Pensions law group – December 2020

The composition of the Retail Prices Index set to change

RPI to be aligned with CPIH from 2030

The composition of the Retail Prices Index (**RPI**) is set to change from February 2030. RPI index values will be calculated using the same methods and data sources that are used to calculate the CPIH (the Consumer Prices Index including owner occupiers' housing costs). Based on recent economic conditions, this is likely to result in RPI being lower by an average of 1% per annum. Pension schemes (in particular, defined benefit schemes) are likely to be affected in two ways:

1. a reduction in the value of any RPI linked assets; and
2. a reduction in any liabilities linked to RPI (for example indexation and revaluation calculated on the basis of RPI).

The overall effect this will have on the funding of a scheme will depend upon the nature of the liabilities in the scheme, how those liabilities have been hedged and the asset portfolio of the scheme.

Background

It has long been recognised that there were shortcomings in the composition of RPI meaning it did not accurately reflect the rate of inflation.

2013

RPI's status as a 'National Statistic' is revoked but it remained in widespread use – not least in many private sector defined benefit pension schemes.

2015

A review of price indices published by the Institute for Fiscal Studies recommended that, given the fundamental flaws in the way RPI is calculated, the Office for National Statistics (**ONS**) should maintain RPI as a legacy measure only.

2017

CPIH became the lead inflation index in the ONS's statistical releases from 21 March 2017.

2018

The Government consulted on whether pension schemes should be permitted to move from RPI to CPI on the grounds of rationality and fairness and the results of the consultation were published in the March 2018 White Paper "*Protecting Defined Benefit Pension Schemes*". The Government found there was no clear consensus on whether "fairness" meant protecting employers who may be at a competitive disadvantage if RPI is hard-coded into their pension scheme rules, or protecting pension scheme members who were promised pension increases on a certain basis.

Jan 2019

The Economic Affairs Committee published a report which found that RPI's continued publication in its current form was untenable. It recommended that the UK Statistics Authority (**UKSA**) request a programme of periodic improvements to RPI.

March 2019

The UKSA wrote a letter to the Chancellor recommending:

1. that publication of RPI should cease; and
2. since recommendation 1 would require primary legislation and therefore take time, a second parallel course of action: to align RPI with CPIH.

The UKSA was obliged to ask the Chancellor to consent to these recommendations as it is legally obligated to produce RPI. It cannot, without the consent of the Chancellor, change the index until 2030 (when the last relevant index-linked gilts mature) in a way that would determinately affect index-linked gilts.

Sept 2019

The Chancellor responded to the UKSA recommendations noting that RPI is widely used across the economy and ceasing to publish RPI would be highly disruptive. The Chancellor would not agree to promote legislation that would remove the requirement for the UKSA to publish RPI.

The Chancellor recognised the statistical arguments for the second proposal to fix RPI by aligning its methodology with CPIH. The Chancellor notes, however, there would be significant effects of these changes on users of RPI and time will be needed for those who use RPI to prepare.

March 2020

A consultation was published seeking views on whether the change to the composition of RPI should be made earlier than 2030 and, if so, when between 2025 and 2030 the change should occur.

What will change?

From the implementation date (please see below), RPI index values will be calculated using the same methods and data sources that are used to calculate the CPIH. The consultation document provides that, based on recent experience, RPI is likely to be lower by an average of 1% per annum, although depending on the economic climate this will not always be the case; the change could be positive or negative from time to time. The RPI and CPIH will continue to be calculated and published as separate indices.

"…the proposal would ensure users of the RPI were using a statistically robust measure of inflation by applying the more robust methods and data sources used for…the CPIH" A Consultation on the Reform to Retail Prices Index Methodology 11 March 2020

When will it change?

The response to the consultation seeking views on when the timing of the proposals should occur was published on 25 November 2020. In order to minimise the impact of the proposals on the holders of index-linked gilts, the Chancellor has stated that he will not consent to the composition of RPI being aligned with CPIH until the final index linked gilt has matured in 2030. After this time, the Chancellor's consent will no longer be required. The UKSA has therefore confirmed it will align RPI with CPIH in **February 2030**.

Impact for pension schemes

Defined benefit pension schemes will be the main pension schemes affected by this change. The extent each scheme is impacted will depend upon the proportion of schemes assets held in index-linked gilts (RPI linked) and whether scheme liabilities are calculated based on RPI or CPI (for example for revaluation and indexation).

"… the extent to which a DB pensions scheme will be impacted by reform will depend on the extent to which it is hedged and the nature of its liabilities " A Response to the Consultation on the Reform to Retail Prices Index Methodology 25 November 2020

Schemes who are perfectly hedged may not be impacted as the total value of the RPI linked liabilities may fall in line with the reduction in the value of the scheme assets. However, a large number of responses to the consultation were from pension schemes who had CPI linked liabilities but RPI linked assets. For these schemes, their funding position will be negatively affected as the value of their assets will fall while the level of their liabilities will not change. The Government has confirmed that it will not be providing compensation to the holders of index-linked gilts (including pension schemes).

It will also be interesting to see if this change leads to a reduction of court cases where employers whose pension scheme rules seemingly hard-code RPI as the measure of inflation for revaluation and indexation have sought to use CPI instead. If from 2030 RPI will generally produces a lower level of inflation than it has in the past, employers may consider that it is not worth the time and cost of attempting to change the newly reformed RPI to CPI.

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