FYI® Alert
For Your Information®

Volume 2020

Issue 45

1 December 2020

Authors

Mark Alexander
Sarah Brown

RPI to reform in February 2030

The Government and UK Statistics Authority (UKSA) have published the response to their consultation on reforming the Retail Prices Index (RPI) methodology.

As originally proposed, RPI inflation will be aligned with CPIH (the version of the Consumer Prices Index with allowance for owner occupiers' housing costs). This change is to be introduced from 2030 (rather than at some point from 2025 as had been considered.) No compensation will be payable to the owners of index-linked gilts, who will now expect to see lower future returns (as CPIH inflation typically averages around 1% p.a. lower than RPI inflation).

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.

In this issue: The rationale behind the decision | The impact on pension schemes | Actions to consider | Comment

The rationale behind the decision

In 2010, the Government changed the minimum statutory increase measure for pension schemes from RPI to CPI inflation, resulting in many pension promises automatically switching to CPI indexation. However, many schemes ended up with some or all benefits pegged to RPI as a result of the wording in their Rules.

Since then, the statistical community has raised concerns around the calculation methodology currently underlying the RPI index – driving a prior consultation on RPI reform held in 2012. The then proposed changes were not made, and as a result of the shortcomings in the RPI, the UKSA took away its status as a "National Statistic" seven years ago.

In the consultation response, the UKSA was quoted as wanting to make changes to the RPI "at the earliest legal and practical time". However, the Chancellor's consent would be required before any "fundamental and materially detrimental change" was made which would impact on holders of "relevant" gilts.

The Chancellor declined to consent to such a change, and so the alignment with CPIH will happen in 2030, by when all relevant gilts will have matured.

The impact on pension schemes

The change will have a material impact on pension schemes in the following areas:

- **Changes to future increase rates:** Where RPI-linked pension increases (in payment or deferment) follow CPIH in future, this will reduce the value of members' benefits, although the caps and floors applied to many benefit increases will mean that the impact may be less than the headline 1% p.a. change.
- **Changes to asset returns:** Schemes will see lower future returns from long-dated RPI-linked securities (gilts, swaps, and some property and infrastructure assets), and this could upset existing liability hedging arrangements. Asset price movements on the day of the announcement (25 November) were relatively modest, suggesting that much of this change may have already been factored into current asset valuations, but additional volatility may be expected in coming days as markets settle on a new equilibrium.
- **Actuarial assumptions for RPI and CPI inflation:** Changes to the market expectations for inflation (which are typically taken from the index-linked gilt market) may mean that a review is required to the way in which inflation assumptions are set for both RPI-linked and CPI-linked benefits.
- **Changes to funding levels:** The impact on funding levels will vary considerably from scheme to scheme, depending on the mechanics of benefit increases (RPI vs CPI, caps and floors etc), and the amount of RPI-linked assets held. While some schemes may see an improvement in funding, for others this will drive a funding loss.

The response explicitly notes the impact of the changes on some defined benefit pension schemes and confirms that "the government keeps the occupational pensions system under review and will continue to do so." It is not entirely clear what is meant by this statement, but there is no indication that there will be any special treatment for pension schemes alongside the change.

Actions to consider

Trustees and pension scheme sponsors should therefore consider what action needs to be taken – particularly if this hasn't been considered since the consultation was launched in March. For example:

- **Assessing the effect on members' benefits:** This change will feed directly through to members' RPI-linked benefits for most schemes, but a review of the Rules may be necessary to determine whether there is any scope or desire to apply an alternate increase to benefits in future.
- **Funding information**: Any funding metrics monitored by the trustees or sponsor should be reviewed to allow for the expected change to benefits and to the market view of RPI and CPI.
- **Investment strategy:** Trustees will want to review their investment strategy, to ensure that their scheme retains an appropriate level of inflation hedging, and to review the suitability of any inflation-linked investments.
- **Transfer values:** The way in which pension increase assumptions are set for transfer value calculations should be reviewed, especially for schemes where there is significant transfer value activity.
- **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.

- **Accounting treatment:** Consideration should be given to the potential impact on the sponsor's accounting disclosures, especially for those businesses with December year ends. The sponsor should discuss the treatment of the change with their auditor and actuary.
- **Securing benefits:** Any decisions over securing RPI-linked benefits (for example, on buyout) should be reviewed. This may mean reconsidering whether pricing remains reasonable or looking again at the terms of the contract.
- **Communication to members:** While this change will not impact members for a decade, trustees should consider whether it would be appropriate to communicate to members to explain the impact of this announcement on their benefits.

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.

Comment

Reform to RPI inflation has been long awaited, and many will be relieved to see that the method chosen to implement change should provide certainty, with the reform feeding automatically through to the overwhelming majority of uses of RPI. Hopefully this approach will avoid the potential for loose ends and legal challenge which could have happened if the index had instead been "retired".

It will be important for trustees to understand the impact this will have on members' benefits and their scheme's funding level. It should also drive a review of current practices to ensure that funding methodology, hedging strategies and relevant factors are all updated to reflect the new reality.

This change will result in many losers, with pensioners losing out on RPI pension increases and the RPI-linked assets held by pension schemes (and other investors) taking a hit. The flip-side of this is the gains seen for the Government, who have saved an estimated £100bn of future borrowing costs, along with those consumers who should, in future, see lower increases in rail fares, student loans and various other measures which are typically pegged to RPI inflation.

Produced by the Knowledge Resource Centre
The Knowledge Resource Centre is responsible for national multi-practice compliance consulting, analysis and publications, government relations, research, surveys, training, and knowledge management. For more information, please contact your consultant or call us on 0800 066 5433.

This publication is for information only and does not constitute legal advice; consult with legal, tax and other advisors before applying this information to your specific situation.

Buck is a trading name in the UK for Buck Consultants Limited (registered number 1615055), Buck Consultants (Administration & Investment) Limited (registered number 1034719), and Buck Consultants (Healthcare) Limited (registered number 172919), which are private limited liability companies registered in England and Wales. All have their registered office at 20 Wood Street, London EC2V 7AF. Buck Consultants (Administration & Investment) Limited and Buck Consultants (Healthcare) Limited are authorised and regulated by the Financial Conduct Authority.

© 2020 Buck Consultants Limited. All rights reserved.