PENSIONS AND LIFETIME SAVINGS ASSOCIATION

THE REFORM TO RETAIL PRICES INDEX METHODOLOGY

A RESPONSE TO TREASURY AND UKSA'S CONSULTATION PAPER

AUGUST 2020

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

ABOUT THE PLSA

We're the Pensions and Lifetime Savings Association (PLSA); we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with 20 million members and £1 trillion in assets, across master trusts and defined benefit, defined contribution, and local government schemes. Our members also include some 400 businesses which provide essential services and advice to UK pensions providers. Our mission is to help everyone to achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings, and to build the confidence and understanding of savers.

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

EXECUTIVE SUMMARY

- The PLSA welcomes the opportunity to respond to the joint consultation from the Treasury and UK Statistics Authority (UKSA) on proposed reforms to the RPI methodology.

- The PLSA understands that RPI is a flawed measure of inflation, and supports plans to develop a more robust measure. However, we caution that if the Government takes the decision to proceed with aligning RPI with CPIH as planned, it must also take steps to mitigate the detrimental impact this change will have on holders of index-linked gilts, of which pension schemes are the predominant investors, as well as those who will be impacted as a result, namely pension scheme members.

- We strongly believe that the implications of the change must be addressed in a way which allows various stakeholders to provide input to determine the most equitable way to transition away from RPI. A precedent has already been set for reforming benchmarks, as in the case of LIBOR, where a Working Group was established to ascertain that the transition to the replacement index, SONIA, minimised the impact on stakeholders. We believe the government should consider implementing a similar approach.

- Depending on the timing of the changes, pension scheme members will lose between 4-9% of their pension value. The yearly average DB income with RPI uprating of a man aged 65 in 2020 is predicted see a drop of 17% if changes are made in 2025 and women aged 65 will see a drop of 19%. If the change is made in 2030, a man would see his yearly average income fall by 12%, while a woman would see her income reduce by 14%.[1]

- Aligning RPI to CPIH is likely to exacerbate problems with the gender pension gap and intergenerational fairness, due to women and younger members being the most detrimentally effected by the change. This will increase the disparity in pension wealth at a time where these groups - which are already known to be more financially vulnerable due to pay gaps and their reliance on flexible and part-time work - face increased uncertainty.

- DB pension schemes will be significantly impacted if the government decides to go ahead with the change. Currently, they invest an estimated £470bn in index-linked bonds, with 29% of private sector scheme assets invested into index-linked bonds. A simple switch to CPIH is expected to reduce the value of these pension scheme investments by £80bn if done in 2025, and £60bn if made in 2030[2,3]. This could lead

[1] PPI (2020) "How could changes to price indices affect Defined Benefit schemes?"
[2] PPI (2020) "How could changes to price indices affect Defined Benefit schemes?"
[3] Analysis from others indicates that this figure for all holders of index-linked gilts could be £90bn if the change is made in 2025 or £120bn if made in 2030. See here.

to some DB pension schemes closing to new entrants or future accrual to help address this loss, meaning that, ultimately, scheme members are worse off.

- The impact of the change on funding levels will be of particular concern to DB pension schemes at a time where there is already much uncertainty. Currently, schemes are potentially facing significant impacts on funding levels arising from COVID-19 and TPR's new DB Funding framework. It has been estimated by the Pensions Policy Institute that for pension schemes who use RPI-linked gilts to hedge CPI liabilities, for every £10m invested, they would see a loss of £1m in asset value if the changes are made in 2030, this figure doubles if the change is made in 2025. A significant fall in the income received from RPI-linked gilts would lead to a reduction in scheme funding. This funding gap would require higher contributions from employers, which may be difficult to achieve, particularly for sectors significantly impacted by COVID-19.

- Depending on the date of the change, these reforms' could result in a large wealth transfer of approximately £90bn[4] from those who hold index-linked gilts – the majority of which are UK pension schemes and insurers - to the UK government. The government must therefore be as transparent as possible as to where this wealth will go, and who will benefit from this transfer.

- We believe that trust in pensions schemes and the government will be potentially damaged by these changes. Implementing the changes will effectively cut benefits for many members, which could reflect poorly on both pension savings and the government, despite schemes following a prudent investment strategy on the basis of assurances that RPI would not undergo any substantive changes in the near future.

- In order to transition away from the use of RPI in a fair and equitable way, we suggest the government and the UKSA deliberately adjust index-linked gilts from RPI to CPIH + X, where X is an agreed and transparently calculated adjustment reflecting the expected long term average future income of RPI over the new inflation measure. This solution is also commonly referred to within industry as "CPIH + a spread". Alternatively, the Government may also wish to consider paying any future lost income to index-linked gilt holders upfront.

- Taking up mitigating factors will help to ensure that prudent schemes - that invested in RPI-linked gilts in good faith with an expectation of certain returns which have been factored into funding plans - should not face funding shortfalls as a result of these reforms. There is also no need for savers to be so unduly effected, particularly in the context of financial hardships from COVID-19.

- We also urge that if the Government does decide to align RPI to CPIH prior to 2030, that on top of mitigation, the changes should be made as close to 2030 as possible. This

[4] Insight Investment (2019) "Proposed changes to RPI: Nobody needs to lose out". Please see: https://www.insightinvestment.com/globalassets/documents/regulatory-updates/uk-proposed-changes-to-rpi.pdf

will be a more viable solution allowing for the establishment of a Working Group for the transition, giving investors in index-linked gilts enough time to prepare while also providing a better outcome for pension scheme members.

BACKGROUND

1. The PLSA welcomes the opportunity to respond to the joint consultation from the Treasury and the UK Statistics Authority (UKSA) on proposals to reform the methodology of the Retail Price Index (RPI).

2. The PLSA has been an active participant of the debates around this evolving issue over the last decade, conducting surveys and responding to earlier consultations which covered the reform or statistical review of RPI and CPI:

   - The PLSA's 2017 Annual Survey found a dichotomy in the use of RPI and CPI as a measure of inflation; the most popular measure of inflation for the revaluation of benefits is capped CPI (54%) followed by capped RPI (32%). For the indexation of scheme benefits, this was reversed, with 59% reporting using capped RPI and a quarter (25%) capped CPI.

   - We responded to DWP's 2010 consultation which sought views on plans to allow private sector pension schemes to switch from using RPI to CPI as the basis of indexation of pensions in payment and of the revaluation of deferred pensions.[5] The PLSA indicated that the process of developing CPI policy had been "poorly handled" as the government had raised expectations that pension schemes would be given a power to modify their rules, but then decided against it. We stated at the time that the government's suggestion of introducing a statutory requirement for schemes to consult their members over changes to its rules on inflation increases "could introduce unnecessary rigidity into the process".[6]

   - In 2012, the ONS consulted on options for improving RPI by scrapping the use of the Carli formula and instead using RPIJ[7,8]. In response, we recommended that no change be made at the time. While the PLSA also accepted the argument to cease the use of the Carli formula over the long term, immediate cessation of it could have resulted in reputational risk for the government caused by reducing the interest payments on government debt; a reduction in liabilities for pension schemes using RPI to revalue and index their pensions; legal implications for trustees over the interpretation of their pension scheme rules; reduced returns on RPI-linked investments; and reduced benefits for pensioners of both defined benefit and defined contribution schemes.[9]

[5] DWP (2010) "CPI as the measure of price increases on private sector occupational pension schemes" https://www.gov.uk/government/consultations/cpi-as-the-measure-of-price-increases-on-private-sector-occupational-pension-schemes

[6] Please see: https://www.plsa.co.uk/portals/0/Documents/0167_CPI_NAPFs_response_to_the_DWP_consultationv3.pdf

[7] ONS (2012) "National Statistician's consultation on options for improving the Retail Prices Index". Please see: https://webarchive.nationalarchives.gov.uk/20160108030655/http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html

[8] RPIJ recalculates the RPI by replacing the Carli averaging method with Jevons. Please see: OBR brief. https://obr.uk/box/revised-assumption-for-the-long-run-wedge-between-rpi-and-cpi-inflation/

[9] Please see: https://www.plsa.co.uk/Policy-and-Research/Document-library/Office-of-National-Statistics-options-for-improving-the-Retail-Prices-Index-consultation-An-NAPF-response

- In 2015, the PLSA responded to the UKSA's consultation which sought users' views on the future development of the UK's range of consumer price statistics.[10] Our consultation response stated that RPI has clearly been shown to be based on an inferior methodology to CPI and we agreed with the approach to abandon the measure. However, we recommended that this move could not occur in isolation from other areas of Government policy, as the RPI legacy has a number of consequences for pension schemes.[11]

3. In order to inform our response, the PLSA has consulted extensively with its members over the proposals in the consultation. While we do not disagree that RPI is an inferior measure of inflation, historically RPI has been around 1% higher than CPIH[12], therefore aligning RPI to CPIH will have a detrimental impact on scheme assets and will cause a significant reduction in the benefits of scheme members.

4. It is disappointing that the consultation did not address the need to mitigate the negative impact the change may have on holders of index-linked gilts, of which pension schemes are the predominant investors, as well as those will be impacted as a result, namely pension scheme members. We urge the government to take steps to ensure the move to CPIH is done so in the fairest and most equitable way possible.

5. The government is also only consulting on the impact on index-linked gilts that mature before 2030 but have not consulted on the impact on index-linked gilts that mature after 2030, which could be significant. We believe the government should also take the impact on longer dated gilts into consideration.

6. The facilitation of the creation of a CPI linked market via the issuing of index linked gilts should also be an option for the government to consider. There is considerable demand among UK pension schemes for instruments that would match CPI based liabilities accurately, and a CPI linked market would address this issue.

IMPACT ON SCHEME MEMBERS & GENERATIONAL FAIRNESS

7. Implementing the alignment of RPI and CPIH between 2025 and 2030 will ultimately reduce the pension benefits for many scheme members, particularly effecting women and younger scheme members. Given the wider social and economic contexts, the Government must take this into consideration before moving forward with any changes.

8. Many schemes use RPI to uprate or increase member benefits, with 64% of private sector schemes required by their scheme rules to index scheme benefits via RPI and

[10] UKSA (2015) "Measuring Consumer Prices: the options for change". Please see: https://www.statisticsauthority.gov.uk/reports-and-correspondence/consultations/
[11] Please see: https://www.plsa.co.uk/Policy-and-Research/Document-library/ONS-consultation-on-consumer-price-indices-An-NAPF-response
[12] ONS (2020) Inflation and price indices. Please see: https://www.ons.gov.uk/economy/inflationandpriceindices

34% of schemes required to use RPI to revalue scheme benefits and 56% using CPI.[13] Those whose pensions are linked to RPI will experience lower benefit increases over time once RPI is aligned with CPIH, meaning they will receive a lower pension benefit than they expected. However, those whose benefits are increased and revalued using CPI are unlikely to see a large impact on their pension as a result of the changes.

9. The change is likely to exacerbate the gender pensions gap. In 2019, the median women's private pension wealth for women in their 60s was found to be £51,100, approximately one third of men's private pension wealth, at £156,500. Implementing the alignment to CPIH will worsen the situation, with the value of the RPI linked pension of a 65-year-old woman expected to fall by 5% if the changes are made in 2025, and 9% if made in 2030. While a 65 year old man whose pension is linked to RPI stands to lose either 4% or 8% of his pension value if the change is made in 2025 or 2030 respectively.[14]

10. By the time the individual reaches their life expectancy, the yearly average DB income with RPI uprating of a man aged 65 in 2020 is predicted see a drop of 17% from £6,300pa to £5,200pa if changes are made in 2025; a woman aged 65 in 2020 will see a drop of 19% from £6,200pa to £5,000pa. If the change is made in 2030, a man aged 65 in 2020 would see his yearly average income fall by 12% from £6,300pa to £5,500pa; a woman would see her income reduce by 14% from £6,200pa to £5,300pa.

11. The impact on those who have purchased an annuity linked to RPI should also be considered. If RPI is aligned with CPIH, then it could be viewed that consumers have overpaid for the annuity as it will provide a lower income than expected over their lifetime.

12. The issue of generational fairness must also be considered, with the reduction in benefits higher for younger members. For example, if RPI is aligned with CPIH, it is expected that 55-year-old deferred members will see an estimated 17% fall in the value of their pension if the alignment is made in 2025 and a 12% reduction if it is made in 2030. Older retirees whose pensions have been aligned to RPI will have been able to benefit from greater pension increases for a longer period of time than those that are younger. It should also be noted those who will bear the cost of the changes will be current employees, who may not necessarily be in the scheme. Any funding gap caused by the change will see employers needing to increase their contributions to fund the DB pension, and consequently may have less to invest in the DC scheme for younger members.[15]

13. The full impact of COVID-19 is still unknown, however, it is likely to have a lasting impact on individuals and the wider economy, with unemployment expected to

[13] PLSA (2017) Annual Survey 2017
[14] PPI (2020) "How could changes to price indices affect Defined Benefit schemes?"
[15] The PPF's Purple Book revealed that 44% of DB schemes were closed to both new members and accrual in 2019.

increase to 4.7% in 2020, up from 3.8% in 2019.[16] We therefore urge the Government to consider how making these changes could add to disparity in pension wealth, particularly to younger people and women, who are already more vulnerable over their lifetime to pay gaps and work security. Those approaching retirement will also be affected, given that they will have had little time and opportunity to adjust to a potentially significant drop in retirement income. For this group of savers it may also lead to an increase in demands for transfers out, which will in the vast majority of cases not be in savers best interests.[17] We believe that the current environment for pensions does not need more uncertainty and confusion for savers.

14. Trust in the pension savings and the government could be potentially damaged by these changes. Members trust their schemes to make investment decisions which ensure they receive the pension they have been promised. By changing the measure of inflation, the government will effectively cut member benefits.

IMPACT ON SCHEMES

15. The PLSA acknowledges that RPI is a flawed measure of inflation, but cautions that if the Government does decide to go ahead with implementing changes to RPI methodology prior to 2030, then there needs to be consideration on the financial consequences on pension schemes.[18] Below, we outline the potential issues schemes could encounter with their assets, liabilities and funding levels in the event that mitigating measures are not put into place.

Assets and Liabilities

16. A simple transition from RPI to CPIH, as proposed in the consultation, is likely to have a material impact on millions of investors, particularly UK DB pension schemes and UK pensioners. The effect of the change for individual pension schemes will depend on the extent to which they are invested in index-linked gilts. However, we know that it will be substantial for the industry as a whole.

17. Currently DB schemes invest an estimated £470bn in index-linked bonds, with 29% of private sector scheme assets invested into index-linked bonds. According to independent research from the Pensions Policy Institute (PPI), simply mirroring RPI to CPIH is expected to reduce the value of these investments by £80bn if done in 2025,

[16] KPMG (2020) "COVID-19 brings UK economy to temporary standstill but upturn expected in 2021". Please see: https://home.kpmg/uk/en/home/media/press-releases/2020/03/covid-19-brings-uk-economy-to-temporary-standstill-but-upturn-expected-in-2021.html

[17] For more information regarding potential harms, please see the FCA/TPR Joint Strategy Statement (2018) https://www.fca.org.uk/news/press-releases/fca-and-tpr-publish-joint-pensions-strategy

[18] Additionally, the Covid-19 pandemic has had an impact on the ONS's ability to collect the necessary data when tracking the cost of goods and services given that they are unable to physically go into shops for an extended period of time (See ONS website here). There is also a question as to whether the "basket of goods" currently used to measure CPI remains relevant. For example, spending on hotels and restaurants, both of which will have fallen significantly in recent months and are unlikely to recover in the near future.

and £60bn if made in 2030.[19] Analysis from others indicates that this figure could be £90bn if the change is made in 2025 or £120bn if made in 2030.[20]

18. While a very small minority view within our membership, it is worth noting that there will be some schemes who benefit from an alignment to CPIH, as it may help some to reduce their liabilities. However, on balance, the PLSA urges the government to think about mitigating negative impacts of such a change on a large number of schemes and members' benefits.

Hedging

19. In the UK an estimated £300bn of pension scheme liabilities are CPI-linked, while £1.1trillion of scheme liabilities are RPI-linked.[21] Many schemes who employ RPI-linked assets in order to hedge their CPI-linked liabilities are likely to experience a material deterioration in their funding position as a result of the change.

20. Many of our DB Pension scheme members hedged against inflation risk using RPI-linked assets and RPI-linked swaps. These de-risking strategies were chosen based on assertions from the government and the regulator that hedging in this way was part of a prudent risk management approach and with the assurance that it would deliver the income level which they purchased.

Funding Levels

21. The Government must consider the likelihood that while the changes may address the flawed inflation measure, they will cause an increase in many scheme deficits unless mitigating measures are put into place.

22. The impact of the change on funding levels will be of particular concern to many DB pension schemes. For those who use RPI-linked gilts, for every £10m invested, it is estimated schemes would see a loss of £1m in asset value if the changes are made in 2030, this figure doubles if the change is made in 2025.[22]

23. The significant fall in income received from RPI-linked gilts will lead to a reduction in scheme assets to meet their liabilities. Any such gap will need to be addressed by increased contributions from employers or by greater returns on assets. As DB schemes in particular are maturing, and may reach peak maturity across this period, they will be seeking to de-risk rather than hold more risk which will make achieving this difficult.

24. It is also important to note that schemes will be facing greater liabilities resulting from lower interest rates. In order to limit the economic disruption of COVID-19, the Bank

[19] PPI (2020) "How could changes to price indices affect Defined Benefit schemes?"
[20] See Pension Age article here.
[21] Alpha Real Capital (2019) "The Slow demise of RPI"
[22] PPI (2020) "How could changes to price indices affect Defined Benefit schemes?"

of England cut the interest rate to a record low of 0.1%[23], however, this will cause lower gilt yields and ultimately, increase pension liabilities. Due the severity of the disruption of COVID-19, the Bank has warned of a longer term risk to the economy, which could see interest rates kept low for the foreseeable future.

25. One of our DB scheme members predicted that as a result of the change to CPIH, there would be a potential fall in their scheme assets of between 15% and 20%, coupled with a fall in liabilities of approximately 3%. Leaving the scheme with a net deterioration in their funding position of approximately 15%, a significant amount which could prove difficult to address. Another of our DB scheme members considers it will see a drop in funding level of c.14% or c.£500 million in cash terms.

26. The potential burden on employers arising from this change must be considered. If the Government decides to align RPI to CPIH without mitigating the negative impacts, it will place a greater need for Deficit Recovery Contributions (DRCs) from the sponsoring employers at a time when many will be struggling to overcome the impact and aftermath of COVID-19. The Pensions Regulator (TPR) had previously allowed sponsors to reduce or suspend DRCs for a three-month period, and has now advised trustees to undertake due diligence on their employer's financial position before agreeing a new suspension or reduction. However, as discussed above, COVID-19 poses a longer term risk to the economy, which could see employers finding it increasingly difficult to meet their pension obligations in future.

27. Any increase to deficits resulting from these changes will lead to a longer amount of time needed for schemes to reach their goal of being fully funded, and potentially increase the risk that they will not meet their obligations. We therefore urge the Government to consider the current pressures on scheme deficits and how implementing the changes without taking steps to mitigate their impact could increase risk of the ability of schemes to meet their long term obligations.

TRANSFER OF WEALTH

28. Depending on the date of the change, on the surface of these reforms' impacts, there will be a large wealth transfer of approximately £90bn[24] from those who hold index-linked gilts – the majority of which are UK pension schemes and insurers - to the UK government. Pension scheme members will be significantly impacted as well, as explored in paragraphs 9 and 10. The government must therefore be as transparent as possible as to where this wealth will go, and who will benefit from this transfer.

29. If the government does not offset the loss of value, or be as transparent as possible, trust in the government, as well as trust in the pensions industry, is likely to be affected

[23] Bank of England (2020) Official Bank Rate History. Please see: https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp

[24] Insight Investment (2019) "Proposed changes to RPI: Nobody needs to lose out". Please see: https://www.insightinvestment.com/globalassets/documents/regulatory-updates/uk-proposed-changes-to-rpi.pdf

– as mentioned previously, many pensions bought RPI linked gilts in good faith and with an expectation of certain returns which have factored into funding plans based on the provision that the methodology for calculating would not be changed. Any such change may seem like the government has reneged on this.

MITIGATION

30. The implications of the change must be addressed in a way which allows various stakeholders to provide input to determine the most equitable way to transition away from RPI. A precedent has already been set for reforming benchmarks, as in the case of LIBOR, where a Working Group was established to ascertain that the transition to the replacement index, SONIA[25], minimised the impact on stakeholders.[26] We believe the government should consider implementing a similar approach.

31. In order to transition away from the use of RPI in a fair and equitable way, we also suggest the government and the UKSA deliberate adjusting index-linked gilts from RPI to CPIH + X, where X is an agreed and transparently calculated adjustment reflecting the expected long term average future income of RPI over the new inflation measure. Also known as the CPIH + spread, it would ensure gilts and benefits would continue to be paid out at the index measurement, plus the spread.

32. By doing this, the government would ensure that both holders of index-linked gilts and pension scheme members do not lose out.

33. Alternatively, the Government may also wish to consider paying any future lost income to index-linked gilt holders upfront. However, there is a risk too that this may not work for all the other assets linked to RPI such as swaps and infrastructure. Additionally, any member with RPI-linked benefits effectively see a cut in their benefits whilst the pension fund assets will remain unchanged.

TIMING OF THE CHANGES

34. We urge the government not to implement these changes without mitigating any negative impact they will have and we believe these changes should be made as close to 2030 as possible; this will be a more viable solution allowing for the establishment of a Working Group for the transition, giving investors in index-linked gilts enough time to prepare while also providing a better outcome for pension scheme members. As described previously, if the government were to implement the change in 2025 compared to 2030, pension scheme members would stand to lose 4% more of their pension value. This is a substantial amount (please see paragraphs 9 and 10).

[25] The London Interbank Offered Rate (LIBOR) was a benchmark interest rate used by global banks lend to one another in the international interbank market for short-term loans. It was replaced by the Sterling Overnight Interbank Average Rate (SONIA).
[26] Bank of England (2020) Transition to sterling risk-free rates from LIBOR. Please see: https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

35. However, we do believe the decision as to when to align RPI to CPIH should be made as soon as possible to lessen the uncertainty for investors and markets.

36. If the government does decide to push ahead and implement the change between 2025 and 2030, we believe they must consider the issues outlined in our response, and ensure a fair and equitable approach is taken to ensure any negative implications are addressed.

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