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The long goodbye to RPI? RPI reform consultation

In March 2020, the Government and UK Statistical Authority (UKSA) published their expected consultation on aligning the Retail Prices Index (RPI) with CPIH (the Consumer Prices Index with allowance for owner occupiers' housing costs). This change is expected to take place from 2025 or 2030, or some date in between.

Many pension schemes have RPI inflation 'hard-coded' within their Rules, and so RPI is still used to calculate benefit increases despite the general move towards CPI over the past decade. RPI inflation also drives the indexation of assets such as index-linked gilts and inflation swaps.

If the proposal goes ahead then we expect RPI inflation will be lower going forward (all else being equal). The impact on pension schemes and their members will vary depending on whether benefits increase with CPI or RPI, and the extent to which scheme assets are RPI-linked.

The scope of the consultation

The main focus of the consultation is to seek feedback on the following points:

- How the proposed change will impact on holders of index-linked gilts – in particular those "relevant" gilts where the Chancellor's consent is required before any fundamental and materially detrimental change is made.
- On the timing of the change – noting that the relevant gilts all mature before 2030, and so the Chancellor's consent is only required if the change is made prior to 2030.
- Whether users have any comments on the technical details of the proposed changes, particularly around the planned cessation of the lower level RPI indices (which cover subsets of the RPI basket , such as "food", "household goods", "clothing", and appear to be rarely used).

The consultation encourages feedback on other impacts of the proposed changes. However, as the Chancellor's decision-making powers narrowly focus on the impact on index-linked gilt investors and the UKSA solely considers "the statistical integrity of the RPI" it is unclear whether they will take into account feedback highlighting the impact on pensioners, pension schemes and their sponsors.

The Chancellor and the UKSA note that they "do not have full sight of the use of the RPI in the economy, including in financial contracts and impacts from the change to the RPI could therefore have unintended and diverse impacts". As such, they say they "are mindful of the potentially wide-ranging impacts of the proposed changes to the RPI and of their responsibilities as public sector bodies to consider these impacts in future policy making".

Despite hopes that the consultation would provide an opportunity to debate the change and its implications, there is no suggestion that the Government or the UKSA are considering any alternate reforms to RPI, nor does it address the issues of potential compensation to index-linked gilt investors.

The consultation was to have closed on 22 April 2020, but due to the impact of Covid-19, this timescale has now been extended until 21 August 2020. The Government and the UKSA will now respond to the consultation in the autumn.

Effect on pension schemes

In the long run, CPIH inflation is expected to be around 1% p.a. lower than RPI inflation. This will have a material impact on pension in the following areas:

- **Changes to future increase rates:** If RPI-linked pension increases (in payment or deferment) will follow CPIH in future, this will reduce 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. Additional volatility is to be 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.

Market reaction

Given the volatility of markets as a result of the Covid-19 epidemic, it can be challenging to isolate the market reaction to any one issue. However, since the consultation was first announced (in September 2019), we have seen markets react by reducing the "wedge" between RPI and CPI at longer terms (beyond 2030). At the time of writing, this was around 0.4% to 0.5% at longer terms, suggesting that markets are pricing in some uncertainty around the outcome of the consultation and/or the possibility that compensation will be payable to the holders of index-linked gilts to cushion the impact of any changes.

Where schemes have updated their funding assumptions to reflect this shift in expectations, then this movement in asset pricing will have reduced funding levels for those schemes using RPI-linked assets to hedge CPI-linked benefits. Funding levels should have remained more stable for those schemes hedging RPI benefits with RPI assets, subject to the impact of caps and collars on benefit increases.

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 conclusions of the consultation process. 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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