In Touch technical update

Future for RPI confirmed

HM Treasury and the UK Statistics Authority (UKSA) have published a response to their March consultation on the Reform of the Retail Prices Index (RPI) Methodology. From 2030, RPI is now expected to be calculated in line with CPIH.

At a glance…

- Chancellor will not consent to a change to RPI before 2030
- It is UKSA policy to address the shortcomings of RPI in full at the earliest practical time. The change to CPIH can legally and practically be made by UKSA in February 2030.
- The Government will not offer compensation to the holders of index-linked gilts

Why bring you this note?

HMT and UKSA have published their response to the consultation on RPI reform.

Next steps

Speak to your usual Aon consultant regarding implications for your scheme

Background

In January 2019 the House of Lords' Economic Affairs Committee published a report on the use of the Retail Prices Index (RPI), which was critical of flaws in RPI remaining unaddressed, and raised the prospect of RPI being replaced.

On September 4, 2019, the then Chancellor published a response to this report and announced that a consultation would take place in early 2020 on proposals to align the calculation of RPI with that of the Consumer Prices Index including owner occupiers' housing costs (CPIH) from a date between 2025 and 2030.

The response explained that if this change is to be made before 2030, the consent of the Chancellor would be needed (the requirement for consent falls away in 2030 when the last 'relevant' gilt, to which this consent requirement applies, expires). The Chancellor noted that the UKSA had signalled that "it is unlikely that the UKSA in 2030 would take a different view", suggesting that the change was likely to be made in 2030 if consent was not given for an earlier change. It was also confirmed that the Chancellor would not consent to the introduction of the change any earlier than February 2025.

The consultation was published in March 2020. It focused on whether the change should be made at a date other than 2030 and, if so, when between 2025 and 2030, along with the technical details of the change.

Prepared for: Aon clients
Prepared by: Aon's In Touch Group
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Consultation outcome

The consultation response confirms that the Chancellor will not consent to a change in RPI before 2030.

The response confirms that it is UKSA policy to address the shortcomings of RPI in full at the earliest practical time. The change to CPIH can legally and practically be made by UKSA in February 2030.

In addition, the Government will not offer compensation to the holders of index-linked gilts.

As a result of the consultation, the calculation of RPI is expected to change from February 2030, so that in future it will be calculated in line with CPIH.

RPI versus CPIH

In practice the change will mean that RPI inflation will be expected to increase at a lower rate after 2030.

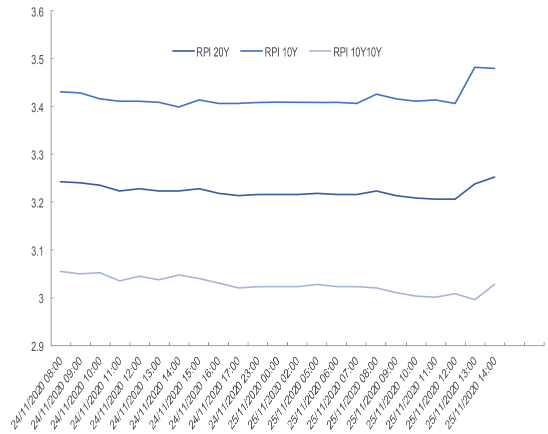
Over the long term, CPIH inflation is expected to be similar to CPI inflation - which is already in common use in occupational pension schemes.

Both CPIH and CPI inflation are expected to be materially lower than RPI, on average.

Market reaction

Market reaction has been relatively muted. The biggest move was seen in 10-year swaps where there was relief that there was to be no move prior to 2030.

The graph below shows inflation expectations from the RPI swap market, over the period from 8am on 24 November to 2pm on 25 November, just after publication.



Source - Bloomberg

30 year RPI swaps and Index-Linked Gilt breakevens had declined nearly 50bps since the House of Lords report although some of this can be attributed to changes in Brexit expectations and the Covid epidemic.

Impact on scheme funding

Many schemes have liabilities that are linked to RPI and investments in index-linked gilts (ILGs). The impact on scheme funding positions will be scheme specific, but in general (over the period since the change was first proposed):

- For well-hedged schemes using ILGs to hedge RPI-linked liabilities, there is unlikely to be a material change in the funding position;
- For schemes that use ILGs to hedge CPI-linked liabilities, a change from RPI to CPIH is likely to lead to a deterioration in the funding position; and
- For schemes that are not well hedged but have RPI-linked liabilities, a change from RPI to CPIH is likely to lead to an improvement in the funding position.

Impact on members

Where schemes provide benefits linked to RPI, a change from RPI to CPIH is likely to lead to lower expected benefit payments to members in the future (from 2030).

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