PO-CH/NL/0287
PART A

Part. A.

CONFIDENTIAL

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Begins: 17/11/86.
Ends: ~~10/7/87.~~ 24/7/87

PO -CH /NL/0287

PART A

Chancellor's (Lawson) Papers:

MORTGAGE LENDING GUIDANCE AND THE RETAIL PRICE INDEX

Disposal Directions: 25 Years

D.A. 18/10/95.

PO -CH /NL/0287
PART A

3107/45

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 17 NOVEMBER 1986

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Hall
Mr Murphy

Thanks. WA spoke.

MORTGAGE LENDING GUIDANCE

You asked whether anything can be done to limit, on prudential grounds, the proportion of a property's value which a bank or building society may advance as a mortgage. You may like a quick reaction in advance of your meeting tomorrow. For more considered advice, we shall need to consult Mr Bridgeman and the Bank supervisors.

2. I do not think we have complete figures for the growth in 100% advances. But BSA figures for the middle of 1986 do suggest a sharp rise in 100% advances to first time buyers (who account for the great bulk of such mortgages). In 1986 Q2, about a third of advances to first time buyers were for 100% of purchase price, compared with about one quarter in 1983 and only a fifth in 1984. Comparable figures for former owner occupiers were 6% in 1986 Q2, as against 3% in 1983 and 1984. But the proportion of advances in the 95-100% range seems to have remained fairly stable, at about one quarter for first time buyers. However, some of the recent publicity reflects an earlier growth in 100% advances, to some extent associated with council house sales, under the right to buy.

3. The question is whether these developments should be singled out as a special focus for supervisory attention. Both the Bank and building society supervisors are of course concerned with what is prudent behaviour for the institutions they supervise, and only indirectly with what is prudent behaviour on the part of private individuals. Two points are relevant:

- the first line of defence for an institution is the borrower's personal covenant. It is only when that fails that the security of the property is relevant. So income multiples are every bit as important as percentage advances. So too is the relationship (or absence of one) between a customer's ability to pay and the value of his property. (A 100% advance on a corner shop is riskier than a 100% advance on residential property).

- The supervisors' main concern is to ensure that an institution is adequately capitalised for the quantum of risk it assumes. The terms on which loans are made matters; but so too does the mix of an institution's business. Other things being equal, the Bank of England supervisors can afford to take a more broad brush view of the quality of a bank's mortgage book than is sensible for the building society supervisors. So the Bank supervisors do not in general differentiate between types of mortgages in deciding how much capital is appropriate to back a mortgage book. Even so, the proportion of 100% advances will feature in the supervisors' forthcoming questionnaire (referred to in the letter at Annex B of Mr Peretz' minute.) This is one aspect of their mortgage business the supervisors do want the banks to think about, even if it has no automatic consequences for capital required.

4. The Building Society Commission's proposed approach makes much finer distinctions, because mortgages are such a high proportion of building society business. Percentage advances are not the only factor determining how much capital backing a building society will need for its mortgage book. But they are <u>one</u> of the factors differentiating the four proposed classes of mortgage loans, each of which will attract progressively higher capital requirements. For example, the capital required to back loans secured by first mortgage on wholly owner occupied residential property where the loan has been outstanding for more than 5 years

(and has not been topped up) is 1%: the backing for new mortgages where the advance is for more than 90% of the valuation will require 2½% capital backing. (These proposals may be modified in the light of consultations, but probably not drastically).

5. If the supervisors felt that the growth of 100% advances warranted a tougher prudential regime, their natural response would be to impose steeper capital requirements. It might also be in keeping with Mr Bridgeman's style to issue a public homily, in a suitable speech, if he felt so moved. But I suspect that both he and the Bank supervisors would want to stop well short of anything resembling a directive, because this smacks of a degree of involvement in commercial lending decisions which both would regard as inappropriate. Arguably, too, it would be odd, even perverse, to single out 100% advances for mortgages, while remaining silent on unsecured consumer credit. X The sums of money may typically be larger, but at the end of the day any mortgage is intrinsically more secure than an unsecured loan.

RL.

RACHEL LOMAX

Money Figures and Interest Rates

'86 and '87

2149e

R A BARNES

Assistant Director,
Banking Supervision Division

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

24 November 1986

Mrs Rachel Lomax
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Rachel

The Chancellor has asked whether any supervisory action could be taken to limit on prudential grounds the extent to which banks and building societies lend to individuals against the value of their property.

It is open to the Bank to issue guidelines about lending characteristics which, in its judgment, could either constitute imprudent behaviour (and thus lead to the possible revocation of an authority) or to require, in the course of normal supervision, additional capital to be held against assets which were deemed to be riskier than the norm. But such guidelines would need to be justified in terms of protecting the interests of depositors.

Lending to individuals, whether secured against property or not, is not, of itself, an activity which has involved lenders in particularly pronounced risk. The lender's first line of defence is the borrower's capacity to repay rather than the value of the security. If the lender reduces his standards of judgment about the capacity to repay solely because he takes comfort from the security, the loan may become riskier. If, in addition, he lends more than he would otherwise have done, because he gives full value to the security, the riskiness of the loan may increase further. However, even in this case, the lender is not exposed, except in extreme circumstances, to total loss. Sometimes, where the capacity of the borrower to repay is undoubted, it may not be imprudent to lend against the full value of the security. Given this continuum of risk it would be difficult to draw up a detailed guideline affecting individual lending decisions which the institutions would accept as workable and justified.

But even if an institution does undertake some lending with riskier characteristics, that is not necessarily imprudent (if it is appropriately priced) in the context of its business overall, unless the volume of such business affects the quality of its total assets to an extent that depositors are threatened. Lending to consumers whether against security of a mortgage or not, rarely predominates within a bank's asset base. It does not justify a special risk-weighting within the broad-based risk asset measure which is currently in use. The situation may well be different for building societies where the assets are more homogenous and where variations in risk can properly be measured by more precise differentiations within a class of similar assets.

It would also be odd to single out this sort of lending specifically for detailed guidelines. Might it not be taken to be the precursor of similar guidelines, eg say, about margins to be taken on marketable securities when charged against loans, or about unsecured lending to small businesses? The Bank believes that a letter on the lines proposed in the draft you have already seen is a more appropriate supervisory response to any reduction of lending standards which may be occurring.

If, on the other hand, the concern expressed is not so much the supervisory issue of protecting depositors but concern about, say, overheating in the property market or changes in the personal sector's propensity to save, then it may be relevant to note that personal loans of this sort are also granted by non-deposit-taking companies which would not be subject to any guidelines the supervisors might issue.

I am conscious that this adds very little to the points which you made in your note of 17 November.

Yours sincerely

Roger Barnes

P.S. I am sending a copy of this letter to Michael Bridgeman.

3108/2

[redacted]

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 25 NOVEMBER 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz - o/r
Mr M Hall
Mr Murphy
Mr Bridgeman (without attachment)

MORTGAGE LENDING GUIDANCE

My note of 17 November gave quick reactions to the Chancellor's query about the scope for limiting, on prudential grounds, the extent to which banks and building societies lend to individuals against the value of their property. I attach a letter from Roger Barnes setting out the Bank of England supervisors' comments, which are generally in the expected direction. I understand that Michael Bridgeman will be letting you have a separate note.

RL

RACHEL LOMAX

26 NOV 1986

CONFIDENTIAL

Economic Secretary

From: J.M. Bridgeman

Date: 25 November 1986

c.c. PS/Chancellor of Exchequer
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Scholar
Mr Culpin
Mr Grice
Mr Cropper
Mr Ross Goobey
PS/IR
Mr Pitts(IR)
Mr George - BoE
Mr Coleby - BoE
Mr Barnes - BoE

Mr Watson (BSC)
Mr Devlin (BSC)

I agree that income multiples are more dangerous

MORTGAGE LENDING GUIDANCE

Mr Allan's Minute of 17 November to your Private Secretary recorded the Chancellor's wish to know as soon as possible what could be done to limit - on prudential grounds - the proportion of a property's value which a bank or building society may advance as a mortgage.

2. As the first table in the Annex to this Minute shows, there was a step change in Building Society practice between 1981 and 1983: the proportion

of first time buyers receiving advances of 100% of the purchase price rose from 2% in 1981 to 26% in 1983. Since then the percentage has fluctuated. The proportion of former occupiers securing a further mortgage equivalent to 100% of the purchase price is naturally much less: it has risen from 1% in 1981 to only 4% in 1985.

3. The change has been, in part, due to advances on council houses, which have been sold to their tenants at a substantial discount from their market value. But the main cause is undoubtedly the increased competition in the mortgage market following the entry of the banks into that market in 1981. This has both meant that societies have had funds to lend (rather than mortgage queues) and also exposed them to pressure to match the terms offered by others. The building societies allege that it was the banks which first adopted more generous criteria, and then the building societies were forced to match them: there may well be some truth in this.

4. The relaxation came at a time when societies ought to have been tightening their criteria: the fall in the rate of inflation creates a presumption that house prices will not rise so fast (a presumption that is not currently being fulfilled in London and the South East), so there is less additional protection for the society after a few years on that account. There is no doubt that some of the worsening arrears experience has been due to this relaxation in lending standards: but mortgage arrears are still extremely low compared with virtually any other form of lending.

5. The Registry (from 1 January 1987 the Commission take over this responsibility) has been doing three things to bring pressure to bear on societies to stop erosion of their lending standards and, where appropriate to restore them:-

i. General exhortation: I have been making cautionary remarks on this in speeches and reports to Parliament for the last two years or so. The risks on this account were specifically referred to in the discussion of the changing nature of the risks which societies face on their mainstream business in the consultation paper on capital adequacy issued this August. I suspect that there has probably been sufficient public exhortation on this particular topic for the time being, and that to say anything more could well prove counter productive;

ii. Following through with the societies which have had the worst arrears experience the reasons for it, and the corrective measures which they are taking: such societies have been changing their policies;

iii. By imposing a higher capital requirement for societies in respect of loans at or near to 100% of valuation than for the generality of mortgage lending to owner occupiers. Such a differential was proposed in the August consultation paper. Although the exact form of it may be modified in the light of comments during the consultation, I expect it to be a feature of the final paper when it is issued by the end of the year.

6. I consider that this last capital requirement, which effectively brings in a form of "price mechanism", is probably the most effective way by which the Commission can influence the behaviour of societies on this. (I recognise that it is a way which is not open to the Bank because we can adopt a finer classification of assets for the purposes of calculating capital requirements than it can, given the far wider spread of activities of banks compared with building societies.) To go further - for example to seek to impose a limit of 95% of valuation - would be difficult to justify on prudential grounds on present evidence.

7. I am currently more concerned about the relaxation of income criteria - since the value of the house in relation to the loan only becomes relevent if there is a default. This is far harder to monitor properly, because of problems over defining income, and the allowances to be made for second incomes and for any potential for income growth. The Commission and BSA are agreed that this is a factor which theoretically might be allowed for in the capital requirements, but that it is not practicable for the immediate future.

J.M.B.

(J.M. BRIDGEMAN)

ADVANCES, INCOMES AND HOUSE PRICES

The major constraint on those wishing to borrow money from a building society did not, in the 1970s, centre on the type of dwelling which the borrower wished to purchase but on the amount of money societies were able to advance. Shortage of funds often resulted in borrowers having to accept an advance which was a lower percentage of the purchase price than they might have wished, or an advance which was lower in relation to their income than the borrower and indeed the society believed he could afford to repay. In recent years, however, competition in the mortgage market has meant that funds have been readily available and this has significantly affected some of the key series.

The table below shows changes in the average percentage advance and in the proportion of borrowers receiving 100% of the purchase price since 1971.

Table 5 Advance as a Percentage of Purchase Price 1971-1985

Year	Average Advance as % of Average House Price		Proportion of Borrowers Obtaining 100% of Purchase Price	
	First-Time Buyers	Former Owner-Occupiers	First-Time Buyers	Former Owner-Occupiers
1971	81	66	1	
1972	81	62	3	
1973	77	53	2	
1974	73	50	1	
1975	76	54	1	
1976	79	56	1	
1977	78	56	1	
1978	80	57	2	–
1979	76	49	2	–
1980	74	46	1	–
1981	79	51	2	1
1982	85	57	19	2
1983	85	57	26	3
1984	85	59	20	3
1985	85	59	27	4

Note: A dash (–) indicates less than 0.5%.

Prior to 1982 the average percentage advance to first-time buyers tended to vary cyclically according to the availability of building society funds. In 1974 and 1980, for example, societies were not competitive in the savings market and first-time buyers could probably not obtain as large a loan as they wanted. In contrast in the early 1970s and early 1980s societies were fairly successful in the savings market and were more able to meet first-time buyers' requirements.

The most notable feature of Table 5, however, is the very sharp increase since 1981 in the proportion of first-time buyers obtaining loans for 100% of the purchase price. By 1985 over one in four first-time buyers obtained such loans, compared to only one in fifty during 1981. There are two factors associated with this change–

(a) The sale of council houses. There is probably a higher proportion of 100% advances among first-time buyers purchasing council houses than among the generality of first-time buyers. Most council houses are, of course, sold at a substantial discount from their market price.

(b) Competition in the mortgage market. The banks marked their entry to the mortgage market in 1981 by relaxing the criteria traditionally applied by building societies and societies reacted to this competition in order to retain their business.

For former owner-occupiers the changes over the years have been less dramatic: the average percentage advance in the mid-1980s is only slightly above the figure for the mid-1970s. This suggests that the vast majority of owner-occupiers moving tend to plough most of the "profit" they make on the sale of their existing house into the purchase of their new house. Thus when house prices have risen rapidly, owners have a great deal of equity (the difference between the sale price of the existing house and the outstanding mortgage) and require a smaller advance for the purchase of their new house. In 1974 and 1980 therefore the average percentage advance to former owner-occupiers fell, following the house price inflation of 1972-73 and 1978-79.

The loan to income ratio also exhibits cyclical fluctuations as is shown in the table below.

Table 6 Ratio of Advance to Income 1971-1985

Year	Ratio of Average Advance to Average Income		Percentage of Borrowers Advance 2.5 Times Income or Over	
	First-Time Buyers	Former Owner-Occupiers	First-Time Buyers	Former Owner-Occupiers
1971	1.96	1.79		
1972	2.17	2.02		
1973	2.24	2.01		
1974	2.03	1.82		
1975	1.94	1.72		
1976	1.88	1.70		
1977	1.77	1.64		
1978	1.82	1.72	16	14
1979	1.79	1.67	13	10
1980	1.67	1.54	6	3
1981	1.74	1.63	10	7
1982	1.76	1.70	14	10
1983	1.87	1.79	21	17
1984	1.93	1.84	22	19
1985	1.94	1.83	23	19

The figures in the first two columns of the table move generally as house prices have moved. Thus in 1972-73, 1978 and 1985, when house prices were rising rapidly, borrowers required a larger loan in relation to their incomes in order to complete their purchases. It is noticeable that current loan to income ratios have some way to go before reaching 1973's levels.

The proportion of borrowers obtaining loans of more than 2.5 times their incomes has risen in recent years – a trend which has been influenced by the fact their mortgage rates have fallen after reaching a peak in 1980, and by competition for new mortgage business which has resulted in lenders relaxing their criteria slightly.

MR 1/92

CONFIDENTIAL

1 Mr Carr
2 JWG

B9.

FROM: A C S ALLAN
DATE: 27 NOVEMBER 1986

PS/ECONOMIC SECRETARY

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Scholar
Mr Culpin
Mr Grice
Mr Cropper
Mr Ross Goobey
PS/IR
Mr Pitts - IR
Mr George - BoE
Mr Colbey - BoE
Mr Barnes - BoE
Mr Bridgeman - RFS

MORTGAGE LENDING GUIDANCE

The Chancellor has seen Mr Bridgeman's note to the Economic Secretary of 25 November. He was interested in the point in paragraph 3 that the increase in 100% mortgages has been, in part, due to advances on council houses sold to their tenants at a discount. He feels that it is 100% of valuation, not 100% of purchase price, that gives cause for concern.

2. He shares Mr Bridgeman's concerns about the relaxation of income criteria.

3. The Chancellor would be grateful for the Economic Secretary's views on what might be done on this front, before next Thursday's meeting.

ACSA

A C S ALLAN

4/170

CONFIDENTIAL

FROM: P D P BARNES
DATE: 2 December 1986

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Scholar
Mr Culpin
Mr Grice
Mr Cropper
Mr Ross Goobey

PS/IR
Mr Pitts - IR

Mr George BoE
Mr Colbey - BoE
Mr Barnes - BoE

Mr Bridgeman - BSC
Mr Watson - BSC
Mr Devlin - BSC

MORTGAGE LENDING GUIDANCE

The Economic Secretary has seen your minute to me of 27 November, and was grateful for Mr Bridgeman's submission of 25 November to which it referred.

2. The Economic Secretary does not think that it is the percentage either of valuation or of the purchase price that gives cause for concern. Rather, he agrees with Mr Bridgeman that income multiples are more dangerous.

PB

P D P BARNES
Private Secretary

14/174

CONFIDENTIAL

Mr ~~Rutnam~~

Mr Kelly

MINUTES OF A MEETING IN THE CHANCELLOR'S ROOM HM TREASURY, AT 9.00AM ON THURSDAY, 4 DECEMBER

Present

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir T Burns
Mr Cassell
Mr Peretz
Mr Scholar
Mr Culpin
Mr Grice
Mr M Hall
Mr Cropper
Mr Ross Goobey

Mr George - B of E
Mr Coleby - B of E
Mr Barnes - B of E

Mr Bridgeman - BSC

Mr Pitts - I/R

MORTGAGE LENDING GUIDANCE

The Chancellor asked for views on whether there was any alternative to ending mortgage lending guidance before the end of the year. Mr Cassell wondered whether it might be possible to hold back the announcement until the Budget. The Chancellor felt this would give it altogether too high a profile. Mr George said he was not persuaded that we could not struggle on indefinitely. There was no legal framework for the current guidance to the banks. Mr Bridgeman did not think this would be possible. The guidance was already being ignored by some banks and even some building societies. Mr Peretz said he thought that delaying after 1 January greatly increased the risk that the guidance would be subject to legal challenge, which would potentially be more damaging.

13/12

2. The Chancellor said it seemed generally agreed that we should end the guidance this year. The precedents indicated that there was no need for this to be done when Parliament was sitting. He therefore favoured an announcement in late December.

3. The Chancellor said the next step was to consider what other measures might accompany an announcement on mortgage lending guidance. There was nothing that could be done now on new tax measures. The Financial Secretary was looking yet again at whether anything could be done on abuse of the tax relief. The Economic Secretary said he thought there would be attractions in toughening up the penalties. Mr Pitts explained that any false claims for mortage interest relief were subject to exactly the same penalities as any other tax evasion. In practice the cases usually came to light were early on in the term of a loan, when the tax at stake was very small.

4. The Chancellor asked whether tax relief was available on advances of more than 100 per cent of valuation. Mr Pitts said tax relief would only be available if the excess was to finance improvements. Mr Bridgeman noted that building societies were not allowed to lend more than 100 per cent of valuation. Mr Barnes said the banks were free to do so at their own discretion.

5. Turning to the prudential issues, the Chancellor said he was aware that these were matters for the Building Societies Commission and the Bank of England. Nevertheless, the figures showed a disturbing growth in 100 per cent mortgages, which now made up 31 per cent of all loans for first time buyers, even excluding council house sales. This trend, coupled with the move to lending higher multiples of earnings, meant that mortgage lending was now being done on less security than ever before. He recognised that the prudential concerns mainly applied to building societies, since mortgage lending was a fairly small part of banks' portfolios. But the doctrine of a level playing field seemed to point to action being taken on both fronts at the same time.

6. Mr George said that from the Bank's perspective, the impact of competition was inevitably to push up lending and bring down returns. The risk/reward ratio on all forms of lending had declined. The response of the Bank supervisors had been to look at capital adequacy across the whole of the banks' loan portfolios; within this, mortgage lending was one of the better areas. He also noted that many 100 per cent mortgages were partly covered by insurance contracts; this meant that advances of 100 per cent of valuation did not necessarily imply that banks were taking 100 per cent of the risk. Mr Barnes said he would not favour singling out specific assets and applying separate rules. But the Bank was planning to draw to the attention of senior management the prudential problems of some types of mortgage lending, and to send round a special questionnaire to collect information on experiences with such lending. The supervisors would then be in a position to point out any large growth in arrears or other problems and to use that as the basis for tightening up on capital adequacy.

7. Mr Bridgman said that the BSC already had some figures for arrears. These had increased sharply, but were still minuscule relative to total lending. Some societies had burnt their fingers over 100 per cent mortgages; they had now recognised the need for improved management systems and were adopting a more cautious attitude. He thought the real problems came on income multiples. The great difficulties here were that this was not dependent simply on what building societies lent, but also on what was lent by all other sources. Many people tended to borrow up to the limit a building society would allow, and then borrow further from other sources via hire purchase etc. Building societies did sometimes start trying to use their rights to control lending on second mortgages. But they then tended to run into problems with the OFT. Mr Bridgeman felt that the supervisors could tackle the problems to a limited extent by discussions with individual societies. But the fundamental problem was the growing demand for consumer credit.

8. The Chief Secretary said he hoped that problems of increased consumer indebtedness would largely be self-correcting. But he thought there were problems for the Government: for example, when mortgages were foreclosed, families jumped the council house queue and this led to pressure for more council house building.

9. Mr Cassell said that he thought some action on prudential grounds could help calm down the markets. But he felt we should not under-estimate the actual effects of ending mortgage lending guidance. If we wanted to contain the growth of credit we would have to have higher interest rates.

10. Mr Ross Goobey said that in the short term an increase in interest rates caused worse problems for existing borrowers, even if it did choke off some new lending. The Chief Secretary agreed; these problems rose most noticably when a young couple had taken out a large mortgage with two incomes, and the wife then stopped work in order to start a family.

11. Sir T Burns thought that it was difficult to tackle the growth of consumer credit via action on that part which was best secured and best supervised. The part which needed closest supervision was the marginal lenders, the finance houses. Mr Barnes agreed. If banks and building societies were discouraged from lending, the effect would be a mushrooming of lending by other institutions who were not so constrained.

12. Summing up this part of the meeting, the Chancellor said that the growth of consumer indebtedness raised wider issues, which could not be solved by prudential action on mortgage lending alone. But he felt the signals from an increased official focus on the prudential risks could provide a helpful offset to the implied signal from the ending of mortgage lending guidance. He would be grateful if the Bank and BSC could consider what further steps

might be sensible. He welcomed the Bank's suggestion that they might send a questionnaire to banks to get information on mortgage lending policies and mortgage arrears.

ACSA

A C S ALLAN

5 December 1986

Distribution

Those present
Sir P Middleton
Mrs Lomax

PS/Inland Revenue
PS/Customs & Excise
PS/Governor

CONFIDENTIAL

FROM: **M A HALL**

16 December 1986

PPS

c c Economic Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Murphy

ENDING OF MORTGAGE LENDING GUIDANCE

I attach a speaking note for use with the Prime Minister.

MAH.

M A HALL

SPEAKING NOTE : ENDING OF MORTGAGE LENDING GUIDANCE

The Bank of England and the Treasury issued guidance in 1982 to banks, insurance companies and building societies, requesting them not to make loans at a level which would permit borrowers to remove their capital on changing or remortgaging their properties (equity withdrawal). It does not - and cannot - cover all mortgage lenders, some of which fall outside the various systems of supervision, and advertise mortgages for any purpose. Nor does it cover topping up existing mortgages.

2. The guidance is therefore increasingly ineffective. It is anachronistic, since it is the only remaining non price financial control of this kind. And it is an unreasonable restriction on people's freedom to use their capital as they wish. Furthermore, it would be ridiculous to continue it after 1 January, when the new powers available to building societies under the Building Societies Act come into force. They will be permitted to diversify into new forms of lending, and the effect of retaining the guidance would be to push them into unsecured lending rather than taking full security.

3. The Treasury will therefore be withdrawing this guidance to building societies next week. The Bank will do likewise in respect of banks and insurance companies.

4. It is difficult to estimate what the effect of removing the guidance will be on the expansion of credit. We believe that latterly the guidance has been honoured more in the breach, so that the main effect of withdrawing it is likely to be to remove restraints on advertising. There is clearly a risk of a significant increase in mortgage lending for non-housing purposes. But it is in any case impossible to gauge the effect of retaining the guidance, which lacks statutory backing, after the Building Societies Act comes into force.

5. The Bank of England accept that the guidance has to be removed before 1 January, but both they and we have been concerned to minimise the unsettling effect removal might have on the markets. We have therefore looked for a low key opportunity to withdraw it. The original guidance was in the form of letters at official level from the Treasury and Bank, and it will be withdrawn in similar fashion just before Christmas.

6. This has no implications for the tax relief on mortgages. That will continue to be available only for loans for "qualifying purposes" - house purchase and improvements for residential purposes.

7. While it is clear we have no choice but to end the guidance, I have been very concerned to stop this being seen as Government endorsement or encouragement of even more consumer lending. Action is in hand on several fronts:-

(i) The Bank are sending out a survey later this week to banks to gather data on mortgage arrears and mortgage losses - especially for 100 per cent mortgages and for high income multiples. This will provide evidence to back up any future prudential action.

(ii) The Building Societies Commission proposals on capital adequacy include larger capital requirements for 100 per cent mortgages; they have also considered larger capital requirements for high income multiples, but have not so far felt this is practicable.

(iii) The Inland Revenue will be requiring lenders to carry out more extensive checks on whether new loans from home improvement really do qualify for tax relief.

8. Treasury Ministers and the Bank have also been drawing attention to the prudential risks from excessive mortgage lending in recent speeches.

DRAFT (18.12.86)

PRESS NOTICE

MORTGAGE LENDING GUIDANCE

1 The Bank, in conjunction with H M Treasury, has reviewed the mortgage lending guidance issued to monetary sector institutions, building societies and insurance companies in January 1982. In the light of structural changes in the personal lending market and the enactment of the Building Societies Act 1986, it has been decided that this guidance shouldbe withdrawn with effect from 1 January 1987.

2 Changes in market structure over a longer period have also rendered inoperative the qualitative guidance on banks' lending priorities first issued in 1972 and last reaffirmed in March 1980. This guidance too is now being formally withdrawn.

Notes to Editors

1 The mortgage lending guidance introduced in 1982 sought to ensure that lending on mortgage for house purchase was in fact applied to the purchase or improvement of residential property and not to the realisation of capital profits on their houses by the borrowers. The withdrawal of the guidance coincides with the coming into force of wider powers for building societies to offer unsecured consumer loans, under the Building Societies Act 1986. Given the ready availability of consumer finance in other forms, the guidance is serving to deny to lenders the added security that could be provided by undertaking such lending against a first mortgage on residential property, and is therefore no longer appropriate.

2 The qualitative guidance on banks' lending priorities has effectively been in abeyance since the abolition of the Supplementary Special Deposits Scheme in 1980. Its withdrawal now therefore is simply a formality.

December 1986

DRAFT (8.12.86)

December 1986

To all recognised
banks and licensed
deposit-takers

Dear Sir

As I expect you are aware, there has recently been a considerable growth in the level of consumer lending (including mortgage-backed lending). There have also been indications that some lenders have adopted more generous approaches to lending proposals eg by lending against a higher proportion of valuation or based on higher income multiples.

While growth in lending to a particular sector is not necessarily of itself a matter for supervisory concern, rapid growth may at times be associated with a lowering of credit standards and a worsening of bad debt/arrears experience. A gradual deterioration of asset quality of this sort may not be easy to detect; nevertheless the Bank expects all institutions to keep their sectoral experience under review, particularly where a particular sector represents an important contribution to profits or a significant proportion of total assets.

To supplement our regular discussions with senior management and to standardise our understanding of the overall situation in the consumer lending sector, we propose to approach a sample of banks and licensed deposit takers in the near future to gain some more detailed statistical information, including trends both in arrears experience and the terms and conditions (including margins) on which such finance is made available.

Yours faithfully

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460
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David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

8 July 1987

Dear David

RETAIL PRICE INDEX

... I enclose a copy of our note and draft press release on the Index of Retail Prices due to be released at 11.30 pm Friday 10 July.

Numbered copies also go to Alex Allan (Treasury), Sir Peter Middleton (Treasury), Timothy Walker (Trade and Industry), Rachel Passmore (CSO), John Footman (Bank of England), Chris Cloke (CO) Peter Smith (Chancellor of the Duchy of Lancaster's Office) and Sir Brian Hayes (Trade and Industry).

Yours sincerely

Beverley Evans

BEVERLEY EVANS
Private Secretary

PRESS NOTICE
Department of Employment

EB7.

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154/87 July 10, 1987

STATEMENT BY THE SECRETARY OF STATE FOR EMPLOYMENT ON JUNE RETAIL PRICES INDEX

There was no change in the overall level of prices between May and June but the annual rate of inflation has risen slightly from 4.1 per cent to 4.2 per cent. But this figure is fully consistent with the Chancellor's forecast of an inflation rate of under 4 per cent by the end of the year.

Controlling inflation remains a crucial priority. We cannot afford to lose the benefits which have strengthened the economy and contributed to job creation and the steady fall in unemployment.

PERSONAL AND CONFIDENTIAL

GENERAL INDEX OF RETAIL PRICES : JUNE 1987

The annual rate of inflation, as measured by the 12-month change in the retail prices index, rose to 4.2 per cent in June compared with the 4.1 per cent recorded for May.

2. The overall level of prices in June was the same as in May whereas there was a decrease of 0.1 per cent recorded for the same period last year (when mortgage interest rates fell by about one percentage point). Owner occupiers' housing costs were lower in June as residual effects of the reductions in mortgage interest rates announced after the Budget were taken into the index. There were decreases in the prices of fresh vegetables but increases in the prices of motor vehicles.

3. In July the 12-month rate is expected to rise further, to around 4½ per cent. Though the overall level of prices between June and July is likely to be little changed it will replace, in the 12-month comparison, a fall of 0.3 per cent recorded between the same months last year. A reduction of 3p per gallon of 4 star petrol over the month contributed to last year's figure.

Producer Prices

4. The pattern of movements in producer prices in recent months do not suggest any change in the short-term movements of retail prices. The June figures on producer prices will be published next Monday. The latest available figures are for May when the annual change in the price index for home sales of manufactured products was 3.5 per cent, the same as in April.

5. The 12-month rate of increase in the prices for materials and fuels purchased by manufacturing industry was 1.7 per cent for May. April and May were the first months since June 1985 in which this rate has been positive.

Tax and Prices Index

6. The tax and prices index increased by 2.5 per cent in the year to June compared with 2.4 per cent recorded for May.

PERSONAL AND CONFIDENTIAL

International comparisons

7. The latest 12-month percentage changes in consumer prices in the main OECD countries and the averages for all EEC and OECD countries are as follows:-

	UK	FRANCE	FEDERAL GERMANY	ITALY	NETHER-LANDS	JAPAN	USA	CANADA	OECD Averages	EEC Averages
1986										
Q1	4.9	3.6	0.7	7.6	1.2	1.6	3.1	4.2	3.8	4.4
Q2	2.8	2.4	-0.2	6.1	0.4	0.8	1.6	3.9	2.5	3.2
Q3	2.6	2.1	-0.4	5.4	-0.4	0.2	1.7	4.2	2.5	3.0
Q4	3.4	2.1	-1.1	4.4	-1.8	-0.5	1.3	4.3	2.1	2.9
1987										
Q1	3.9	3.2	-0.2	4.1	-1.2	-1.3	2.2	4.1	2.3	2.1
January	3.9	3.0	-0.8	3.8	-1.3	-1.6	1.4	3.9	2.3	2.8
February	3.9	3.4	-0.5	4.4	-1.2	-1.4	2.4	3.9	2.4	2.9
March	4.0	3.3	-0.2	4.2	-1.1	-0.8	3.0	4.2	3.0	3.0
April	4.2	3.5	0.1	4.2	-1.1	-0.2	3.8	4.5	3.5	3.1
May	4.1	3.4	0.2	4.2	-1.1	-0.3	3.8	4.6	..	..
June	4.2									

STATISTICS DIVISION
DEPARTMENT OF EMPLOYMENT 8 JULY 1987

PERSONAL AND CONFIDENTIAL UNTIL 11.30AM ON FRIDAY ~~June 12~~ July 10 1987

125/87 July 10, 1987

GENERAL INDEX OF RETAIL PRICES

JUNE 1987

The general index of retail prices for all items for June 9, 1987 was 101.9 (January 13, 1987 = 100). This represents no change on May 1987 (101.9) and an increase of 4.2 per cent on June 1986 (385.8, January 1974 = 100).

The overall level of prices in June was the same as in May. There were decreases in the prices of fresh vegetables and increases in the prices of motor vehicles over the month. Owner occupiers' housing costs were lower as the residual effects of the reductions in mortgage interest rates announced in March were taken into the index.

The movements for the main groups in the index are shown in Table 2.

Table 1.

	All items				All items except seasonal food		
	Index Jan 15 1974 = 100	Percentage change over 1 month	6 months	12 months	Index Jan 15 1974 = 100	Percentage change over 1 month	6 months
1987							
January	394.5	+0.4	+2.5	+3.9	396.4	+0.3	+2.5
	Index Jan 13 1987=100				Index Jan 13 1987=100		
February	100.4	+0.4	+2.6	+3.9	100.3	+0.3	+2.5
March	100.6	+0.2	+2.3	+4.0	100.6	+0.3	+2.3
April	101.8	+1.2	+3.4	+4.2	101.6	+1.0	+3.0
May	101.9	+0.1	+2.6	+4.1	101.7	+0.1	+2.2
June	101.9	+0.0	+2.3	+4.2	101.8	+0.1	+2.1

TABLE 2

	Indices (13 January 1987 = 100)		Percentage change
	May 14, 1987	June 9, 1987	over the month
All items	101.9	101.9	0.0
All items excluding food	101.8	101.9	+0.1
All items excluding housing	101.6	101.6	0.0
Food	102.2	101.6	-0.6
Seasonal food	110.6	105.2	-4.9
Non seasonal food	100.7	100.9	+0.2
Catering	101.8	102.3	+0.5
Alcoholic drink	101.2	101.4	+0.2
Tobacco	99.8	99.8	0.0
Housing	103.6	103.4	-0.2
Fuel and light	99.4	99.4	0.0
Household goods	102.0	101.9	-0.1
Household Services	101.4	101.6	+0.2
Clothing and footwear	101.0	100.8	-0.2
Personal Goods and Services	101.4	101.9	+0.5
Motoring Expenditure	102.8	103.2	+0.4
Fares and Other Travel Costs	101.3	101.5	+0.2
Leisure Goods	101.6	102.0	+0.4
Leisure Services	101.1	101.3	+0.2

NOTES TO EDITORS

1 The General Index of Retail Prices (RP1) measures the average change from month to month in the prices of goods and services purchased by most households in the United Kingdom. The expenditure pattern on which the index is based is revised each year using information from the Family Expenditure Survey. The expenditure of certain higher income households and pensioner households, mainly dependent on state pensions and benefits, is excluded.

2 The index is compiled using a large and representative selection of more than 600 separate goods and services for which price movements are regularly measured in about 180 towns throughout the country. Approximately 130,000 separate price quotations are used each month in compiling the index.

3 The prices of some items of food show significant seasonal variation. A separate price index is compiled for these "seasonal foods", the expenditure on which accounts for around 2½ per cent of household expenditure. The variation caused by these items is removed from the series of indices for 'all items except seasonal food'.

4 Rates of change of indices can be calculated over periods of any length. Rates calculated over long periods are slow to detect changes in trend while calculations over very short periods give rather volatile results. To help in assessing what is happening to prices, rates of changes in the all items index and the index for all items except seasonal food are shown in Table 1 over successive periods of one month, six months and twelve months.

5 Following the recommendations which the Retail Prices Index Advisory Committee made in its report submitted to the Secretary of State for Employment in July 1986, the index has been re-referenced to make January 1987 = 100. Calculations of movements in the index over periods of time which span January 1987 are made as follows:-

The index for the later month (January 1987 = 100) is multiplied by the index for January 1987 (January 1974 = 100) and divided by the index for the earlier month (January 1974 = 100). 100 is subtracted to give the percentage change between the two months.

Using the all items index for example: take the index for June 1987 (101.9) and multiply it by the January index (394.5) then divide by the June 1986 index (385.8). Subtract 100 from the result which gives 4.2 as the percentage change in the index over the twelve months to May.

6 The index for June 1987, if translated to the old reference date (January 1974 = 100) would be 402.0.

7 Other changes made to the index in 1987 are given in an article in the April edition of Employment Gazette.

8 The Retail Prices Index Advisory Committee was first established in 1946 and advises on the methodology used for compiling the RPI. Committee members include representatives of consumers, employees, employers, retailing organisations, academic experts, government departments and other official bodies. The Committee's latest report - 'Methodological Issues Affecting The Retail Prices Index' Cmnd 9848 HMSO £6.50 - was published on 15 July 1986. The Government announced at the same time that all its recommendations were to be accepted.

9 The housing costs of owner-occupiers are reflected in the index using an indicator which represents mortgage interest payments. A weighted average of building societies base mortgage interest rates is used in the calculation.

10 The index is given in full in the Employment Gazette.

PERSONAL AND CONFIDENTIAL

FROM: C MILLS

DATE: 9 July 1987

P.N.S
9.vii

1. MR SEDGWICK
2. CHANCELLOR OF THE EXCHEQUER

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr F Cassell
Mr Kemp
Mr N Monck
Mr Odling-Smee
Mr Scholar
Mr Bottrill
Mr Davies
Mr Culpin
Mr Gilhooley
Mr Mowl
Miss O'Mara
Mr Brooks o/r
Mr Pickford
Mr Halligan
Mr Patterson

THE JUNE RPI (to be published at 11.30 am on Friday 10 July)

The level of the RPI remained unchanged between May and June. The twelve month rate of inflation rose to 4.2 per cent in June from 4.1 per cent in May. Excluding mortgage interest payments, the twelve months rate of inflation fell from 3.9 per cent in May to 3.5 per cent in June.

2. The June figures were affected by the cut in mortgage interest rates introduced by a number of the smaller building societies who had held back from last month's cuts. Seasonal food prices fell by 4.9 per cent over the month, leaving them 1 per cent higher than in June 1986, while prices of motor vehicles rose 1.1 per cent, giving an increase of 7.7 per cent over the year. The prices of private sector goods and services (excluding food, housing and petrol) rose by 0.2 per cent between May and June, less than in recent months.

3. In the City there is a range of expectations of the change between May and June, with Wood Mackenzie and Alexander Laing and Cruickshank expecting +0.3 per cent, James Capel +0.1 to +0.2 per cent, and Phillips and Drew predicting +0.1 per cent. The correct figure is 0.0 per cent.

4. [NOT FOR PUBLIC USE]: The increases in the twelve months to June of 4.2 per cent in the total RPI and 3.5 per cent in the RPI excluding mortgage interest payments are 0.3 per cent lower than the forecasts included in Mr Sedgwick's 29 June submission on the June Treasury Economic Forecast. This difference is primarily accounted for by the large fall in seasonal food prices in June. We had not expected a large fall in summer food prices to be picked up until publication of the July index. The lower than expected outturn in June thus does not at first sight have significant implications for the monthly profile in the rest of the year.

C. Mills

CHRISTOPHER MILLS
EA1 DIVISION
x 5388

1. Alex ✓
2. C/Content?

CR 9/7

COVERING CONFIDENTIAL

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213..................
Switchboard 01-213 3000 GTN Code 213
Facsimile 01-213 5465 Telex 915564

Ch

Not sure I see the point of doing this, but seems O/C.

AA

(I doubt you'd get DEm to highlight figs excluding mortgages)

Cathy Ryding
Private Secretary to the Chancellor
Treasury

9 July 1987

I have suggested an amendment: not only to get in the point on mortgage interest but also to avoid the misleading practice of foreshadowing next month's fig.

Dear Cathy,

RPI STATEMENT

We spoke. I explained that Mr Fowler would like the Chancellor to clear his press statement on the RPI, which will be released at 11.30 am tomorrow, Friday 10 July. This statement is in addition to the fuller departmental statement, a draft copy of which was sent to Alex Allen yesterday evening.

I should be grateful if you would let me know whether the Chancellor has any comments on the statement before 9.30 am Friday.

Yours sincerely,

Beverley Evans
Private Secretary

DRAFT STATEMENT BY THE SECRETARY OF STATE FOR EMPLOYMENT ON JUNE RPI

There was no change in the

~~The~~ overall level of prices ~~has not changed~~ between May and June but ~~as the Chancellor anticipated in his Budget statement~~ the annual rate of inflation has risen slightly from 4.1 per cent to 4.2 per cent. ~~This is largely because of what happened 12 months ago and it is likely that there will be a further slight rise in the annual rate next month - again because there were several large price reductions last summer. However, I am confident that we are in line with the forecast for inflation to fall back in the later months of the year.~~

Excluding mortgage interest payments, the annual rate of inflation fell from 3.9 per cent in May to 3.8 per cent in June. This is fully consistent with the Chancellor's forecast of an inflation rate of under 4 per cent by the end of the year.

Controlling inflation remains a crucial priority. We cannot afford to lose the benefits which have strengthened the economy and contributed to job creation and the steady fall in unemployment.

RC2.13

CONFIDENTIAL

B K
20/7

FROM: CATHY RYDING

DATE: 10 July 1987

MR SEDGWICK

cc Sir T Burns
Mr S J Davies
Mr Matthews

INTERNATIONAL COMPARISONS OF RPI

The Chancellor has seen Department of Employment's press notice on the RPI for June 87.

2. The Chancellor has noted the international comparisons included at the end of the press notice and wonders whether these are flawed to our disadvantaged by the fact that the UK includes the mortgage interest rate and other countries (in general) do not. He would be grateful for a note.

CR

CATHY RYDING

PS2/3R

CONFIDENTIAL

RD

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

10 July 1987

Ms Beverley Evans
PS/Secretary of State for Employment
Caxton House
Tothill Street
LONDON SW1H 9NF

Dear Beverley,

RPI STATEMENT

Thank you for your letter of 9 July.

The Chancellor has suggested a number of amendments to your Secretary of State's press statement on the RPI to explain the important mortgage interest point and also to avoid foreshadowing ... next month's figures. A retyped version is attached.

Yours sincerely,
Cathy Ryding

CATHY RYDING

CONFIDENTIAL

DRAFT STATEMENT BY THE SECRETARY OF STATE FOR EMPLOYMENT ON JUNE RPI

There was no change in the overall level of prices between May and June but the annual rate of inflation has risen slightly from 4.1 per cent to 4.2 per cent. Excluding mortgage interest payments the annual rate of inflation fell from 3.9 per cent in May to 3.5 per cent in June. This is fully consistent with the Chancellor's forecast of an inflation rate of under 4 per cent by the end of the year.

Controlling inflation remains a crucial priority. We cannot afford to lose the benefits which have strengthened the economy and contributed to job creation and the steady fall in unemployment.

Ch
Shall I fix up bilateral with Fowler?
AA

FROM: **P F L ALLUM**
DATE: 13 JULY 1987

1. **MR S J DAVIES** SJD

2. **CHANCELLOR OF THE EXCHEQUER** yes pls

cc Sir Peter Middleton
Sir Terence Burns
Mr P N Sedgwick
Mr Culpin
Mr Matthews
Mr Brooks o/r

INTERNATIONAL COMPARISONS OF THE RPI

Ms Ryding's minute of 10 July to Mr Sedgwick asked whether the comparison provided in the Department of Employment RPI press notice between the RPI and other countries' consumer price inflation was flawed to our disadvantage because the RPI includes mortgage interest payments while other countries' consumer price indices, in general, do not.

2. The cost of owner-occupied housing is reflected in the consumer price indices of the countries shown in the Department of Employment table in different ways. In the UK the RPI includes mortgage interest payments. We, along with Canada, are an exception in this. The US consumer price index previously included interest payments on housing loans but was revised in 1983, and now measures owner-occupier housing costs in terms of a measure of imputed rent (ie what it would cost the owner-occupier to rent similar property in the housing market). Japan, Germany and the Netherlands also include imputed rent, while the consumer price indices for France and Italy exclude owner-occupiers' housing costs altogether.

3. By measuring owner-occupier housing costs using mortgage interest payments the RPI is sensitive to movements in interest rates in a way that other countries' consumer price indices are not; for this reason it is not strictly comparable. Because of this volatility in the all items RPI we give emphasis in internal briefing to the profile of the RPI excluding mortgage interest payments. We have also made references to the RPI excluding mortgage interest payments in recent Industry Act forecasts; for example in the 1986 Autumn Statement, paragraphs 1.08 and 1.45. This measure ~~of~~ is not published by Department of Employment but they do, however, publish a series for the RPI excluding all

housing costs. The table below shows that both of these measures show lower inflation during 1987 than the all items RPI.

	RPI	RPI excluding mortgage interest payments	RPI excluding all housing costs
1986Q1	4.9	4.6	4.1
Q2	2.8	3.3	2.6
Q3	2.6	3.3	2.6
Q4	3.4	3.4	2.7
1987Q1	3.9	3.7	3.2
1987 Jan	3.9	3.6	3.1
Feb	3.9	3.7	3.1
Mar	4.0	3.8	3.3
April	4.2	3.6	3.3
May	4.1	3.9	3.5
June	4.2	3.5	3.1

4. The RPI less mortgage interest payments and the RPI less all housing costs show lower inflation because mortgage interest payments and other housing costs (rent, rates and water charges) have risen more rapidly, on average, than the other components of the RPI. While exclusion of mortgage interest payments from the RPI almost undoubtedly provides a better measure of underlying UK inflation, exclusion of all housing costs, including rent and rates, involves the omission of important parts of household expenditure and could not be defended as a comprehensive measure of inflation.

But will community charge be in RPI?

Possible action to be taken

5. The ideal solution would be for Department of Employment to include in their table a more comparable measure of UK inflation. We would not recommend a measure excluding all housing costs, as this would inevitably draw accusations that by leaving out rapidly rising costs such as rates the comparison was being "fiddled". A more acceptable alternative would be to publish figures for the RPI less mortgage interest costs. As you know, Department of Employment are reluctant to do this - they argue that the merits of the inclusion of mortgage interest rates has been fully discussed by the RPIAC; and proliferation of alternative RPI series would tend to undermine the weight of the all

items index, with calls then likely to be made for other specially constructed series. This argument has some weight, but D.Emp are already some way along the road in this direction by publishing indices excluding food and excluding housing. A further index excluding mortgage interest payments would be a useful addition - particularly for use in the difficult area of international inflation comparisons.

6. Failing this we could point out to Department of Employment press office the difficulties of making international comparisons of consumer price inflation when housing costs are measured differently. (The contrast between UK inflation measured by the RPI and RPI less housing shows how sensitive the measurement of inflation is to the exact definition of the price index used.) D.Emp could include a footnote to their comparisons table stressing this point.

P F L ALLUM

RC2.13

CONFIDENTIAL

FROM: CATHY RYDING

DATE: 10 July 1987

MR SEDGWICK

cc Sir T Burns
Mr S J Davies
Mr Matthews

INTERNATIONAL COMPARISONS OF RPI

The Chancellor has seen Department of Employment's press notice on the RPI for June 87.

2. The Chancellor has noted the international comparisons included at the end of the press notice and wonders whether these are flawed to our disadvantaged by the fact that the UK includes the mortgage interest rate and other countries (in general) do not. He would be grateful for a note.

CATHY RYDING

17/7

US changed to exclude recently.

FROM: CATHY RYDING
DATE: 16 July 1987

MR P F L ALLUM

cc Sir P Middleton
Sir T Burns
Mr P N Sedgwick
Mr Culpin
Mr S J Davies
Mr Matthews
Mr Brooks

INTERNATIONAL COMPARISONS OF THE RPI

The Chancellor was grateful for your minute of 13 July.

2. The Chancellor would like to discuss this with Mr Fowler, and would be grateful for a good one page note on the merits of the RPI less mortgage interest costs (perhaps with a graph attached). This should ideally be in a form that the Chancellor can hand to Mr Fowler.

CR

CATHY RYDING

1 Alex
2 C content?

CE 21/7

Paymaster
PSC,

FROM: P F L ALLUM
DATE: 17 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc : Sir Peter Middleton
Sir Terence Burns
Mr P N Sedgwick
Mr Culpin
Mr S J Davies o/r
Mr Matthews
Mr S Brooks o/r

INTERNATIONAL COMPARISONS OF THE RPI

Mrs Ryding's minute of 16 July commissioned a short note on the merits of the RPI less mortgage interest payments, ideally in a form that could be handed to Mr Fowler. This is attached together with a chart.

Peter Allum

P F L ALLUM

CL

This is useless. See my quick redraft.

AA

Many thanks for yr substantially improved draft, which I have ~~[illegible]~~ amended a little.
2. Cd the chart be drawn with a black & a coloured (rather than a black & a dotted) line? It wd be much easier to read.
3. [illegible] or wd she [illegible] also like a table.

cm
pns-rpi

RPI LESS MORTGAGE INTEREST PAYMENTS

1. The RPI Advisory Committee (RPIAC) recommended last year that changes in mortgage interest payments *should* continue to be reflected in the RPI as a proxy for owner occupiers' *housing* shelter costs. Although alternative measures of shelter costs were considered the RPIAC decided that none were demonstrably superior to the present methodology, and that the latter had achieved wide public acceptance. This has left us with a consumer price index which is liable to indicate significant upward or downward movements in inflation simply because of changes in the mortgage interest rate. The UK and Canada are *alone* now an exception among major countries in this respect - the US dropped the cost of interest payments on housing loans from *its* their consumer price index in 1983. *This means the RPI*

continuing to include changes in mortgage interest payments in their consumer price indices.

2. Over the 1970s when inflation was high and subject to large fluctuations *erratic,* changes in mortgage interest rates *were not a major source* accounted for a relatively small component of the *variations* changes in *the* recorded RPI inflation. But with domestic inflation *now down to* currently around 4 per cent - and with relatively small changes from year to year in the underlying trend - changes in the RPI brought about by movements in the mortgage rate can attract disproportionate attention. The largest part of the variation in RPI inflation over the last few years has, in fact, been associated with changes in the mortgage interest component (see attached chart) - even though this currently has a weighting in the total index of less than 5 per cent.

3. Not only does the behaviour of the mortgage component of the RPI tend to produce mistaken interpretation of the trend in UK inflation, it also on occasions greatly prejudices the usefulness of the RPI in making international comparisons of inflation. In general where other countries' consumer price indices include a contribution to reflect owner-occupiers' shelter costs the latter show a much less volatile contribution than in the UK.

4. Comparison of inflation across countries might ideally be carried out after adjusting for differences in coverage and definition, in the same way that figures adjusted to a common set of definitions are used for international comparisons of unemployment. More simply, the comparison between UK and other countries measures of inflation would be improved if the RPI excluding mortgage interest payments were used rather than the all items RPI. This measure would still contain a

cm
pns-rpi

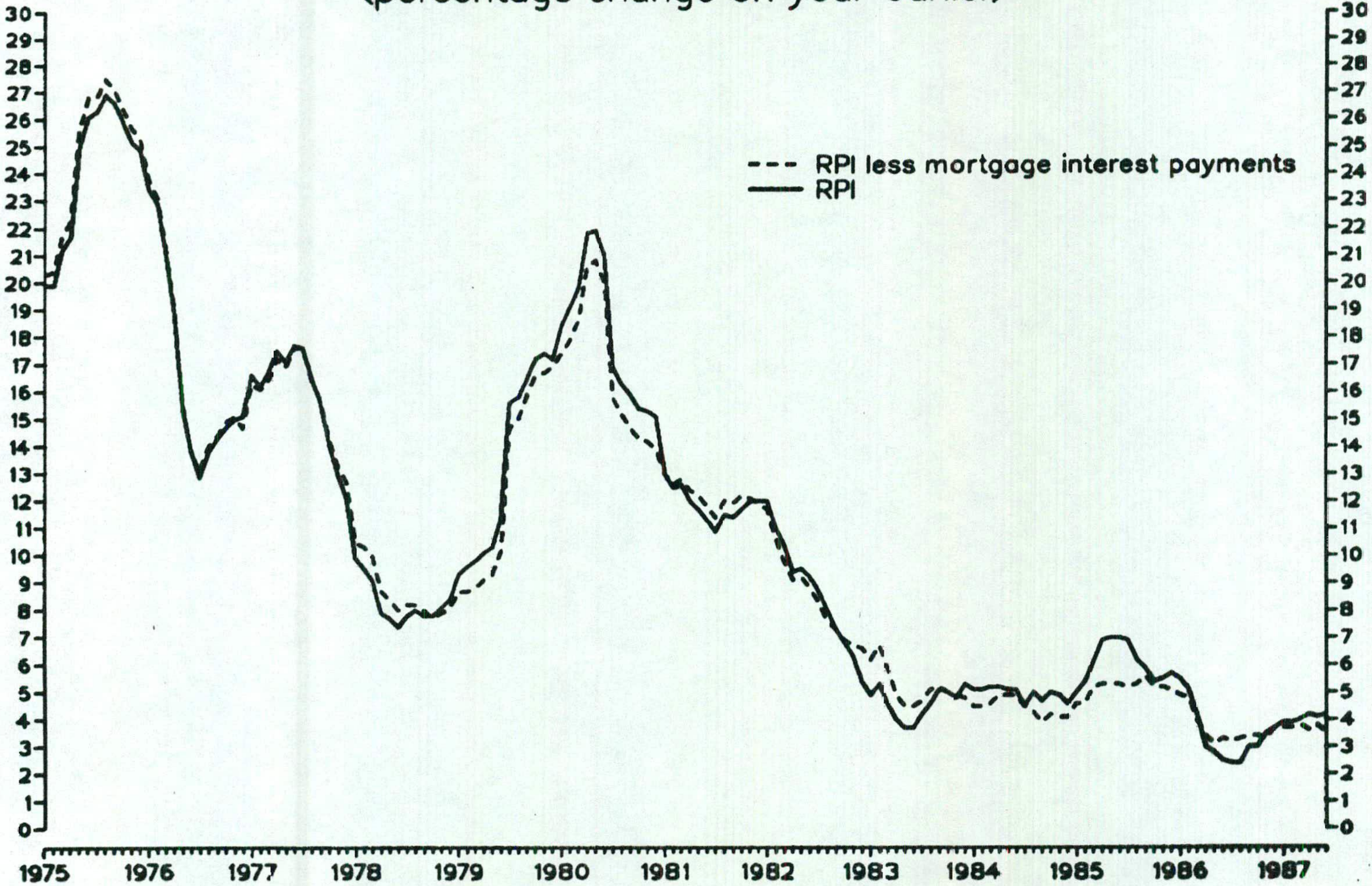
relatively fast rising housing component (rates etc) but not one that distorts the general picture. There would still be differences between countries' measures of inflation, but the most blatant discrepancy would have been removed.

5. There is thus a strong case for publishing a series for the RPI excluding mortgage interest payments. It would both aid interpretation of the trend in UK inflation and facilitate a better comparison between UK and other countries' consumer price inflation. This would be of direct benefit, for example, when producing the international inflation comparisons table currently included in the RPI press notice.

›

RPI AND RPI LESS MORTGAGE INTEREST PAYMENTS

(percentage change on year earlier)



psl/31A

UNCLASSIFIED

~~BF 27/7~~

FROM: A C S ALLAN
DATE: 24 July 1987

MR P F L ALLUM

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies
Mr Matthews
Mr S Brooks

bf to m 27/

RPI AND MORTGAGE INTEREST PAYMENTS

The Chancellor was grateful for your minute of 17 July. He has amended your draft note, and I attach his redraft. I should be grateful for any comments, and if you could supply the table referred to.

2. The Chancellor also wondered whether it was possible for the chart to be drawn with a black and a coloured line (rather than a black and a dotted one); that would be much easier to read.

ACSA

A C S ALLAN

THE RPI AND MORTGAGE INTEREST PAYMENTS

The UK and Canada are now alone among major countries in including changes in mortgage interest payments in their consumer price indices. The US dropped them from its consumer price index in 1983, while other countries have never included them. But in the UK the RPI is liable to show significant fluctuations simply because of changes in short-term interest rates.

2. This is perverse: it means that if we tighten monetary policy so as to put downward pressure on inflation, the short term result is an increase in recorded inflation. And it clearly makes a nonsense of international comparisons of inflation.

3. It also makes the RPI path misleadingly volatile. In the 1970s, when inflation was high, the effect of changes in mortgage interest rates was a relatively minor matter. But with our success in reducing inflation to its current level of around 4 per cent, changes in mortgage interest rates can bring about quite disproportionate fluctuations. This is clearly demonstrated in the chart and table attached. The ~~table~~ chart shows the monthly series, with and without mortgage interest payments, over the period since 1975; and the table gives figures for the two series ~~over the four years from June 1983 to June 1987.~~

4. We are unlikely to be able to persuade the RPI Advisory Committee (RPIAC) to change the construction of the RPI itself: they recommended only last year that changes in mortgage interest payments should continue to be reflected in the RPI as a proxy for owner occupiers' so-called "shelter costs". But there is no reason why we should not use figures for the RPI excluding mortgage interest payments in our briefing. Indeed, the Treasury already does so, although Department of Employment have been resistent to this. We ~~have~~, for example, used the figures for the RPI excluding mortgage interest payments in last year's Autumn Statement (paras 1.45 and 1.51) to stress that the dip in RPI last summer exaggerated the underlying fall in inflation, and - conversely - we have pointed out that the rise in the RPI since then has provided a misleading guide to the trend of inflation. It is clearly most unhelpful to get a public perception that inflation is accelerating when the underlying path is in fact pretty stable.

(while other countries have never included them.)

Alex's redraft

THE RPI AND MORTGAGE INTEREST PAYMENTS

The UK and Canada are now alone among major countries in ~~continuing to include~~ including changes in mortgage interest payments in their consumer price indices. The US dropped them from its consumer price index in 1983, ~~This means that~~ But in the UK the RPI is liable to show significant fluctuations simply because of changes in short-term interest rates.

2. This is perverse: it means that if we tighten monetary policy so as to put downward pressure on inflation, the short term result is an <u>increase</u> in recorded inflation. (path misleading) ~~volatile~~

3. It also makes the RPI ~~quite unnecessarily~~ gratuitously volatile. In the 1970s, when inflation was high ~~and erratic~~, the effect of changes in mortgage interest rates ~~were not a major source of variations in the RPI~~ was a relatively minor matter. But with our success in reducing inflation to its current level of around 4 per cent, changes in mortgage interest rates can bring about quite disproportionate fluctuations. This is clearly demonstrated in the chart attached. The table shows the monthly series, with and without mortgage interest payments, over the 4 years from June 1983 to June 1987.

4. We are unlikely to be able to persuade the RPI Advisory Committee (RPIAC) to change the construction of the RPI itself: they recommended only last year that changes in mortgage interest payments should continue to be reflected in the RPI as a proxy for owner occupiers' so-called "shelter costs". But there is no reason why we should not use figures for the RPI excluding mortgage interest payments in our briefing. Indeed, the Treasury already does so, although Department of Employment have been resistent to this. We have, for example, used the figures for the RPI excluding mortgage interest payments to stress that the dip in RPI last summer exaggerated the underlying fall in inflation and - conversely - that the rise in the RPI since then has provided a misleading guide to the trend of inflation. It is ~~most~~ clearly unhelpful to get a public perception that inflation is accelerating when the underlying path is in fact pretty stable.

And it clearly makes a nonsense of international comparisons of inflation.