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Spending Review 2020—government publishes response to reform to RPI methodology consultation

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The government and the UK Statistics Authority (UKSA) have published their response to their consultation on reforms to the Retail Prices Index (RPI) methodology, following the Spending Review 2020. The response confirmed that the RPI is to be aligned with the Consumer Prices Index including owner occupiers' housing costs (CPIH) in order to address its statistical shortcomings. However, the Chancellor of the Exchequer has exercised his power to postpone implementation of this change until 2030, when the final specific index-linked gilt will mature. Simon Tyler, Legal Director at Pinsent Masons, Chris Edwards-Earl, senior associate at Stephenson Harwood, and Georgina Wardrop, senior associate at Taylor Wessing, discuss the reform to the RPI and what the reform means for pension schemes in particular.

The Chancellor's letter to the UKSA

The Chancellor of the Exchequer, Rishi Sunak, in his letter to the Chair of the UKSA, Sir David Norgrove, dated 23 October 2020, confirmed that, 'in order to minimise the impact of the Authority's proposal on the holders of index-linked gilts, he will be unable to offer his consent to the implementation of a proposal (such that the Authority intends to make) before the maturity of the final specific index-linked gilt in 2030'. Chris Edwards-Earl, senior associate at Stephenson Harwood says that 'ever since important updates were made to the RPI a decade ago, various court cases have been brought exploring the composition, suitability and recognition of the RPI. The pensions industry is therefore already conscious of the issues (for good or ill) with the RPI and it had been anticipated for some time that changes would be coming down the road. Mr Sunak has just confirmed when that change will occur. Some will welcome this move, which acts on criticism that has been levelled at the RPI for years and the National Statistician's discouraging end-users from using the RPI'.

Georgina Wardrop, senior associate at Taylor Wessing, adds that 'this postponement to 2030 is likely to come as a relief to many, including DB pension scheme members with benefits increased by reference to RPI, and schemes holding index-linked gilts which increase by reference to RPI but where scheme liabilities are calculated on the basis of CPI.'

The Chancellor's letter to Sir David Norgrove can be viewed here.

The impact of reform

Simon Tyler, Legal Director at Pinsent Masons, highlights that 'insurance companies may be hit by the reforms because of the large amount of RPI-linked assets they hold. This may increase the cost for trustees of buying out liabilities, although it is largely priced into the markets. In its response, the government confirmed that 'it will not offer compensation to the holders of index linked gilts'. He adds that the proposed reform to RPI 'is some way off and it is unclear when pension schemes providing RPI-linked indexation will be able to reflect the change in valuation and funding plans. Until the reform is implemented, employers will need to be paying - and perhaps overpaying - contributions into their pension schemes on the existing basis. Affected pension schemes should discuss the potentials impact on their own schemes with their advisers.'

Edwards-Earl adds that 'the importance of RPI for many contracts left few choices available though but to reform the RPI itself not to drop it. Changing the inner workings of RPI, replacing its 'RPI-ness' as it were with that of CPIH, whilst leaving the name and the statutory framework around the index is apparently designed to avoid causing inadvertent problems through the reform. That said, depending upon the way in which some pension schemes' rules were originally drafted, this upcoming change could set off 'triggers' or prompt Trustees to take decisions, which Trustees will want to consider in good time.'

What does this mean for DB pension scheme members?

The consultation response highlights that some defined benefit (DB) pension scheme members 'will be affected by the Authority’s reform of the RPI'. Tyler explains that this is because ‘from February 2030 CIPH will automatically be used where RPI is otherwise prescribed (eg by the terms of a pension scheme's governing documentation)'. Since ‘the alignment of RPI with CIPH could have considerable impact on future funding levels and member benefits, trustees who have not already done so may wish to raise this now with their actuaries or investment consultants and keep an eye on future developments'.

Wardrop adds that 'when the change does come into effect in 2030, DB scheme members whose benefits are increased by reference to RPI (whether in payment or deferment) are likely to receive lower benefits than they would have expected under the old calculation basis. The Pensions Policy Institute estimated that it could result in an average reduction in lifetime income from an individual's RPI-linked pension post-retirement of four percent for a woman and five percent for a man. Where scheme increases or revaluation are based on RPI, the result of its alignment with CPIH is consequently likely to be reduced scheme liabilities.'

Edwards-Earl states that 'RPI becoming, in effect, CPIH will reduce the growth of some members' pension benefits (where those were linked to RPI), which would reduce the growth in pension benefits for schemes to fund. Nevertheless, this reform has the capacity to negatively impact the funding levels and risk exposure of a significant number of schemes. Many use RPI-linked assets to hedge against CPI-linked liabilities due to the lack of availability of appropriate CPI-linked assets. Where this is the case, this change will reduce the value of a pension scheme’s RPI-linked assets whilst having no corresponding reduction to a scheme’s CPI-linked liabilities. This could have a big effect on scheme funding levels.'

The full consultation response document can be viewed here.

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Sources:

• A consultation on the Reform to Retail Prices Index (RPI) Methodology

• Response to the joint consultation on reforming the methodology of the Retail Prices Index