From: Fred Emden
Sent: 19 August 2020 15:17
To: RPIConsultation@hmtreasury.gov.uk
Cc:
Subject: HM TREASURY: A CONSULTATION ON THE REFORM TO RETAIL PRICES INDEX (RPI) METHODOLOGY

To whom it may concern

Please find below the Society of Pension Professionals' response to your consultation on the reform to RPI methodology.

If you require any further information, please do get in touch.

With best wishes

Fred

Fred Emden
Chief Executive
The Society of Pension Professionals

INTRODUCTION TO THE SOCIETY OF PENSION PROFESSIONALS (SPP)
SPP is the representative body for a wide range of providers of advice and services to work-based pension schemes and to their sponsors. The breadth of our membership profile is a unique strength for the SPP, including actuaries; lawyers; providers; consultants; administrators; investment managers; professional trustees and covenant assessors. Our members lead pensions thinking by working collaboratively, allowing views and knowledge to develop with a true breadth of perspective.

We do not represent any particular type of provision or any one interest - body or group. Many thousands of individuals and pension funds use the services of one or more of SPP's Members, including the overwhelming majority of the 500 largest UK pension funds. SPP's membership collectively employs some 15,000 people providing pension-related advice and services. This consultation has been considered by SPP's Defined Benefits and Investment Committees, which primarily comprise representatives of actuaries, consultants, investment managers and lawyers.

CONSULTATION - KEY POINTS
SPP wants to highlight the importance of this issue to pension schemes and that for many pension schemes it will lead to a reduction in their funding level putting additional strain on sponsors at a time of stress in the economy. The consultation refers to the substantial demand from defined benefit (DB) pension funds seeking to match RPI-linked liabilities. We agree that broadly such schemes will see both a reduction in their liabilities and their assets.

However, we want to emphasise that many DB pension funds have CPI-linked liabilities – substantially more than indicated by the House of Lords Economics Affairs Committee report. In the absence of CPI-linked gilts, these schemes are also encouraged by The Pensions Regulator to use RPI-linked gilts as the closest match. Such schemes will see a reduction in their assets, but no corresponding reduction in the liabilities.

Further, RPI is used in other long-term investments such as infrastructure which are also held by pension schemes, so the impact of a change to the RPI index is far wider than the gilts market.

In assessing whether there should be compensation, HM Treasury should also consider the position of prudent individuals who used their own assets to buy a RPI-linked annuity – the annuity payments will be lower in future than anticipated, but the amount paid will not change nor, under the proposals, will the member receive a refund or compensation.

DETAILED RESPONSE

1 Do you agree that this proposed approach is statistically rigorous?

This question could be read as asking whether the chain linking approach is statistically rigorous. If so, we are happy with the method proposed. In particular, we would prefer that the annual change and monthly changes in the index were consistent. It is not important that the new RPI and CPIH have the same absolute index values – it is the change in the index that matters.

The question could also be read as asking whether the revised RPI, based on CPIH, is the best index available. There will be a range of views within SPP on that question. In the BT court case (EWHC-2017-002523), the judge opined that "notwithstanding the powerful statements from the UKSA, ONS and others to the effect that RPI is flawed and that it ought not to be used as a measure of inflation, I have reached the conclusion for the above reasons that RPI has not at this time "become inappropriate" for the purposes of uprating pensions, within the meaning of that phrase in the 2016 Rule …" This demonstrates that however statistically robust or flawed a measure might be, there will be differing views as to the point at which it become inappropriate; and similarly, we believe there will be differing views as to the best measure of inflation for any given purpose.

It is also not possible for one measure to accurately measure inflation for all the many purposes for which RPI is still used. For example, within defined benefit pension schemes some measure of inflation is required both to increase benefits in deferment i.e. typically for members of working age and in payment i.e. mainly for older people. The inflation experienced by those groups are not the same because their expenditure patterns will differ. As you may be aware from a number of court cases, schemes are not always able to choose which measure of inflation to use.

2 What will be the impact on the interests of holders of 'relevant' index-linked gilts (i.e. 2½% IL 2020, 2½% IL 2024 and 4 1/8% IL 2030) of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

If the perceived shortcoming is addressed in 2030, there will be no impact on any of these specified gilts. The shorter two will have matured and even the 2030 gilts will have had its final redemption payment set with reference to inflation as at 2029 (due to the lag in the contracts). For the shortest two gilts, their value will be unaffected by a change anywhere in this window, but of course the 2030 gilt may have its value negatively impact if indexation was to be lower in its latter years.

The ultimate impact cannot be known until there is certainty around the new measure of inflation. An index linked gilt is a series of contractual payments based on RPI inflation; a well understood inflation measure, so an index linked gilt is valued by inflating the coupons and redemption payment and discounting the resulting cash flows at a risk free rate. If the later coupons are reduced by a reduction in the inflation measure, then the current value of the gilt is less.

If an RPI calculation methodology was simply changed to a CPIH calculation methodology within gilts contracts, with no adjustment to recognise the erosion in value that this would cause, it would have about 4% drop in value. Whether this would be seen on the day the change was announced, or partly priced in during the run up to an announcement, would depend on the market expectation of the government action.

Please also see the answers to questions 4 and 5.

3 What will be the impact on the interests of holders of all other index-linked gilts of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

Again, this depends on the action the government takes. The calculation in our answer to question 2 above assumed that a change from RPI to CPIH will reduce the inflation on the contractual cash flows by 1%. This is about the differential the market places on its expectation of RPI versus CPIH, largely due to the difference in calculation methodology (with RPI using an arithmetic average and CPI measures, a geometric approach). To suddenly change the contractual cash flows on a gilt, reducing the growth in these cash flows by 1% pa, will cause a material drop in value. To calculate this drop in value requires a projection of cash flows on RPI and a projection of cashflows with a c.1% lower inflation rate from the time of the change, discounted to today's value at a risk free rate. The impact could be estimated by considering the term the bond is exposed to a lower rate, using a duration measure and a 1% drop in real yield. With assets with maturities out to 48 years the impact could be very severe for the longest securities - over 30%.

Please also see the answers to questions 4 and 5.

4 What will be the impact on the index-linked gilt market or those dependent on it of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

The impact will depend on the action of the government. If what was always published as RPI, is suddenly calculated in line with CPIH, such that RPI and CPIH are equal, there are significant ramifications. We have addressed above the material impact this could have on the value of the index linked market, where participants reasonably felt that they had contractual security to receive an income flow based on the well understood and estimated RPI. However the impact goes far beyond the gilt market itself.

Well managed UK pension funds hedge their liabilities with index linked gilts, gilt repos and swap contracts based on RPI, but may have CPI based liabilities. Here the liabilities will not change, but the asset values of these pension funds will drop meaning that material deficits will arise – in turn forcing additional deficit contributions into pension funds at a time UK Plc can little afford it. This issue is explored in more detail in our answers to questions 5 and 6 below.

Many individual annuities, providing pensions to individuals, will have been bought with RPI pension increases, and priced assuming the higher level of RPI inflation. A change to RPI will mean that these prudent pensioners, who paid up to secure real protection on their pensions in payment, will have overpaid for their annuity.

5 What other impacts might the proposed changes to address the shortcomings of the RPI have in areas or contracts where the RPI is used?

Our response focusses on the impact on pension schemes.

Looking first at assets.

The impact goes well beyond the index-linked gilt markets. As a very well established and trusted index of inflation, many markets use RPI linkage. We have already referenced the over the counter derivative market. In addition there are non-government RPI bonds, PFI loans, other UK infrastructure contracts and real estate contracts (including ground rents). These are billion dollar markets and for each asset within them the specific contracts would need to be reviewed to understand how a change to RPI should be handled. Because these investments are long-term and inflation linked, they are often held by pension funds.

As demonstrated in 6 below, many DB schemes have CPI-linked liabilities and this change means that there will still be no CPI-linked gilts on the market – albeit that CPIH is expected to be a closer match to CPI than RPI-linked gilts.

Turning to liabilities

In some schemes, pensioners have shown that they are well aware of the difference between CPI and RPI-linked increases. This change will reduce the benefits of members with RPI-linked increases. The press might take up such

stories further damaging trust in pensions. As noted above, the prudent minority who used their own money to purchase RPI-linked rather than flat annuities now have less protection against future inflation.

RPI is also used to increase some limits for tax-advantaged savings, for example, the earnings cap for those schemes that retained it. This will mean lower benefits or increased likelihood of a tax charge for exceeding the lifetime allowance.

By contrast, this will also mean that for some schemes their liabilities will reduce increasing the security of other benefits and/or reducing the contribution burden on sponsors. This is explored in more detail in answer to Q6 below.

We also acknowledge the point made in paragraph 59 that cutting future interest payments could have a wider benefit for the public finances, which in turn can help the economy and the survival of the sponsors of DB pension schemes. This would also reduce the probability that such schemes enter the Pension Protection Fund.

By moving RPI to CPIH instead of CPI, there will still be a difference in the pension increases granted in those schemes where RPI was hard-coded in the rules and those where the increases are linked to the statutory CPI based measure. Further, for deferred members, the ability to use RPI instead of the statutory CPI measure is tightly defined and we suggest this should be reviewed to avoid granting members the better of two otherwise similar measures of inflation – surely not the intention. We would be happy to discuss this point further. This test unnecessarily complicates administration.

It may be that in due course the Government decides to switch the statutory minimum requirements for pension increases in deferment and/or pension increases in payment away from CPI to CPIH – or indeed one of the other measures of inflation that ONS is developing. If so, please can we ask that the Government engages with the pensions industry in advance to ascertain the impact on liabilities and the availability of assets to hedge those liabilities. In particular, we don't want to have three measures commonly in use!

6 Are there any other issues relevant to the proposal the Authority is minded to make of which the Authority or the Chancellor ought to be aware?

Our main purpose in responding is to explain how important this issue is for pension schemes. As set out below, in our view the evidence provided to the House of Lords materially understated the prevalence of CPI benefits in pension schemes.

The consultation notes in paragraph 60 of the consultation that "many – but not all – holders of index-linked gilts hold them to hedge RPI-linked liabilities." and in paragraphs 13 and 21 refers to DB schemes holding these instruments to match RPI-linked liabilities implying that most such liabilities are RPI linked. By contrast, we estimate that over half of UK occupational pension scheme DB liabilities have some CPI linkage albeit that might not be CPI linkage throughout the member's life; (the most common pattern would be CPI linkage in deferment and RPI in payment). Those schemes that choose to hedge CPI-linked liabilities must do so with RPI linked assets. This means that many schemes will see a fall in the value of their assets with only a partial change in the value of their liabilities. However, the effect will vary by scheme and sponsor – and schemes with unhedged RPI linked liabilities will instead benefit.

By reference to the £1,860bn of liabilities in TPR's latest data, we estimate that:

- From TPR's data, 17% of pre-97 excess over the GMP and 25% of post-97 excess has CPI linked increases in payment. We estimate this amounts to a liability of some £100bn in respect of pensioners and a further £200bn for actives and deferred members who will have CPI-linkage once in payment.

- We estimate that approximately 20% of pensioner liabilities and 10% of active and deferred liabilities relate to post-88-GMP. The post-88 GMP increases at capped CPI increases in payment, so this adds more than £250bn.

- The majority, perhaps three quarters, of increases in deferment on the excess over the GMP is CPI-linked. This adds more than £400bn that has CPI-linkage in deferment, but not in payment.

By contrast, the House of Lords Economics Affairs Committee was told

"To give you a sense of the two different markets, the PPF at the end of October last year suggested that total defined benefit pension liabilities stood approximately at £1.7 trillion. In November last year, a private sector bank, NatWest Markets, made an estimate in something it put out that there is £100 billion to £150 billion of existing CPI liabilities in pension schemes."

http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/economic-affairs-committee/the-use-of-rpi/oral/86754.html

The reason why some schemes will win and others lose primarily stems from Government measures as set out below:

1 Almost a decade ago, the Government announced its intention to use CPI instead of RPI as the measure of price inflation for the statutory minimum revaluation and indexation of occupational pension schemes. Depending on their scheme rules, some schemes found that their liabilities automatically switched from RPI to CPI – this was particularly true of deferred liabilities where a majority of schemes switched to CPI revaluation in deferment. For other schemes, they were able to choose to switch and yet other schemes, including some high profile court cases, found that they were committed to RPI-linked benefits.

2 In 2011 the UK debt management office ran a consultation to help inform the decision as to whether to introduce CPI-linked gilts – mainly to help occupational pension schemes match the CPI liabilities created by the Government's switch of inflation measure. The Government decided not to issue CPI-linked gilts and therefore it is not possible for pension schemes to match CPI-liabilities exactly.

3 Pension schemes are encouraged by TPR to hold index-linked gilts. For example TPR's investment guidance states "You are legally required to invest assets backing DB liabilities in a way that's appropriate to the nature, timing and duration of the expected future retirement benefits payable under your scheme. To help achieve this, many schemes hold 'matching assets' in order to manage investment risk relative to the liabilities…"

4 There can be a financial penalty if liabilities are unmatched as gilts are valued more generously than equities in the assessment of the PPF levy.

This means that many pension schemes hold index-linked gilts and so will suffer a reduction in the value of their assets. For some schemes with predominately CPI-linked liabilities, there will be no corresponding reduction in their liabilities – though admittedly, such schemes received a windfall a decade ago. Other schemes with matched RPI linked liabilities will see a fall in both their assets and liabilities and some unmatched schemes will benefit because there will be a fall in RPI linked liabilities with no corresponding reduction in assets. In general, however, those schemes that have most closely followed the spirit of TPR's guidance to hedge their inflation risk will be the most adversely impacted. The effect on sponsors may also vary.

Such pension schemes include the PPF which has CPI linked liabilities and some RPI linked assets. If this change meant that the PPF needed to increase the levy, this would fall to be met by DB pension schemes, some of whom would also have been hit by a fall in their own assets – a double whammy.

We note that the paper is silent as to whether any compensation will be available and it is important that this is covered in the response to this consultation. It is noteworthy that the assets that schemes hold to achieve their hedging can vary, but the most typical are physical gilts, or derivatives such as swaps or gilts repos. This being the case, any compensation structure should ideally address the range of assets held.

You might also be interested in the results of this survey of our members, which we issued in advance of the consultation.

7 Which lower level or supplementary RPI indices are currently used, and what are they used for?

As far as we are aware, lower level or supplementary RPI indices are not used by pension schemes.

8 What guidance would users of lower level or supplementary RPI indices find most useful for the ONS to provide?

Not applicable – see our answer to Q7.

Ends.

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