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RPI reform – round 2

By Stephen Ruggiero – Derivatives Quant Manager

The sterling inflation market was rocked at the beginning of September as letters exchanged between the UK chancellor of the exchequer and the chairs of the UK Statistics Authority (UKSA) and the Economic Affairs Committee created renewed uncertainty around the future of the Retail Price Index (RPI) and a possible switch to a version of the Consumer Price Index (CPI) – the Consumer Price Index including owner occupiers' housing costs (CPIH).

Subject to a consultation starting next year, the UKSA is ultimately recommending that RPI, which has existed for many years, switches to CPIH, which is a relatively new measure, in the future. This would have significant downward pressure on RPI – in the region of 0.5% to 1.0%. In his announcement of the consultation last week, the chancellor also confirmed that, after 2030, government consent will not be required to alter RPI methodology, potentially leaving its fate beyond this date purely in the hands of the statisticians.

Care and attention is required by pensioners, pension schemes and their advisers in relation to the potential future impact of any reforms.

Here we go again ...

The consultation announcement is highly reminiscent of the Consumer Prices Advisory Committee (CPAC) consultation in 2012, which asked whether the RPI calculation methodology should change, with an expectation that any change would lower RPI. However, the outcome of the consultation was to make no changes and the market rebounded from the prolonged period of uncertainty during the consultation. Pensioners and many pension schemes breathed a sigh of relief that their RPI income/assets would not be subject to a 'haircut' – an imposed reduction in value – that would have resulted from a methodology change. However, the government took the opportunity to issue a large amount of very long-dated inflation-linked gilts to a naïve investor base – one that had assumed there was no prospect of future RPI reform.

What does the latest uncertainty mean for inflation?

Around one third of the total current outstanding issuance of UK government debt is in bonds linked to RPI inflation, which is currently at a higher rate than other measures including CPI and CPIH. This difference in rate is often referred to as the 'RPI wedge'. The impact of this is that investors receive additional benefits with an estimated current value of £150bn.

The UK inflation curve (formed from inflation breakeven rates – the difference between the yields of conventional government bonds and those of index-linked equivalents that are, themselves, market-priced expressions of expected future inflation – across the maturity spectrum) has already been predicting future RPI reform; the inflation curve has been in a flattening trend since the second quarter of 2019, as illustrated by the difference between 30-year and 10-year breakeven rates (figure 1).

Notwithstanding some negative impact of sterling/Brexit on front-end inflation expectations, this flattening trend can be interpreted as the market pricing in downwards revision to RPI as a result of a future change in methodology. Such a downward revision would mean a reduction in the benefit to investors. One interpretation of this reduction in benefit to investors is a wealth transfer from investors to the government.

Can RPI really be reformed, or is this just kicking the can down the road?

Compared to the 2012 CPAC consultation, the chance of reform this time around is higher. However, there are ways to reduce the risk of loss suffered by RPI investors. We believe that many market participants will push for a transition from RPI to CPIH. We expect that legacy RPI linkage (for example, in index-linked gilts) could be set to CPIH plus some spread. If this is in line with historical averages between RPI and CPIH, this could be enough to allow the RPI market to transition smoothly to CPIH, minimising the loss if the UKSA recommendation of switching to CPIH were to prevail.

Impact on pension schemes

For defined benefit pension schemes, such a change could have varying consequences on funding levels, depending on the nature of the inflation indexation of scheme liabilities and which inflation-hedging assets have been put in place, as well as the varying durations of the inflation linkage. Pension schemes therefore need to understand the precise nature of their inflation liabilities in the context of these uncertainties.

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We can look at a variety of different institutions from pension schemes to an annuity buyer. Assuming a wedge of between 0.7%-1.0% and a 20-year duration (figure 2), this could result in a 14-20% fall in liabilities for those schemes impacted. According to the latest DWP study, the total reduction could be up to c. £100bn.

Impact of RPI to CPIH switch on annuities

Age of annuitant (single life) (Years)	Expected life* (Years)	Reduction in liabilities† (%)
55	30-31	11-16%
65	21	7-11%
75	11	4-6%

* Males, according to recent tables
† Illustrative example for immediate switch from RPI to CPIH

Source: RLAM

We would expect the annuity provider to supplement this income through a spread above CPIH. However, the ability to do this would be critically dependent upon the wording of the annuity agreement and any precedent set or any government guidance. In the first instance, schemes should engage with their investment consultant as soon as possible.

Conclusion

This announcement must be treated carefully. The impact on pensioners and pension schemes of a switch from RPI to CPIH would be significant. However, given where UK politics is right now – in the middle of the political crisis with the strong possibility of a general election in the near term – we should remember that announcements made by the current government could very easily unwind should a general election not result in a Conservative-led government.

Thoughts for the future

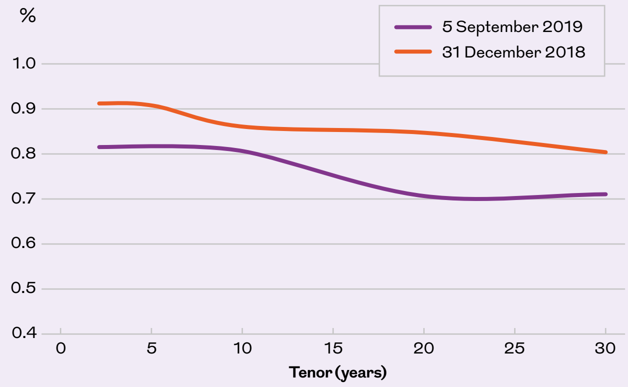
There has, in recent years, been a boom in transfers out of defined benefit pension schemes by members looking to capitalise on increasingly expensive long-dated index linked bonds. The uncertainty around the future valuation of such assets could cause a further acceleration in transfer activity, in turn putting even more pressure on longer-dated breakeven rates.

In addition, pensioners who have recently bought an annuity will have been subject to very high RPI expectations (figure 3) being embedded in the price. The future of RPI could be a cause for some pensioners to consider themselves as having been mis-sold a policy that will no longer deliver what was expected.

Figure 1: 10-year vs 30-year inflation breakeven

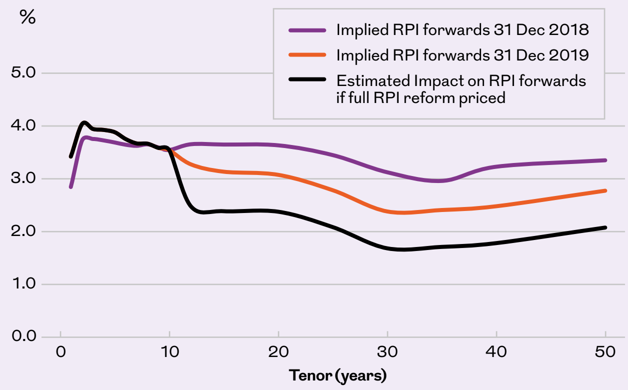
Source: RLAM

Figure 2: Market-implied RPI wedge



Source: RLAM

Figure 3: Implied RPI forward rate



Source: RLAM

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