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The long goodbye to RPI?

The Retail Prices Index (RPI), while no longer officially classed as a National Statistic, still retains great importance for many pension schemes.

Despite the general move to using the Consumer Prices Index (CPI) over the past decade, many pension schemes have found great difficulty in switching to CPI due to provisions in their rules. As a result, RPI is still used to calculate pension increases, as well as driving the indexation of assets such as index-linked gilts and inflation swaps.

Ahead of this month's Spending Review, the Chancellor published correspondence with the UK Statistics Authority (UKSA) and the Chair of the House of Lords' Economic Affairs Committee, to indicate that RPI will be aligned with the same methodology as CPIH (the variant of CPI that includes housing costs) by 2030, if not sooner.

We anticipate that this will mean lower RPI inflation going forward (all else being equal). Amongst pension schemes, there will be winners and losers (depending on whether benefits are linked to CPI or RPI, and the extent to which the assets are linked to RPI).

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Background

The UKSA has been clear for some years that RPI is not a good measure of inflation and has treated it as a legacy measure. Earlier this year, its Chair, Sir David Norgrove, wrote to the then Chancellor of the Exchequer, with two proposals: either scrap RPI or align it with CPIH.

Existing legislation requires the UKSA to obtain the Chancellor's consent to any proposed changes to RPI that are fundamentally and materially detrimental to the holders of index-linked gilts. This requirement only runs until 2030.

The Chancellor has rejected the UKSA's first proposal, because of the potential damage to the economy and public finances. There is support, however, for the proposal to align RPI with CPIH to address the flaws in the RPI's methodology.

Given the potential for significant and diverse impacts of moving RPI to the same basis as CPIH, the Chancellor will not consent to any change before 2025. The Treasury will therefore consult early next year on whether to align RPI with CPIH before 2030, and if so, when between 2025 and 2030 this should be.

We will be providing further details when the consultation is launched in 2020.

Liability implications

In the long run, CPIH inflation is expected to provide increases that are around 1% p.a. lower than RPI inflation. A lot of clarification is still required on the exact changes that will be made, so market estimates of the impact vary. Whatever the extent of the changes, where member benefits are currently increased based on RPI, this change is expected to reduce future pension increases, which will reduce pension scheme liabilities.

Although the change is not expected to be implemented until 2025 at the earliest, the financial impact may be recognised sooner. Actuarial valuations could start to reflect this now (either via a direct adjustment in relation to this issue, or because inflation assumptions tend to reference break even inflation derived from gilt prices which have already started to reflect this). As well as reductions in Technical Provisions, any change to RPI would have other impacts, including on transfer values provided to members and company accounting positions.

The implication of these provisions will vary from scheme to scheme depending on the linkages to CPI, RPI and Limited Price Indexation (LPI).

Investment implications

The market reacted immediately to the news on 4 September 2019 with gilt implied forward inflation falling across most of the curve. The largest falls occurred beyond 2025, consistent with the time frames for the proposed change to the calculation of RPI.

The total return for the FTSE > 5 Year Index-Linked Gilt Index on 4 September 2019 was -4.9%[1] reflecting the fall in inflation expectations and a rise in nominal yields that also occurred. In a historic context this is an extraordinary change over a single day. Given the uncertainty over the outcome of the RPI review, we would expect to see continued volatility in inflation expectations.

Matching portfolios typically combine a mixture of nominal and full RPI assets. Whilst this facilitates a reasonable match for a typical pension scheme's liabilities, there are limitations – e.g. the match is not perfect where caps and floors apply or there is a CPI link. These limitations will be exacerbated by the ongoing dialogue around the future of RPI. The practical consequence will be greater potential for i) the liability hedge to deviate from the liabilities it is designed to cover and ii) the liability hedge ratio to deviate from the target set.

[1] Source: Bloomberg

Given the above background, regular monitoring of the hedge ratio vs. target takes on greater importance. This is particularly relevant for schemes that are well funded and looking to manage risk relative to the cost of buy-out and those with a high proportion of CPI-linked benefits hedged using market instruments linked to RPI.

Funding implications

The funding implications will be driven by a combination of the liability implications and the investment implications.

Your usual Buck contact will be able to carry out an estimate of the possible impact for your scheme. This will be particularly relevant for any schemes which are currently considering their benefit indexation.

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