

RPI RIP? Linking Pensions to Consumer Prices

Trustees need to tread carefully if they are considering linking pension increases to the consumer price index.

The Government has announced that consumer price inflation (CPI) rather than retail price inflation (RPI) will become the yardstick for the minimum rates at which pensions have to increase in private sector pension schemes. The relationship between CPI and RPI is a matter for discussion but it is widely expected, that on average, CPI will be lower.

Some trustees may be sympathetic to employers' hopes that this presents an opportunity to save costs and reduce the scheme deficit. Employers could benefit significantly as both revaluation (of deferred pensions) and indexation (of pensions-in-payment) could potentially reduce.

However, trustees need to tread carefully as pensions that have already built up could be affected. For many schemes it will be unclear how properly to balance members' expectations and existing scheme rules with the employer's interests, particularly while the fine detail of the legislative changes is unclear.

Scheme Rules

The announcement suggests CPI will be adopted for statutory minimum revaluation and indexation. This will clearly have an impact in schemes where increases are defined unambiguously to be at the statutory minimum level. However, many schemes' rules refer expressly to RPI and some may refer more loosely to "inflation" or confer discretion on trustees or the employer to determine increases. For these, the impact will depend on exactly how legislation is amended.

On one hand, switching to CPI may have no impact at all and could even impose an additional "underpin" on increases. On the other hand, it is conceivable that there may be scope to link increases to CPI even where scheme rules refer to RPI (for example, if the Government were to introduce over-riding legislation permitting this). If Trustee consent is required for a change, Trustees may face some difficult decisions.

Communication

Trustees will need to consider whether increases in line with CPI would be in line with members' expectations (including pensioners). This may necessitate revisiting past member communications, including booklets and announcements, as well as the scheme's legal documents.

Where the employer has recently closed the pension scheme to future accrual, the understanding between employees and employer about how existing benefits will be protected, and how this was communicated, could be important. Members who paid AVCs or were granted benefits following a transfer-in may also have expectations about increases, shaped by the terms communicated to them at the time.



Housekeeping

Switching to CPI would in due course have implications for many aspects of running the pension scheme, including setting technical provisions, agreeing contributions with the employer, calculating transfer values, setting commutation terms, converting AVC funds into pension etc. It could also shape investment decisions as the risk profile of a scheme holding index-linked gilts (still linked to RPI) will change.

Decisions about these matters should wait until the legislative changes are available. Where this is not possible, for example, where a triennial funding exercise is nearing its completion deadline, leave the door open for subsequent revisions.

A bit of background on RPI and CPI

Why is there more than one inflation measure?

Basically because there are many different ways of measuring the way that prices change. Both the CPI and RPI are attempts to estimate inflation in the UK, but they come up with different values because there are slight differences in what goods and services they cover, and how they are calculated.

The RPI measure is arguably the better known in the UK. Sometimes referred to as the "headline" rate of inflation, it is the rate often cited by unions as a benchmark for agreeing pay settlements. The CPI measure is the rate the government's inflation target is based on. It is an internationally comparable measure of inflation - CPI inflation measures are analysed by the European Central Bank when setting interest rates in the eurozone. It has been around informally since 1988, but was properly launched in January 1997.

How are they calculated?

Both the CPI and RPI are an attempt to measure the changes in the cost of buying a representative basket of UK goods and services. The methods used to calculate both indexes are similar. Each month thousands of prices for a selection of goods and services are analysed to check on any increases. Some of the goods and services will carry a higher weighting, reflecting the fact that we spend more on some items than others. Each year, the make-up of the "basket" of goods and services, and the weightings assigned to them, are revised to take into account changes in spending patterns. For example, in recent years people have tended to spend more of their money on electrical goods, travel and leisure, while the proportion they have spent on basic items such as food has fallen.

So why do the CPI and RPI values differ?

Not all the items covered by the RPI are included in the CPI measure. For example, the CPI does not include Council Tax, mortgage interest payments and some other housing costs. The CPI measure also includes some items - such as charges for financial services - which are not in the RPI. There is also a difference in the mathematical methods used to calculate the price changes which, according to the Office for National Statistics, means that in practice the CPI always shows a lower inflation rate than the RPI rate for given price data.

In summary

- The Government intends to link statutory minimum pensions increases to CPI rather than RPI.
- Trustees should watch out for further announcements and keep abreast of the legislative changes the Government makes as part of the move to CPI.
- Trustees should review existing scheme rules for indexation, revaluation etc and consider the impact of the corresponding new statutory rules.
- Understand the relationship between CPI and RPI and the potential financial impact on the scheme of switching to CPI.
- Maintain an open dialogue with employers and be prepared to revisit funding agreements and review various actuarial factors once full details emerge.

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