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RPI will be aligned to CPIH from 2030 with no compensation for holders of index-linked gilts

At a glance

On 25 November, heralding the conclusion to the long running debate around the use of the "flawed" Retail Prices Index (RPI), the Treasury and the UK Statistics Authority announced that from February 2030 the RPI will be calculated using the data and methods of the alternative CPIH – a variant of the Consumer Prices Index including owner-occupiers' housing costs. There is to be no compensation for holders of index-linked gilts.

The CPIH gives a lower measure of inflation than the RPI – by around 1% per year on average since 2010. This will mean that RPI inflation is expected to be materially lower from 2030 than it would otherwise have been. Lower RPI inflation will impact many aspects of a DB pension scheme (whether liabilities are RPI or CPI linked), including benefits, funding, investments and company accounting figures. We explore these in more detail below.

Key Actions

Trustees

- Consider whether to suspend transfer value quotations in order to revisit inflation assumptions
- Review any inflation hedging arrangements and consequential impact on investment strategy
- Review impact on de-risking policies and triggers
- Urgently revisit valuation inflation assumptions, particularly for any valuations in progress, even where agreed in principle
- Consider whether to review commutation and other factors used in member benefit calculations
- Consider suspending any pension increase exchange options that you offer retiring members on an ongoing basis or GMP equalisation / conversion exercises planned or underway whilst you revisit inflation assumptions

Scheme sponsors

- Urgently consider the impact on end of year Company accounting figures, engaging with advisers and auditors to decide whether and how the change to RPI from 2030 should be reflected in the accounting assumptions for pension increases based on the RPI and the CPI
- Engage with trustees on appropriate funding assumptions for any valuations in progress
- Consider whether scheme rules require or enable a switch to CPIH (or CPI) indexation earlier than 2030
- Review any liability management exercises in the pipeline

The Detail

The Retail Prices Index (RPI) is the oldest measure of inflation in the UK and is still used widely across the economy and in financial contracts. However, it has a number of shortcomings which have meant that for the best part of a decade there have been concerns that it is a “flawed” statistic.

In 2010, the general inflation measure applied to the uprating of most social security benefits, including State pensions, was switched to the Consumer Prices Index (CPI). In 2011 a similar switch happened to the statutory revaluation and indexation basis applicable to occupational pension schemes.

In 2013 the RPI lost its National Statistic status. However, index-linked gilts remain linked to the RPI for calculating coupon payments and the principal to be repaid. The CPIH – which extends the coverage of the CPI to include a measure of owner-occupied housing costs – was launched in 2013. Since 2010, the measured rate of RPI inflation has been on average 1% pa above CPIH inflation and 0.8% pa above CPI inflation.

The Chancellor of the Exchequer has a role, albeit limited in agreeing to changes to the measurement of the RPI which stems from its use as the reference rate for index-linked gilts. The framework for this role is set out in legislation, and the circumstances giving rise to the Chancellor’s consent being required come to an end in 2030.

In March 2020, HM Treasury and the UK Statistics Authority (UKSA) launched a joint consultation considering whether the methods and data sources of the CPIH should be brought into the calculation of the RPI in 2025 (the earliest date the previous Chancellor said he would agree to), 2030 or at some date in between.

The 2030 date has now been decided by the current Chancellor concluding, having considered a number of factors, that he was unable to agree to the implementation of the change any sooner.

In the rest of this Alert we will explore the implications of this decision.

Implications for member benefits, transfer values and option factors

As a result of the lower index values likely to be returned by the RPI after 2030, pensioners who have RPI-linked pension increases (including members of private sector DB schemes) can expect to receive lower increases to their pensions. Similarly, benefits for other members with RPI-linked revaluation and indexation should be lower in the long term than they otherwise would have been. However, there is no immediate reduction and indeed no impact for 10 years. Trustees can take their time in deciding how best to communicate these changes to scheme members.

From a benefit design perspective, it is important to check the specific wording in scheme rules in case the construction of the pension increase rule is such that a more immediate change to CPIH is required. Although this is likely to be rare, the rule may instead *enable* an earlier adoption of the switch to CPIH (or CPI), which some trustees and sponsors may wish to take advantage of given the still significant time until 2030.

In terms of the impact on transfer values, continuing to use "spot" RPI rates to calculate transfer values when we know that the RPI assumption should fall by reference to the 2030 change may no longer be appropriate and may result in paying out transfers that are either too high (which is inefficient) or too low (which may be unlawful). Also, how the CPI inflation assumption is set will need to be reviewed to ensure it remains consistent with the RPI inflation measure post 2030. Schemes may therefore wish to suspend transfer quotes and payments in the short term while carrying out an urgent review. Similar considerations apply to any GMP equalisation and conversion exercises and pension increase exchange exercises that are carried out as a matter of course at retirement.

Other options factors should also be considered, even if the conclusion is that no immediate action is required, recognising there may be less urgency to review these because of how they are calculated (eg early and late retirement factors) or because they are not directly linked to market conditions (eg commutation factors).

Our viewpoint

So, a mixture of short-term and longer-term actions for trustees (and sponsors). In all of this member communications will need to be handled sensitvely given the likely media backdrop of members losing out on their pension promise.

Implications for funding

For DB scheme funding the decision will have implications for both asset values and liabilities. On the asset side there could be a fall in the value of RPI-linked assets, to the extent that this announcement hasn't already been priced into markets. On the liability side the situation is more nuanced. This is because DB liabilities depend crucially on both the RPI – which is essentially decreasing on this announcement – and CPI which might be assessed differently in the new market environment and because CPI assumptions are traditionally expressed in terms of a deduction from the RPI assumption, which will fall – or possibly disappear altogether from 2030.

Schemes with predominantly RPI-linked liabilities

Where DB schemes provide pension increases in payment primarily linked to the RPI but are only partially hedged with RPI-linked assets, the reforms should result in an improvement of their financial position – as the value of their assets should fall by less than the value of their liabilities – and therefore reduced costs for the sponsor. To the extent that the RPI market has already substantially factored in this announcement, schemes will have already seen this benefit.

Schemes with predominantly CPI-linked liabilities

If there is no change to CPI-linked liabilities, where DB pension schemes provide pension increases in payment primarily linked to the CPI but have invested primarily in assets linked to the RPI, any fall in asset values as a result of the reforms will result in a worsening of their financial position, and therefore additional costs for the sponsor.

However, if the RPI market has already substantially factored in this announcement but it is not yet reflected in the assumptions made for the wedge between RPI and CPI, a possible outcome is that there will be a material increase in CPI-linked liabilities without any impact on asset values.

The impact on an individual scheme will, of course, depend on the nature of its liabilities, its assets and how gilt markets respond. Schemes with valuations in progress (including those agreed in principle but not yet finalised) should urgently review assumptions to see whether any changes will be required. Other schemes should be aware that their inflation assumptions may now be out of date and so should consider investigating the impact of updating them.

Implications for investment strategy

The announcement will clearly impact on scheme investment activity relating to inflation hedging and even if intuitively the decision should reduce RPI inflation expectations, it is not actually obvious which way the markets will move, what was already priced-in and the shorter-term and longer-term impacts may also be different.

Whilst all schemes will have their own unique circumstances, schemes should consider reviewing:

- their liability hedging arrangements in light of the announcement, particularly those schemes with significant CPI exposure;
- how liability measures are tracked and whether any changes should be made to reflect changes in inflation assumptions (for example it may be less appropriate to assume CPI continues at 1% pa below RPI);
- any de-risking policies that reference triggers based on a scheme's funding position, to appropriately allow for the impacts of this reform and reduce the risk of taking de-risking actions that were not intended; and
- how the impacts of this reform could have affected the wider risk and return characteristics of the investment strategy and whether any changes should be made.

Our viewpoint

Immediately following the announcement markets appeared to be pricing inflation slightly higher which may seem counter-intuitive. However, there are some possible explanations, including that the news was already priced in; pent-up demand for inflation hedging from schemes who delayed inflation hedging programmes until the announcement driving the price of inflation hedging up; the announcement quelling the possibility of RPI being reduced between 2025-2029; and the market expecting other elements of the Chancellor's Spending Review to have an impact on future inflation.

Implications for accounting figures

The market reaction to this announcement could be very significant for setting assumptions for accounting figures as we approach the 31 December year-end. Prior to the announcement, market indicators of inflation were not very different compared to December 2019, but we could see some significant changes on the back of this consultation response which may need to be factored into the assumptions used at the 31 December year end.

Our viewpoint

This reform could present significant risks and opportunities for DB schemes – and it is therefore important that companies consider the implications of this announcement with their advisers before landing on assumptions at the year end.

The approach chosen to transition between current and new methods

The consultation also asked for views on the technical approach to be used in the year of transitioning from the current calculation of the RPI to the "new" RPI aligned with CPIH. The "chain link" proposal put forward in the consultation is to be used.

Our viewpoint

The practical implications of this are that up until February 2030 the annual rates of RPI and CPIH will be calculated as currently. Thereafter, the monthly growth rates will be the same for both indices, but the annual growth rates will only converge after the first year (ie from February 2031). So, annual rates or dates in between – for example at September 2030 which is used for statutory pension increases – will be a mixture of the two (as the September 2030 index will be converged but the September 2029 index will not be).

Was this decision expected?

The decision to reform the RPI has been a long time coming, but now it has arrived it is in a sense no great surprise. The Chancellor has not disputed the statistical arguments used by the UKSA in its approach to reform; his concern has been focussed on a limited number of index-linked gilts whose holders could potentially demand compensation should RPI be reformed ahead of their maturity dates. As the last of these matures in 2030 he has neatly achieved the necessary reform without the risk of having to stump up any cash.

Whilst the Chancellor's work has now concluded, that of DB scheme trustees (and to a lesser extent, scheme sponsors) is only just beginning. As we have demonstrated, there are a number of strands to this work.

Although the curtain is starting to come down on the “flawed” RPI, as things currently stand, there will be two competing inflation measures from 2030 – the CPI and the RPI / CPIH – both of which could well be in use in pension work. While these inflation measures are similar, there will continue to be differences due to price changes in owner occupied housing (based on rental equivalence), which is included in the CPIH but not the CPI. It is unfortunate that the opportunity has not yet been taken to simplify this, but who is to say that CPI will not also disappear and maybe well before 2030?

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