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Sixty second summary

RPI reform – save the date

The results of the consultation on the reform of the Retail Price Index (RPI) are to be announced on 25 November 2020, according to a letter from the Chancellor[1]. This will conclude many months of speculation on the future of RPI. Specifically, if RPI will be aligned with CPIH, when and whether there will be compensation.

Coinciding with the UK Budget on 11 March 2020, the much-anticipated Consultation on reforming the Retail Price Index (RPI) was released. The consultation was originally due to close in late April, but the deadline was extended to late August because of the coronavirus pandemic.

The outcome of the Consultation may conclude many months of speculation on the future of RPI, initially triggered by the House of Lords Economic Affairs Committee's January 2019 report, Measuring Inflation[2], which recommended that statistical deficiencies with the RPI be addressed.

This will be released alongside the one-year spending review, which the government announced last month.

Proposed reform

Issues with RPI have been known for many years and some may recall a previous consultation launched in 2012 on a similar topic, which created a lot of uncertainty and eventually concluded with no change being made to the calculation of RPI.

The reform proposed is to effectively replace RPI with CPIH. CPIH is the Consumer Price Index (CPI) adjusted for owner occupier housing costs. The proposed timescale for making this change is between 2025 and 2030. Timing is a key question in the Consultation as are the technical aspects of how to align RPI with CPIH.

Replacing RPI with CPIH is expected to materially reduce the rate of inflation measured by RPI going forwards. The Consultation states that the difference in inflation between RPI and CPIH has averaged 1% per annum since 2010. The potential impact on index-linked gilts is therefore large. In simplistic terms, an index-linked gilt today with 20 years' duration would be worth 10% less if RPI inflation was reduced by 1% per annum from 2030 onwards and 15% less if the change is implemented from 2025.

Market pricing

The immediate market impact of key announcements on RPI swap breakeven rates was reasonably muted and against the background of other sources of volatility over the period (Brexit, General Election and Coronavirus), it is difficult to distil market sentiment on RPI reform definitively.

Nevertheless, the consensus is generally that market pricing indicates that the market has now re-priced RPI assuming it will be aligned with CPIH with a reasonable likelihood this will happen between 2025 and 2030, although does not imply that RPI will be aligned to CPIH with certainty.

[1] https://www.gov.uk/government/publications/a-letter-from-rishi-sunak-to-sir-david-norgrove-on-the-date-of-the-government-and-uk-statistics-authoritys-response-to-their-joint-consultation-on-re

[2] https://publications.parliament.uk/pa/ld201719/ldselect/ldeconaf/246/24602.htm

What might be the eventual fate of RPI?

Although alignment of RPI to CPIH still seems the most likely outcome, we have set out below some of the main permutations we think are possible:

- **Full alignment of RPI to CPIH:** In this scenario, we expect RPI after the implementation date to be 0.8% to 1% lower, index-linked gilts will further re-price downwards when confirmation is announced, although, we assume material re-pricing has already taken place; RPI swaps will similarly re-price and underperform CPI swaps.

  In terms of an implementation date we expect the majority of responses to the Consultation to have expressed a preference for the most distant date on offer (2030), as this reduces the impact of the change, but we do not rule out an earlier date being adopted. The current environment is placing enormous stress on the Government's finances – lowering costs will be seen as attractive.

- **Compensation for index-linked gilts:** Market pricing suggests this is still a possibility and we expect index linked gilt holders to have lobbied for this in the Consultation. Given the complexities involved, it is the topic for a lengthier discussion, but the impact could be full compensation so that there is no loss in value to existing index-linked gilts holders and a beneficial reversal of re-pricing that has occurred to date. Depending on the mechanism used for compensation, other RPI-linked instruments such as RPI swaps could also benefit to a similar degree and outperform CPI swaps. Again, the outlook for Government finances is worth bearing in mind.

- **No change to RPI:** This was the surprise result of the previous consultation in 2012 and it would in many ways be the simplest thing to do. If this was announced, we would expect an immediate upward re-pricing of index-linked gilts and RPI swaps (similar to full compensation).

Implications for pension schemes

The overall financial impact of aligning RPI to CPIH on defined benefit pension schemes depends on the value of liabilities that are linked to RPI and the proportion of those liabilities backed by RPI-linked assets.

Liabilities and assets linked to RPI have already been re-priced downwards, and would fall further in value if RPI is set equal to CPIH (ignoring changes in interest rates and other factors), so schemes that would typically benefit most financially are those with a high proportion of liabilities linked to RPI and a low inflation hedge ratio.

Schemes that have a high proportion of liabilities linked to CPI and a high inflation hedge ratio (achieved using RPI-linked assets) would typically be the most financially disadvantaged from an alignment of RPI to CPIH. All this assumes no compensation to asset holders.

Even though some schemes may not be materially affected or could even benefit financially from RPI reform, pensioners with RPI-linked pension increases would see the value of their pension incomes fall as a result.

Assumptions

There will be implications for assumptions with inflation assumptions used across funding, accounting and member option terms (such as transfer values). In particular, with assumptions for CPI typically set as RPI less a fixed deduction, revisions are likely to be needed to ensure the RPI-CPI wedge remains reasonable.

What next

Trustees and employers will be watching closely for the announcement to come on 25 November and the subsequent market reaction. As the detail starts to become clearer pension schemes will need to be ready to revisit implications for investment and funding decisions.

The central expectation appears to be that RPI will become CPIH from 2030 although markets have not fully priced this in. Whilst many are talking about the possibility of "compensation" there is not much consensus on how likely this lobbying is to succeed. As always, any surprise result could cause volatility in the inflation markets.

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