Since 2010, the question of which inflation index (Retail Price Index (RPI) or Consumer Price Index (CPI)) should be used for pension increases (in payment and deferment) has caused a huge amount of uncertainty for pension schemes. The Government now intends to bring the two indices together, by aligning RPI with CPIH (a variant on CPI which includes owner-occupier housing costs). However, this will create further questions for trustees and employers.

The question of whether to use RPI, CPI or CPIH as the measure of inflation may seem like a technical detail, as indeed it is. However, the impact can be very material. The Government's proposals represent both a threat and an opportunity, depending on your circumstances.

The Government is consulting on its proposals and wishes to deepen its understanding of the range of impacts the proposed change might have. We encourage all trustees and employers with defined benefit pension schemes to engage with this point.

Key questions for trustees and employers

1. What do your rules say?

Trustees and employers need to understand whether the Rules of their pension schemes prescribe a particular index, or whether there is a discretion (and if so, who can exercise it). This may require different indices for different tranches of accrual, as minor drafting changes can have a significance that was not appreciated at the time the provision was introduced into the Rules.
2. Do your rules say what they ought to say?

We are aware of some Rules where changes in the wording used from one deed to another have had unintended consequences, e.g. by hardwiring RPI where this not intended, or by inadvertently changing the balance of power between employer and trustee. If the employer or trustee suspects that this may have happened, it should consider taking legal advice on whether the position can be rectified.

3. Are your investments linked to RPI?

Schemes which have invested in index-linked gilts (or RPI-based inflation swaps) will see a fall in asset value if RPI is aligned with CPIH, unless investors are compensated. Your investment advisers can advise in relation to this[1].

4. Do you have inflation hedging?

If you have hedged RPI-linked inflation increases, the position is likely to be broadly neutral, because both the assets and liabilities will fall and the effect will be self-cancelling, other things being equal. However, schemes that have CPI-linked increases and have fully hedged them will see a fall in their funding level. Schemes and employers will need to discuss with their investment adviser how they are affected by this.

5. Should you engage with the process?

The Government is consulting on this issue, and acknowledges that it may not have the complete picture on how the market will be affected by the proposed change. We will be responding to the consultation on behalf of our clients, and trustees and employers who are particularly affected may wish to respond directly.

Background

The Government switched from RPI to CPIH as its chosen index for pension increases in 2010. This applied to public sector schemes and the statutory minimum increases that private sector defined benefit pension schemes are required to provide.

However, the change did not flow through automatically to every private sector scheme,
because many had RPI expressly written into their Rules. Since then, there has been a string of cases in the courts on whether particular scheme Rules allow a change to CPI or not.

Meanwhile, the UK Statistics Authority (UKSA) has been clear in its view that RPI is a flawed index which overstates inflation. Rather than abolish the RPI altogether, it intends to align it to CPIH, by calculating RPI using the methods and data sources of CPIH. CPIH is broadly the same as CPI with owner-occupier housing costs included.

From 2030, the UKSA can make this change unilaterally. Before then, it needs the approval of the Chancellor of the Exchequer, because of RPI’s role in index-linked gilts. Defined benefit pension schemes are significant holders of such gilts, so this proposal affects both the assets and the liabilities of most defined benefit pension schemes.

The consultation

The Government is consulting on whether this change should be made before 2030, and, if so, when between 2025 and 2030.

Therefore, nothing is going to change overnight. However, the responses the Government gets now will likely shape what happens in the future, so pension schemes should not miss this opportunity to have their voices heard.

The Government recognises that it does not have a complete understanding of the use of RPI in the economy, and that making this change could therefore have unintended consequences. The consultation therefore seeks to address that by inviting participants to comment on the impact the change could have.

There is very little in the consultation that is specific to pensions, but it does acknowledge that RPI is commonly used to uplift defined benefit pensions, and that pension schemes are significant investors in index-linked gilts.

What does this mean for pension schemes?

Trustees and employers with defined benefit pension schemes should consider the effect of what is proposed on both their liabilities and their assets.

Liabilities
If RPI becomes the same as CPIH, then pension schemes with RPI-linked pension increases will see a reduction in their liabilities. CPIH tends to increase around 100 basis points slower than RPI per annum. Of this, around 75 basis points is attributable to the "formula effect", i.e. the fact that CPIH is calculated using a different mathematical formula.

This means, of course, that members will experience less generous increases. Also their transfer values will be lower. This may lead to member complaints, particularly if trustees have any discretion in their Rules that would enable them to mitigate the impact of the change, and have not given proper consideration on whether or how to exercise it.

Trustees and employers will need to understand both what their Rules require them to do, and what their Rules allow them to do.

This gives rise to various legal issues, including the following:

- In our experience, most schemes have already commissioned legal advice to understand whether RPI is incorporated into their Rules, and if so, whether there is any power to substitute a different index (and who has that power). There has been a string of legal cases on this. Trustees or employers who are unsure of the position should speak to their legal advisers, as we are now able to interpret most Rules with a high level of confidence, although further litigation does seem likely in relation to difficult cases.
- It is important to stress that this is not a case of looking only at the current Rules. Historic deeds may be expressed differently and may still apply to certain tranches of benefit. Also, it may be that the Rules, through an accident of drafting, do not reflect what the parties intended. If that is the case, there are potential solutions, and any trustees or employers who consider that they may have been affected by this should consider taking legal advice.
- If the proposed alignment of RPI to CPIH goes ahead, the analysis on the above points may change.
- For schemes which give the trustees or employer a discretion to choose the index, the relevant factors to take into account when making that decision will be affected.
- Some scheme Rules contain provisions for what happens if RPI is materially changed. It is possible that such Rules will be engaged by what is proposed. Trustees of such schemes should consider taking legal advice on whether they will automatically be required to adopt the new-style RPI, and, if not, what the position is.
Assets

If RPI is aligned to CPIH, then any asset which is linked to RPI, such as index-linked gilts or RPI-based inflation swaps, will lose value. Therefore, for a scheme which has RPI-linked increases but has fully hedged them using index-linked gilts, the effect on its funding position will be broadly neutral (other things being equal); the liabilities will fall, but so will the assets.

A problem arises for schemes which have CPI-linked pension increases but have hedged them. It is not possible to obtain CPI-linked assets to hedge inflation risk. Instead, schemes will have hedged using RPI-linked assets, after having made an allowance for the fact that RPI increases faster than CPI (the so-called "CPI wedge").

For these schemes, their liabilities will be unaffected but their asset value will fall, so their funding position will worsen. Such schemes will need to discuss this with their investment advisers.

Of course, in reality for most schemes it will not be as clear-cut as the above suggests. The following factors will create shades of grey in between the broad principles outlined above:

- Schemes will typically have some increases which are RPI-linked and some increases which are CPI-linked.
- Schemes may have only partial inflation hedging.
- CPI and CPIH are not the same thing (although they are much closer to one another than RPI is to CPI).

It is possible that there may be compensation for holders of RPI-linked gilts that will offset the loss in value, and we consider that there is likely to be considerable pressure from investors for this, and indeed there could be litigation if it is not forthcoming. Pension schemes may wish to join the lobbying on this. For example, one major LDI provider is arguing that RPI should be replaced not by pure CPIH, but by CPIH plus a margin.

The consultation does not give away anything on the Government's plans on this.

What should you be doing?

This is a big issue. The effect of changing the measure of inflation from RPI to CPI or CPIH can be very material for any scheme, depending on the size of pensions it contains and the way its Rules are drafted.
Schemes therefore need to understand the position under their Rules and the possible effect on their investments, and to take appropriate professional advice where necessary.

We encourage pension scheme trustees and employers to engage with the consultation process, whether that is by responding directly, or failing that we can pass on the views of the industry and our client base in our response.

The consultation closes on 22 April 2020 and contains details on how to respond.

Footnotes

[1] This Insight was written before the most recent developments on COVID-19. Clearly, there are now also other reasons why pension schemes may need to be engaging with investment advisers.

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