



CPI versus RPI: impact on pensions?

On 8 July, the new pensions minister, Steve Webb, announced plans to link private sector pension payments to the Consumer Prices Index (CPI) measure of inflation instead of the Retail Prices Index (RPI). This follows the Chancellor's budget statement, which announced a similar change for most state and public sector pensions. This note considers the implications of this announcement on defined benefit occupational pension schemes.

What changes are being proposed?

It is proposed to amend the statutory minimum increases for pensions both for revaluation up to retirement and for pensions in payment, which currently use RPI, so that in future they use CPI. The new pensions minister, Steve Webb, has stated that the Government believes that CPI is "a more appropriate measure of pension recipients' inflation experiences and is also consistent with the measure of inflation used by the Bank of England".

What is CPI?

Inflation is measured by looking at the increase in prices of a basket of goods and services. More than one official measure of inflation is published by the Office for National Statistics (ONS). As well as RPI and RPIX (RPI excluding mortgage interest payments), there is also the CPI, which arguably is now the headline rate of UK price inflation. CPI is used by the Government to set their annual inflation target of 2%. It is calculated using rules set out in EU regulations and is an internationally comparable measure of price inflation.

How does CPI differ from RPI?

CPI and RPI are calculated from the same underlying price data; however, there are several differences between them in coverage and methodology, described below.

Exclusion of housing costs from CPI

Various housing elements included in RPI are excluded from CPI including mortgage interest payments and council tax. In terms of the contribution towards the difference between RPI and CPI, the most significant housing cost item excluded is mortgage interest payments.

However it should be noted that developing a harmonised approach to owner-occupied housing costs is a high priority for Eurostat, the statistical office of the EU. In addition, the ONS are considering UK inflation measures that include such costs whilst an EU solution is developed. It is therefore possible that

In brief

- The Government proposes to link private sector pensions to CPI instead of RPI, bringing the private sector in line with its plans for the public sector.
- It remains unclear precisely how this will be done, and there is a risk of a "planning blight" until the details are known.

Next steps

- Trustees and sponsors will be interested in how this will affect their schemes.
- Matters will become clearer as draft legislation is published for consultation.
- Trustees and sponsors should consider reviewing their scheme rules to understand the potential issues.

housing costs will eventually be included in CPI, thus removing a significant element of the difference between the two measures.

"Formula effect"

CPI is generally calculated using a geometric mean (i.e. an average based on multiplying the n items in the basket together and taking the n th root). RPI, however, uses an arithmetic mean (i.e. an average based on adding all the n items in the basket together and dividing by n) which leads to a small upwards bias in the overall price index. Since 1997, this "formula effect" has led to a relatively stable contribution of at least 0.4% a year and an average of 0.5% a year towards the difference between RPI and CPI.

Differences in reference baskets

In classifying goods and services, CPI follows an international classification system whereas RPI follows its own system. Housing costs aside, the two baskets are now very similar although the weighting that is applied to each is different. RPI covers all private households (excluding the poorest pensioner households and the richest 4% of households), whereas CPI covers all private households plus foreign visitors and residents of institutions.

Impact of differences between RPI and CPI

As a result of these differences, since 1997 (when the 12 month rate of change for CPI was first available), RPI has been on average 0.8% a year higher than CPI. However, there have been six short periods in the past twenty years where CPI was higher than RPI,

the most recent from September 2008 to December 2009. The impact of housing costs on the indices contributes most to the volatility in the difference.

What pension scheme increases use RPI?

Pensions accrued from 6 April 1997 in an occupational pension scheme are required by legislation to increase once in payment at least in line with RPI (capped at 5% or 2.5% a year). Pensions accrued before 6 April 1997 are not required to be increased apart from Guaranteed Minimum Pensions (GMPs) accrued between 1988 and 1997.

The majority of pensions are also required to increase between leaving service and retirement in line with statutory revaluation orders currently based on the increase in RPI subject to an overall cap of 5% or 2.5% a year. GMPs have their own statutory rates of revaluation.

How will the changes work in practice?

At present information is scarce; however, on 12 July, the Department for Work and Pensions (DWP) issued a short statement about the proposals including some examples of how it might work in practice. The key points to note are:

- Statutory minima will remain both for revaluing pensions pre retirement and for increasing pensions in payment.
- The statutory orders for revaluation and pension increases for 2011 will be based on CPI.
- The statutory revaluation order applicable to pension rights deferred for at least two complete years, where the relevant years straddle the change from RPI to CPI will be based on a combination of RPI and then CPI.
- The 2011 GMP Increase Order will be based on CPI.

Will all schemes benefit from the change?

At present, this is a somewhat difficult question to answer. In the private sector, each scheme has its own rules to follow. Common approaches are for rules to refer either to RPI explicitly, or to the legislation that covers 'statutory increases' although rules can vary considerably between schemes and even within schemes between the two types of increase (i.e. pre-retirement and post-retirement). Sometimes rules refer to 'RPI or some index of inflation'.

Where rules simply cross-refer to the legislation, one would expect the Government's change to flow through automatically to apply to members' benefits. However, it is possible that members will have been told that their future increases will be linked to RPI, so it might not prove easy to implement the change.

Where a scheme directly refers to RPI, then it is possible that section 67 of the Pensions Act 1995, which restricts changes being made to accrued rights, might prevent the change from applying to the scheme. The Government may have to consider whether (a) it is necessary and (b) it is desirable to override section 67 for such schemes. If the change is enabled (i.e.

trustees are allowed to disregard section 67 and make the change) but is not automatically applied, trustees may find it difficult to decide to implement it given that such a change would be expected to disadvantage members.

Although there is no legal requirement to increase pre-April 1997 non-GMP pensions, many schemes do so, often with increases derived from RPI. It appears that the DWP proposals would not affect such increases.

What about the actuarial valuation?

As mentioned above, CPI is expected to be lower on average than RPI over the long term. Assuming that a scheme is able to and does implement the change, then the technical provisions should fall, perhaps by up to around 10%. This could lead to some interesting discussions where valuations are currently being finalised.

Actuarial assumptions for future price inflation need to reflect long-term expectations, and are typically set by considering the difference between quoted yields on fixed and RPI-linked gilts. At present there are no CPI-linked gilts nor is there a developed CPI swap market. In the absence of a sufficiently liquid market in CPI-linked gilts or swaps, a CPI-inflation assumption for funding is likely to be derived as the present RPI assumption less an allowance for the expected difference between RPI and CPI.

What about investment strategy?

Schemes that hold index-linked gilts as a matching asset might find themselves exposed to a slight mismatching risk in future. In addition, any hedging arrangements put in place may need to be modified. It will be interesting to see if CPI-linked gilts are issued and if a CPI swap market develops. We understand that the first CPI swap has already taken place since the announcement was made.

Trustees may wish to consider contacting their investment advisers to discuss the possible implications of the announcement.

Conclusions

On the face of it, this would appear to be good news for pension scheme sponsors, but less good news for current and former employees and pensioners. If fully implemented across all schemes, it would be a very significant change. However, it remains to be seen whether it can be effectively implemented for all defined benefit schemes or whether it gets lost in a legal quagmire.

Where can I get further information?

For specific advice, please get in touch with William Fitchew on 020 7839 8600 or by email on william.fitchew@puntersouthall.com or discuss with your usual Punter Southall contact.

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