CPI-way or the highway?

Following the switch of public-sector schemes to CPI from RPI in 2011, and the recent report from the House of Lords that slammed the government for continuing to use RPI, Elizabeth Pfeuti looks at whether private-sector schemes can, and should, make the switch

Summary
• The Retail Price Index has been discredited by peers, but vast numbers of pension schemes use it to measure inflation.
• How can trustees negotiate to maintain promises to members while keeping on good terms with the sponsoring employer?
• Does the sector still have to wait for CPI-linked gilts – or has the starting gun just been fired?

In January, The House of Lords' Economic Affairs Committee slammed the UK Statistics Agency for continuing to publish a monthly figure it knew to be inaccurate – and admonished the government for using it only when it was beneficial to the public purse.

The figure was the Retail Price Index (RPI) and the rebuke could reignite the embers of an argument that has been smouldering in the pension sector since the turn of the decade.

In 2011, the UK's public-sector employers were told by the government to change the inflation-linking part of their pension provision to follow the uplift in the Consumer Price Index (CPI) rather than the RPI measure they had been traditionally using.

CPI, unlike RPI, excluded housing costs such as rent and mortgages, which it was assumed pensioners would no longer be paying, making it a more accurate reflection of their monthly outgoings.

Importantly, the new measure had also risen more slowly. At the time of the change in legislation, the Bank of England and the Department for Work and Pensions estimated RPI would increase around 2.7 per cent each year, with CPI rising just 2 per cent.

This point was not missed by unions who strongly challenged the change but were ultimately unsuccessful. CPI had, after all, been the UK's official inflation measure since 2003, so this was just bringing pensions into line, the government said.

The move, set by statute, saw hundreds of millions of pounds in liabilities shaved off the public-sector pension bill. In a submission to the House of Lords' consultation at the end of last year, KPMG estimated that public-sector defined-benefit pensions liabilities linked to CPI were worth £200 billion.

Going private

The next step looked to be moving the private sector across to the same calculation. It would have been welcome, too, as companies were struggling with desperate underfunding after more than two years of the financial crisis – but there was a problem.

Each corporate defined benefit scheme had documents written explicitly for itself. To enable each scheme to switch from RPI to CPI automatically would need further, intricate legislation.

Despite the original measure becoming increasingly discredited, the government was not keen to restart the battle with the unions and potentially millions of employees over whom they had no control.

Instead, each scheme was left to fend for itself.

Ever since, corporate pensions have had to examine their internal documents to scope out the potential for switching. They fall into four main categories, according to Addleshaw Goddard legal director, pensions, Judith Donnelly.

First, benefits must be increased in line with the statutory minimum, making a switch to CPI possible; second, the rules require increases to be specifically in line with RPI, meaning no switch is possible. Third, the rules require an increase in line with RPI, but allow a different measure to be used in clear, distinct circumstances; lastly, the increase should be in line with RPI or potentially another index, but the mechanisms for allowing the change is not clear.

Over the past couple of years, the cases that have hit the headlines have fallen into the latter two categories, in which there is significant ambiguity. Household names have been dragged before judges – Barnardo's, Arcadia and BT – to ask for permission to switch to the lower rate.

Some have been successful in switching, others have not. Donnelly says the way in which the government changed the legislation had created a "lottery" and handed responsibility to the courts.

"There are numerous ways in which scheme rules can be drafted," says Donnelly. "The Barnardo's case confirmed that a judge might not look just at the scheme wording as it pertained to the clause about indexation, but the whole document to see whether there is a meaning implied elsewhere."

Stick or twist?

There has been a lot of activity with companies switching across to CPI, but not all have publicised their decision, according to KPMG director John Hodgson, noting that the process was not always an easy one.

In its submission to the House of Lords, KPMG estimated of the £2 trillion private-sector, defined-benefit pension liabilities, £1.1 trillion are still linked to RPI, with just £300 billion linked to CPI. A further £600 billion are not inflation linked.

As part of their risk management obligations, companies are looking at the potential to switch, says Hodgson. This did not guarantee they would move, "but the financial impacts mean it should be looked at".

For Hodgson, companies need to consider the switch as a business decision – a corporate obligation to pay the

intended benefits, rather than a moral one. For the trustees, the decision is more complex.

"Despite having the power to switch to CPI, trustees sometimes feel a moral duty to uphold the use of the inflationary measure members were told would apply at the time of joining the scheme," Womble Bond Dickinson managing associate director, Gavin Ellison, says.

Any change to CPI cannot affect benefits already paid out, but it can impact what members are paid in future. Additionally, employers are under no obligation to consult with pensioners already in receipt of their pension that their benefits are set to change. Most do tell them, but it is a wrinkle that needs ironing out.

"In practice, a balance needs to be struck between protection of member interests and avoiding additional liabilities being imposed on the company," Ellison says. "Cost-saving alone is not sufficient. A more nuanced balancing of the relevant factors is needed. Is it the right and proper thing to do? Should they be using this power? Or simply is CPI actually the more appropriate measure?"

Association of Member Nominated Trustees co-chair, David Weeks, says, in his experience, most trustees were not in favour of making such changes. "Trust rules have obligations and they should be honoured," he says. "Some schemes might have a shortfall but switching inflation measures is a bit of a blunt instrument – there must be more considered ways to a solution."

For Weeks, despite the rhetoric about more appropriate measures, for trustees, "the net effect is that CPI is 1 per cent lower. Why not just come out and say the employer wants to reduce inflation linkage by 1 per cent?"

Deal making

Ellison says that employers should be aware that they are unlikely to get a straight 'yes' from trustees, even if they agree that the switch is appropriate.

"Typically, there will be a negotiation about whether to augment members' benefits and how the savings made from the switch may be recycled back into the scheme to improve the funding position," he says.

"In some cases, we have found that where employers have told trustees that they want to reduce benefits, the trustees have indicated that they will only exercise their power to consent if the employer gives them something else of value in return," Donnelly says.

There is a lot of work involved and realistically, it can take months from getting the legal opinion to agreeing – and the process takes time, effort and money.

"Employers need to talk to trustees," LCP head of the pensions research team, David Everett, notes. "Some might be waiting to put any plans into action, in case there is a governmental reaction to the House of Lords report, and they end up having to do it anyway."

Everett warns that, as it stood, CPI-linked assets were not available in such numbers for so many schemes to switch, but there are signs within the House of Lords report that could change.

"The government should begin to issue CPI-linked gilts and stop issuing RPI-linked gilts," the report said, citing evidence from the Bank of England that suggested there was enough demand to make a viable market.

"It is tricky for trustees, who are likely to be beneficiaries, with friends and colleagues who are, too," Hodgson says. "But there is a direction of travel for away from RPI and the rest of the world is moving on – so why should those pension funds with flexible rules be stuck using it?"

Written by Elizabeth Pfeuti, a freelance journalist