

**The Impact of using CPI as the
measure of price increases on
private sector occupational pension
schemes**

**a response by the National
Association of Pension Funds**

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Executive summary

- The NAPF strongly supports the Government's commitment, set out in the Coalition Agreement, to 'reinvigorate occupational pensions'. We share the Government's view that greater simplicity and flexibility could play a key role in strengthening retirement saving.
- The process of developing the CPI policy has been poorly handled. The Government raised expectations that pension schemes would be given a power to modify their rules, but then decided against this course of action.
- The handling of this issue has generated extra complexity and uncertainty for schemes. Many schemes are already incurring costs as they take legal and other advice on what changes they can or cannot make to their own rules and how they should go about any such changes.
- The Government has created a drafting lottery: many scheme members will find that their pension depends on how their scheme's rules were drafted when the scheme was first established. This may have been some decades ago, at a time when there was no reason for debate over the best measure of inflation and when CPI had not even been invented.
- The NAPF welcomes the decision to allow those schemes that continue with RPI to use RPI even in those years where CPI is higher.
- Introducing a new statutory requirement that schemes must consult their members over changes to their rules on inflation increases could introduce unnecessary rigidity into the process. Schemes should be free to take their own decisions on how best to consult.
- There are potentially significant implications for many schemes' investment strategies. The NAPF is working to assess the likely demand for CPI-linked gilts and we are currently conducting a member survey to give us a better understanding of pension schemes' views on this important issue. We are keeping the Debt Management Office informed.

About the NAPF

The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes and 400 businesses providing essential services to the pensions industry. Our members provide pensions for 15 million people. Collectively they own assets of £800 billion. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

The NAPF's approach to the consultation

The NAPF welcomes the opportunity to respond to the DWP's consultation on the impact of using CPI for pensions increases in private sector occupational pension schemes.

The NAPF strongly supports the Government's commitment, set out in the Coalition Agreement, to 'reinvigorate occupational pensions'. We share the Government's view that greater simplicity and flexibility could play a key role in strengthening retirement saving.

It is unfortunate that the present proposals - and the process that led up to them - have instead created an unwelcome period of uncertainty for pension schemes and their members. It should be noted that schemes are already incurring costs as they take legal and other advice on what changes they can or cannot make to their own rules and how they should go about any such changes. We note that these costs are not factored into the Regulatory Impact Assessment issued by the DWP on 11th February.

One of the regrettable consequences of the policy is that the Government has created a drafting lottery: for many members, their pension will depend on how their scheme rules were drafted when their scheme was set up – perhaps some decades ago at a time when there was no reason for debate over what measure of inflation to use and when CPI had not even been invented.

Many schemes will now be considering the potential implications for their investment strategy and, in particular, whether they would wish to purchase CPI-linked gilts in order to match CPI-linked liabilities. The NAPF is working to assess the likely demand for CPI-linked gilts and we are currently conducting a member survey to give us a better understanding of pension schemes' views on this important issue. We are keeping the Debt Management Office informed.

We also note that the Office of National Statistics is currently reviewing the composition of the Consumer Price Index itself, and it seems possible that this work may lead to a measure of housing costs being included. This inevitably causes further uncertainty and makes it more difficult for schemes to plan their investment strategies.

NAPF member survey

In order to inform its response to the Government's proposals, the NAPF conducted a member survey in September 2010. 162 NAPF members responded, and their answers and comments form the basis of this response. A key theme to emerge from this work was the sheer variety of scheme rules on indexation and revaluation; the selection below gives a flavour:

NAPF member comments on scheme rules for indexation and revaluation

On indexation

"As a multi employer scheme we have a mixture of specific reference to RPI and to statutory requirements."

"A mixture of RPI and in line with statutory requirements - varies with history and different tranches of benefit. The vast majority of the liabilities are linked to RPI wording."

"Increase by RPI subject to a cap. In one of our schemes the LPI cap is 5% / 3.5% rather than 5%/ 2.5%".

"Increase for some members is RPI. Increase for majority is in line with increase under pension increase order."

On revaluation

"Our scheme has 2 sections. One revalues by RPI up to 5%, the other in line with statute."

"Rules are silent so revaluation in line with statutory requirement."

"We have three schemes with numerous sections, some RPI but where trustees have the power to select an alternative index if they believe it to be more appropriate but majority revalue in line with statutory requirements."

Answers to the consultation questions

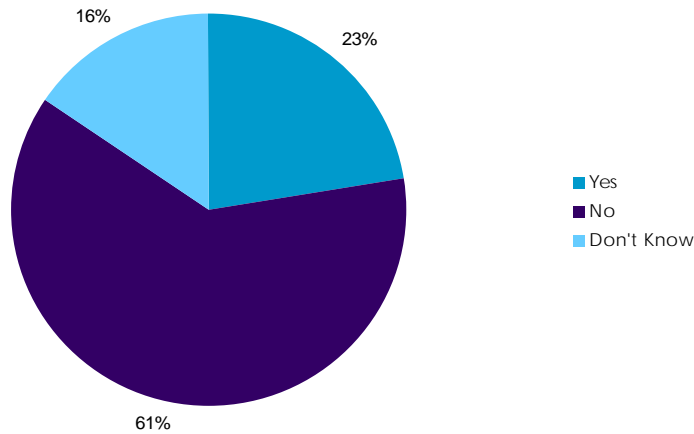
Q1. The Government welcomes views on whether the impact of using CPI has been correctly summarised.

The summary is correct. It is particularly important to appreciate the sheer variety of scheme rules on inflation, as described in feedback to an NAPF survey already shared with DWP officials (a further copy is attached as an annex to this response.) Many schemes have several sections, each with different rules. This is usually a result of past mergers and restructuring exercises. These schemes may find that they can switch to CPI for some employees, but not for others – a 'rules lottery'.

The impact of using CPI as the measure of price increases on occupational pension schemes: a response by the NAPF

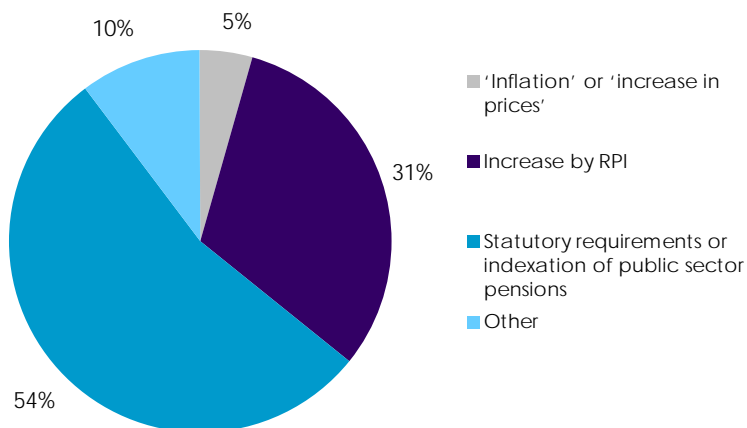
The NAPF's survey also provides useful data on the extent to which schemes will be able to switch to CPI. 61% of schemes say their rules would *not* permit them to switch to CPI for indexation – mostly because they have RPI written into their rules.

Fig 1: Do your scheme rules permit you to switch to CPI?



The picture for revaluation of deferred pensions is quite different. More than half of schemes - 54% - follow 'statutory requirements' or the approach used for public sector pensions. Only 31% have rules that specify RPI.

Fig 2: What do your scheme rules say about the way in which pensions in deferment should be revalued?



Q2. The Government welcomes views on whether it is right to apply the employer consultation requirements in respect of changes to scheme rules on indexation and revaluation.

Good practice suggests that schemes would want to consult members about changes to indexation or revaluation, but making this a statutory requirement could introduce unnecessary rigidity into the process. Schemes should be free to take their own decisions on how best to consult.

Furthermore, the statutory minima for revaluation and increases to pensions in payment already provide a good degree of protection for members.

The NAPF also has reservations about the way in which the potential costs of this new policy are factored into the revised Regulatory Impact Assessment published by DWP on 11th February. This assumes that the communications involved in consultation would cost £0.68 per member. The view of NAPF members is that the costs would be much higher.

One member commented that the cost of writing to all members in a 20,000-strong scheme is around £20,000. A full consultation exercise would, of course, be more expensive than this £1.00 per head unit cost for a simple 'one-way' round of communication.

Q3. The Government welcomes views on the draft Occupational Pension Schemes (Consultation by Employers – Amendment) Regulations 2011.

It would be useful if the DWP could issue clear guidance on which members schemes would be obliged to consult. Section 7 of the *Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006* indicates that the 'affected members' whom schemes must consult on 'listed changes' are 'the active or prospective members of the scheme to whom the listed change relates'. This raises the prospect that schemes would be obliged to consult employees who are not yet members of the scheme (and perhaps never will be), but would *not* be obliged to consult pensioner members, who clearly would be affected. The DWP should clarify its intentions on this point.

This reinforces the argument set out above – that schemes should be able to decide for themselves which members (or employees) to consult.

Q4. The Government welcomes views on whether there are any issues that should be considered in respect of career average arrangements.

The key issues that arise in relation to CARE schemes relate to the proposal discussed in question 2 above – the suggestion that changes to the index used for indexation or revaluation should become 'listed changes' that require 90-day formal consultation.

This proposal is causing serious concern among NAPF members that operate CARE schemes. Many CARE schemes only grant *discretionary* revaluation to career average benefits, as there is no statutory requirement to provide any revaluation at all if active member and deferred pensioners are treated in the same way. It seems unnecessary to have a listed change that applies to a discretionary practice.

Q5. The Government welcomes views on whether there are any issues that should be considered in respect of GMPs.

Scheme rules rarely specify the inflation index to be used for uprating GMPs in payment, so we would expect most schemes to switch automatically to CPI for these purposes.

There do not appear to be any issues of principle that would cause the NAPF to suggest an alternative approach to GMPs. Nevertheless, the Government should be aware that a change in inflation increases for GMPs could be particularly significant for those with shorter periods of service, for whom the GMP element of their pension tends to be greater.

Q6. The Government welcomes views on whether there is any justification for overriding the rules of private sector occupational schemes to impose CPI as the measure of increase in prices.

The NAPF is pleased that the uncertainty over the Government's intentions in this area is being resolved. The uncertainty has been damaging to confidence in pensions and has led many schemes to incur costs by seeking legal advice on what changes their scheme rules would or would not permit.

The priority now should be to provide final clarification of the policy as soon as possible so that schemes can implement the change where appropriate.

Q7. The Government welcomes views on whether there are other reasons why a scheme whose rules do contain a modification power would nonetheless be unable to, or find it difficult to, use CPI for indexation and revaluation.

There is a very wide range of scheme rules, but the NAPF is not aware of any reason why a scheme whose rules do contain such a power would be unable to make the switch to CPI - other than considerations that trustees would naturally bear in mind when making any decision, including whether the change would be in the interests of the members and the costs and practicalities of making such a change.

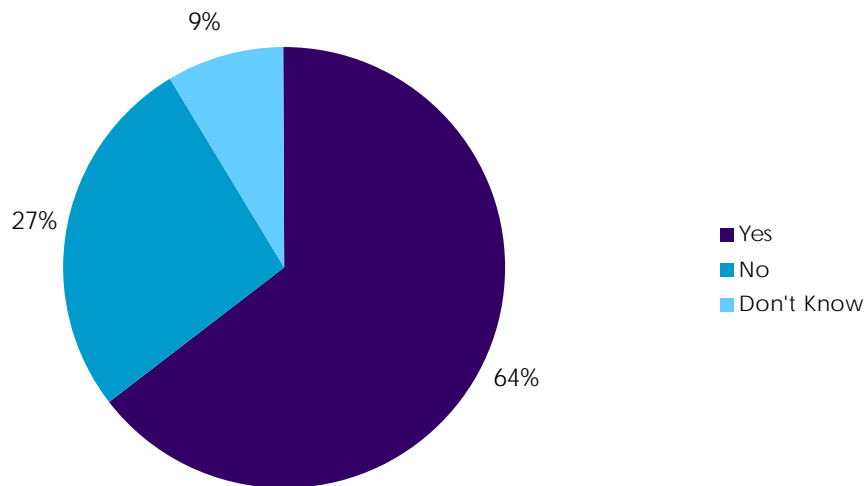
Trustees are already dealing with a wide range of challenges, and many will be relieved that they do not have to take a difficult decision on whether to make use of a 'modification power' to switch to CPI.

Q8. The Government welcomes views on whether it is right to rule out granting modification powers.

The NAPF recognises – as the consultation paper notes – that there are arguments for and against the introduction of a modification power.

In the NAPF’s member survey, a majority of members (64 per cent) was in favour of amending legislation, but a significant minority (27 per cent) took the opposite view.

Figure 4: Do you think the Government should provide legislation allowing schemes that have RPI written into their rules to use CPI instead?



It was disappointing that the Government raised expectations that a modification power would be provided, only to decide against this course of action.

One of the regrettable consequences of the policy is that the Government has created a drafting lottery: for many members, their pension will depend on how their scheme rules were drafted when their scheme was set up – perhaps some decades ago at a time when there was no reason for debate over what measure of inflation to use and when CPI had not even been invented.

The Government should note that its approach may strengthen incentives for people to take their pensions earlier rather than later, as there will now be more schemes where revaluation of deferred pensions will be based on CPI but indexation of pensions in payment will be based on RPI. Some workers will note that their benefits would be treated more generously if they were to crystallise them, rather than leaving them to be taken at a later date. This would appear to run counter to the Government’s wider objective of encouraging people to work longer.

Q9. The Government welcomes views on whether there would be a way to restrict any modification power to those schemes which had previously adopted RPI solely in order to match the statutory minima.

We believe there are significant numbers of schemes that adopted RPI because it was the measure used for statutory purposes. However, there are very few such schemes that would have wished to refer both to RPI and statutory increases in their rules; most would have opted to refer to RPI.

It is difficult to think of a simple way of distinguishing between these schemes and those that adopted RPI for other reasons. We would urge the DWP not to add extra complexity to the current proposals.

Q10. The Government welcomes views on whether you agree that the issue of CPI underpins should be addressed.

The NAPF agrees with the Government's approach to this issue. The proposed solution is sensible and has been welcomed by our members.

Q11. The Government welcomes views on whether there are any other options to address the CPI underpin issue.

There is no need for any further options. The proposed approach should deal with the issue satisfactorily.

Q12. The Government welcomes views on whether the proposed amendments to remove references to RPI from primary legislation are satisfactory.

The amendments appear satisfactory.

Conclusion

The period since the Government's initial announcement on CPI in private sector schemes has been marked by damaging uncertainty for pension schemes, trustees and members. The NAPF urges the Government to bring this to a swift conclusion so that schemes can focus on the other challenges that they face.

In the meantime, the NAPF remains ready to assist the DWP with any further information that may be required.

James Walsh

Senior Policy Adviser: workplace pensions, NAPF, March 2010

Annex: NAPF member survey, December 2010

CPI: THE VIEWS OF PENSION SCHEMES report on an NAPF member survey

This report sets out the views of NAPF members on the Government's plans to allow private sector pension schemes to switch from using the Retail Price Index (RPI) to the Consumer Price Index (CPI) as the basis of indexation of pensions in payment and revaluation of deferred pensions.

It presents findings on pensions schemes' current approaches to indexation and revaluation, examines how easily they could make the switch to CPI and considers how any necessary changes to scheme rules could be made.

Key findings

- Comments from NAPF members (a selection is given in this report) illustrate the complexity and variety of pension scheme rules. Many schemes have several sections – each with different rules.
- 68% of schemes have RPI written into their scheme rules on indexation.
- 61% of DB pension schemes say they would not be able to make the switch to CPI indexation without some form of legislative assistance.
- Almost half of schemes (48%) would make use of legislation that helps them to switch to CPI. A further 31% 'don't know' on this point. It is likely that many of these are waiting to see the details of the legislation before deciding on their approach.
- Only 31% of schemes have RPI written into their rules for revaluation of deferred pensions. 54% of schemes follow 'statutory requirements' or adopt the increase used for public sector pensions.
- 55% of schemes feel the decision to switch to CPI should be a matter for the employer acting with trustees' consent.

Notes on the survey

This online survey was conducted between 1st and 13th September 2010. 162 NAPF members responded.

In addition to answering a number of specific questions, members were also invited to supply comments, a selection of which is highlighted below. These underline one of the key factors in the current CPI debate – the sheer variety and complexity of pension scheme rules.

NAPF member comments on indexation

“As a multi employer scheme we have a mixture of specific reference to RPI and to statutory requirements.”

“A mixture of RPI and in line with statutory requirements - varies with history and different tranches of benefit. The vast majority of the liabilities are linked to RPI wording.”

“Increase by RPI subject to a cap. In one of our schemes the LPI cap is 5% / 3.5% rather than 5%/ 2.5%”.

“Increase for some members is RPI. Increase for majority is in line with increase under pension increase order.”

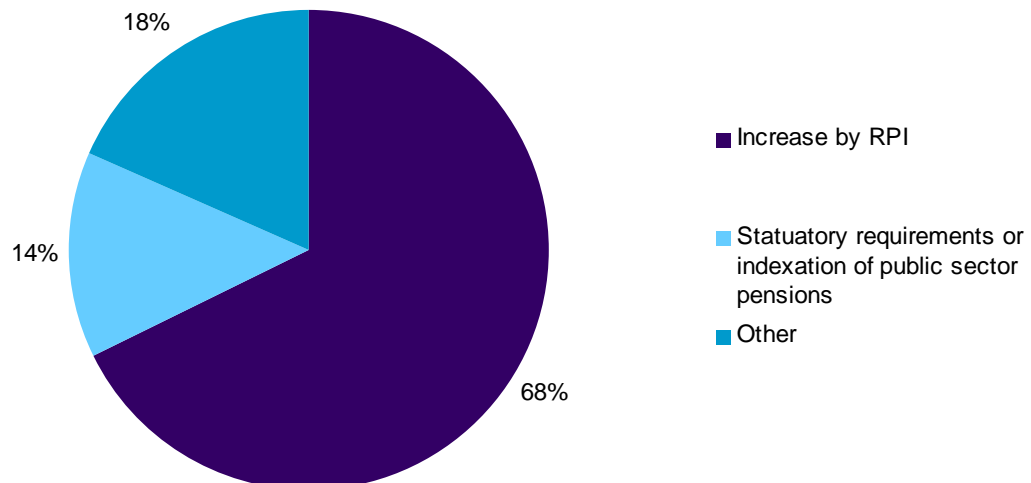
“RPI min 3% / max 5% post-1997; pre-1997 3% on non-GMP, GMP 88-97 3%; other GMP 0%.”

Scheme rules on Indexation

It has been widely assumed that many schemes will not immediately be able to make the switch to CPI because they have another specific measure of inflation (typically RPI) written to their rules.

The NAPF survey shows that 68% of schemes have RPI written into their scheme rules on indexation. 14% follow ‘statutory requirements’ or the increase used for public sector pensions. 18% gave details of ‘other’ arrangements’.

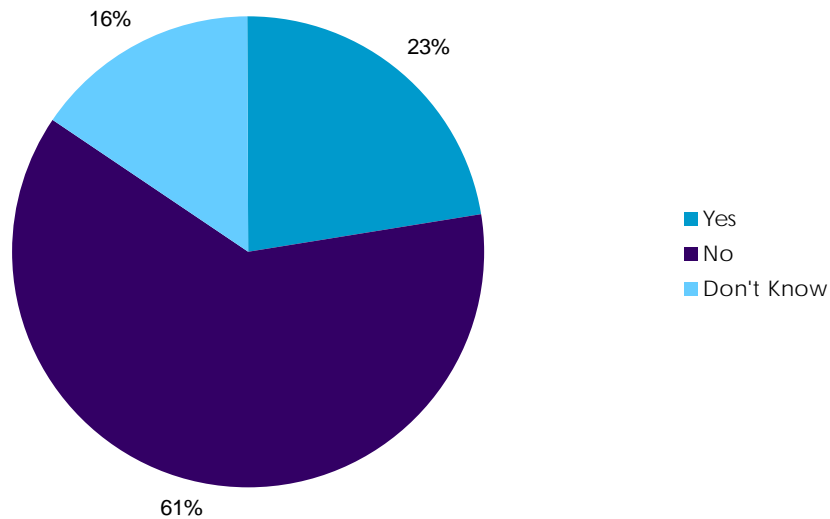
Figure 1: What do your scheme rules say about the way in which pensions in payment should be increased?



Base: 158 respondents

We then asked whether schemes would be *able* to make the switch to CPI indexation. As the chart below shows, 61% of schemes say their rules would *not* permit them to make this change:

Figure 2: Do your scheme rules permit you to switch to CPI?

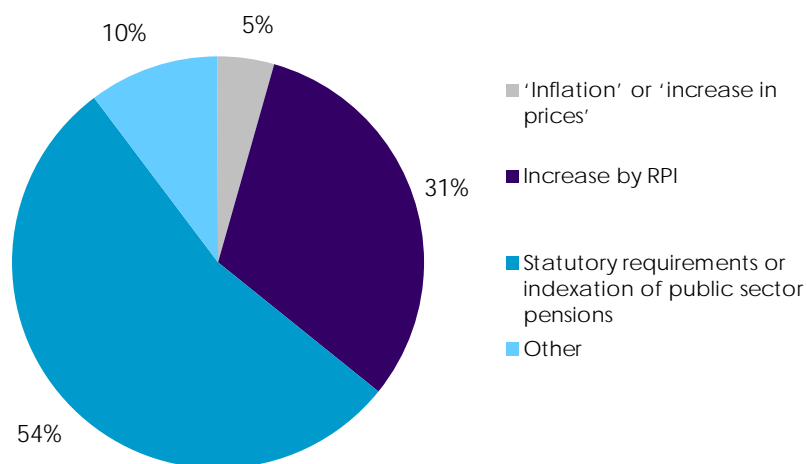


Base: 160 respondents

Scheme rules on revaluation

The picture for revaluation of deferred pensions is quite different. More than half of schemes - 54% - follow 'statutory requirements' or the approach used for public sector pensions. Only 31% have rules that specify RPI.

Figure 3: What do your scheme rules say about the way in which pensions in deferment should be revalued?



Base: 157 respondents

NAPF member comments on revaluation

“Our scheme has 2 sections. One revalues by RPI up to 5%, the other in line with statute.”

“Rules are silent so revaluation in line with statutory requirement.”

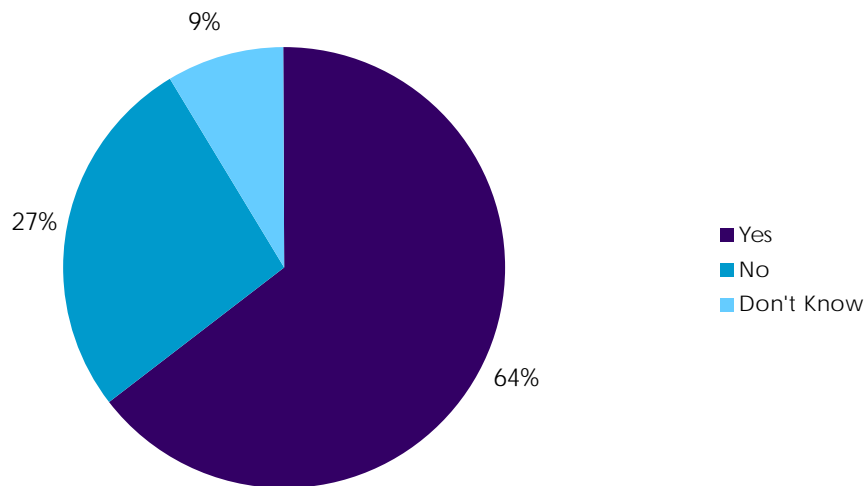
“We have three schemes with numerous sections, some RPI but where trustees have the power to select an alternative index if they believe it to be more appropriate but majority revalue in line with statutory requirements.”

“Increase in line with the increase in the cost of living.”

As the results above demonstrate, many schemes will be unable to make the CPI switch without some form of Government assistance. It is understood that DWP are considering providing such overriding legislation, probably in the form of an 'amending power' that schemes could choose to use if they so wish.

The NAPF survey shows that 64% of respondents say the Government *should* provide legislation that enables schemes that have RPI indexation written into their rules to switch to CPI.

Figure 4: Do you think the Government should provide legislation allowing schemes that have RPI written into their rules to use CPI instead?



Base: 160 respondents

NAPF member comments on need for legislative assistance

“Flexibility to move to CPI would be generally welcomed.”

“Every scheme should have an individual right rather than the Government being prescriptive.”

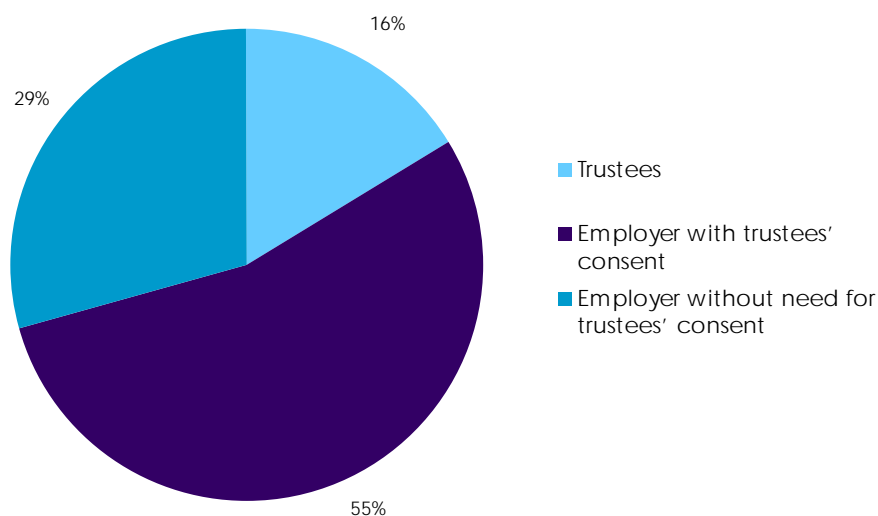
“Any help in keeping lid on liabilities is welcome.”

“Absolutely not. This is the thin end of a wedge that would allow Government to change any scheme rule it liked to the detriment of members. Incidentally, this change will not prolong the life of DB schemes or make them materially more affordable.”

Providing legislative assistance for the CPI switch is one thing. Deciding who should be able to use it is another.

When asked who should be able to make use of such legislation, 55% of our respondents said this should be a matter for the employer acting *with* the trustees’ consent. 29% said it should be the employer *without* the need for trustees’ consent. 16% said it should be a matter for the trustees alone.

Figure 5: Who should be able to make use of legislation allowing schemes that have RPI written into their rules to use CPI instead?



Base: 146 respondents

NAPF member comments on employer or trustee decision

"I think the Trustees and Employers should have the ability to discuss and decide the best way forward for their scheme, depending upon funding levels, savings etc."

"If the legislation requires trustee consent then we think very few trustees would feel able to make this change."

"The scheme ought to reflect a negotiation between the members, the trustees, the employer, and the actuary. We don't want government coming down on one side or the other for party political reasons."

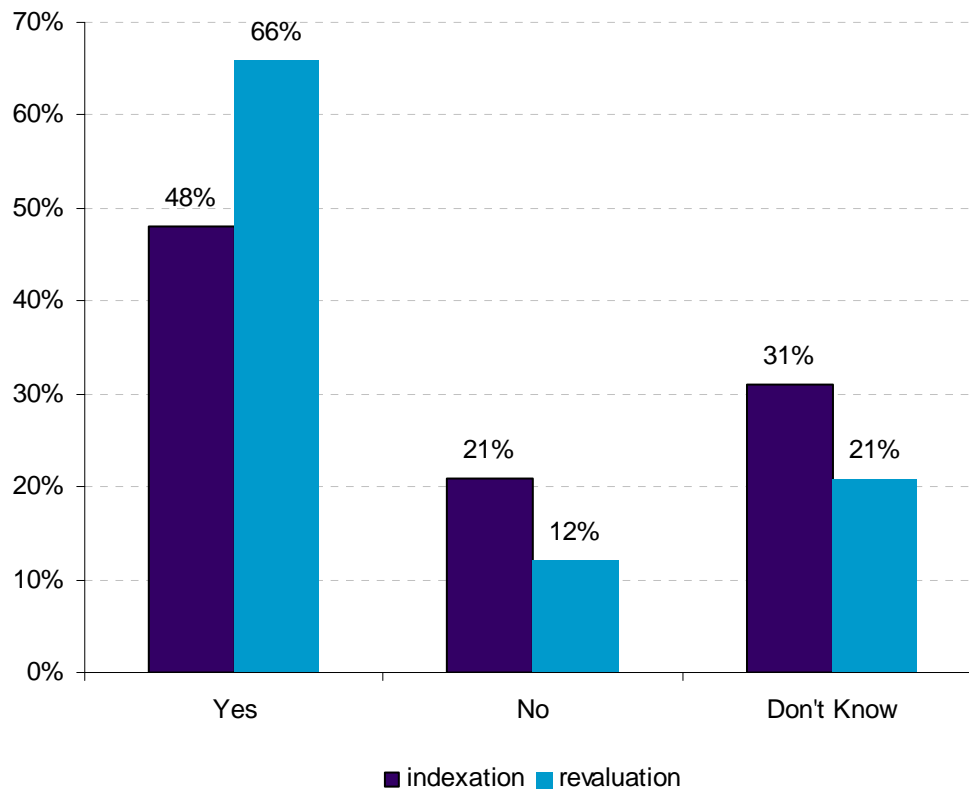
Demand for legislation

There is still a wide range of views on whether NAPF members would make use of legislation to help schemes change their rules.

In practice, much will depend on the precise form of the legislation; this is undoubtedly why 31% of respondents are in the 'don't know' camp in relation to indexation. However, almost half of respondents – 48% - said they *would* make use of such legislation for indexation purposes.

The situation looks more straightforward for revaluation, where 66% said they *would* use such legislation and only 21% were 'don't knows'.

Figure 6: If the Government provides the necessary legislation, would you expect to make the switch to CPI for (i) indexation and (ii) revaluation of pensions in deferment?



Base: 157 respondents for indexation, 155 for revaluation