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Court declares change of RPI to CPIH lawful

RPI to be aligned with CPIH from 2030

September 2022

The composition of the Retail Prices Index (**RPI**) is set to change from February 2030. RPI index values will be calculated using the same methods and data sources that are used to calculate the **CPIH** (the Consumer Prices Index including owner occupiers' housing costs). This would likely result in RPI being lower by an average of 1% per annum. Pension schemes (in particular, defined benefit schemes) are expected to be affected in two ways:

1. a reduction in the value of any RPI linked assets; and
2. a reduction in any liabilities linked to RPI (for example indexation and revaluation calculated on the basis of RPI).

Given that many defined benefit pension schemes are invested in RPI-linked gilts, the proposed change could have a detrimental impact on the funding position of a number of schemes. A large number of pension schemes with CPI linked liabilities will have RPI linked assets. For these schemes, their funding position will be negatively affected as the value of their assets will fall while the level of their liabilities will not change.

The trustees of five pension funds brought judicial review challenges against the decision by the then-Chancellor (and the UK Statistics Authority (**UKSA**)) that RPI should be aligned with CPIH. The High Court has rejected the challenges and determined that the process by which the decision was reached, and the decision itself, was not unlawful.

Background

It has long been recognised that the way in which RPI is compiled, and its significant divergence from CPI, could make it an inappropriate measure for pension uplifts. The issue has been the subject of protracted disputes and hard-fought cases (British Airways, Barnardo's, Thales, etc).

In March 2019 the UKSA wrote to the Chancellor recommending:

1. that publication of RPI should cease; or

2. since recommendation 1 would require primary legislation and therefore take time, a second parallel course of action - to align RPI with CPIH.

The Chancellor would not agree to promote legislation that would remove the requirement for the UKSA to publish RPI, but did recognise the statistical arguments for the second recommendation to take steps to align the methodology of compiling RPI with CPIH.

In March 2020, a consultation was published seeking views on whether the change to the composition of RPI should be made earlier than 2030 and, if so, when between 2025 and 2030 the change should occur. Following the consultation, it was decided that RPI would be aligned with CPIH in February 2030. This date was chosen because this is the time the last index-linked gilts with early redemption clauses in the event of a fundamental change to RPI will have matured. There was concern if the change occurred before this time, it would trigger early redemption on a large scale of this 'old style' gilts.

It is generally accepted that RPI produces, and will continue over the long term to produce, an estimate of 1 inflation percentage point higher than CPIH.

Impact for pension schemes

Defined benefit pension schemes, in particular, would be affected by the proposed change. The extent each scheme is impacted will depend upon the proportion of schemes assets held in index-linked gilts (RPI linked) and whether scheme liabilities are calculated based on RPI or CPI (for example for revaluation and indexation).

> *"… the extent to which a DB pension scheme will be impacted…will depend on the extent to which it is hedged and the nature of its liabilities"* A Response to the Consultation on the Reform to Retail Prices Index Methodology 25 November 2020

Depending upon the hedging measures taken, some schemes may not be impacted as the total value of the RPI linked liabilities may fall in line with the reduction in the value of the scheme assets. However, a large number of pension schemes with CPI linked liabilities will have RPI linked assets. For these schemes, their funding position will be negatively affected as the value of their assets will fall while the level of their liabilities will not change.

The Government confirmed that it would not be providing compensation to the holders of index-linked gilts (including pension schemes).

Judicial Review

The trustees of five pension funds sought to judicially review the decision to align RPI with CPIH given that the proposed change would negatively impact the funding of their schemes (*BT Pension Scheme Trustees v UKSA)*. The decision of the UKSA and the Chancellor was challenged on three grounds:

1. The decision to align RPI with CPIH (**RPI Decision**) by the UKSA was unlawful;
2. The UKSA failed to take into account the impact of aligning RPI with CPIH on the holders of RPI index-linked gilts and bonds and those entitled to index-linked pensions (so called **Legacy Users**). The Chancellor also failed to take into account these members when deciding that no compensation would be payable as a result of the change; and
3. The UKSA failed to consult (i) the public on the RPI Decision or (ii) Legacy Users on the compensation point.

The court rejected all three grounds and held that the decision to align RPI with CPIH was lawful.

Comment

Judicial review challenges are notoriously difficult to pursue so this case was always going to be a hard one to win for the trustees. We understand that this judgment may yet be appealed. If the trustees were to be successful, the decision would stand to be revisited and potentially taken with a different outcome. If so, then it may be that compensation would be payable to these schemes - as well as to other schemes in the same position. However, subject to such a successful appeal, the decision to align RPI to CPIH stands and will take effect in February 2030.

Trustees and administrators of defined benefit pension schemes should therefore continue to prepare for what impact the change in February 2030 will have upon the funding position of their scheme. Whilst it will result in a reduction of any RPI linked liabilities, it will also see a reduction in value of any RPI linked investments held. Liability driven investment means a large number of pension schemes have relied upon index-linked gilts. Markets are already pricing in the expected reduction in the value of RPI linked gilts which mature after 2030. Therefore, the extent to which the changes to RPI will affect schemes, and to increase or decrease liabilities/assets, will depend upon the circumstances of those schemes. It will also be interesting to see if this change leads to a reduction of court cases in which Courts are asked to analyse and give directions as to how indexation provisions should be applied.

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