Winners and losers

Nick Reeve assesses the potential impact the proposal to bring RPI in line with CPIH will have on pension schemes

Summary
- HM Treasury and the UK Statistics Authority plan to adjust RPI to align it with CPIH.
- The change could benefit under-hedged schemes but hurt those hedging CPIH liabilities with RPI-linked assets.
- Pensioners with inflation-linked benefits could suffer a 10-20 per cent hit to lifetime DB pension earnings.
- Trustees will have to wait for the consultation's conclusion before deciding how to respond.

It is not often that pension schemes without hedging or protections in place can have cause for celebration, particularly in turbulent markets.

However, the recently-launched government consultation on the methodology for calculating the Retail Prices Index (RPI) could be one such reason to be cheerful.

According to analysis by consultancy Barnett Waddingham, the proposals put forward by HM Treasury and the UK Statistics Authority to bring RPI in line with the Consumer Prices Index including owner occupiers' housing costs (CPIH) could provide a reduction of as much as 10 per cent to the liabilities of schemes with benefits linked to RPI.

With the Office for National Statistics (ONS) having scrapped RPI as an official statistic several years ago, and many experts calling for it to be abandoned altogether, schemes have been moving away from the measure as well. However, despite their desire, some schemes had been unable to do so.

Hymans Robertson partner, Laura McLaren, says schemes that have been unable to make this change – usually due to quirks in the wording of their rules, as was the case with children's charity Barnardo's in 2018 – will likely welcome the proposals. However, direct investors that stand to lose out will lobby hard against some elements of the consultation, she adds.

Not only will the link to inflation fall in value as a result of the reform, but the price will also likely fall as demand adjusts. When the consultation was first announced last year, one bond fund manager described the market reaction as 'carnage' in an interview with the *Financial Times.*

Barnett Waddingham senior investment consultant, Ian Mills, says the impact of the changes on defined benefit (DB) pension schemes could be 'seismic', particularly for schemes matching CPI-linked liabilities with RPI-linked assets.

"The government runs the risk of punishing those who have been prudent, with a well-funded and well-risk-managed scheme, whereas those that have left risks unmanaged could be rewarded," he says. "The government needs to be careful about moral pitfalls like this, as setting such a precedent can dangerously affect trust and behaviour."

There is no sign in the consultation of compensation for those investors that will be worse off after the RPI changes are enacted – something several asset managers had called for.

"Unless this changes, pension schemes hedging CPI-linked liabilities with RPI-linked assets, and individuals with RPI-linked pension benefits – who stand to see aggregate lifetime pension payments reduce by between 10-20 per cent – are likely to be among the biggest losers," says McLaren.

Impact on members

Percentage-point estimates of losses will translate to real-world falls in future benefits for current and future pensioners.

LCP partner, Gordon Watchorn, says a pensioner currently aged 65 "could find that replacing the RPI will reduce their pension by around 10 per cent" over 20 years, compared to what they expected before the reform.

Much will depend on when the reform is implemented. The government has yet to settle on a firm date, but has outlined options to bring the changes in between 2025 and 2030.

While there is "no crystal ball" to work out which members will be worse off, TLT legal director Richard Leigh says "it is reasonable to suppose that members will be worse off over time" if realigning RPI benefits to CPIH. "Those *[already]* using CPI will find the difference is marginal and more difficult to assess," he adds.

"Historic patterns would suggest that members would receive lower inflation protection, but the future likely impact would need to be carefully considered as the decision either way will impact on cash in pensioner pockets," says Burges Salmon pensions partner, Michael Hayles.

Isio co-head of investment strategy, John Hodgson, says that working out impact on members requires an assessment of other scheme factors such as "benefit affordability, funding strength, covenant, likelihood of PPF entry and much more".

Funding implications – good or bad – are not always obvious, Hodgson says. Even within the same scheme, members with CPI-linked benefits may view the change positively if the overall effect improves the security of the scheme.

The RPI reforms could also, inadvertently, provide a form of relief for schemes and employers under strain as a result of the market impact of the Covid-19 pandemic. Hodgson argues that a switch to CPIH indexation "could suit all parties if it reduces the deficit and supports a covenant-preserving contribution easement".

Sourcing assets

Those schemes that have been able to switch to CPIH have faced problems acquiring CPI-linked assets. There are very few CPI-linked bonds available, and any new issuance tends to be snapped up by insurance companies.

Finding assets that match CPI-linked liabilities is a perpetual problem for pension funds and asset managers, especially those running liability-driven investment (LDI) strategies. There is no appetite at government level to issue CPI gilts, and the issuance of RPI-linked gilts has been falling for several years.

This is despite a recognition by the Treasury in the consultation paper that "issuing index-linked gilts has proven to be a cost-effective approach to raising debt", due in part to the huge demand from pension funds and other investors.

BMO Global Asset Management head of LDI client portfolio management, Simon Bentley, says managers are "engaging with the full range of market participants in an attempt to source CPI and other inflation-linked assets".

Most of the limited CPI-linked corporate issuance comes from companies such as water companies, property companies and other infrastructure providers, according to Bentley. However, BMO has been discussing alternatives with counterparty banks and other market stakeholders, including options such as real estate debt and equity.

Premier head of trustee services, David Jarman, is positive about future access to CPI assets. "Markets always innovate and if there is demand it is likely that corporates and bankers will develop suitable products for pension plans to buy," he says.

Isio co-head of investment strategy, Barry Jones, cites instruments such as inflation-linked US Treasury bonds – although schemes must be aware of the additional currency risk – index-linked corporate bonds and private market assets.

Jones argues that only a few pension schemes are likely to choose these routes, as 'standard' liability-driven investments are easier and more efficient.

In reality, he says, most schemes with CPI-linked liabilities will probably carry on as before and accept a loss as and when the adjustment to RPI is made. Alternatively, they could reduce their hedges and take more absolute inflation risk, he adds.

"A difficult choice in normal times, but especially hard with the current frequency of significant government interventions," Jones says.

Bentley warns against reducing hedging levels, arguing that the effects of RPI reform are "more than 60 per cent priced in" to the inflation-linked market.

"Secondly, with such an uncertain economic and inflation outlook, it is potentially preferable to run the basis risk between CPIH and RPI than to have no hedge at all, given the expected high correlation between the two measures," he adds.

Wait and see

Arc Pensions Law senior partner, Anna Rogers, points out that there are many other complexities to be considered, including the effect on guaranteed minimum pensions (GMP).

"Pensions earned before 1997 might not have increases, or members might have given up their pre-97 increases under a pension increase exchange," Rogers says. "The GMP earned from 1988 to 1997 only has to have CPI-related increases, and pre-1988 GMP didn't have to be increased at all. Some schemes give fixed 3 per cent increases on GMPs, so it will depend on the rules.

"Trustees of DB schemes should give this some thought. They should make sure someone is checking the rules that apply to all generations of leavers, not just the latest set."

In the meantime, RPI-linked schemes "should focus more on refining their hedges, not wholesale change", Jones concludes.

For most DB scheme trustees, the next few months will be a game of wait-and-see as the consultation plays out, says Mills.

Time to put the inflation-linked champagne on ice.

Written by Nick Reeve, a freelance journalist