RPI to CPI: all change for pension increases?
On 8 July 2010, the Minister for Pensions, Steve Webb, stated that the Government believes that the Consumer Prices Index (“CPI”) should replace the Retail Prices Index (“RPI”) as the inflation measure to use in determining the minimum pension increases applied to occupational pension schemes.

The move from RPI to CPI as the basis for the statutory revaluation and indexation of pensions in private sector schemes has widespread implications. In this document we outline these implications, focusing on defined benefit schemes, where the impact will be greater than for defined contribution schemes, and highlight the key areas for immediate consideration by scheme sponsors and trustees.

This generic document reflects public statements by the UK Government to 16 July 2010 and should not be relied upon as detailed advice. You should seek advice taking into account the specific circumstances of your scheme before taking any action.
Immediate actions for DB schemes

- Work through the flow chart on page 6 to see how your scheme increases may be affected - legal advice will be essential in due course.
- Consider whether to:
  (a) continue administering your scheme as usual, but keep the position under review; or
  (b) delay issuing benefit quotations, eg transfer values, for a short period (where permitted by statutory deadlines) until it is clearer how increases will be affected.
- Review current member communications, eg booklet, website, benefit quotations and leaver statements, for references to RPI. Does the wording give sufficient flexibility to be consistent with whatever the final settled legal position is?
- Consider implications for any funding discussions currently taking place or investment de-risking triggers that are linked to funding levels.
- Seek urgent advice if you are currently engaged in any special activities, eg benefit changes (including closing to accrual); buy-out; corporate restructuring; enhanced transfer or pension reshaping exercises.

What is proposed?
The Government has announced its intention to link statutory minimum pension increases to CPI rather than RPI in future. If the Government proceeds with the change, this will affect minimum increases to pensions in payment and between leaving and retirement from 2011 onwards.

The revised minimum increases in payment will apply to most pensions paid by occupational schemes, including Guaranteed Minimum Pensions earned from April 1988 onwards. The minimum increases applying between leaving and retirement will be a mixture of RPI and CPI where the period of revaluation straddles the change.

How increases are actually affected for a particular scheme will depend on:
- whether the scheme’s increases are defined by reference to the statutory minimum increases or by a “hard-coded” definition involving RPI;
- what member communications have said (eg in booklets or benefit statements);

Aaron Punwani
Partner
Head of Trustee Consulting
LCP

Trustees and employers will need to engage with this issue quickly if they are currently working on exercises to change pension benefits, investment strategies, funding discussions or corporate transactions.

At present there is no indication that the Government intends to introduce any over-riding legislation that would automatically replace RPI increases (where hard-coded in scheme rules) with CPI increases, or give the trustees the option of doing so. Unless the Government legislates, employers, trustees and members face a “small print lottery”.

Aaron Punwani
Partner
Head of Trustee Consulting
LCP
Where trustees have some control over whether to adopt the new statutory minimum increases, they will potentially have a difficult decision given that it is expected to reduce the value of members’ existing benefits.

- whether the company and/or trustees decide to continue paying increases linked to RPI (perhaps by changing the scheme rules or exercising their discretion); and
- how precisely the Government implements the change.

Different sections of the scheme and pensions earned for different periods of service will not necessarily be affected in the same way. As things stand, revaluation between leaving and retirement would appear most likely to be affected.

The worst case scenario would be if the change to the statutory minimum introduces a new underpin to current pension increases, both increasing benefits and introducing more benefit complexity. Much of the pressure on Government over coming months will be to ensure the implementation of the change is kept as simple as possible.

**When will we know more?**

There is considerable uncertainty about how the Government will implement the move to CPI and, indeed, whether or not it can. The Government’s announcement implies that the change will take effect from the 2011 statutory minimum increases and that the exact rates of these increases will be published in November or December 2010. However, more important for schemes is any overriding legislation that may accompany the change. It is likely to be many months before it is clear what the Government will introduce.

Given the substantial cost reductions it should achieve on public sector pensions, the Government has a real incentive to push this through, and the technical nature of the change makes it difficult for employees to challenge it directly.

The proposals may be subject to legal challenge in the UK and ultimately through the European courts – members could argue that they expected to receive a pension linked to RPI and it is not fair or reasonable to link it to the (usually lower) CPI instead. Any legal challenges could go on for many years.

**RPI vs CPI explained**

RPI and CPI are two different measures of inflation, i.e., the rate at which prices increase. CPI was first published in February 1997, although estimates of CPI have been produced going back to 1988. In December 2003 CPI replaced RPI as the basis for the Government’s inflation target.
Inflation levels compared

The Government’s stated reason for the proposed change in pension increases is that CPI provides a more appropriate measure of benefit and pension recipients’ inflation experiences than RPI, and that differences in calculation mean it may be considered a better representation of the way consumers change their consumption patterns in response to price changes.

Unstated is that using CPI rather than RPI is expected to deliver substantial savings. This is because of differences in the “basket” of goods and services (e.g., RPI includes housing ownership costs but CPI currently does not), the nature of the weightings applied, and differences in the aggregation process used in the index construction.

Although CPI can be higher than RPI (most notably in 2009 when the UK experienced a short spell of negative RPI), the index construction process point above means that, over the long term, inflation as measured by CPI is likely to be lower than that measured by RPI. Over the last 20 years, CPI has on average been 0.7% pa less than RPI, and the Government expects that CPI will continue to be lower than RPI, although this cannot be guaranteed.

CPI should also be less volatile than RPI, given that the Bank of England remit targets CPI. There is a suggestion that housing costs may become included in CPI, in which case RPI and CPI could be expected to move more in tandem in future.

James Trask  
Partner  
Investment Consulting  
LCP

We urge the Government to provide the assets for pension schemes to match their liabilities by committing to a programme of CPI-linked debt issuance.
Flow chart: How are your scheme’s increases affected?
This chart assumes that the Government implements the change via the statutory minimum pension increase orders and does not override or provide an option to change scheme rules. In the event of an over-ride or option to change scheme rules, schemes may be able to move to CPI-linked pension increases, even if their trust documentation specifies RPI-linked increases. For the avoidance of doubt, for existing deferred pensioners revaluation between leaving and the changeover to CPI is not expected to be affected.

Consider separately for each element of increase, and for each section of membership, before and after retirement.

The chart below should not be used as a basis for decision making without obtaining legal advice on your scheme’s specific circumstances.
If you are interested in learning more about how we can help you, please contact the partner who normally advises you, one of our specialist team below or visit our website at www.lcp.uk.com.

Aaron Punwani  
Partner  
aaron.punwani@lcp.uk.com  
+44 (0)20 7432 6785

Richard Murphy  
Partner  
richard.murphy@lcp.uk.com  
+44 (0)1962 872716

James Trask  
Partner  
james.trask@lcp.uk.com  
+44 (0)20 7432 6641

LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.