Institute
and Faculty
of Actuaries

Call for evidence into use of the retail price index

IFoA response to House of Lords Economic Affairs Select Committee

25 July 2018

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Lord Forsyth of Drumlean
Chair, House of Lords Economic Affairs Select Committee
House of Lords
London
SW1A 0PW

25 July 2018

Dear Lord Forsyth,

IFoA response to the House of Lords Economic Affairs Select Committee Call for evidence into use of the retail price index

Introduction

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the Select Committee's call for evidence. As a royal chartered professional body, the IFoA has a duty to comment on issues in the public interest and we believe that we can provide an objective view on this issue.

2. With this in mind we have sought to provide an overview of the impacts that any changes could have on groups of consumers in practical terms, rather than comment from a purely statistical standpoint. We have also gathered views from across a number of actuarial practice areas, including pensions, life insurance, general insurance and investment to demonstrate the variation in impact across various financial products.

3. In general, the retail price index (RPI) is widely considered an imperfect measure of general inflation, greatly overestimating and at other times underestimating changes in prices and how these changes are experienced. RPI can also be more volatile, and it does not match with other countries' inflation measures. Whilst the consumer price index (CPI) can provide a more realistic reflection of inflation, it also possesses some inherent weaknesses, including the fact that the consumer goods it considers do not provide an index that measures all production or consumption in the economy. It is therefore important to recognise that any form of measure is a simply a construct; each will have its own strengths and weaknesses, and will measure what it is designed to measure.

4. In practical terms, a change to CPI from RPI would benefit those who make payments based on the value of the index; however, those who receive benefits linked to the value of the index will be more likely to receive lower future benefits. As a result, changes to the measure of inflation used will create winners and losers in all cases, sometimes very unevenly. A change in the inflation rate has most impact on long-term contracts which contain an explicit linkage to RPI.

Pensions

5. Many employer-sponsored pension schemes provide benefits that increase before and after retirement, with increases linked in some way to RPI. Some pension schemes have their

pension increases concretely defined in the scheme rules and are therefore tied to using RPI, rather than a more flexible definition of inflationary increases, whilst others have wording in their rules that might allow CPI to be used if it replaces RPI or becomes a more appropriate index.

6. To put this into context, if a scheme was to replace RPI with CPI, a 65 year old man who had been expecting pension increases in line with RPI, could expect to receive aggregate lifetime pension payments to be around 10 - 15% lower (using typical assumptions for the expected difference between future RPI and CPI).

7. Many pension scheme liabilities are linked to Limited Price Indexation (LPI). LPI caps the inflationary increase in pension payments to a maximum (e.g. 5%) and protects pensioners against decreases in the event of deflation. The economic value of these caps and floors will change on a move to CPI.

8. Crucially, this is a very complex area of law and if RPI ceases to be measured there would be a variety of impacts on schemes and their members, often turning on the precise wording of their own scheme rules. Where lower index values are used, members will generally receive lower benefits, whilst schemes may see an improvement in funding levels and a consequent reduction in any contribution requirements from the sponsor, particularly if their RPI risk has not been fully hedged. Thus far, the Government has chosen not to legislate for an overriding trustee power to allow schemes to adopt CPI (or another index) by default.

9. Employer-sponsored pension schemes are significant investors in index-linked stocks and holders of RPI linked swaps. These are used to hedge RPI risks and as a proxy for salary inflation risks. The impact on investments is discussed later in this response, but it is important to note that reductions in investment returns as a result of a change to the RPI calculation could have material adverse implications for schemes' funding positions and consequent implications for sponsor contribution requirements and member security.

<u>Life Insurance</u>

10. Many annuities paid by life insurers are linked to the value of RPI. As with pension funds, the cost of purchasing these annuities should be lower, whilst the benefit payments will also be lower if insurers were to switch to CPI. Those most affected will be current annuitants, who purchased annuities priced using a formula that generated a higher RPI assumption. There would also be an impact on products where benefit escalations are inflation linked, such as income protection.

<u>Investment</u>

11. Many actuaries are involved in areas of work where assets held include index-linked bonds and inflation linked bonds. Any change from RPI to CPI would result in a reduction of income and capital, reducing the value of assets. However, the reduced payments would benefit government and other issuers of index-linked securities. Existing investment products, such as annuities, face basis risk (the risk that arises where perfect hedging is not possible) if future RPI linked assets either become, or are only issued in, CPIH (CPI including owner occupiers' housing costs) plus style linkage. Some of these swaps are linked to LPI and the value of exercising the caps and floors will change on moving from RPI to CPI.

12. On the index-linked gilts side, it is difficult to see how gilts could be switched from RPI to another inflation measure without some kind of adjustment being made to ensure that

investors would not lose value. Whilst some investors will currently hold index-linked gilts to source RPI, many others will be holding them as a proxy for other types of inflation.

13. Unless this is dealt with in a satisfactory way, it is unlikely that it would be possible to transition the index-linked gilt markets away from RPI for existing issues. Clearly, it would be possible to issue CPI-linked gilts in the future without any particular difficulty. However it would take many years for the overall market to switch from RPI to CPI. Indeed the longest-dated RPI-linked gilt is the 2068 index-linked gilt, which has another 50 years to go until maturity.

General Insurance

14. Most insurance contracts will not be affected due to the short-term length of the contracts. However, damages claims awarded by courts are frequently linked to RPI and therefore any potential reduction in RPI would reduce the value of these awards.

15. Periodical Payment Orders (PPOs) - a form of compensation award in personal injury claims – were linked to RPI when they were initially issued. However the courts were persuaded to instead use the Annual Survey of Hours and Earnings (ASHE) and since then all are ASHE-linked, which has driven a significant increase in PPO settlements. Stopping RPI would affect a small number of PPOs in payment, and therefore the impact would be fairly limited. That said, there are still PPOs settling with an RPI element, where the PPO is not wage-related or due to loss of earnings (e.g. prosthetics), or where the wages are linked to RPI, but the care is linked to ASHE.

16. For more information on the impact of changes to inflation with regards to personal injuries, the Committee may wish to consider the independent report produced for the Ministry of Justice on the Discount Rate[1].

Health Insurance

17. Health insurance payments are generally short term so most claimants would not see a material change in benefit payments. However, a small number of claims (for the long-term disabled) are for longer periods and those claimants would see the largest reduction in future income. Most policyholders would see a small reduction in premiums.

Responses to inquiry questions:

Should the retail price index be abolished? If so, how should that be achieved?

18. Any measure of inflation is, by necessity, an estimate and no method of estimation can be perfect. The methods available for measuring inflation in the UK all have different features, and the most appropriate measure could vary depending on the objective i.e. whose inflation experience we want to measure. Whilst the CPI has become the more commonly used measure of macro-economic inflation, we would note that the RPI continues to be used for a variety of purposes, including the indexation of inflation-linked government debt, tax rates, rail fares and utility costs.

19. If the Government wanted to change the measure of inflation used, it could, through time, replace RPI-linked issues with CPI. Eventually the markets would clear and pension schemes would likely hedge RPI with CPI assets, and have to accept and manage the basis risks. There would likely be some disruption as schemes adjust but it would have to be managed

[1] https://consult.justice.gov.uk/digital-communications/discount-rate/results/discount-rate-report.pdf

carefully. That said, there are number of unknown factors that could present unintended consequences, such as index-linked gilts becoming illiquid.

20. However, if the RPI link in benefits is altered retrospectively, it would have a negative impact on members but would be positive for sponsors, unless the schemes are hedged, in which case it would only impact members negatively.

21. Regardless, we would expect there to be continued demand to keep producing RPI in parallel with a new inflationary measure, should one be introduced, due to the sheer number of existing products and investments linked to it, many of which will run for very many years.

If not, how should the retail price index be changed? If so, how should that be achieved?

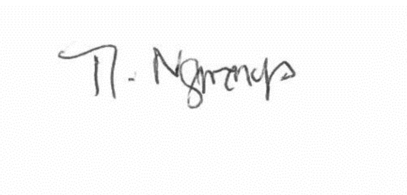
22. One approach could be to continue to calculate RPI but bring it in line with CPI (or CPIH). A side effect of this would however be that many schemes which have a criteria for changing indexation based on RPI ceasing to be published may be trapped in the new calculation rather than being enabled to consider what is most suitable for them.

What would the implications be of changing or abolishing the retail price index?

23. There are a number of potential impacts:
    - The abolition of or switch from RPI would not mean that for legacy contracts such as index-linked gilts or pension promises one simply has to replace RPI by CPI. This would be have repercussions given that CPI is systemically lower.
    - Actuarial assumption bases use RPI for RPI linked benefits: a lack of RPI index-linked gilts would mean an inability to back out of market implied future rates of RPI to determine the appropriate valuation assumption.
    - Actuarial assumption bases also typically use RPI for expense projections and indeed for future house price growth when valuing equity release mortgages. A shift to CPIH is possible but again, there would be questions over the reliability of market implied future rates.
    - On a practical level, a number of existing policies would likely require changes (and potentially some form of statutory override) to cater for changes in published indices.

Should you wish to discuss any of the points raised in further detail please contact Henry Thompson, Policy Manager, (henry.thompson@actuaries.org.uk / 0207 632 2135) in the first instance.

Yours sincerely,



Marjorie Ngwenya
Immediate Past President, Institute and Faculty of Actuaries