methodology would have had on the Mortgage Interest Payments (MIPS) series and the all items RPI had it been in place since 2004. Following standard practice, no revisions would be made to the RPI for previous periods following the introduction of the new methodology.
2. The actual Standard Variable Rate (SVR) used currently and the proposed Average Effective Rate (AER) are graphed in chart 1. From January 2004 to late 2007, the SVR was above and drifting further from the AER before starting to move closer again and crossing over to be below the AER from February 2009.



3. Chart 2 shows the effect of the different interest rates on the percentage changes over 12 months in the MIPS series. Up to March 2008, the AER based series was generally below the SVR, but as the bank rate fell, the SVR fell below the AER series.

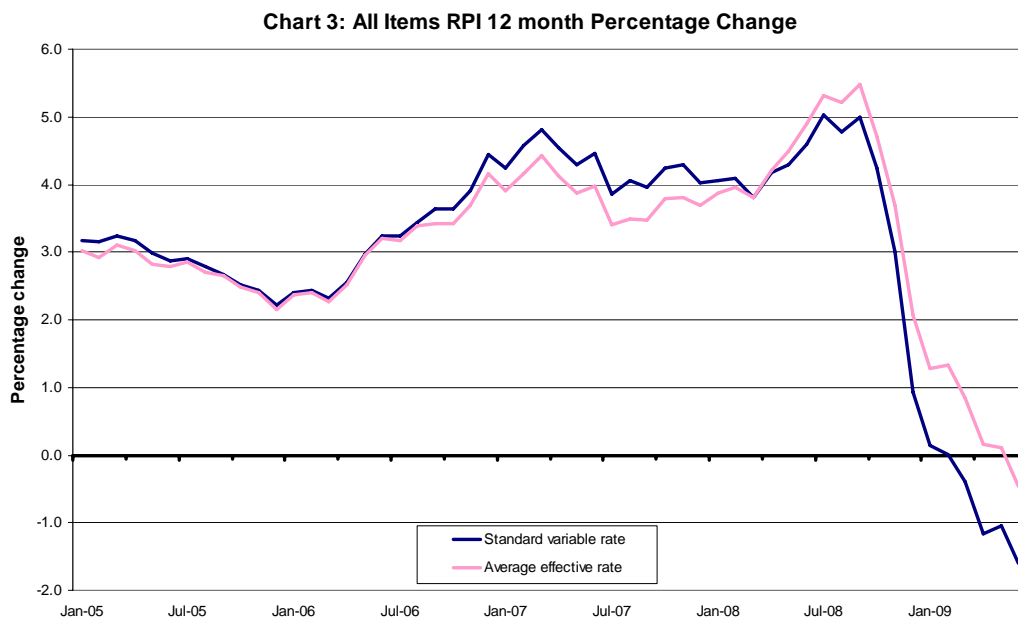


4. For most recent years the use of the SVR for weighting MIPs leads to a higher weight than would be attributed to the item if the wider range of interest rates included in the AER was used. This is due to its generally high value compared to the average rates borrowers are actually facing once the range of fixed and discount rates are taken into consideration. The effect of a move to using the AER reduces the MIPs weight as shown in table 1.

Table 1: MIPs section weights using SVR and AER

Year	Weight (RPI = 1000)		
	SVR	AER	Difference
2005	50	42	8
2006	50	44	6
2007	55	44	11
2008	60	48	12
2009	41	39	2

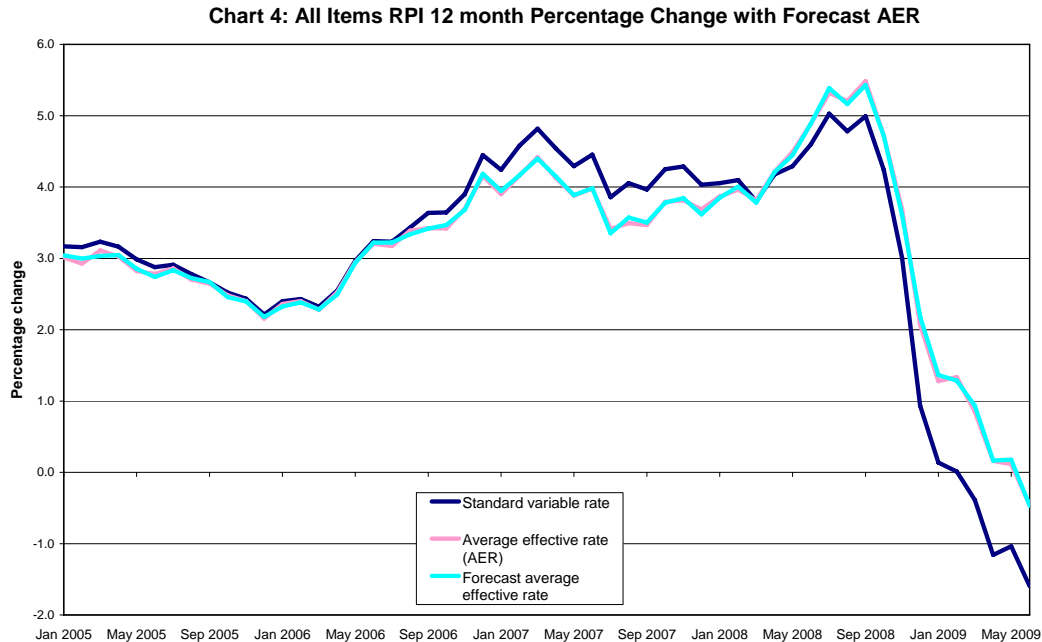
5. Chart 3 shows the all items RPI twelve month percentage change incorporating the SVR and the AER. For the period of analysis, the RPI twelve month percentage change using the reweighted AER series is 0.1 percentage points higher on average than the RPI using the SVR and the average of the absolute differences between them is 0.4 percentage points. Up to December 2007 the RPI twelve month percentage change using the SVR was generally higher than with the AER. As the official bank rate fell from December 2007, the relationship reversed with the RPI incorporating SVR falling further. The impact of incorporating this change going forward will depend on the relationship between the AER and the SVR from the point of implementation.



Annex B

Effect of Forecasting AER Series on MIPs Index and All Items RPI

1. One issue with the use of the AER is that it is not available in time to meet current RPI publication schedules. If the MIPs series is to be based on the AER then a one month ahead forecast is required to meet publication dates.
2. The preferred forecast is produced by weighting together a combination of fixed and floating rate mortgage series. The fixed rate series uses 2 and 5 year quoted fixed rates weighted together after taking 24 month and 60 month rolling averages respectively. The SVR has been used for the stock of floating rates.
3. Chart 4 shows the effect of the forecast on the all items RPI. The average error over the period January 2005 to June 2009 between the forecast and the AER based series is 0.00 percentage points, and the average of the absolute differences is 0.04 percentage points. To one decimal place, the RPI rate would have changed in 20 months out of 54 observations with a maximum absolute difference of 0.1.



4. The use of forecasting does have an effect on both the MIPs series and the all items RPI but any error introduced is much smaller than the difference between SVR and AER based series.