01/2021

XPS Express for Employers

Bringing you the latest pensions news for employers

How employers can respond to changes to RPI inflation

At a glance

Following the Government's November 2020 consultation response, we now expect increases in the Retail Prices Index (RPI) to be aligned with the Consumer Prices Index including Housing (CPIH) from 2030

Since CPIH is generally lower than RPI, pensions linked to RPI are expected to have lower increases from 2030. However any RPI linked assets may also pay a lower level of income

Pensions linked to the Consumer Prices Index, or CPI, would not be expected to change, but estimates of the cost of these pensions may change because the CPI assumptions are typically set as a fixed deduction to RPI

The overall impact on your scheme will depend on which inflation measure your scheme uses, its hedging level and its approach to assumption setting

Investment markets did not appear to adjust inflation expectations following the latest RPI announcement – we saw no significant change in expected RPI after 2030

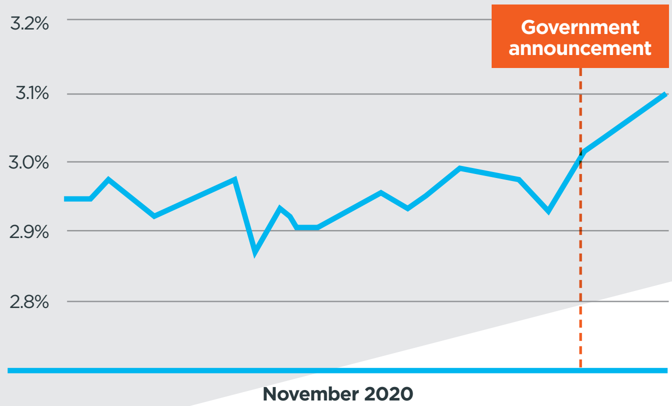
As a result, some employers may face calls to fund increasing deficits – which is at odds with an announced reduction in RPI

The investment market's reaction

If a full alignment of RPI and CPIH in 2030 was not already priced into the market then, all else being equal, we might have expected a fall in RPI in reaction to the November announcement.

However, the market's expectation of future RPI did not change materially.

Expected RPI in 2040 according to market data



Source: Bank of England inflation forward rates

What is the impact of the RPI change?

RPI linked pensions	**Lower** expected increases from 2030.
RPI linked assets	**Lower** expected future income.
CPI linked pensions	**No change** expected to CPI pension increases, **but** the estimated cost may change.

The overall impact on your scheme will depend on which inflation measure your scheme uses, its hedging level and its approach to assumption setting.

Actions employers can take

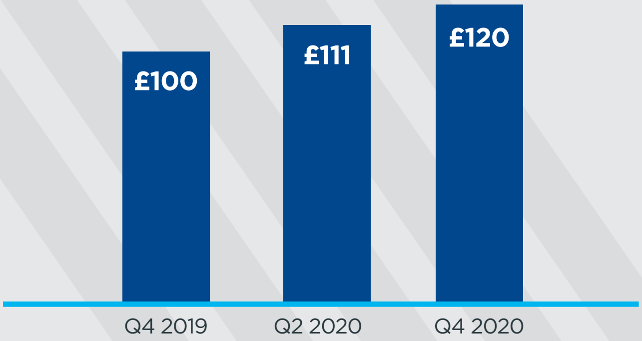
To make sure pension costs are not overstated, there are 3 actions employers can take now:

1. **Agree your approach to managing inflation risk including the level of hedging with your trustees;**
2. **Ensure all aspects that affect benefit payments, not just inflation, are considered together – most notably recent changes in life expectancy due to the pandemic; and**
3. **Review and set appropriate inflation assumptions for long term targets and cash funding.**

Accounting update

Companies reporting at 31 December 2020 are likely to have increased defined benefit obligations on their balance sheets due to a fall in corporate bond yields over the year, offset slightly by a decrease in future inflation expectations. The resulting net balance sheet positions will depend heavily on investment strategy, with schemes that have greater exposure to growth focused assets such as UK equity and property likely faring significantly worse than schemes with a high degree of interest rate and inflation protection.

Changes in value per £100m of accounting liabilities



Source: XPS Pensions Group

Returns on key asset classes

	Dec 19 –Jun 20	Jun 20 –Dec 20	Year to Dec 20
Global equities	0.7%	12.2%	**13.0%**
UK equities	-17.5%	9.3%	**-9.8%**
Property	-24.1%	10.8%	**-15.9%**
Index-linked gilts	12.1%	-1.0%	**11.0%**
Corporate bonds	2.9%	5.6%	**8.6%**

Source: Thomson Reuters

Why am I being asked to fund an increasing deficit due to the RPI change?

CPI assumptions are typically set as a fixed deduction to RPI. To reflect the recent change to RPI, it would be logical to remove the deduction post 2030 to align the CPI assumption with RPI.

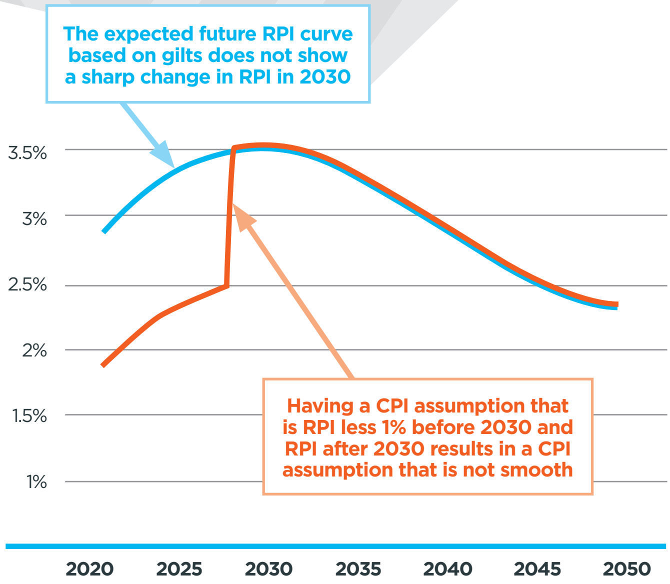
Given the market did not react to the announcement however, this change acts to increase the estimated cost of CPI pensions.

If the market RPI data does not fully reflect the change in 2030, removing the deduction post 2030 can result in a CPI assumption that jumps up in 2030.

Other approaches to assessing RPI companies can consider:

1. Using market data, such as swap data, the shape of which shows a step down in RPI in 2030.
2. Allowing for an inflation risk premium to reflect RPI potentially being overvalued by the market data.

The validity of each approach will depend on the purpose of the assumption and the extent to which inflation is hedged.



Source: Bank of England inflation forward rates

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

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