XPS Pensions Group

XPS Insights
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RPI to be aligned with CPIH some time between 2025 and 2030

What you **need to know**

- The Government and the UK Statistics Authority are consulting on aligning the Retail Prices Index (RPI) with the Consumer Prices Index including owner occupiers' housing costs (CPIH). The consultation ends on 22 April 2020.
- The consultation asks when and how RPI should be aligned with CPIH between 2025 and 2030 – not if.
- The consultation suggests a direct alignment – i.e. that increases after a transition period will be the same. In the recent past CPIH has been an average of 1% lower than RPI.
- Future RPI-linked pension increases and RPI-linked asset proceeds are therefore expected to reduce. No compensation was suggested for holders of index linked gilts in the consultation.
- CPI benefits are not impacted but CPI assumptions made by actuaries may be as these are typically derived relative to RPI.
- The impact on funding will depend on whether benefits are linked to RPI and CPI and also the extent of any inflation hedging. Member options, such as transfer values, will also be impacted.
- It is unclear if the consultation has affected market expectations of inflation. Expectations fell over March (expected to be linked to market uncertainty relating to COVID-19) but not on the day it was launched.
- The Government expects to respond to the consultation before the parliamentary summer recess.

Actions you can take

- **Understand the impact for your scheme**, in particular how funding levels move with changes in inflation expectations.
- **Review inflation assumptions** to ensure that they reflect latest developments and expectations.
- **Decide whether to hold an inflation reserve** if you are carrying out a valuation now.
- **Review your inflation hedging**. Is it sufficient or should it be refined to provide suitable protection?
- **Review your approach to member options** to ensure you are providing fair value to your members.

Possible impact on scheme assets and liabilities

Proposal	Impact	Comment (assuming all other market influences being equal)
Assets – RPI linked	High risk	Expected to reduce proceeds
Assets – CPI linked	Medium risk	No impact on proceeds
Liabilities – RPI linked	Low risk	Change will flow through automatically – cost expected to reduce
Liabilities – CPI linked	High risk	Estimated cost may increase – assumptions are set as a deduction to RPI
Scheme funding	Medium risk	Will depend on extent of hedging and mix of CPI and RPI liabilities

High risk   Medium risk   Low risk

The finer detail: Key items covered by the consultation

Reminder of the different measures of inflation	**Retail Prices Index (RPI)** – formerly the UK's main measure of inflation. **Consumer Prices Index (CPI)** – required by EU regulations, uses a different construction to RPI and, unlike RPI, excludes owner occupier housing costs (OOH). Recently CPI has been around 1% lower than RPI. **Consumer Prices Index including owner occupiers' housing costs (CPIH)** – Office for National Statistics' preferred inflation measure since March 2017. Same construction as CPI, but includes OOH costs. CPIH inflation has recently been broadly in line with CPI.
How the different measures of inflation typically impact schemes	Both statutory in-payment pension increases and revaluation prior to retirement are linked to CPI, having been switched in 2010 by the Coalition Government. Typically pension inflation protection awarded prior to retirement is linked to CPI. Many schemes provide increases in payment which are linked to RPI, because this is written into scheme rules. Schemes that are hedging inflation risk hold assets that move in line with RPI. There are currently few instruments available to hedge CPI inflation.
Background to the consultation	
Why did the UK Statistics Authority want to change RPI?	It is widely accepted that the statistical method used to calculate RPI is flawed, however RPI remains widely used. The UK Statistics Authority proposed in 2019 that RPI be aligned with CPIH, its preferred measure of inflation, to ensure a statistically robust measure of inflation is being used.
What did the consultation say?	
RPI is to be aligned with CPIH	There appears to be no doubt that RPI will be aligned with CPIH. From 2030, the UK Statistics Authority will be able to make the change to RPI without seeking the consent of the Chancellor. The consultation suggests a direct alignment. After a year for the mathematical effect to come through (essentially a transition period) RPI and CPIH will be the same.
When will this happen?	The consultation does not propose a date for the alignment, rather it seeks to understand the potential impact of making the change between 2025 and 2030.
Will compensation be provided for RPI gilt holders?	There is no mention of compensation in the consultation. Some gilts issued prior to 2002 require a redemption offer to be made in the event of any change to RPI that is a fundamental change that is materially detrimental to the holders of these gilts.
Broader considerations	The consultation seeks to better understand any wider uses of RPI, for example in financial contracts, and whether the change to the RPI could have unintended consequences. It notes that these factors are unlikely to be relevant to the Chancellor's final decision, but it may impact future financial policy. It also notes that other sub-RPI indices, including RPIX, will cease to be published.
What happens next?	The consultation will be open for six weeks, until 22 April 2020. The response to the consultation is expected before the parliamentary summer recess.

For further information, please get in touch with **Heidi Webster** or **William Fitchew** or speak to your usual XPS Pensions contact.

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