

RPI to CPI switches in practice

Identifying and using powers of selection:
the “can we” and the “should we” change?

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Context

RPI to CPI switches

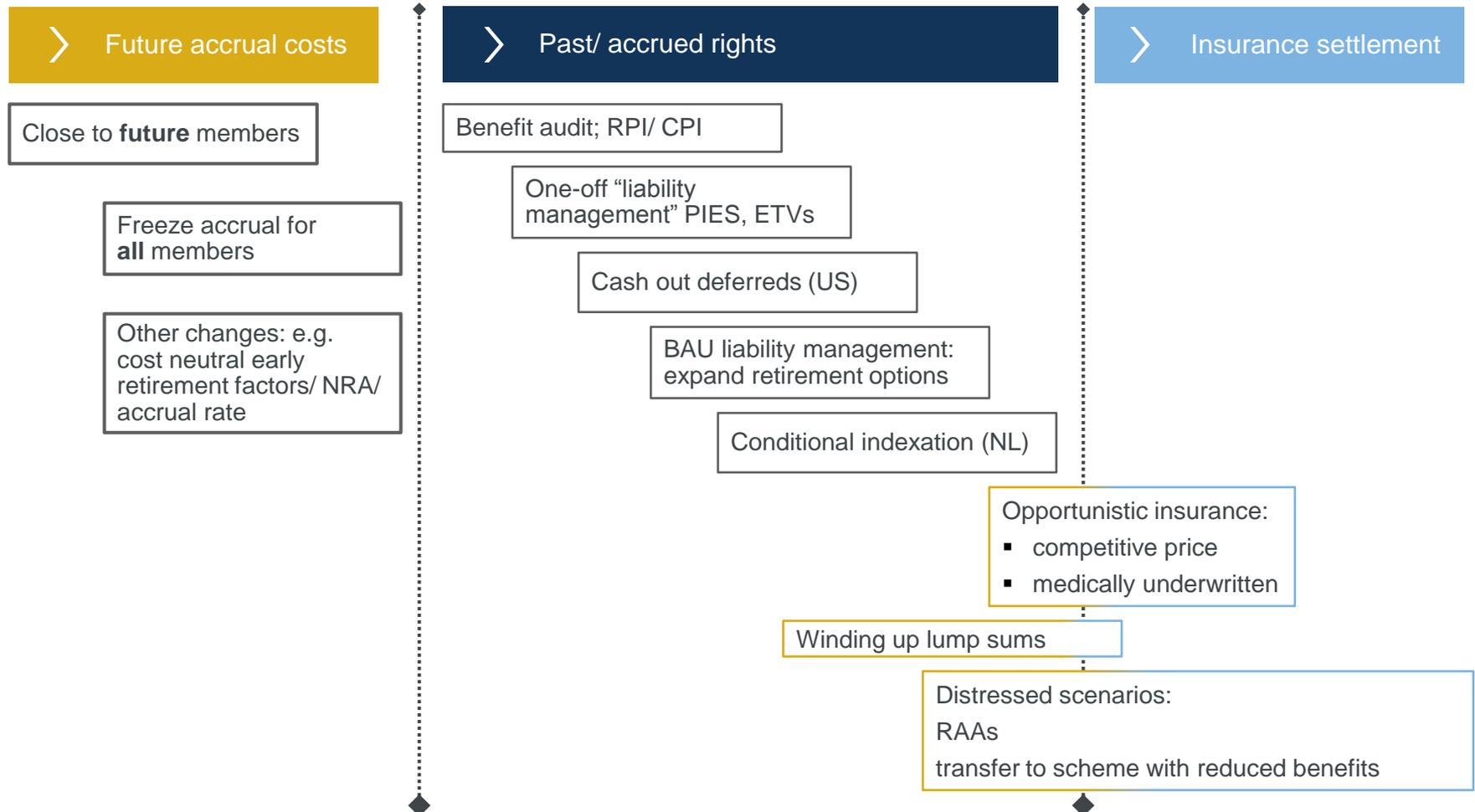
- This concerns the basis for inflation-proofing:
 - pensions between members leaving pensionable service and retirement (revaluation)
 - annual increases to pensions in payment (indexation)
- RPI and CPI are the most well-known indices — but there are others
- Broadly (ignoring contracted-out rights): the statutory minimum basis for inflation-proofing most pensions is now CPI (up to a cap); before 2011 it was RPI (up to a cap); but scheme rules may be more generous
- CPI typically increases at a rate 1% lower than RPI — this affects the level of uplift enjoyed by members, and the cost of scheme liabilities

Two Key Questions

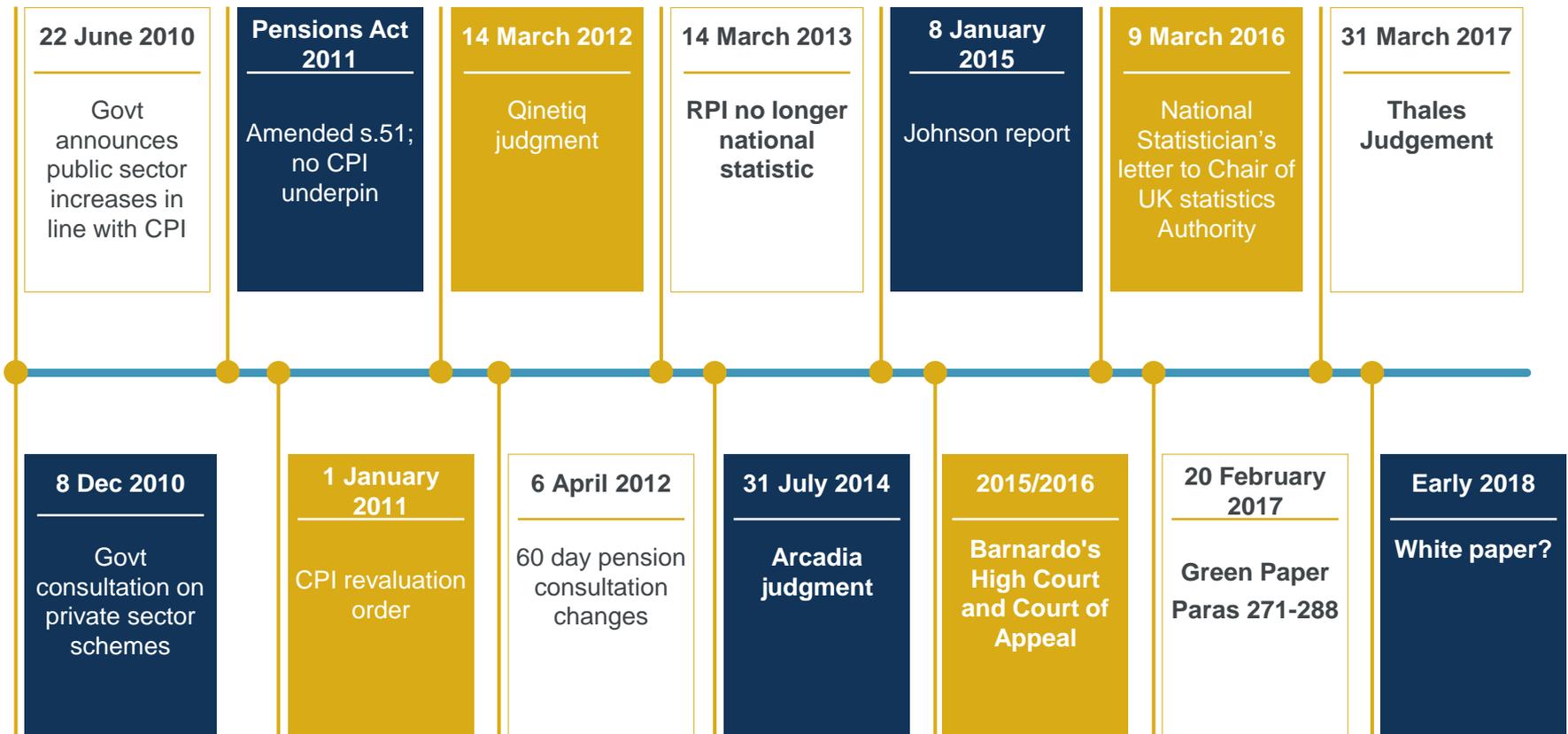
- **Can** RPI be switched to CPI (for revaluation, indexation, or both?)
- **Should** RPI be switched to CPI?

Context

Liability management/ BENEFIT OPTIONS "menu"



Main developments — so far ...



No overriding or modifying power

- Note that the Government confirmed in June 2011 that it would **not** introduce an overriding statutory power to allow schemes to switch to CPI if constraints in scheme rules otherwise prevented a switch.
- Hence, we have ...

Power of selection “rules lottery”



RULES AUDIT: SOME POSSIBILITIES

“Government’s Index of Retail Prices or any similar index satisfactory for the purposes of the Inland Revenue”

"Index of Retail Prices published by the office of National Statistics or any other suitable cost-of-living index selected by the Trustees"

"General Index of Retail Prices published by the Department of employment or any replacement adopted by the Trustees"

"All pensions payable in respect of Pensionable Service from 6 April 1997 shall be increased by 5 percent per annum or, if less, by the increase in the Index of Retail Prices"

"All pensions shall, where required, be increased in accordance with the appropriate percentage under Section 51 of the Pensions Act 1995"

"All pensions shall be increased in payment by the lesser of 5 per cent per annum and the increase in the [R]etail [P]rices [I]ndex"

POTENTIAL OUTCOMES

Switch to CPI can create immediate P&L gain and reduce funding deficit.

Future inflationary increases are *likely* to be lower for members (CPI lower than RPI in 22 out of last 27 years)

BUT do the **plan rules** provide for:

- Hard-coded RPI?
- Discretion to switch index? (jointly?; trustee alone?; employer alone?)
- Option to switch if government replaces or ceases to “publish” RPI?
- Automatic switch to CPI (potentially back dated? from when?)
- HMRC consent/ approval to be required?
- Or should the Rules have mentioned the statutory maximum (or the “appropriate percentage” for indexation for post 5/4/97 service instead of RPI 5%

THALES JUDGMENT (2017)

Even when a power of selection is engaged, restrictions on the choice of alternative index may curtail flexibility on the alternative to RPI.



**RPI to CPI switches: the “can we”
and “should we” from a legal
perspective**



**Cases so far
("can you switch"?): rule
interpretation and Section 67**

The journey so far

Case law

Scheme Rule	Outcome	Comments (high level)
<p><i>"Index of Retail Prices published by the office of National Statistics or any other suitable cost-of-living index selected by the Trustees"</i> (<i>Qinetiq</i>)</p>	<p>Trustees have a power to switch to CPI</p>	<p>This is clear power of selection: "any other... index... <i>selected by the trustees</i>"</p> <p>Switch can apply to rights already built up. Section 67 not infringed: right to RPI (or other) uplift only crystallises when each year's annual uplift is determined</p>
<p><i>"Government's Index of Retail Prices or any similar index satisfactory for the purposes of the Inland Revenue"</i> (<i>Arcadia</i>)</p>	<p>A power of selection jointly held by the trustees and the employer</p>	<p>It is not immediately clear that there is a power of selection. However, there is a power to propose a different inflation basis to HMRC (as HMRC would not do this off its own bat), so this must vest in the parties to the trust deed; and in the circumstances of this scheme this was found to be a joint power. Followed <i>Qinetiq</i> on Section 67 issue. HMRC test not a barrier.</p>

Arcadia — to take one example

Arguments re power to select index?

No ability to select index (Trustees)



- RPI applies until discontinued/replaced
- If intended that power to select, definition would have identified who exercises power (as in Qinetiq)
- Significant that defined expression is “Retail Prices Index” rather than “Index”

Power to select index (Company)



- Implicit in definition that power to select index
- IR12 and Pension Schemes Office Manual refer to ability to agree alternative index

Key points



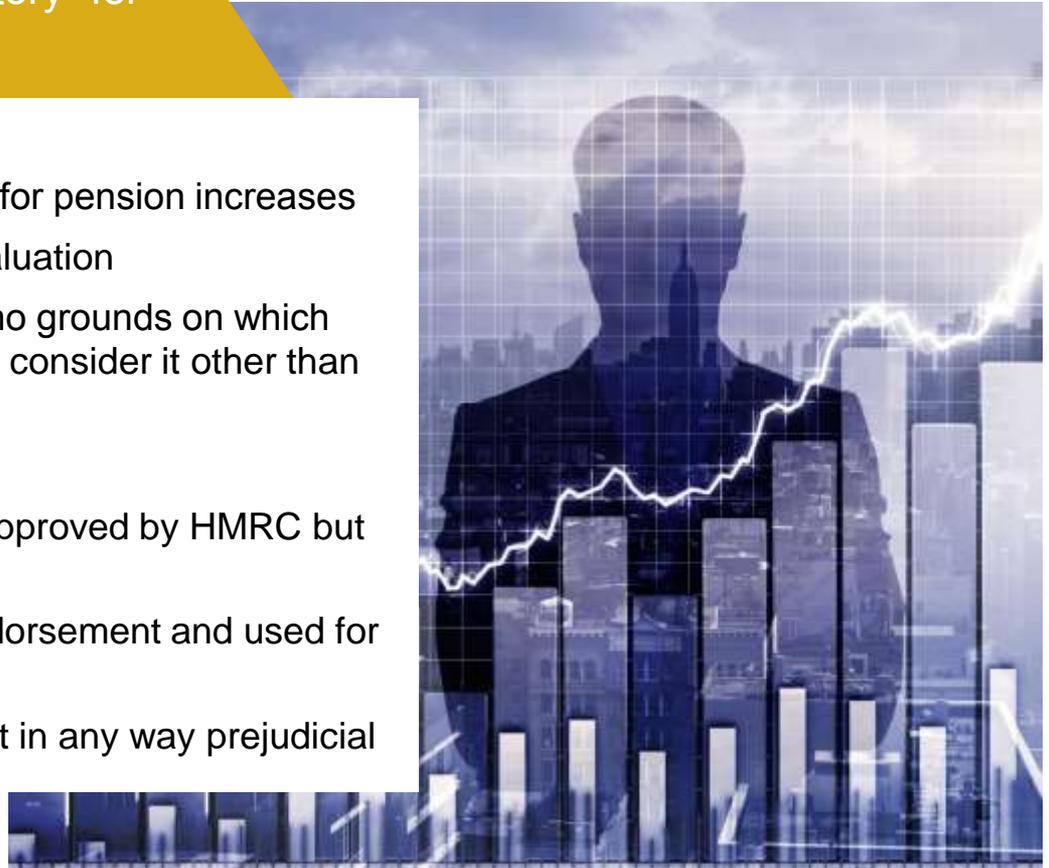
- Both arguments require words to be read into Index definition
- Must be some power of selection: what would happen if RPI is scrapped or HMRC permitted two alternatives?
- Label “Retail Prices Index” only reflects expectation
- Infer draftsman had in mind IR12/ Pension Schemes Manual which allows selection

Arcadia — example of a rules condition/restriction

Use of CPI

Is CPI a “similar” index that is “satisfactory” for HMRC purposes?

- Trustee accepted CPI is “similar” to RPI
 - HMRC confirmed CPI “satisfactory” for pension increases
 - No reply from HMRC regarding revaluation
 - Judge held that CPI satisfactory if “no grounds on which HMRC could properly or reasonably consider it other than satisfactory”
 - CPI should be satisfactory as:
 - Pension schemes no longer approved by HMRC but only registered
 - CPI received Government endorsement and used for statutory revaluation
 - Use of CPI rather than RPI not in any way prejudicial to HMRC



The journey so far

Case law

Scheme Rule	Outcome	Comments (high level)
<p><i>"General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees"</i></p> <p><i>(Barnardo's)</i></p>	<p>The Trustees have a power to select a new index... but only where RPI has first been officially "replaced".</p>	<p>The High Court judge said RPI must be retained so long as RPI is an officially published index. The Court of Appeal (by a 2-1 majority) upheld the decision that RPI must be officially replaced before a power to select can be used. However, there is a powerful dissenting judgment, which agreed with the employer that it was a one-stage test (the trustees could replace RPI — and by definition any selected index would be the "replacement"), rather than a two-stage test (requiring RPI to have been officially "replaced" first). Again, no s.67 issue.</p>



COMPANY GIVEN PERMISSION TO APPEAL TO SUPREME COURT. MEMBERS SEEK PERMISSION TO CROSS APPEAL (E.G. ON S67 QUESTION)

The journey so far - Thales

Case law

Scheme Rule	Outcome	Comments (high level)
<p>CARE Rules: <i>"If the Government retail prices index for all items is not published or its compilation is materially changed, the Principal Employer, with the agreement of the Trustees, will determine the nearest alternative index."</i></p> <p>TOPS Rules: <i>"if the Retail Prices Index is revised to a new base or if that Index is otherwise altered... all subsequent variations in that pension will be on a basis determined by the Trustees having regard to the alteration."</i></p> <p><i>(Thales)</i></p>	<p>The power of selection was engaged but they could only select the nearest alternative index, which was RPI as amended.</p>	<p>Two stages: (1) "gateway" condition: whether compilation of RPI "materially altered" or "otherwise altered"; (2) then consider "nearest alternative index" as a matter of construction</p> <p>The High Court judge held that the recent change to the housing price component of the RPI did result in RPI being "materially changed."</p> <p>The judge also construed "otherwise altered" widely and believed this condition was also met by the various recent "alterations" to RPI (including the housing index change).</p> <p>However, the High Court judge held that RPI (as amended) could itself be considered an alternative index and it was the only nearest alternative that could justly be selected.</p>

Further points of interest

Thales

- Another example of a case turning on its specific Scheme Rules
- **Focus on the Rule** **not** abstract appeals to the purpose being "to protect members from the effect of price inflation" without analysing what the Rules actually provide for
- Judge incorrectly stated that the Court of Appeal in *Barnardo's* held that RPI has not ceased to be "published". CA in *Barnardo's* did not consider that question
- Regarding "material change", Judge focused on the change to RPI's compilation (i.e. the methodology), not the effect of the change
- Use of expert evidence:
 - to assist Judge on the *construction* of the Rules, **not** whether CPI is "better"
 - but how much detail must trustees and employers go into before considering whether triggers in Rules are met? Case says a "broader brush" is permissible.
- Judgment contains useful summary history and comparison of RPI and CPI



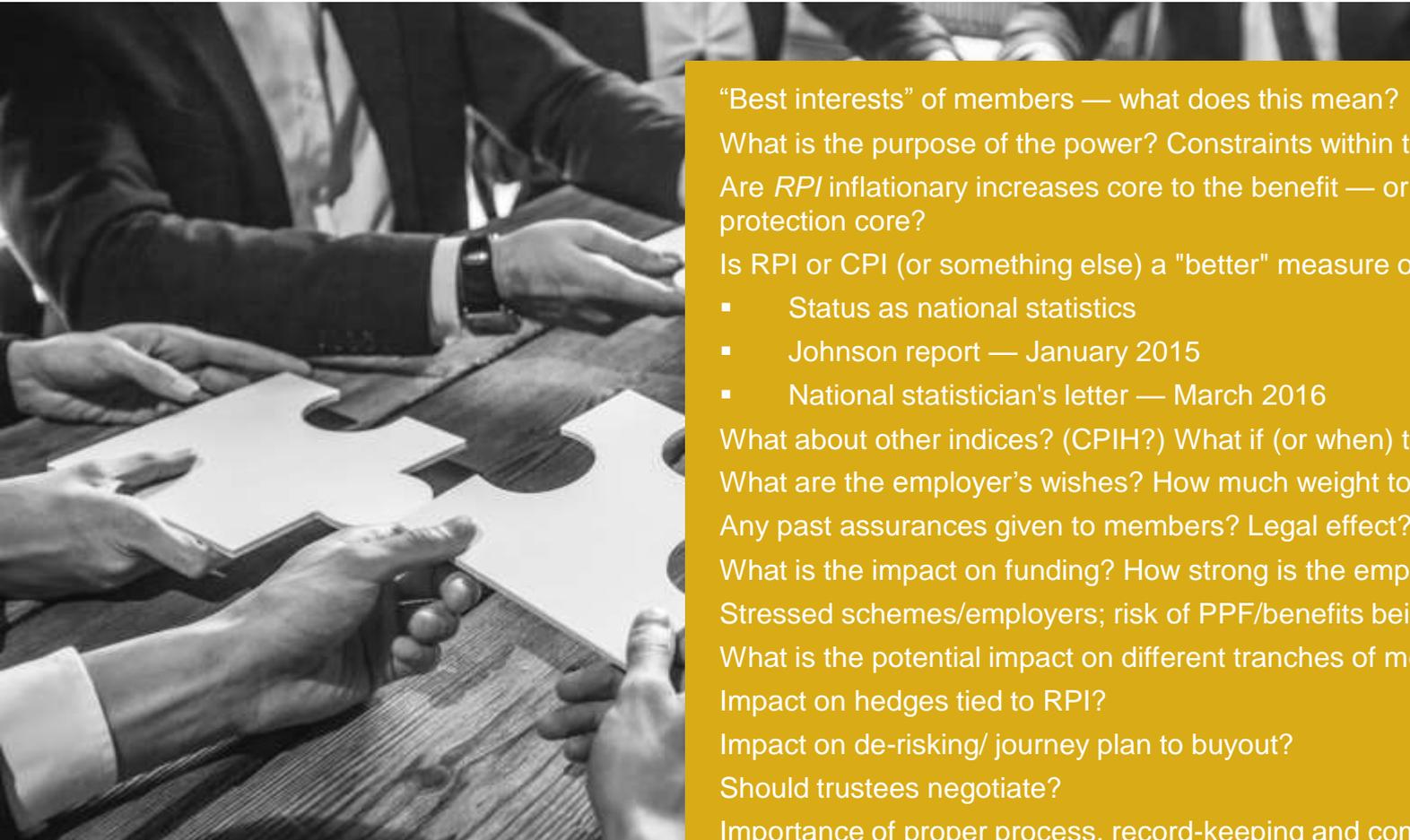
Clock is now ticking for employers/trustees to act where they need to rely upon a (material) change having been made to the compilation of the RPI



**Considerations for trustees and employers
("should you switch"?)**

Should a power of selection be exercised?

Some considerations for trustees and employers



“Best interests” of members — what does this mean?

What is the purpose of the power? Constraints within the Rules?

Are *RPI* inflationary increases core to the benefit — or is reasonable inflation protection core?

Is *RPI* or *CPI* (or something else) a "better" measure of inflation?

- Status as national statistics
- Johnson report — January 2015
- National statistician's letter — March 2016

What about other indices? (*CPIH*?) What if (or when) they change again?

What are the employer's wishes? How much weight to attach?

Any past assurances given to members? Legal effect?

What is the impact on funding? How strong is the employer covenant?

Stressed schemes/employers; risk of *PPF*/benefits being scaled back

What is the potential impact on different tranches of members?

Impact on hedges tied to *RPI*?

Impact on de-risking/ journey plan to buyout?

Should trustees negotiate?

Importance of proper process, record-keeping and communications

The “best interests” test

Q

“Can it ever be in members' best interests to exercise a discretion to switch to CPI”

A

“...the “best interests of the beneficiaries” should not be viewed as a paramount stand-alone duty. In my judgement it should not be treated as if it were separate from the proper purpose principle ...It is necessary first to decide what is the purpose of the trust and what benefits are intended to be received by the beneficiaries before being in a position to decide whether a proposed course is for the benefit of the beneficiaries or in their best interests.”

Asplin J (NB. stating a general principle, not specifically related to RPI/ CPI)

What the experts say



RPI is not a credible measure of consumer price change. The RPI should not be used for new contracts. Taxes, benefits and regulated prices should not be linked to RP.

**Johnson Report
January 2015**

“RPI is a flawed measure of inflation with serious short comings and we do not recommend its use”

**ONS Director General
Jonathan Athow, July 2017**



Put simply, I believe that RPI is not a good measure of inflation and does not realistically have the potential to become one. I strongly discourage the use of RPI as a measure of inflation as there are far superior alternatives. Nonetheless, RPI is still used for a number of legacy purposes and its production is mandated by legislation.



**National Statistician, John Pullinger
9 March 2016**

The future

- Employers and trustees to re-review RPI/CPI (as past exercise in 2010/2011 may not have picked up “power of selection” rules)
- Appeal to the Supreme Court in *Barnardo’s*?
- Appeal to Court of Appeal in *Thales*?
- BT Scheme Court case
- Alternative arguments?
 - Has RPI *already* been “replaced” or “ceased to be published”?
 - Rectification where plan rules do not do what the employers/trustees intended?
- Any ability to amend rules retrospectively and argue tPR should not void the amendment under s67?
- Clock is ticking for some schemes to act

Green Paper “ Security and Sustainability in Defined Benefit Pension Schemes” paras 271-288:

*“There is argument that if the fundamental nature of the promise that was made to members was to protect them against inflation, then the specification in scheme rules of a particular rate of increase, or a specific index, may have made sense at the time but may now be anachronistic, and has little to do with the fundamental nature of the promise to protect against inflation”.
“However... some members’ pensions would be significantly lower”*

Is DWP’s review confined to stressed schemes?





Questions



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