

RPI/CPI issue for UK pension schemes – The dust is settling (a little!)

The UK Government has recently announced a proposal to change the way that pension benefits are adjusted to reflect changes in the cost of living. The current statutory requirements for both revaluation of benefits in deferment and pension increases in payment are based on changes in the Retail Price Index (RPI). The Government has proposed that this be altered so that in future the Consumer Price Index (CPI) is used instead, although there is still a considerable degree of uncertainty around how this change will be implemented. The most striking aspect of this announcement is that the proposals apply to all accrued benefits rather than simply to benefits accrued in future.

This follows the announcement in the recent Budget that state pension benefits would in future be linked to CPI rather than RPI. The proposed changes to private sector pensions would therefore be consistent with this change and also with the long term inflation target given to the Bank of England which is set relative to CPI (target 2% p.a.).

What is the difference between CPI and RPI?

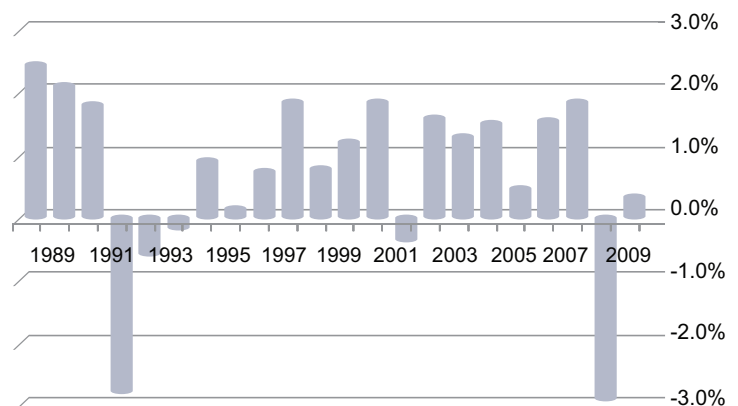
There are two main differences:

- Calculation method – RPI uses an arithmetic averaging method whilst CPI uses a geometric averaging method. The result of this calculation method is that CPI will tend to be lower than RPI.
- Housing costs – RPI includes an allowance for housing costs whereas CPI does not. Therefore, if housing costs increase faster than general living costs, RPI will exceed CPI and vice-versa.

Over the last 20 years, CPI has on average been around 0.5% p.a. lower than RPI. The ONS has calculated that over the last 13 years, the impact of the calculation method on the gap has been fairly constant – it has averaged 0.5% p.a. and never been lower than 0.4% p.a. The impact of housing costs has been far more volatile.

Over the long term, the two measures move broadly in sync, but over shorter periods they can diverge significantly. The chart above shows the annual difference between RPI and CPI over calendar years since 1988 (when CPI data is first available).

RPI and CPI Difference



Source: ONS/Barnett Waddingham

Looking forward, we expect that CPI will on average be lower than RPI over the long term, perhaps by around 0.5% to allow for the calculation method effect set out above. The impact of housing costs is more uncertain, but likely to be less significant over the long term.

It is worth noting that in May 2010, the Chancellor, George Osborne, asked the Bank of England for its views on accelerating the process for incorporating housing costs into the CPI inflation target. Therefore, it is possible that housing costs will be included within CPI at some point in future. This would be expected to significantly reduce the volatility between RPI and CPI.

What is the impact on pension benefits?

If CPI does turn out to be lower than RPI in future then the statutory minimum increases applying to pension benefits both in payment and in deferment will be lower. Members would therefore be expected to receive lower benefits as a result of the proposals. It should be noted that it is quite possible that in a given year, that CPI will exceed RPI. However, on average for the reasons set out above, we would expect that CPI will be lower than RPI over the long term.

Significantly, the impact on individual schemes will vary depending on the interaction between scheme rules and the changes to legislation. For example, if scheme rules specifically state that benefits will increase in line with RPI then this may remain the case even if the proposed changes to statutory minimum increases are carried out. Other scheme rules will simply refer to benefits being increased in line with the statutory requirements and therefore any changes will automatically come into effect. This may lead to something of a "small print lottery" where different schemes and different benefits are affected in different ways, depending on the precise wording of scheme rules. In some cases, future increases might be subject to the greater of CPI or RPI since schemes could have to comply with both their rules and the statutory minimum.

Depending on just how the Government seek to introduce these changes, it is very likely that Trustees will need to take legal advice to understand exactly how any changes that are introduced to legislation interact with their schemes' rules.

How does this affect pension scheme funding?

The impact on a scheme's funding position will very much depend on the specific circumstances of the scheme and the final details of the Government legislation. For a scheme where the majority of benefits are linked to inflation, if future uplifts to benefits are linked to CPI rather than RPI this might be expected to improve the funding position of the scheme by 5-10%. This is clearly a significant effect, although in general this is not likely to be sufficient to reverse the deterioration in funding levels seen as the result of the recent financial crisis.

For schemes which would be required to continue to pay RPI increases in line with their rules (if the legislation is not overriding), the addition of a CPI underpin would actually be

expected to slightly increase liabilities, as they could be required to pay the higher of the two inflation measures! The impact on funding position would be expected to vary considerably from scheme to scheme depending on wording of scheme rules and the final legislation.

It should be noted that the Pensions Regulator has issued a statement saying that, until legislation is finalised, it will continue to assess funding recovery plans on the current (i.e. RPI) basis.

What are the implications for investment strategy?

Historically, schemes have sought to control risk through their investment strategy by looking to match their inflation linked liabilities with inflation linked assets. At its simplest, this can just mean investing in index-linked government bonds, whilst some schemes have opted for more sophisticated strategies using instruments such as swaps. These assets all provide returns that are linked to RPI, therefore if pension benefits become linked to CPI instead there will then be a new element of mismatch between assets and liabilities. The difference between CPI and RPI in this context is referred to as basis risk. Although the existence of this basis risk is clearly disadvantageous to schemes, an RPI linked asset is likely to be a much closer (if imperfect) match for the liabilities than a fixed asset.

In theory, pension schemes could instead invest in CPI linked assets. However, in practice there is at present little or no market in CPI linked assets which therefore makes this impractical. RPI linked assets therefore remain, for the time being at least, the best match for inflation linked liabilities. In the longer term, it is likely that a market for CPI linked assets will develop given the likely demand for such instruments from pension schemes. This market would be aided were the Government to issue CPI linked bonds rather than RPI linked bonds in future.

For some schemes, the one-off improvement in funding position resulting from the proposed changes may present an opportunity to reduce risk within their investment strategy whilst remaining consistent with their funding plan - though any action will need to await the final legislation.

If you would like to discuss these issues further please contact your usual Barnett Waddingham consultant.

This document provides general information about financial and other relevant professional issues with which we are involved. The information and opinions provided on the document should not be relied upon or be used as a substitute for advice on how to act in a particular case. No content in this document is intended to provide or should be interpreted as providing regulated investment advice.

Barnett Waddingham - JULY 2010

| | | | | | | |
|--|---|---|---|---|--|--|
| Chalfont Court Hill Avenue Amersham HP6 5BB Tel: 01494 788100 Fax: 01494 788800 | Rigby Hall Rigby Lane Bromsgrove B60 2EW Tel: 01527 559111 Fax: 01527 559222 | St James's House St James's Square Cheltenham GL50 3PR Tel: 01242 538500 Fax: 01242 538501 | 163 West George Street Glasgow G2 2JJ Tel: 0141 243 4400 Fax: 0141 243 4432 | West Riding House 67 Albion Street Leeds LS1 5AA Tel: 0113 394 3700 Fax: 0113 394 3760 | Port of Liverpool Building Pier Head Liverpool L3 1BW Tel: 0151 235 6600 Fax: 0151 235 6640 | Cheapside House 138 Cheapside London EC2V 6BW Tel: 020 7776 2200 Fax: 020 7776 3800 |
|--|---|---|---|---|--|--|

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office.

Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), Barnett Waddingham Investments LLP (OC323081), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at Cheapside House, 138 Cheapside, London EC2V 6BW.

Barnett Waddingham LLP is authorised and regulated by the Financial Services Authority and is licensed by the Institute of Actuaries for a range of investment business activities. Barnett Waddingham Investments LLP and BW SIPP LLP are authorised and regulated by the Financial Services Authority. Barnett Waddingham Actuaries and Consultants Limited is regulated by the Institute of Actuaries in respect of a range of investment business activities.