# First Briefing, December 2020
# RPI Reform

Following the Spending Review speech last week, the Government released the response to the RPI reform consultation. This briefing provides a summary of the position and its implications

What was announced

- The chancellor will not consent to RPI being reformed before 2030
- The UK Statistics Authority confirmed that its preference for reforming RPI is to align with CPIH from February 2030
- The government also confirmed there will be no compensation for holders of index-linked gilts

As a result, RPI looks more certain to be aligned with CPIH from 2030 but concerns about it occurring before then have been allayed.

### What does this mean for the future of RPI?

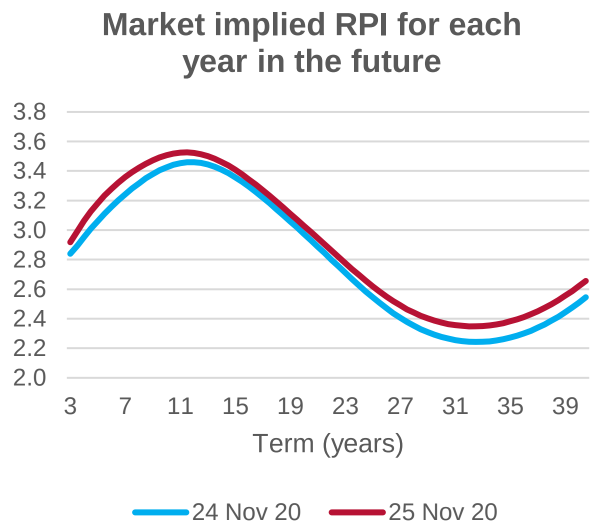
Looking at the historic differences between RPI and CPIH this might mean RPI will be 1% pa lower than it would otherwise have been from 2030 onwards.

### Implication for pension scheme members

For pension schemes which apply statutory increases to benefits, members will continue to receive increases linked to CPI and so this change to RPI will not affect them.

However, many pension schemes have benefits with increases that are linked to RPI, especially in payment. As future RPI is now be expected to be lower this will mean a reduction in the value of future benefits for many pension scheme members.

The government recognised this in their response to the consultation but simply said “The government keeps the occupational pensions system under review and will continue to do so”.




### What have markets done?

The gilt market is undoubtedly distorted due to supply and demand and other factors. As such the inflation rates that are “priced in” are not an entirely reliable predictor of future inflation. However, so long as the distorting factors remain unchanged, we would expect the rates of inflation priced in to react to a major change in inflation expectations and this would cause inflation-linked gilts to perform differently to fixed-interest gilts.

On the face of it, this announcement would be expected to drive down the value of long-dated inflation-linked gilts. Since 2010, the rate of inflation measured with reference to RPI has typically been 1% higher than CPIH so inflation-linked gilts will therefore pay out less.

However, on the day of the announcement index-linked gilts made positive returns. Indeed, returns on these gilts were on average ahead of their non-inflation linked equivalents.

This suggests that there has not been a major repricing of inflation as a result of the announcement.

We believe there are a number of factors driving this.

## What markets had already priced in

We believe, based on a recent survey of market participants we carried out, that markets had already priced in:

- A high probability that RPI reform would occur in the manner stated beyond 2030
- A possibility that this reform would take place earlier than 2030 (as early as 2025). We understand that the “price” of the inflation between 2025 and 2030 increased between these years on the day of the announcement

## Some remaining uncertainty

We have also detected, from the immediate response of a number of LDI managers, a reluctance to accept that their fight to get compensation is over. Whilst the odds of RPI reform occurring in 2030 without compensation from gilt holders has increased, it is by no means a certainty.

In addition, there is uncertainty about how big the gap between RPI and CPIH will be ten years from now. In particular, changes to how price data is collected, undoubtedly required as the shopping habits of the nation change over the next 10 years, could bring the gap between RPI and CPIH down from historic levels. Price and sales data collection reform could result in a meeting in the middle, with both RPI decreasing and CPI increasing as a consequence.

## Implications

### *Investment*

The announcement provides increased certainty as to what an inflation-linked gilt (and RPI swaps) will deliver. Those delaying an increase in inflation hedging as a result of the uncertainty can now go ahead with greater confidence. Indeed, this may already be supporting the price of inflation-linked gilts.

### *Scheme funding*

Inferring inflation from market data has been difficult since reform was first announced in September 2019, and this latest announcement does not make things much easier. The construction of inflation-related assumptions will continue to be difficult and subject to change.

### *Further information*

For further information, please contact your usual First Actuarial consultant