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Current issues

From RPI to CPIH – what should insurers be considering ahead of 2030 reforms?

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On 16th December 2021, amid concerns about inflation, and with an impending wave of Omicron virus, the Bank of England raised interest rates in the month of December for only the second time in 45 years. This article considers why the level of future assumed inflation is important to life insurers, why the gap between the different measures of inflation has increased recently and what actions insurers are taking in response. It also touches on some implications of RPI reform.

Background

In November 2020, the government announced plans to reform the Retail Price Index ("RPI"), and specifically that the calculation methodology for RPI, which is used as an index to determine payments on index-linked government bonds and certain pension benefits, would become aligned to the Consumer Price Index including owner occupiers' housing costs ("CPIH") from 2030. In this announcement, the government cited an opinion from the Office for National Statistics ("ONS") which described RPI as no longer fit-for-purpose and CPIH as a more appropriate measure of inflation.

The move to align RPI with CPIH for index-linked government bonds will have widespread implications because these two measures of inflation provide different results and historically there has been a gap between RPI and CPIH. Whilst this varies over time, RPI is typically higher than CPIH.

The Association of British Insurers ("ABI") estimated that the value of index-linked government bonds would fall by about £100bn due to the change in indexation (with no compensation offered to the holders of these bonds) and that lifetime incomes for some annuitants might fall by 10% to 15% or more as a result. In effect, from 2030, pension scheme annuitants currently receiving payment increases based on RPI would receive increases based on CPIH and thus likely receive lower future pension increases. In addition, many business contracts, such as those that many life insurance companies have with their out-sourced service providers, specify payment terms which reference RPI and these will also be impacted.

The announcement to reform RPI was not universally popular and a legal challenge has been brought by the Trustees of a number of large pension schemes. This challenge has been formed on the basis that the reform would result in smaller future increases to pensions of schemes' members, as well as reducing the value of RPI-linked assets held to meet schemes' pension promises.

In December 2021, the High Court granted permission for a formal judicial review to be heard on the government's decision to replace RPI with CPIH from 2030, and the hearing is expected to take place in Summer 2022.

In the following sections of this article we consider why future price inflation is important for (re)insurers, the gap between RPI and CPIH, the recent growth in this gap and why it exists, and the actions we are seeing (re)insurers take in response.

Why is future price inflation important for insurers?

Reserving

Insurers set aside reserves to meet their best estimate liabilities, which are determined based upon a suite of assumptions.

The size of some policyholder liabilities, and hence the adequacy of reserves that have been set aside to meet these liabilities, is directly impacted by the assumed rate of future price inflation. For example, RPI-linked annuity-in-payment contracts have future payments whose size is directly determined by the level of future inflation. Hence, as a consequence, RPI reform is of interest to insurers with material annuity portfolios where payments are linked to inflation.

However, long-term insurers without annuities are also likely to be interested because of the linkage between future price inflation and the size of the reserves they need to set aside to meet future operational costs. Many insurers out-source certain activities (e.g. policy administration) to external third parties where the provision of services and future increases in unit-costs are set out in a Master Services Agreement ("MSA"). In such cases, it is common for the level of future increase in fees that the LifeCo pays to the out-sourced service provider to be linked to RPI. The definition and constitution of RPI may therefore be an important consideration when setting expense reserves.

Capital

Under Solvency II insurers using the standard formula to determine their Solvency Capital Requirement (SCR) do not hold capital directly in their regulatory balance sheet to mitigate inflation risk. Such firms would consider such risks in their ORSA. However, Internal Model firms, which have a material exposure to inflation, will calculate and hold an SCR to mitigate inflation risk. Firms with material exposures to inflation will likely need to reflect changes to data that accompany RPI reform in their capital models.

One such change to data includes the difference in how housing costs are measured in each inflation index. RPI includes the interest portion of mortgage payments, whilst CPIH includes "rental equivalence" – the rent paid for an equivalent home on the private rental market, which are used as a proxy for owner-occupier costs. Whilst for interest payments on mortgages there is clearly a direct link between their size and prevailing interest rates, the link between monthly rents and interest payments is a little less clear. For example, rental equivalence will likely be influenced by demand in the rental market and the extent of leverage in the buy-to-let market, on top of prevailing interest rates. Some recalibration of inflation risk may be required to Internal Models and ORSA models capture this change.

Pricing

When insurers price business, they necessarily make a number of assumptions about future experience and the future levels of inflation. The price of annuities is particularly sensitive to changes in the assumed level of future inflation because of the long period of time over which future annuity payments expect to be made. This makes the future inflation assumption especially important for Bulk Purchase Annuity ("BPA") writers. Uncertainty about future inflation presents a unique challenge to BPA writers: On the one hand they ought to require a greater margin to accept inflation risk and to protect future profits. On the other hand, incorporating such margins risks losing business in a highly competitive market where the deal price offered is a key consideration for the trustees of the pension scheme transferring its risks.

Future price inflation impacts the pricing of other life and health insurance products too. In the case of products which provide access to healthcare services, the provision costs of those services may be linked to RPI and so any changes to RPI need to be considered when pricing future new business.

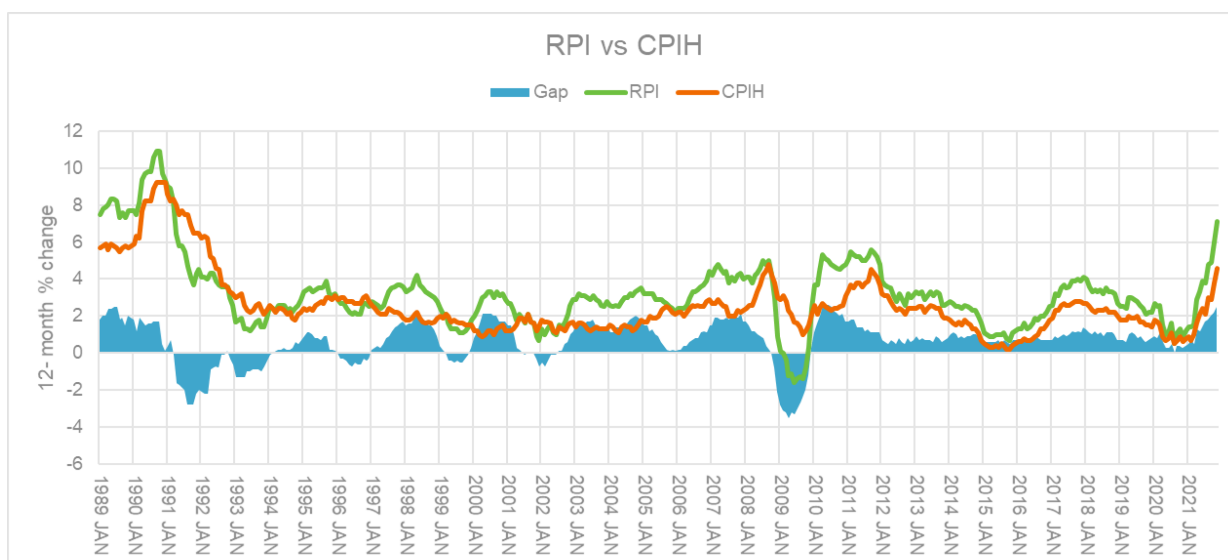
Why is there a gap? And why has it widened during 2021?

RPI and CPIH are both designed to track the inflation of prices of goods and services bought by people in the UK, and therefore one would expect some degree of correlation between these measures.

However, there are differences in how these indices are constructed which results in divergence in certain circumstances. For example:

- The differences in index construction include a "formula effect" which occurs as a result of RPI using an arithmetic mean to calculate average prices whereas CPIH uses a geometric mean for this purpose. For a given set of prices the arithmetic mean tends to exceed the geometric mean which results in RPI typically exceeding CPIH, as can be observed in historic data.

- The way in which costs associated with housing are included in the indices also differs. RPI includes house prices directly and so is directly impacted by the buoyancy of the residential housing market. In contrast, CPIH makes allowance for "Owner occupier housing costs" (rather than the cost of house prices) and mortgage interest payments.
- There are also differences in the weightings given to each component of the indices, and other, typically less significant, differences in coverage of prices of certain goods and services.
- The effect of these factors can be seen from the graph of RPI against CPIH below which shows a gap between RPI and CPIH.



Source: Office for National Statistics

This gap has narrowed and widened many times over the past 30 years, with the most significant gaps occurring around the 2008 financial crisis and now, during 2021. This can be seen in the chart.

Over the course of 2021, the RPI-CPIH gap grew steadily from January and reached an 11-year high of 2.5 percentage points for November 2021.

Our analysis suggests that this is likely to be driven by:

- Strong rises in house prices seen in the market, which is reflected in RPI but not CPIH,
- A pronounced formula effect due to significant levels of inflation in certain shared components of the two indices, where the difference between the approaches to averages is amplified, and
- A difference in how and when the weightings of each components of each index are updated for recent consumer spending habits. This means that the weights of RPI better represent pre-pandemic spending habits (which are now coming back with a vengeance) and those of CPIH better represent the spending habits of 2020 (amidst lockdowns etc.). The result is an RPI measure of inflation which is more sensitive to the recent changes in prices as a result of people's actual spending habits now, whilst CPIH is not so sensitive.

CPI	2020 weight	2021 weights	Change
01 Food and non-alcoholic beverages	9.9%	11.4%	1.5%
02 Alcoholic beverages and tobacco	4.0%	4.5%	0.5%
03 Clothing and footwear	6.1%	7.4%	1.3%
04 Housing, water, electricity, gas and other fuels	13.1%	14.1%	1.0%
05 Furniture, household equipment and maintenance	6.0%	6.2%	0.2%
06 Health	2.7%	2.5%	-0.2%
07 Transport	14.7%	13.6%	-1.1%
08 Communication	2.1%	2.5%	0.4%
09 Recreation and culture	16.8%	14.6%	-2.2%
10 Education	2.9%	3.7%	0.8%
11 Restaurants and hotels	11.9%	8.7%	-3.2%
12 Miscellaneous goods and services	9.8%	10.8%	1.0%

What actions are insurers taking?

Insurers are taking action to better understand the differences between these inflation indices and how any such changes might impact their business. Some actions include:

- Modelling of inflation-linked liabilities, especially BPA writers with liabilities linked to RPI or linked to RPI with a maximum of 5% or 3% (say),
- reviewing their Asset and Liability Management approach and current inflation hedging strategies,
- reviewing the risk calibrations within their Internal Models or ORSA calculations, and
- reviewing business services contracts to understand the financial implications of any inflation index referencing.

How can Hymans Robertson help?

Our award-winning Insurance & Financial Services team consists of around 50 insurance specialists in the areas of investment ALM, risk & capital management, longevity, and products & digital wealth. We have a proven track-record of helping our clients to manage and optimise their businesses.

If you would like to discuss how the differences between RPI and CPIH in combination with the proposed transition of indexation for 2030 affects your business, please get in touch with one of the authors.

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