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September 2019

Future changes to the RPI

The UK Statistics Authority has signalled that it intends to reform RPI to make it consistent with CPIH. The date and method of change is subject to consultation early next year.

Such a change could have material implications for UK pension schemes both as holders of index-linked gilts and payers of RPI-linked pensions.

Background

For a number of years, the UK Statistics Authority (UKSA) and others have expressed concerns about whether the Retail Prices Index (RPI) provides a good measure of inflation. The alternative inflation measure of the Consumer Prices Index (CPI) is widely considered to be a better measure and is used for many purposes such as the Bank of England's inflation target

The UKSA announced on 4 September 2019 that it intends to reform the RPI to bring it into line with CPI including owner occupiers' housing costs (CPIH).

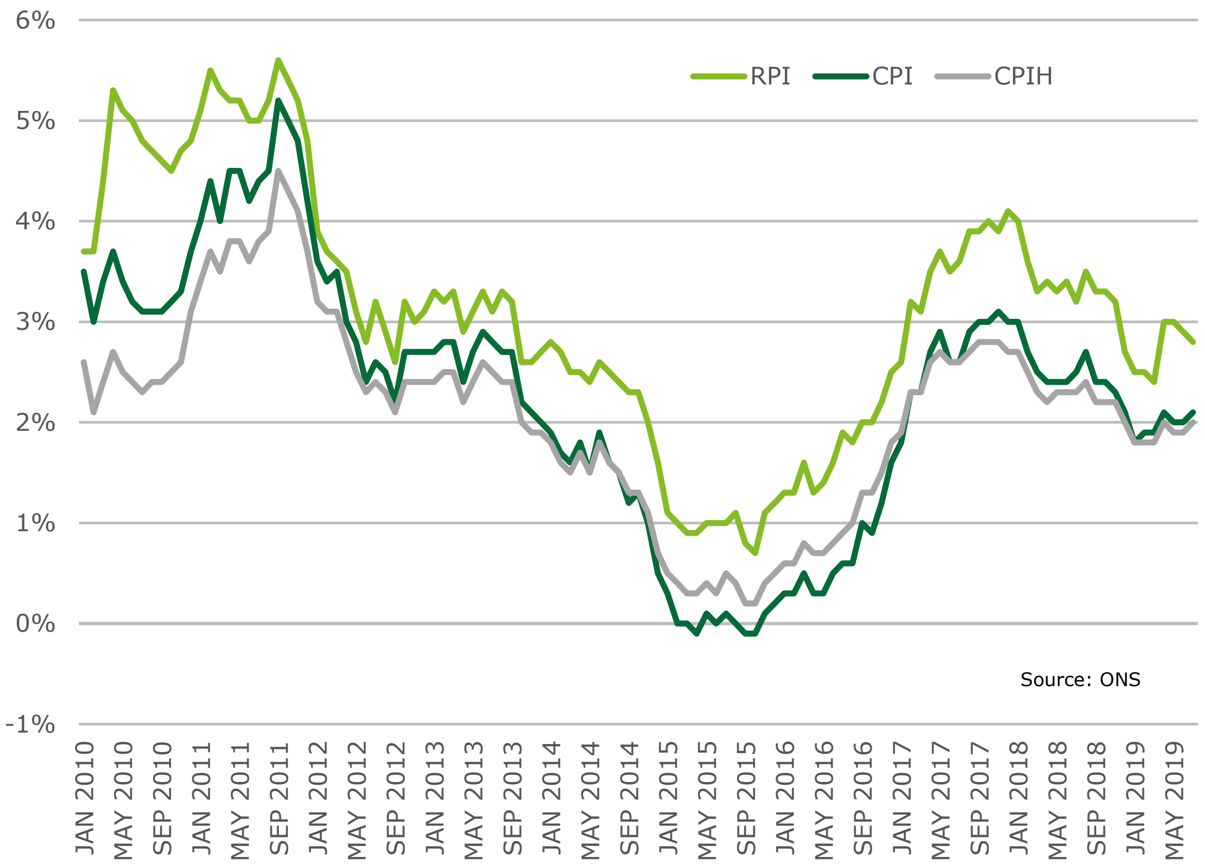
However, the UKSA cannot make this change until at least 2030, except with the consent of the Chancellor of the Exchequer[1]. The Chancellor has confirmed that he is not prepared to consent to the change until at least 2025, and announced a consultation, starting in January 2020, that will consider:

- whether the change should happen before 2030, and if so, the date between 2025 and 2030 at which the change should be made; and
- the detailed methodology underlying such a change.

The consultation response from government is scheduled for March or April 2020.

RPI vs CPIH vs CPI

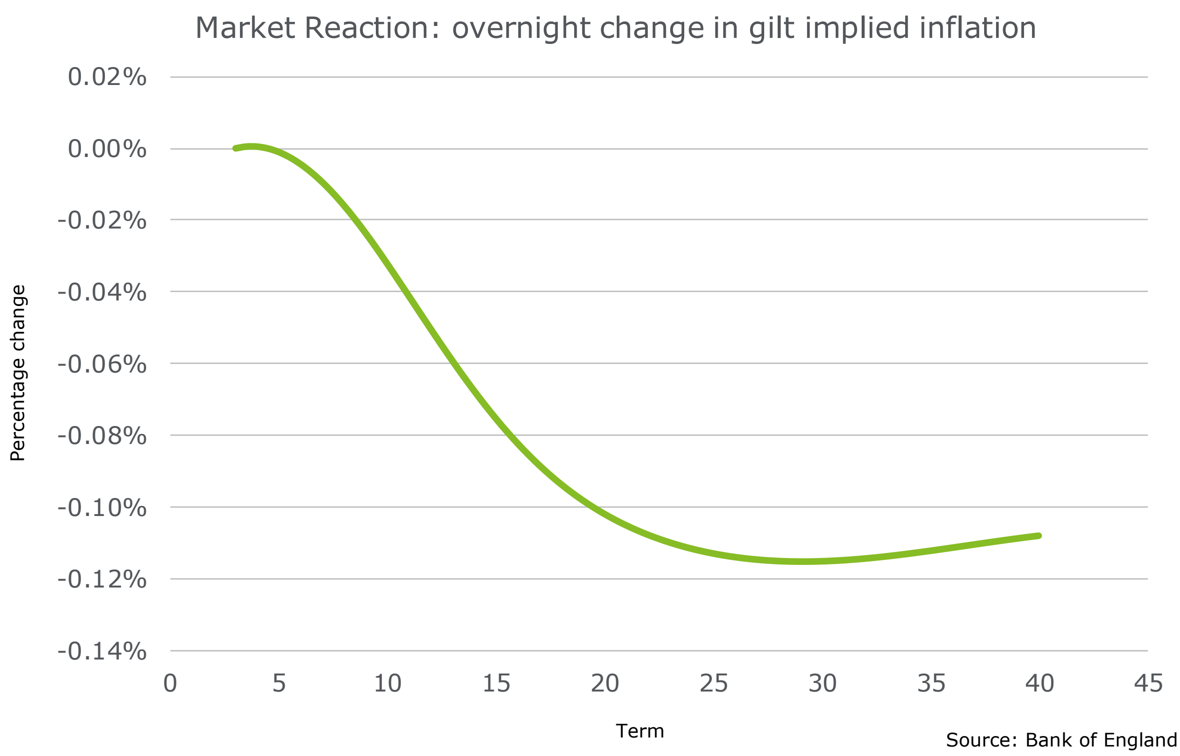
RPI is typically higher than CPI and CPIH, which are generally more closely aligned. The chart below illustrates this, deliberately commencing from 2010 to avoid being distracted by the very high volatility of these measures around the time of the 2008 financial crisis.



Market Reaction

Longer dated inflation expectations (as implied by the index linked gilt market) fell following the announcement. The maximum reduction was seen between the 20 and 30 year points on the curve, of up to around 12 basis points. Compared with experienced daily volatility of 2 or 3 basis points, and volatility-inducing Brexit developments which typified the week in question, it is reasonable to conclude that the fall in inflation is primarily a result of the announcement on RPI.

[1] Under Section 21 of the Statistics and Registration Service Act 2007, before making any change to the coverage or the basic calculation of the RPI, the UK Statistics Authority must consult the Bank of England. Where proposed changes to the RPI are deemed material and detrimental to relevant gilt holders by the Bank of England, changes cannot be made without the consent of the Chancellor of the Exchequer. The longest "relevant gilt" currently in issuance matures in 2030.



However, given CPIH is expected to average around 90 basis points below RPI, it is also reasonable to conclude that the market is not pricing a full devaluation of index-linked gilts and instead is anticipating some form of compensation.

Potential Implications

The RPI is still widely in use. In addition to index-linked gilts and other inflation-linked investment assets, RPI is used to determine increases to regulated train fares; student loan repayments; and pension amounts to many private sector pension scheme members.

The situation is still evolving and further clarity is only expected on release of the consultation document and the government's subsequent response. Given the lack of detail currently, but potentially significant effects, we expect that most trustees and plan sponsors would wish to review the situation now to understand the potential impact for their scheme and consider what action in response might be required and in what timescale. This will facilitate a timely and well-informed response once there is greater clarity.

In particular, there are circumstances in which immediate action may be appropriate, such as where there are liability management and special benefit crystallisation exercises already in train; buy-in or buy-out transitions; and corporate accounting. These and other areas for consideration are outlined overleaf.

Area to consider	Potential Implication
Member benefits	If RPI is made consistent with CPIH then this may mean a reduction in future RPI-linked pension increases. The application and impact will likely depend on the method of implementing a change to RPI and the wording contained in each scheme's trust deed and rules.
Potential compensation to index linked gilt holders	In our view, the simplest form of compensation would be to link coupons and capital repayments to the revised RPI plus a fixed margin. In today's terms, that would equate to CPIH + X basis points. We expect compensation to index linked gilt holders to be a crucial area of next year's consultation.
Hedging	Most pension schemes use index-linked gilts to hedge both RPI and CPI linked liabilities. The impact on funding levels for well hedged pension schemes will depend on the existence, form and level of compensation provided and the impact on member benefits. For example, well-hedged schemes with RPI linked benefits are most likely to see a funding gain whereas well hedged schemes with CPI linked benefits are most at risk of a funding loss. The actual outcome will of course depend on the result of the consultation and in particular, the level of any compensation provided to index linked gilt holders.
Investment Strategy	Schemes' investment exposure to RPI might not be restricted to index-linked gilts or inflation swaps. Certain companies might have price controls or revenue that is linked to RPI, whilst other assets might involve contractual terms which reference RPI directly (e.g. long lease property). Trustees should review their exposure across the total asset strategy.
Funding strategy – long term funding target	Trustees and sponsors should consider the Pension Regulator's guidance on long term funding targets and if improved funding levels might facilitate a lower risk investment strategy or shorter timeframe to self-sufficiency or buyout.
Insurer pricing	Schemes that are currently considering buyout should also consider whether any future savings on index change following transaction with the insurer can be shared with the members and/or sponsor. Schemes that are targeting buyout over a longer timeframe might see the buyout target fall by up to 10% in some cases. It is yet to be seen whether insurers reflect the added uncertainty in their pricing of new deals.
Deficit funding	Employers might look to build in contingencies into recovery plans that allow a reduction in contributions if liabilities are reduced following the consultation response.
Benefit crystallisation	Trustees will need to consider the impact on cash equivalent transfer values, cash commutation factors, trivial commutation and wind up lump sums.
Accounting	Corporate sponsors may wish to consider when and how the RPI change should be recognised in the corporate accounts.
Liability management	This could affect the terms set for certain liability management exercises, for example the terms of a Pension Increase Exercise.

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Next steps

Deloitte will be responding to the consultation in early 2020. One of the key areas we will be raising is the method of providing adequate compensation to holders of index-linked gilts.

We suggest that trustees and sponsors consider what preparation can be made in advance of the consultation response in order to make a considered and well thought through yet timely response. Consideration of the expected change to RPI will also be relevant for current liability management exercises, terms for benefit crystallisation events and any buy-in or buy-out transactions. Sponsors may also wish to consider their approach to funding valuation discussions and whether any contingency (perhaps through an asset backed funding solution) can be offered that incorporates a lower, CPIH-linked funding target.