

In Touch technical update

September 2019

Chancellor announces consultation on RPI changes

- A consultation on changes to RPI will commence in January with a response before the Spring Statement
- Proposed alignment of the calculation of RPI with CPIH between 2025 and 2030

The Chancellor has published his response to the House of Lords' Economic Affairs Committee's January 2019 report on the use of the Retail Prices Index (RPI), which was critical of flaws in RPI remaining unaddressed. A consultation will take place in January 2020 on proposals to align the calculation of RPI with that of the Consumer Prices Index including owner occupiers' housing costs (CPIH) from a date between 2025 and 2030.

Announcement

The Chancellor's announcement was accompanied by publication of a proposal from the UK Statistics Authority (UKSA) which would "address the shortcomings of the RPI by adopting the methods of the accredited CPIH measure. The effect, at least initially, would be to turn the RPI into CPIH by another name".

In order for this change to be made before 2030, the consent of the Chancellor is needed (the requirement for consent falls away in 2030). The Chancellor notes that the UKSA has signalled that "it is unlikely that the UKSA in 2030 would take a different view", suggesting that this change is likely to be made in 2030 if consent is not given for an earlier change.

The announcement confirms that the Chancellor will not consent to the introduction of the change any earlier than February 2025. The Government will consult on whether the change should be made between 2025 and 2030. The consultation will include technical matters "concerning how to implement the alignment of RPI with CPIH".

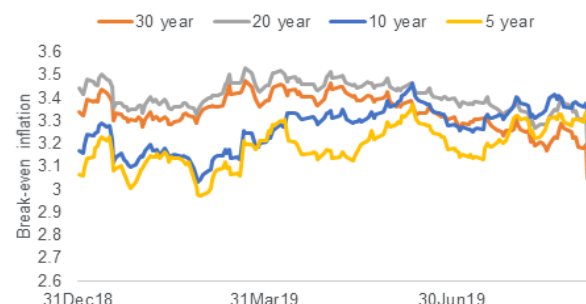
In addition, the Government has confirmed that it will not introduce new uses of RPI but has no current plans to stop issuing gilts linked to RPI.

Financial Impact

Broadly, CPIH increases are expected to average around 1% p.a. below RPI increases in the long term. CPIH increases are expected to be at about the same level as CPI (Consumer Prices Index - without allowance for owner occupiers' housing costs) increases on average – although there will be differences from year to year.

The immediate market impact of the announcement was mainly felt by longer term index-linked gilts. Longer term break-even inflation fell by around 17 basis points. It is likely that some allowance for a possible change was priced in to the market or that the market has not yet moved to fully expecting such alignment.

RPI implied by gilt yields



Source: Bloomberg. 4 September values as at 11am

Impact on scheme funding

Many schemes have liabilities that are linked to RPI and investments in index-linked gilts (ILGs).

The impact on scheme funding positions will be scheme specific, but in general:

- For well-hedged schemes using ILGs to hedge RPI-linked liabilities, there is unlikely to be a material change in the funding position;
- For schemes that use ILGs to hedge CPI-linked liabilities, the announcement is likely to lead to a deterioration in the funding position; and
- For schemes that are not well hedged but have RPI-linked liabilities, the announcement is likely to lead to an improvement in the funding position.

Impact on members

Where schemes provide benefits linked to RPI, the proposed change is likely to lead to lower benefit

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payments to members in the future (from 2025 at the earliest).

Actions for schemes

Where schemes have benefits linked to CPI and trustees set their future CPI inflation assumption relative to RPI, they should consider whether the assumed difference between the two inflation measures remains appropriate – otherwise the drop in market implied RPI inflation might feed through to a lower CPI inflation assumption.

Special consideration should be given where schemes are undertaking particular activities; for example:

- Taking actions based on funding triggers; or
- Carrying out member option exercises such as enhanced transfer value projects or pension increase exchange exercises.

Trustees may also need to determine whether their CETV basis remains appropriate.