Quattro Pensions
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The change from RPI to CPI

As mentioned in an earlier bulletin, the Minister of State for Pensions announced in July last year that the Government intends to use the Consumer Prices Index (CPI) rather than the Retail Prices Index as the basis for determining the statutory minimum increases that apply to benefits from occupational pension schemes.

On 8 December 2010, the Government issued a consultation paper which seeks views on various aspects of how this change will be implemented.

This bulletin examines the main issues covered in the consultation document. Towards the end of the bulletin we have also included some discussion of points that may be relevant for schemes where accounting figures or funding valuations are currently being prepared.

A brief summary of the background to this change is given below to set these issues in context.

Which benefits are affected?

Under legislation, schemes are broadly required as a minimum to:

- Increase part of the pension for deferred members over the period from date of leaving the scheme to retirement age in line with RPI (referred to as “revaluation”)
- Increase part of each member’s pension in payment in line with RPI (referred to as “indexation”)

In each case the increases are subject to a cap of 5% or 2.5% depending on the period over which the pension accrued.

The change announced in July is that CPI will be used in future rather than RPI when determining the minimum increase that a scheme can provide.

The change takes effect from 1 January 2011.

CPI is calculated in a different way to RPI and is generally lower than RPI. So the change above will likely lead to lower benefits for members than would have resulted if RPI had continued to be used. (Although of course the increase granted will be the same in those years where both CPI and RPI are above the relevant cap).

This change is controversial in that it will apply to benefits that have accrued in the past not just those accruing in future.

Where benefits are affected this may have a knock-on effect for scheme funding, transfer values and commutation factors.

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Will the change apply to all schemes?

All private sector defined benefit schemes are subject to the legislation relating to the minimum level of increases.

How any particular scheme will be affected will depend on how the minimum statutory requirements interact with the provisions under a scheme's own Trust Deed and Rules and other governing documentation.

The consultation document describes 5 main categories of provision in this respect:

Category 1 – there is no specific reference in the documentation to a particular level of revaluation or indexation, or the Rules just refer to legislation

In this case, the change to CPI should just feed through and future increases will be at the new statutory level. Legal advice may be needed though to confirm that nothing has been issued to members (eg announcements, benefit statements etc) that have created an obligation to provide RPI increases.

Category 2 – the rules refer specifically to RPI

Without further legislation these schemes would need to continue to give RPI related increases and could not take advantage of the change to CPI.

Category 3 – the level of increase guaranteed under the Rules is higher than the statutory minimum

These schemes will continue to provide increases in accordance with their Rules

Category 4 – the trustees have some discretion over the level of benefit increases eg the rules provide for increases in line with "RPI or such other index as the trustees determine"

Legal advice may be needed here to establish what discretion the Trustees have. Even where there is full discretion it may be difficult for Trustees to move away from past practice.

Category 5 – some schemes refer specifically to the Pensions (Increase) Act 1971

These schemes will continue to be subject to the legislation referred to in their rules.

A number of schemes will fall into two categories – for example it is very common for schemes to refer to statutory increases in deferment (Category 1 above) but refer specifically to RPI for increases in payment (Category 2 above).

Can Schemes tied to RPI change their rules?

The change to CPI has created a "lottery effect" for members' benefits because of the variety of ways that the documentation for a scheme has been drafted. The Government acknowledges that many schemes that refer specifically to RPI were in fact referring purely to the statutory minimum requirement, particularly since RPI was the only generally

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recognised inflation measure at the time the rules were drafted.

One way around this would have been for the Government to introduce legislation such that the scheme's rules were directly overridden and CPI would automatically apply. This is one of the issues on which the Government is currently consulting however it appears that it is minded **not** to go down this route.

The remaining question is then "can an individual scheme change its rules to use CPI rather than RPI"? The answer here will depend on how the scheme's own amendment powers are drafted and where the power to amend lies.

However there is a further obstacle in that legislation (section 67 of the Pensions Act 1995) prevents the modification of accrued benefits without member consent. As mentioned earlier, a change to CPI type increases may affect benefits which accrued in the past as well as those accruing in the future. The Government states that it is not clear whether section 67 will apply in this case and it was mooted that an amendment to legislation may be introduced to remove this obstacle – the Government is consulting on this too but again appears to be reluctant to provide any easement.

Any proposal to introduce changes to pension increases is also likely to be added to the list of changes on which an employer is required to consult.

Statutory Underpin

Although CPI is generally lower than RPI, under some circumstances it can be higher. Since CPI will become the new minimum level of increase, schemes would be forced to give this higher increase in any year where this was this case even though in other years because of the way their rules were drafted they had given a higher (RPI) increase than was required.

The Government proposes to address this issue by ensuring that schemes which routinely give RPI increases are not caught out in this way.

Benefits purchased from a life office

A number of schemes may have purchased benefits from a life office, for various reasons, based on the (RPI related) statutory minimum level of increases that previously applied even though if the benefits had continued to be paid from the scheme they would, as a result of the change now be subject to (lower) CPI increases. The Government does not intend to intervene in any way in this type of arrangement – any renegotiation will need to take place between the scheme and the insurer.

What can schemes do now?

The consultation period will last for 12 weeks and the final detail should then be available. However the new increase order based on CPI will apply from 1 January 2011. We are currently writing to clients to inform them which of the categories described above we believe their scheme is likely to fall into.

Complications

We believe that for the majority of schemes it is likely that legal advice will be needed at some stage - even if it appears easy to interpret a scheme's trust deed and rules it is possible that, depending on the provisions of the Scheme's amendment clause, various items (eg announcements, booklets, and benefit statements) given to members in the past could in effect constitute an amendment to the scheme's formal trust deed. In addition, it is almost inevitable that members of a scheme somewhere will bring a legal challenge. We are therefore advising all of our clients that they should seek legal advice on this issue in due course.

What about valuations in progress and year-end accounting disclosures?

Year-end accounting figures

Companies currently preparing year-end accounting disclosures face a difficult dilemma – should they allow for a change to CPI as the relevant measure of future inflation if that is what they think will apply in their scheme, or should they wait until next year when hopefully the issue will be finalised?

The Financial Reporting Council have issued guidance on the subject which suggests that it is permissible to allow for the change to CPI (if applicable) immediately. For schemes reporting under FRS17 the impact of the change should be recorded as a change in assumption in the Statement of Recognised Gains and Losses, avoiding any impact on the P&L account.

However, for companies which are uncomfortable accounting for an issue on which there is considerable uncertainty we believe it is entirely sensible to say the recognition, if any, should be delayed one year in order to wait until there is greater clarity on the subject.

At the date of writing it appears too early to say what consensus, if any, exists among auditors on this subject.

Funding valuations

For trustees currently contemplating their triennial valuation we believe in most cases it will be reasonable to allow for their best guess of the impact of the change to CPI in their scheme. Our reasoning here is that:

- For a scheme that is in surplus before allowing for the impact of any CPI change, allowing for the change to CPI should make little difference to the contributions being paid,
- For a scheme that remains in deficit after allowing for the CPI change, any previously agreed recovery plan should already show the maximum contribution reasonably affordable by the sponsoring employer anyway, so changing the technical provisions should not in theory affect the contributions payable to the scheme in the short term, and in the long-term the issue can of course always be addressed again if the original interpretation turns out to be wrong.
- For a scheme where allowing for the change could tip the scheme from being in

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deficit to being in surplus, so that the need for a recovery plan disappears due to the introduction of CPI, the trustees need to consider whether to continue as if CPI did not apply (on the grounds of prudence), or whether to proceed with allowance for CPI with a warning to the employer of what contributions will become due if this allowance turns out to wrong.

But what should a CPI assumption look like anyway and does it make that much difference?

CPI and RPI are constructed differently and the CPI measure of annual inflation has averaged around 0.85% lower than RPI over the period from 1997. However, the difference is very volatile and there have been periods when CPI has been higher than RPI (when house prices fell, for example). Around 0.5% of the difference is because of the way the index is calculated, and that part has been relatively stable. The volatility lies in the remainder and is mostly due to the inclusion of housing costs in RPI but not in CPI. The Government is considering including a measure of housing costs within CPI, and so the differences between RPI and CPI may narrow in future to the 0.5% calculation effect.

There is not currently a liquid market in CPI-linked financial instruments that would allow future CPI inflation to be gauged in the normal way used for RPI. Due to mathematical differences in the way the two indices are calculated we believe it is reasonable to assume future CPI will be at least 0.5% lower than future RPI, and indeed anything in the range 0.5% - 0.85% may be justifiable.

How much difference this change will make for a particular scheme will depend on the liability profile of the Scheme but the impact of a change of say 0.5% is likely to be quite significant especially where the change applies pre and post retirement. Your Quattro Pensions adviser will be able to give you more information on this.

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