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Possible future changes to RPI

The Government will consult in March 2020 on aligning the Retail Prices Index (RPI) with the Consumer Prices Index Including Owner Occupiers' Housing Costs (CPIH).

Whilst the alignment will not happen before 2025 (at the earliest), markets have already moved in reaction to the expected direction of travel.

Defined benefit pension schemes will be impacted by this change, and trustees and their advisers should consider whether any action is needed and, if so, when.

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Background

In September 2019, following a proposal from the UK Statistics Authority, the Chancellor announced that the Government will consult on aligning RPI with CPIH. Any change will have practical and economic implications. For example, the Government still uses RPI for a range of purposes, including index-linked gilt payments, and many pension scheme rules require RPI indexation. RPI inflation is generally expected to be around 1% a year higher than CPIH inflation.

The consultation was originally scheduled to open this month, but an announcement on 13 January deferred this to instead run from 11 March (the Budget date) to 22 April. A Government response to the consultation is promised ahead of the summer parliamentary recess.

There appears to be a clear policy intent to amend RPI, with the two main matters to be determined being:

- The timing of implementation: The change is currently proposed to take effect from 2030, or at some earlier date between 2025 and 2030.
- Whether gilt investors should receive compensation: While investors are expected to push for this, there is currently some debate over whether such compensation would be legally required.

The market’s reaction to the planned consultation has been mixed, reflecting uncertainty on these issues. However, there is some evidence that the prices of index-linked gilts have moved in response to news of the consultation, with the market predicting lower RPI inflation over the longer term. This is arguably because some investors are expecting RPI to switch to CPIH in future (without compensation for the change).

Effect on pension schemes

There are three key areas where pension schemes may already be affected by the change:

- **Changes to future increase rates:** There is an expectation that RPI-linked pension increases (in payment or deferment) will instead increase in line with CPIH in future, so reducing the value of members' benefits.
- **Changes to asset values:** The market reaction to the proposals has reduced the value of long-dated RPI-linked securities (gilts and swaps) to reflect the reduction in anticipated future inflation – this will impact schemes' hedging strategies. Further volatility is expected as further announcements are made.
- **Actuarial assumptions for RPI and CPI inflation:** Changes to the market pricing of index-linked gilts may mean that a review is required to the way in which inflation assumptions are set for both RPI-linked and CPI-linked benefits.

Actions to consider

Trustees and pension scheme sponsors should therefore consider whether to take action. For example:

- **Assessing the effect on members' benefits:** An initial assessment of the extent to which any change might affect the scheme's benefits could consider which benefits remain linked to RPI, and whether there is any scope or desire to continue to increase benefits at the current level, even if RPI is changed.
- **Transfer values:** The way in which pension increase assumptions are set for transfer value calculations may need to be reviewed, especially for schemes where there is significant transfer value activity. This review should take account not only of the future level of RPI and CPI, but also which inflation measure to consider when setting the pension increase assumptions.
- **Funding information:** Consideration should be given as to whether any funding metrics monitored by the trustees or sponsor should be adjusted to allow for the possible change to benefits and to the market view of RPI.
- **Accounting treatment:** Consideration should be given to the potential effect on the company's accounting disclosures.
- **Investment strategy:** Consideration should be given as to whether the scheme's investment strategy should be reviewed in light of the potential change – for example, careful consideration should be given to the appropriate level of inflation hedging. It may also be timely to review the suitability of any inflation-linked investments.
- **Member options:** Any options where a member is able to exchange an RPI-linked pension increase for a lump sum, or another pension increase type, should be reviewed. In particular, attention should be given to the risk that some members could be receiving a greater benefit than those who retain RPI-linked benefits.
- **Securing benefits:** Any decisions over securing RPI-linked benefits (for example on buyout) should be reviewed, taking account of the possibility that RPI may be reduced in future. This may

mean reconsidering whether pricing remains reasonable or looking again at the terms of the contract.

Buck would be happy to provide formal advice on any of these areas, or to provide training on the various inflation measures, along with where they are used and the impact of any change.

Next steps

Trustees and sponsors of pension schemes should consider whether to take advice on any of these issues, and if so whether to do so now, or wait for the consultation to be published. They should also consider responding to the consultation.

In the meantime, Buck will continue to provide further updates on developments as they emerge.

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