The 'painful' fallout from the RPI review

As trustees prepare for a judicial review into changing inflation indexes, understanding the broader implications is key for trustees and members alike

Replacing the Retail Prices Index (RPI) with the Consumer Prices Index including owner-occupiers' housing costs (CPIH) from 2030 could be "something of a lottery" for defined benefit (DB) schemes, industry experts say.

A judicial review, expected this year, could have serious implications for scheme funding through reduced asset values and other 'painful' inflationary repercussions.

While many industry voices do not disagree with the principles behind the planned change, they also believe that the current proposal could be detrimental to savers already having to navigate high inflation rates.

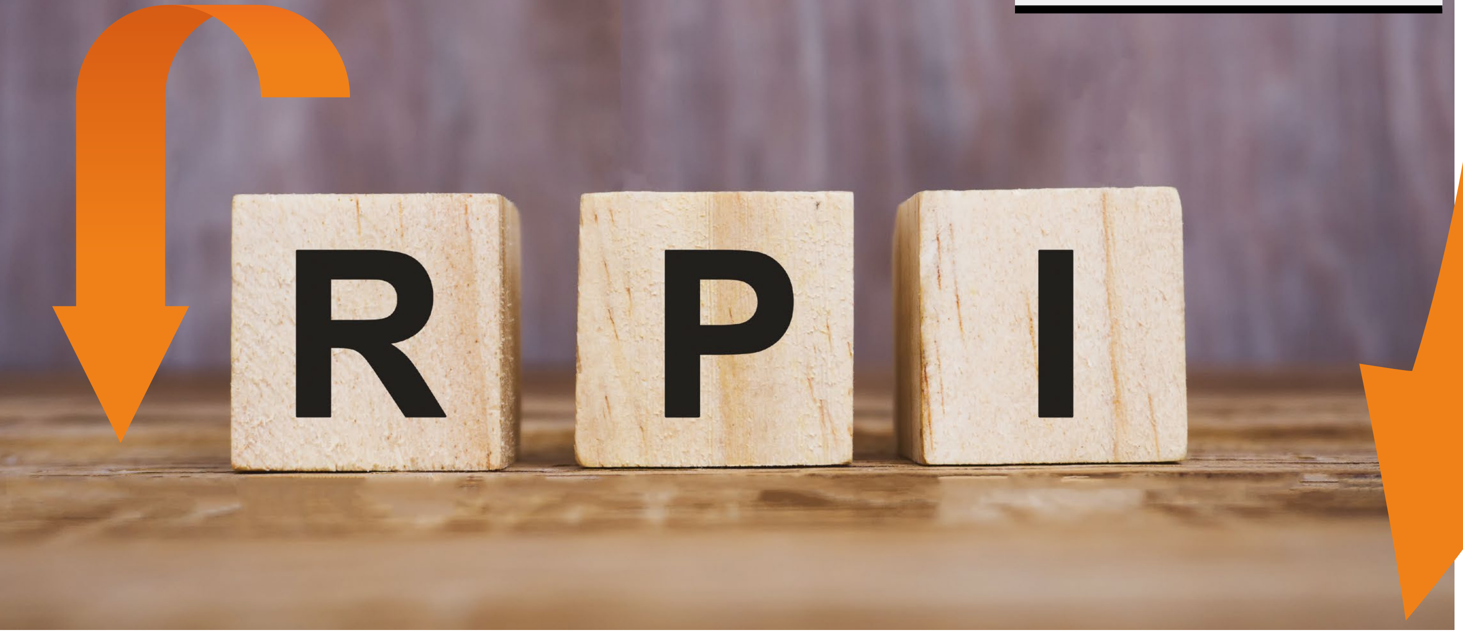
Funding strain forecast

The judicial review application, made by the trustees of the BT Pension Scheme, Ford Pension Schemes, and Marks and Spencer Pension Scheme, was granted in December 2021, with a hearing anticipated in the summer of 2022. The trustees will argue that 'detrimental effects' of the government's decision to replace RPI as its main inflation measure have not been fully considered.

20-20 Trustees' trustee director, Nadeem Ladha, shares the same concerns as the three applicants, with the potential of "significant funding strains for many pension schemes and their sponsors" being of paramount importance.

Summary

- The review into RPI would be a 'lottery' for schemes, with both winners and losers.
- Funding levels may decrease as inflation-linked assets are affected alongside cashflows.
- Those with no link to RPI in their benefit rules will see little to no change.
- Members may see lower benefits where schemes have not hedged their inflation exposure.
- Worst hit would be those with long-term LDI hedges in place, but with CPI-linked benefits.
- One possible solution is to amend RPI to align with CPIH plus a 'transparent margin'.



According to Ladha, funding levels could deteriorate as inflation-linked assets – particularly index-linked government bonds – were mostly bought at a price that reflected expected cashflows. With CPIH a generally lower figure than RPI, these cashflows – and therefore the value of assets – could fall.

"Our role as trustees is to be the guardians of hard-earned pension funds, which has typically been done by removing risk from DB pension funds and historically investing in index-linked gilts, on the understanding they would be uprated by RPI," says Ladha.

"However, as it stands, no compensation for these types of gilt-holders is expected, and therefore there are significant and immediate detrimental consequences for many pension funds, especially those with material CPI-linked pension benefit structures."

Likewise, Broadstone head of London actuarial, Alan Carey, says that the impact of the index change will differ from scheme to scheme but will "be something of a lottery depending on the precise details of the benefit structure".

Those with no link to RPI in their benefit rules, including those with nil, fixed-rate or CPI indexation, will see little, if any, effect from the planned change. Other schemes have specific RPI-linked tranches, which could be negatively affected, while still others apply full RPI indexation for valuations and increases to pensions in payment.

As such, the components of a scheme's investment strategy will dictate how their asset values are affected, Carey says.

"Those schemes that have taken steps to closely hedge their inflation exposure will tend to have done so using index-linked gilts, which are RPI linked. These will see a fall in their expected income beyond 2030, pushing down market values of long-dated gilts," he explains.

"Those with a looser inflation hedge via growth assets may be largely unaffected, although some UK companies' revenue streams have an RPI link, which may act as a drag."

However, this has not played out quite as expected so far, Carey continues. Many schemes, he says, experienced a rise in the value of their CPI-linked benefits, although this went "very much unnoticed throughout 2020".

"The market's CPI outlook is derived from the relative price of index-linked and nominal gilts, in the absence of a direct vehicle for CPI pricing," Carey says. "The confirmation in November *[2020]* of the fall in the RPI-CPI gap from 2030 led to a recalibration upwards of long-term CPI expectations, rather than the more logical fall in expected RPI."

In this regard, the inflation-hedging approach schemes have taken will prove critical, and many schemes that thought they had hedged their inflation-linked benefits "could lose out materially".

Good for employers, bad for members?

For schemes with extensive RPI links in their benefits and with little or no inflation hedging in their investment portfolios, the shift to CPIH could generally favour employers over members, says Aon partner, Lynda Whitney.

"You could argue that, given how much RPI has been discredited as a statistical measure and that CPIH is more representative of the actual increase in prices members will see, this is just giving the member the inflation protection they are due," she says.

Mercer director of investments for the UK, Hemal Popat, explains that where a scheme has not hedged its inflation exposure, the proposed index change "would result in gains where members receive lower benefits".

Likewise, where a scheme has hedged its inflation exposure, there will be an "asset loss that could exceed the reduction in liabilities, since many schemes use index-linked gilts to hedge both CPI- and RPI-linked pensions".

Worst hit would be those with long-term liability-driven investing (LDI) hedges in place, but with CPI-linked benefits, explains Carey.

"These schemes will see their asset values reduce while the values placed on their liabilities have increased, despite there being no direct change to the level of benefits they will need to pay out. This could cause difficult funding conversations – both financially unpalatable as well as technically complex," he says.

From the perspective of those members affected, any reduction in future nominal income levels will be a disappointment. However, Carey says there may be scope to accept the rationale for the change – that CPIH better reflects the growth in prices across the basket of goods and services purchased by the typical pensioner. He says that those with RPI-linked benefits will maintain their spending power instead of watching it grow over time.

"It's a big 'if'," says Carey, and there will "undoubtedly be winners and losers even among this group of members fortunate enough to have enjoyed RPI indexation to date."

He points to the example of a 30-year-old deferred member in a scheme with full RPI-linkage, who "might see a third wiped off their expected lifetime pension income if RPI were to fall by 1 per cent per annum from 2030".

In contrast, a 60-year-old person in the same scheme, retiring in five years, could expect a reduction nearer to 10 per cent, Carey says.

A possible solution

Although many in the industry recognise that CPIH may, in some circumstances, provide pensioners with a more appropriate level of pension increases, the lack of support for those set to lose out is commonly raised.

Ladha says that 20-20 Trustees' preference would have been to amend RPI to align with CPIH plus a "transparent margin", designed to reflect the expected long-term average premium of RPI over the new inflation measure.

"This would reflect pension fund industry norms in designing a suitable CPI hedge with RPI assets, and also provide the certainty that sponsors and pension funds need, while helping mitigate the damaging transfer of wealth from asset owners to asset writers," he says.

He explains that without mitigation, pension schemes that had robust plans in place to minimise risk may require significantly increased cash funding that the sponsor might not be able to support – particularly those that have been hit hard by the pandemic.

Additionally, schemes may also need to undo some of their previous asset de-risking to overcome an increased deficit.

"The resulting unexpected increase in the investment risk would be detrimental to member security and could mean an unacceptable period of time before members' benefit can be secured," Ladha warns.

"Any additional deficit could also impact on a company's ability to service debt and pay dividends, which would jeopardise the company's financial viability and in turn jeopardise the covenant afforded to the scheme. It will be members who suffer."

These discussions are taking place during a period of significant rises in inflation. RPI is *[at time of writing]* at 7.5 per cent, and CPI 5.4 per cent – levels that have not been seen in a generation.

Inflation will undoubtedly receive a lot of airtime from the industry, but it will be scheme members, unaware of their pension's intricate workings, who may see a reduction in their real income over the coming months.

Written by Tom Higgins, a freelance journalist