RPI reform

Coinciding with the UK Budget on 11 March 2020, the much-anticipated Consultation on reforming the Retail Price Index (RPI) was released. 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*,[6] which recommended that statistical deficiencies with the RPI be addressed.

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.

Although many believe that reforming RPI is inevitable, exactly how this is done matters greatly because it could result in a significant transfer in value from index-linked gilt holders to the UK Treasury - or not. **Hence our view is that it is important that index-linked gilt holders respond to the consultation.**

Proposed reform

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.

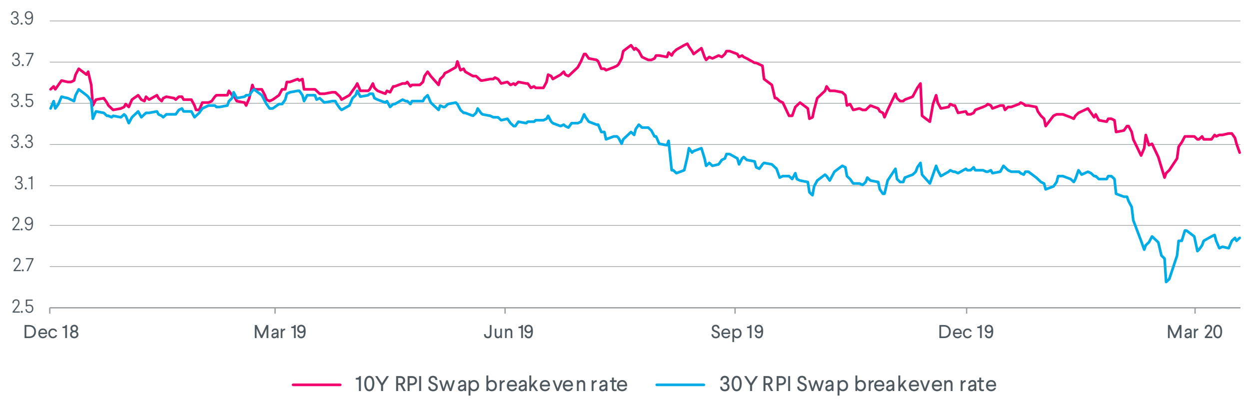
Replacing RPI with CPIH is expected to materially reduce the rate of inflation measured by RPI going forwards. The Consultation states that the difference in inflation between RPI and CPIH has averaged 1% per annum since 2010. The potential impact on index-linked gilts is therefore large. In simplistic 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 has been reasonably muted (see Chart 8). The RPI swap breakeven rate is the rate at which the market is willing to exchange future RPI-linked payments for fixed payments i.e. an indicator of market expectations of the future rate of RPI inflation. The House of Lords report released on 17 January 2019 and a response by the then Chancellor, Sajid Javid, on 4 September 2019 both saw modest one-day falls in RPI swap breakeven rates. Against the background of other sources of volatility over the period (Brexit, General Election and Coronavirus), changes in RPI swap breakeven rates have not been very helpful in distilling market sentiment on RPI reform.

6 https://publications.parliament.uk/pa/ld201719/ldselect/ldeconaf/246/24602.htm

Chart 8: 10Y and 30Y RPI Swap breakeven rates (% p.a.)



Source: Datastream

The most direct way of observing the market view on RPI reform is to compare the pricing of RPI swaps and CPI swaps as set out in Table 1 (there is no market in CPIH swaps). The issue with this approach is that the market for CPI swaps is very small and illiquid, so the measure may be unreliable.

Nevertheless, if we take the prices we have at face value, it indicates that the market has now re-priced RPI assuming it will be aligned with CPIH with a reasonable likelihood from 2030 (with a significant likelihood this will happen between 2025 and 2030).

Table 1: Difference in inflation swap rates between RPI and CPI (% p.a.)

	Period covered	31 May 2019	18 September 2019	20 February 2020
5y spot	2020-2025	0.81	0.83	0.78
5y rate in 5 years	2025-2030	0.85	0.75	0.54
5y rate in 10 years	2030-2035	0.74	0.76	0.36
5y rate in 15 years	2035-2040	0.72	0.62	0.28
5y rate in 20 years	2040-2045	0.68	0.39	0.29
5y rate in 25 years	2045-2050	0.52	0.49	0.27
5y rate in 30 years	2050-2055	0.44	0.50	0.35
5y rate in 35 years	2055-2060	0.60	0.62	0.41
5y rate in 40 years	2060-2065	0.58	0.62	0.41

Source: Insight Investment, Hymans Robertson

What might be the eventual fate of RPI?

An interesting aspect of the swap pricing information is that it does not imply that RPI will be aligned to CPIH with certainty. 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 as the table shows, we assume material re-pricing has already taken place; RPI swaps will similarly re-price and underperform CPI swaps.

- **Implementation date of 2030:** We expect the majority of responses to the Consultation to express a preference for the most distant date on offer, 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 of 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 lobby 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:** We include this because it 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.

Schemes that have not done so already should as a first step seek to understand the impact that the two extreme scenarios may have on their financial position: full alignment of RPI to CPIH and no change to RPI.

Appropriate courses of actions can then be considered given the uncertainties and pricing already built into hedging assets. Discussion with the Scheme Actuary to understand how they will change their funding assumptions is also important, so that investment and funding decisions can be integrated.

We are strongly supportive of schemes responding to the Consultation. This may be the only opportunity for schemes to have a voice in this matter. While other factors have to be considered, for index-linked gilt holders there could well be a significant value transfer away from themselves to the UK Treasury caused by aligning RPI to CPIH without compensation. In our view, responding to the Consultation is an important way for trustees of pension schemes to exercise good stewardship and engagement in the framework of being responsible investors.

Alen Ong

Senior Investment Research Consultant

alen.ong@hymans.co.uk

0207 082 6328

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk