XPS Pensions

Briefing

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Will it finally be RIP for RPI?

In brief

- The Lords Economic Affairs Committee have published a report on measuring inflation
- They recommend a move to a single general measure of inflation to prevent 'inflation shopping'
- Once a single measure has been introduced, the statistical authorities and government should decide on whether RPI should continue in its existing form or converge gradually (in a pre-announced way) towards the single measure
- The government should start issuing CPI-linked gilts and stop issuing RPI-linked ones

Next steps

- The Government is expected to issue a response to the report, although they are not bound by its recommendations
- The report is another authoritative voice calling for a single measure of inflation

On 17 January 2019, the House of Lords Economic Affairs Committee (EAC), following an inquiry during 2018, published a report on 'Measuring Inflation', in which they make a number of recommendations, including that there should only be a single general official inflation measure.

Background

Three main consumer price indices are produced monthly by the Office for National Statistics (ONS). The Retail Prices Index (RPI) was the main UK inflation measure for many years and dates back to the 1940s. The Consumer Prices Index (CPI) is required by EU regulations, was first published in 1997, and is the basis of the Bank of England's (BOE) inflation target. CPIH is a variant of CPI that was introduced in 2013 which includes an allowance for owner occupiers' housing costs (OOH), and which is the ONS's headline rate.

RPI has been on the receiving end of some criticism in recent years, much of it centred on its use of the Carli averaging formula. CPI, on the other hand, does not use the Carli. RPI tends, on average, to be higher than CPI, and that part of the difference between the two which is due to the use of different averaging formulae is known as 'the formula effect'. CPI is also not without its critics, a key shortcoming being that it does not take account of OOH costs (which prompted the ONS to introduce CPIH and make CPIH its headline rate).

RPI is used by a significant number of index-linked gilts (ILGs) (around £435 billion nominal at the start of February 2019, the longest dated of which matures in 2068). A small number of older ILGs have prospectuses which allow the holder to redeem them if there is a 'fundamental' and 'materially detrimental' change to RPI. Legislation also requires that before any change is made to RPI, if the BOE considers it is a fundamental change that is materially detrimental to the interests of holders of these ILGs, then the Chancellor of the Exchequer must approve it. The report notes the last ILG with this clause will mature in 2030.

Shortcomings in RPI – the clothing problem

In December 2009 the formula effect was (estimated) to cause RPI to be 0.54 percentage points higher than CPI; however a year later this had jumped to 0.86 percentage points. This sparked research by the ONS, which found that methodological changes made in 2010 to the measurement of clothing prices was the cause. The change also affected CPI but had a greater effect on RPI because of its use of the Carli.

The then National Statistician carried out a consultation in 2012 on the future of the RPI, the most radical option being to align fully RPI's formulae with CPI's. Many of the respondents were in favour of no change, citing concerns about the impact on ILGs and pensions. Whilst the National Statistician concluded the Carli formula did not meet international standards, she recommended that RPI should be maintained in its current form (including using the Carli). It was also decided that no further changes, bar routine ones, were to be made to the RPI.

Following this the UK Statistics Authority (UKSA), which oversees the ONS, commissioned a review from Paul Johnson, which, amongst other things, recommended that the Government and regulators should work towards ending RPI's use as soon as possible, and that it should be treated as a legacy measure. The ONS also went on record saying that RPI is 'a very poor measure of general inflation'.

The Committee heard differing evidence on the shortcomings of RPI and on what should be done about 'the clothing price problem', with some arguing that the latter should be fixed in isolation. The statistical authorities were not sure that fixing the clothing problem on its own was possible, and also expressed reluctance to 'half-fix' RPI (likening this to putting new tyres on a completely broken down car). They appeared to view that any fix that was suitable would require the statutory approval of the Chancellor, which they believed would not be forthcoming.

The EAC expressed surprise that the UKSA is treating RPI as a legacy measure, noting that it remains in widespread use and recommended that periodic review of RPI's methodology should be resumed. It further suggested that the UKSA could be in breach of its statutory duties by 'publishing an index which it admits is flawed but refuses to fix'. The EAC believes that the legislation requires the UKSA to fix the 'clothing price problem' and that any potential decision of the Chancellor should not be pre-empted. The UKSA should request a fix to the issue and the Chancellor should consent to it. The EAC stated that it was 'untenable for an official statistic, that is used widely, to continue to be published with flaws that are admitted openly'.

Single measure of price inflation

The report notes that where the public makes payments (e.g. regulated rail fares, tobacco and alcohol duty), these tended to be uprated using RPI. However payments made to the public (e.g. state pensions, benefits) tend to be indexed by CPI. The EAC is of the view that multiple inflation indices allow the Government to engage in 'inflation shopping', which risks 'undermining public confidence in economic statistics'. The report therefore recommends that there should be a single measure of general inflation used by Government for all purposes.

Furthermore, the EAC disagreed with the view of the UKSA/ONS that RPI does not have the potential to become a good measure of inflation. The UKSA (after consulting suitably) should decide which index to recommend to Government for use as the single measure and that this should be adopted within five years. To address inflation shopping in the meantime, the Government should switch to CPI in all areas where it is not contractually bound to use RPI (bar the interest rate on student loans).

CPIH is also under scrutiny. The EAC was not convinced by its use of the 'rental equivalence' method to reflect OOH costs, and so more work is suggested to agree the best method to capture OOH costs in a consumer price index.

Once a single general measure of price inflation has been introduced, the UKSA and Government should decide whether RPI should continue in its existing form (for use in existing RPI-linked contracts) or whether it should be gradually adjusted so that it converges on the single general measure (with plans for such adjustments announced in advance, and to take place over a 'sufficiently long time').

Index-linked gilts

The Committee heard evidence that of £2 trillion of private sector defined benefit (DB) liabilities, £1.1 trillion was linked to RPI and £300 billion was linked to CPI. The EAC recommended that the Government should start issuing CPI-linked gilts, having heard evidence there was sufficient demand, and stop issuing RPI-linked ones. Once a long-term single inflation measure has been agreed, index-linked gilts should be linked to it. The prospectuses for new ILGs should make clear that the index used will change to the new single rate of inflation once it has been agreed.

What next?

Mark Carney, the current Governor of the BOE, last year suggested that there should only be one measure of inflation and the EAC is another authoritative voice calling for the same thing. The Government is expected to issue a response to the report, although they are not bound by its recommendations.

Commentary

Pension scheme financing could be crucially impacted by changes to the inflation measures used to revalue benefits or calculate payments delivered by inflation linked assets. Trustees will need to track what changes might happen and the extent (if any) to which they are priced into markets and/or existing assumptions. Trustees can then seek to ensure that funding plans and options payment terms remain appropriate.

For further information

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