XPS Pensions Group

XPS Insights
November 2020

RPI now expected to align with CPIH in February 2030

What you **need to know**

- **On 25 November the Government and UK Statistics Authority (UKSA) issued a response to their joint consultation on aligning the Retail Price Index (RPI) with the Consumer Price Index including owner occupiers' housing costs (CPIH). This confirmed the Chancellor will not consent to the alignment of RPI with CPIH before 2030.**
- **The decision to change RPI is now left with UKSA. UKSA has obtained the confirmations it needs to legally change RPI in 2030 and confirmed its policy to implement the change at the earliest possible time. The clear direction is that (absent any unforeseen event) the UKSA will make the change in February 2030.**
- **The method UKSA will use will result in RPI being calculated the same way as CPIH. The Government confirmed no compensation will be offered to index-linked gilt holders.**
- **The change will impact RPI asset proceeds and automatically impact RPI-linked pension benefits. Assumptions for CPI benefits (and therefore estimated costs) may change as they are typically set as a fixed deduction to RPI.**

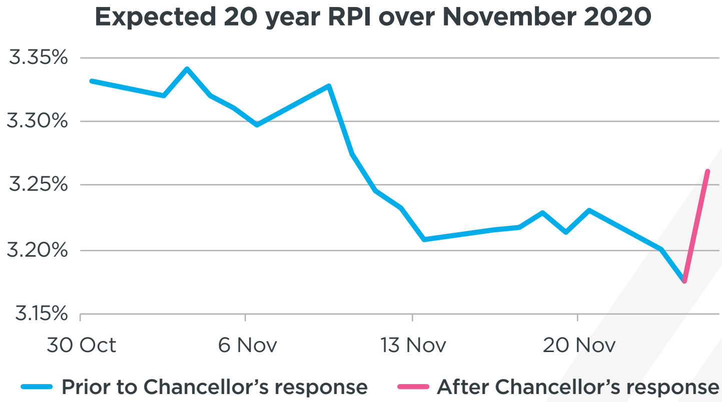
Benefit/liability **actions**

- Review member options and factors
- Review approach to CPI assumptions
- Measure the impact on funding valuations
- Reflect in GMP conversion calculations
- Employers need to review RPI and CPI assumptions for company accounts
- Recalculate cash flows used for valuations and hedging

Investment **actions**

- **CPI benefits** – update hedging to reflect updated CPI assumptions, if material
- **RPI benefits** – consider reviewing hedging to take account of current levels of inflation
- Progress any liability hedging actions that were previously put on hold due to the consultation
- Review any de-risking triggers

How the market reacted to the 25 November RPI response



Source: Refinitiv

- Up to 24 November inflation expectations fell by circa 0.12% as the market started to price in the change to RPI.
- On 25 November expected inflation rebounded by 0.07% as the market reacted to the likelihood of lower index-linked gilt issuance and pent-up demand from investors who had delayed purchases due to the consultation.
- With the consultation complete, and largely priced in, schemes can get on with their hedging activities, although index-linked gilt supply is not expected to pick up until 2021.

The finer detail: Government decision on RPI

Background to the 25 November response to the consultation	
Reminder of inflation measures	**Retail Price 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 housing costs. CPIH inflation has recently been broadly in line with CPI.
Brief history on the road to changing RPI	The UKSA believes RPI is a flawed measure of inflation and should be aligned with CPIH, or better, removed. A 17 January 2019 House of Lords report supported this view. Given terms on certain index-linked gilts, UKSA needs the approval of the Chancellor to change RPI before 2030. On 4 September 2019, the then Chancellor announced he would consult in early 2020 on when exactly between 2025 and 2030 RPI would be aligned with CPIH. This consultation was launched on 11 March 2020.
25 November Government and UKSA response to the consultation	
Timing of change	The Chancellor confirmed he would not consent to the proposed changes before 2030. The UKSA confirmed that its policy is to make the changes at the earliest possible point, which is February 2030. UKSA also set out in the response that it had obtained the necessary confirmation that there are no barriers to it making the change at that date.
Method of change	In February 2030, the UKSA will bring methods and data of CPIH into RPI. In effect this means that RPI will be aligned with CPIH. RPI will continue to be calculated separately. It will also not be set to CPIH plus an additional amount, to minimise the impact of the change, as some had called for.
Compensation	The Government confirmed that compensation would not be provided to holders of index-linked bonds
Impact of the response on assets, liabilities and member's benefits	
Assets – RPI-linked	Cashflows from RPI-linked assets are expected to reduce. This is mostly now incorporated into current asset prices.
Assets – CPI-linked	There will be no impact on expected asset cashflows due to the changes.
Benefits – RPI-linked	The change will flow through automatically to benefits.
Benefits – CPI-linked	CPI benefits will not change. However their cost is typically estimated relative to RPI. If the gap used by actuaries is reduced without a fall in RPI, liability values will increase.
Scheme funding	The impact will depend on the extent of any hedging and the mix of RPI and CPI benefits.
Member options	When members exercise options such as tax-free cash, a transfer value or exchange of pension increases, they realise the value of future inflation increases. Assumptions are made on this and will need to be reviewed to ensure values are fair, and to reduce the risk of winners and losers.

For further information, please get in touch with **Will Fitchew** or **Mark Minnis** or speak to your usual XPS Pensions contact.

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