National Statistician's consultation on options for improving the Retail Prices Index

November 2012

www.napf.co.uk

Contents

Executive Summary

The NAPF believes the ONS should continue its on-going research programme into the formula effect and consult on the way forward once the comprehensive results are available.

We accept the argument for ceasing use of the Carli in the RPI calculation in the longer term. However, the ONS must ensure the design of the RPI is appropriate in all regards before recommending any changes to the formulae used in its calculation.

The reduction in RPI that would be caused by ceasing use of the Carli at this time would have a number of serious ramifications including:

- A reputational risk for the UK 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
- Reduced benefits for pensioners of both defined benefit and defined contribution schemes

These impacts must be afforded adequate consideration by the ONS, Bank of England and the Chancellor of the Exchequer before any decision is taken.

The NAPF recommends that no change is made for the time being. Although a rationale for change exists the case has not been made and now is not the right time.

Options for improving the Retail Prices Index

The NAPF accepts the argument for ceasing the use of the Carli in calculation of the RPI in the longer term. However, we have some serious concerns about the immediate impact of cessation of use and the wider implications of any change.

The emphasis by the ONS on bringing the RPI into line with CPI seems misplaced. The macroeconomic principles underlying the CPI make it suitable for certain purposes (eg a monetary policy target). However the uses of RPI are historically very different, including interest rates on index-linked gilts, social rent increases and wage negotiations.

The ONS' primary objective must be to ensure the design of the RPI is appropriate in its calculation, content and application, not to reduce the formula effect by bringing it into line with the CPI. We are aware of the on-going research the ONS is conducting into the RPI and CPI such as sampling methods and methods of price collection. It seems premature to target the removal of the formula effect before this research is completed. We believe any decision to change the formula used in the RPI should be conducted in the round once all the necessary information has been assessed and disseminated for consultation by the ONS.

Making a change now, which is not clearly understood and justified, and without taking into account the wider implications of the decision, is likely to be alleged as being politically motivated as the changes proposed would result in large savings for the Government.

The options proposed for change have some very significant ramifications if implemented immediately. We are concerned that the consultation document only commits to noting the consequences of any potential change. These consequences are large and need to be afforded the appropriate consideration.

Reputational risk for the UK Government and the ONS

Investors in index-linked gilts have always understood how those instruments are priced, and have bought the bonds on the basis of the old RPI formula.

Any perception that the UK Government is reneging on its promise to honour interest payments would almost certainly lead to a loss of trust. Any loss of trust could result in a risk premium being attached to future UK Government issuance which would affect conventional as well as inflation linked gilts.

It is not clear as yet whether any change would apply to existing or only new bond holders. If a downward change to RPI is introduced for existing index-linked gilt holders the loss of trust among this group of investors is likely to be even more extreme.

Furthermore this reputational risk could extend to the ONS. Whilst it is true that the formula effect has increased recently, it has always existed. The ONS is at risk of being accused of using this statistical issue as an excuse to reduce the Government's liabilities if it recommends a change to the RPI unless the change can be convincingly justified on the basis for comprehensive research and consultation.

Impact on UK pension schemes

As major investors in gilts, defined benefit pension schemes have a strong interest in the calculation of RPI. Because of the impact on scheme liabilities and future benefits, the stability of inflation indices is an important factor both for those running defined benefit schemes and their members. The ONS should therefore take a long-term view on any changes to the index.

Each of the options for change proposed by the ONS looks likely to lead to a reduction in the level of RPI. This will improve the funding position of many schemes which still use the RPI index to revalue their future liabilities and index pensions in payment. The funding improvement has been estimated by Grant Thornton to be as much as £80 billion[1]. One NAPF member calculated that a 0.25% fall in the annual RPI could lead to a 4% fall in liabilities.

Schemes which have fully hedged their inflation exposure will not be affected. However, the average scheme has only hedged 25% of its inflation exposure.

A reduction in liabilities could lead to pension schemes being more sustainable and therefore result in a larger number of defined benefit schemes remaining open. However, whilst this is beneficial for schemes using RPI to index and re-value their pensions and for scheme members who benefit from retaining their defined benefit pension, albeit on reduced terms, it has a negative impact upon members already in receipt of pension who will have factored larger increases into their expected income in retirement.

Legal Implications

In the event a change is implemented there have been calls for the ONS to continue publication of the previous index for comparison purposes. We believe that such a move could cause potential legal complications and additional costs for pension schemes.

The inflationary measure used to revalue and index pension scheme benefits is that which is set out in the scheme rules. For schemes which use RPI, if two figures were published it could cause confusion and legal uncertainty. Scheme rules and administrative practices will not have been established with this possibility in mind. It would be arguable that the trustees could choose either figure, but in doing so they would need to take members' interests into account. Many trustees may feel reluctant to make this decision without taking legal advice which would add a further cost burden to already pressured pension schemes.

[1] Pensions Perspectives, October 2012

Impact on UK index-linked bond holders

Pension schemes which are already revaluing future benefits based on CPI will not benefit from a reduction in liabilities but will still be negatively affected as holders of index-linked gilts. Lowering RPI would lower the future nominal returns for index-linked investors. An estimate from Standard Life indicated that an 80bp drop in the RPI would result in a government saving of £3bn per annum in interest payments[2]. Other investments which are linked to RPI would also be affected eg. Infrastructure and property, two asset classes that are increasingly popular with pension schemes.

Impact on UK pensioners

Defined benefit

The improved position for pension schemes revaluing benefits using RPI does of course have the counter-effect of reducing the ultimate member benefits.

When the Government amended the index for revaluation and indexation of pensions from RPI to CPI in 2011, those schemes whose rules allowed the switch saw the initial value of their pensions in payment become lower and the pension decline in real value more quickly due to the lower limit of indexation. A similar effect would now be seen if the level of RPI were to reduce as predicted by the ONS.

Defined Contribution

Pensioners who have purchased an annuity and have taken the responsible step of choosing to link future increases to RPI will see their pension in payment increase at a slower rate than they understood on purchasing the annuity.

The annuity provider may benefit from lower than expected pension payments. However, the amount of benefit experienced by the provider will vary. Annuity providers are also likely to be holders of significant levels of index-linked gilts on which they will see a reduction in nominal returns.

It could be argued that an implicit contract is being broken with pensioners as it is with index-linked gilt holders. Pensioners, too, have accrued their pension on the understanding that RPI will be calculated in a particular way. There is already concern that RPI understates the level of inflation for pensioners as they tend to spend more on items with higher inflation (such as fuel) and less on items with lower inflation such as technology.

If the Carli is replaced with either the Dutot or the Jevons, both of which have a similar outcome on the level of the index, pensioners will almost certainly face higher inflation than official figures claim. Pensioner representatives are likely to call for the introduction of yet another index which more accurately reflects the cost of living for pensioners. For pension schemes the rising number of

[2] Retail Prices Index, Potential changes to calculation of UK RPI, October 2012

inflation indices complicates the range of benefit definitions being used for deferred members and accruals, and makes it more difficult to find 'matching' investments.

Finally, the change to the index is likely to be extremely difficult for the lay person to understand and thus may cause substantial anxiety among pension recipients.

Length of the consultation period

The NAPF would like to comment on the length of the consultation period of 8 weeks. The ONS has stated that as it provided prior warning of the consultation, respondents had sufficient time to consider the options. However, the rationale and full details of the ONS proposals were not published until 8 October 2012 which we feel was insufficient time to consider such an important change.

Equality impact assessment

We look forward to seeing the ONS' equality impact assessment of any decision before implementation of any change.

Private housing rentals

The NAPF supports the proposal to change the source for the data for private housing rental prices.