Summary
- The Retail Price Index (RPI) is around 0.7 to 1 percentage point a year higher than the Consumer Price Index (CPI) measure of inflation, only reversing if there is a housing crash.
- Currently there is a 'lottery' of schemes that can switch from RPI to CPI, based upon the wording of scheme rules.
- A scheme could save around 10-15 per cent of total liabilities by switching from RPI to CPI.
- A RPI-CPI switch may result in a larger pension for members than the one they would receive in the PPF.
- There is concern that if all schemes were able to switch indexation, companies may move to CPI and therefore reduce the amount pensioners receive, despite having been able to afford RPI indexation.

The final nail in the coffin for RPI?

Discredited by the Office for National Statistics, but hardwired into many scheme rules, will the government finally give all defined benefit schemes the chance to switch from RPI to CPI? David Rowley reports

Amid the heavily-regulated world of defined benefit pensions, the concept of a lottery for sponsors and employees is an oddity that you would expect to be ironed out sooner or later.

While the widespread use of the word 'lottery' to describe whether the wording of a scheme's rules enabled it to switch from a Retail Price Index (RPI) measure of revaluation to a less-generous Consumer Price Index (CPI) measure or not, is loaded.

When the coalition government decided to use CPI as the measure of price inflation for the purposes of regulating occupational pension schemes in 2010, it provided welcome relief to around half of British industry and to local authorities. The measure was a quick and untidy fix for an economy still reeling from the impact of the global financial crisis.

Six years on and many employers, and some trustees, are now looking for parity in their right to change too in the forthcoming green paper on DB pensions.

Reading between the lines, one detects more sympathy for employers than employees from the government on the issue. Here are the words pensions minister Richard Harrington used in a speech to a Trade Union Congress conference on pensions in London on 1 February:

"Some employers think it is unfair, some employees think it is unfair. I am open minded, it has to be looked at. Hopefully some common sense can be applied to this. There was not the sophistication in those who were drafting the rules to say was it that inflation or another."

What might tip the scales in favour of change is the case of the deficit of the £15 billion British Steel Pension Scheme (BSPS) and the imperilled business of its sponsor Tata Steel. Its trustees are seeking one-off permission from the government to change the scheme rules on the basis that a switch to CPI would keep the scheme from entering the Pension Protection Fund (PPF), where members

benefits would be more severely cut.

An open letter from the trustee board of the BSPS on 27 January reads:

"If the only alternative is TSUK insolvency, the trustee would wish to agree separation terms that offer members a choice between staying in the BSPS (and so getting PPF compensation) and transferring to a new scheme that would provide modified benefits. For the vast majority of members and pensioners, these modified benefits would be better than PPF compensation."

The dilemma faced by the trustees of BSPS has posed the question on whether an override to scheme rules should only take place for schemes that would otherwise imminently enter the PPF.

This is the compromise that unions would like in their submissions to government on the matter.

That other trustees feel this way is revealed by Norton Rose associate Julia Ward. "Trustees are not always opposed to it, this is a way they can reduce liabilities and strengthen the health of the scheme," she says. "We have been asked by a few clients to see if it was possible."

Unions, though, only want the government to go so far. Association of Member Nominated Trustees co-chair and BECTU member Janice Turner says: "We know that there are pension schemes where companies are doing incredibly well and yet companies still want to close the pension schemes. If there was a power to reduce these liabilities, these promises, then to what degree are companies going to take advantage of that? That is a real worry."

One of the counter arguments expected to be used by employers is that a company with a DB scheme that can switch to CPI will have a competitive advantage over a company in the same sector that still has RPI.

Savings and losses

So how much could a scheme save by switching from RPI to CPI? Mercer partner Deborah Cooper says it could be in the region of 10-15 per cent of total liabilities for each scheme.

The figure will depend on the age of members, their length of service and accrual rates. "Not everyone would have had the same windfall gains," she says. "The extent to which it is a material bonus will depend on how big their scheme is and how big the deficit is."

One scheme where it has made a big difference is the National Milk Records pension fund, which cut its overall pension deficit from £9.7 million to £3.5 million by moving from RPI to CPI in 2015.

These figures could all change if interest rates rise. Various estimates put the difference between RPI and CPI at around 0.7 to 1 percentage point a year, only reversing if there is a housing crash, but as RPI is linked to interest rates, these calculations could widen if the Bank of England decided to increase interest rates.

This perhaps explains why various forecasts of a full CPI switch for all schemes are so different. Punter Southall estimated in late 2016 that UK firms could save £100 billion, while Hymans Robertson, in evidence to government, put the figure at £175 billion and at an average loss for members of £20,000 over the course of their retirement.

Legal

If the government's green paper does not permit full access for schemes to switch to CPI, then the courts will continue to be a source of redress wherever there is an element of ambiguity in the original wording around inflation increases.

The case law so far shows that a switch to CPI is not contrary to section 67. However, November's unsatisfactory 2:1 Court of Appeal verdict in the bid by the trustees of the Barnardo's pension scheme to have its scheme rules ('the general index of retail prices or any replacement adopted by the trustees') decided in favour of a switch to CPI is likely to lead to further legal action.

The basis of such legal cases have been encouraged by disparaging remarks made about RPI by the Office for National Statistics.

In March 2016 the National Statistician wrote: "I believe that the RPI is not a good measure of inflation and does not realistically have the potential to become one. I strongly discourage the use of RPI as a measure of inflation as there are far superior alternatives."

Telling members

Whatever the consequence of the government's green paper, any trustee attempting to switch to CPI will have a delicate communications exercise ahead of them.

Ward says a minimum 60 days consultation is needed to enable members to understand the reasons for the change and the consequences. Feedback from members must be factored into any final decision.

In the experience of pension communications specialists AHC head of client services UK and Australia Karen Partridge, her firm gets hired to do such communication whenever it is part of a wider set of changes.

When this happens she finds an indexation switch is usually not the main issue.

"Certainly we get feedback about RPI to CPI in consultations, but I would say it is not the most emotive of changes." Closing the DB scheme to future accrual tends to be a bigger blow for members.

She advises employers on how to pitch such communication.

"There is a need for honesty and openness, employers should not express opinion but let people investigate for themselves."

Willis Towers Watson senior consultant David Robbins says that one route for employers to take is to point out that RPI has been discredited in the eyes of many statisticians. Indeed, CPI is the preferred measure of the Office for National Statistics, not least as it has become an internationally-accepted measure of inflation.

Written by David Rowley, a freelance journalist