HYMANS ROBERTSON

Sixty second summary

LGPS and the consultation on the reform of the RPI methodology

Background

On 11 March 2020 the Treasury published a consultation on the reform to the Retail Price Index (RPI) methodology. The need for reform was proposed a year ago by the UK Statistics Authority (the Authority), which has official oversight of the statistics on UK inflation measures. Whilst the Authority is independent of the government, the consent of the Chancellor of the Exchequer is legally required in this situation, as RPI in its present basis is used as reference rate for index-linked gilts.

The purpose of a public consultation is to inform the Chancellor's decision to consent to the changes to the methodology. The Consultation seeks the views of relevant stakeholders and market participants on how the proposed changes, if implemented, would affect index-linked gilts and the market for them, as well as the broader economy beyond the remit of the Chancellor or the Authority. The Consultation also seeks views on the best timeframe to implement the proposed changes – no earlier than 2025, to allow time for proper review, but before 2030 when the legal requirement to seek the Chancellor's consent expires.

Limitations of the current methodology

In the summary of their analysis, the Authority presented their views on the drawbacks of RPI as a suitable measure of inflation, mainly that

- RPI **overstates inflation** because the statistical properties of the formula used for RPI bias the rate upwards, producing an average annual overestimation of 0.7% compared to the inflation estimate of the formula used by the Consumer Price Index (CPI) and CPI including owner occupiers' housing costs (CPIH). The formula used for RPI is **no longer considered best practice** by international standards, as a result, and many countries no longer use it;
- the RPI approach to **measuring homeowners' housing costs** is mainly comprised of housing depreciation, which represents approximately 8% of the RPI 'basket of goods' and can swing RPI steeply in a housing downturn, and mortgage payments, which do not reflect consumption but the cost of financing consumption;

  and further, the RPI **weighting** favours the spending of private households, its **coverage** conditions exclude 12% of demographic households, and it uses a UK-specific **classification system** that doesn't lend itself to international comparison.

Proposed changes

The Authority proposes to integrate into the RPI methodology elements of CPIH. The Chancellor favours this approach over discontinuing RPI abruptly, given its longstanding wide and varied use within the economy. The technical approach for transition hasn't been decided yet, however, and the Consultation seeks views on this. As detailed in Section 3 of the Consultation:

- the methodology and data sources used to calculate CPIH will be used to calculate RPI, and from these index values monthly and annual growth rates would be estimated that are equal across both RPI and CPIH;

- the new methodology would reduce the overestimation of RPI, lowering RPI by approximately 1% p.a. on average compared to previous estimation (albeit this would vary over time);
- RPI would continue to be published separately from CPIH and CPI, and for RPI, lower level detail and supplementary indices will be discontinued, and users referred to the CPIH equivalent; and
- there will be no change to the Authority's legal requirement to publish RPI monthly.

Significance of the consultation

The Consultation poses a series of questions to potential respondents on the timing and procedure of implementation (Section 5) and the broader impacts (Sections 6). In particular, the Consultation asks for views on the impact on index-linked gilt markets and the holders of index-linked gilts or contracts with an RPI linkage. The new methodology will negatively impact the expected cash flows received from longer dated index-linked gilt holdings due to the reduction in the overestimation of RPI. This will directly impact the value of many LGPS funds investments.

Unlike many private sector pension funds the LGPS would not see the same potential benefit resulting from liability valuations given LGPS liabilities are already CPI rather than RPI linked. As might be expected, there is no mention (other than in reference to the historic Cost of Living index) of compensation for those impacted by the proposed changes and therefore this seems unlikely to be part of any proposed change. It is therefore important that the LGPS responds to the consultation and highlights the negative impact the proposals may have on their investments and funding levels.

Our views

If you have not already done so a first step for most Funds should be to seek to understand the extent that the proposals may have on their financial position. Hymans Robertson will be preparing a response to the Consultation over the next couple of weeks ahead of the 22 April deadline, albeit given the current turmoil the deadline may be pushed out.