First Briefing, February 2020 – Changes to RPI

The UK Statistics Authority (UKSA) is planning to amend the calculation of RPI to align it with CPIH. This is expected to happen from 2030, although depending on the outcome of a government consultation the change could be brought forward to February 2025.

The Chancellor has recently confirmed a consultation will be issued as part of the 2020 Budget which will seek to understand the impact of potential changes and consult on what changes should be made to RPI and when these should come into force.

This briefing provides background on the issue and considers the impact this may have on pension schemes.

Background to inflation measures

There has been concern about the suitability of RPI for some years now.

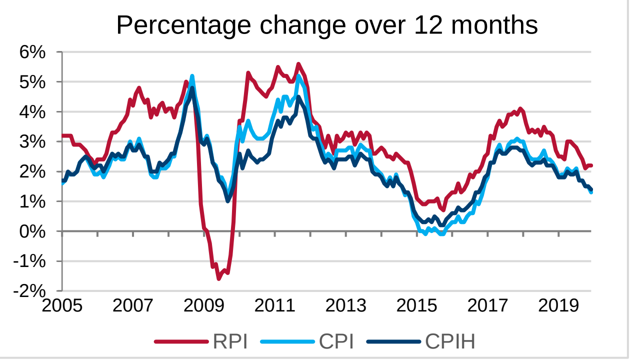
In 2009, the Office for National Statistics (ONS) amended the method used to collect clothing prices which unexpectedly caused a 0.3% increase in RPI and a windfall to the holders of index-linked gilts. The fact that the change had not been tested was the catalyst for a loss of confidence in the RPI.

In 2013, the Retail Price Index (RPI) was removed as a national statistic as the calculation method did not meet international standards, with the Consumer Price Index (CPI) becoming the lead measure of inflation instead. However, the ONS continued to publish RPI as a legacy statistic as it is still used as a reference for certain measures, such as increases on index-linked gilts and certain pension increases.

CPIH was announced as the ONS' lead measure of inflation in July 2017. It is a variant of CPI including owner occupiers' housing costs.

In January 2019, the House of Lords' Select Committee published their report examining inflation methods and making a number of recommendations.

The following graph shows the differences between RPI, CPI and CPIH since 2005.



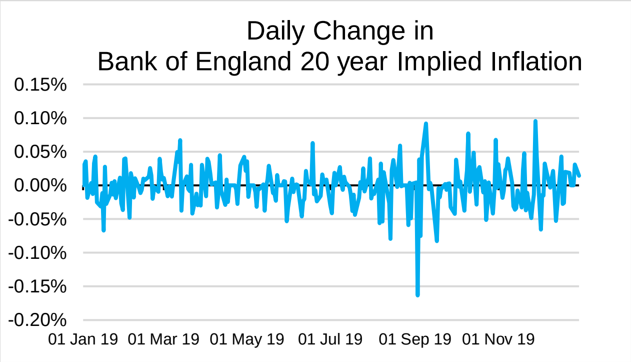
A number of factors contribute to the CPI and CPIH inflation measures being different to the RPI inflation measure. The main one is the mathematical method used to derive the index, with the CPI inflation method producing lower values than the RPI inflation method (the formula effect). Over the last 5 years, this formula effect has contributed to just under 1% of the overall difference.

There are also some shortcomings in the way goods are substituted within the CPI inflation methodology which results in a downward bias.

Impact on market implied inflation

It is expected that RPI increases will be lower from 2030 (or from 2025 depending on the outcome of the consultation), and therefore the value of index-linked gilts will be lower.

On the date the consultation was announced (4 September 2019), the market implied view of future inflation fell by approximately 0.15% pa.



However, had the full impact of the change been factored in, we would have expected the market implied view of inflation to reduce by around 1% pa. Furthermore, an opposite market movement of approximately two thirds of the magnitude was observed a week later. This suggests, some or all of the following:

- the market believes compensation would be paid to holders of index-linked gilts, or
- the market has already factored in any change, or
- demand for index-linked gilts by pension schemes and insurers exceeds supply to the extent it has diluted the effect of any price adjustment.

Impact on pension scheme liabilities

Many pension schemes have pension increases (before and after retirement) linked to RPI inflation, and therefore post change these increases will be lower. The impact on each individual scheme's liabilities will depend on the proportion of liabilities that are linked to RPI inflation.

When valuing the scheme's liabilities, assumptions for future RPI inflation increases are typically derived from the Bank of England's implied inflation curves which represent the difference between the nominal and real yields on gilts. Trustees and employers should consider whether this remains appropriate when setting assumptions, or whether any adjustment should be made.

Impact on pension scheme assets

Where pension schemes hold index-linked gilts or swaps to hedge changes in RPI inflation, then unless the change has already been priced in or compensation is paid, the value of these assets will be expected to fall. However, the value placed on the RPI linked liabilities will also reduce (but not necessarily by the same amount).

Where pension schemes hold RPI linked gilts or swaps to hedge changes in CPI inflation, then again, the value of these assets will similarly be expected to fall.

However, changes to the calculation of RPI inflation should not affect CPI inflation, and therefore CPI linked liabilities will be unaffected. This could lead to a worsening of the scheme's funding level.

Next Steps

There is still much uncertainty about exactly what changes will be made to RPI and when.

While we await any developments, trustees should consider whether any changes need to be made in the meantime following the announcement. In particular, trustees should consider the appropriateness of their transfer value basis and funding basis.

Although a change to RPI may affect inflation hedging, at this point the impact is unknown.

Employers will also want to consider the impact of this on the assumptions they adopt for disclosure of pension scheme costs in company accounts.

Hopefully, when the results of the consultation are available later this year, the position will become a lot clearer.

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Further information

For further information, please contact your usual First Actuarial consultant.

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