RPI to CPI switches in practice
Identifying and using powers of selection: the “can we” and the “should we” change?

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31 October 2017
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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"

Future accrual costs

Close to future members

Freeze accrual for all members

Other changes: e.g.
  cost neutral early retirement factors/ NRA/ accrual rate

Past/ accrued rights

Benefit audit; RPI/ CPI

One-off “liability management" PIES, ETVs

Cash out deferreds (US)

BAU liability management: expand retirement options

Conditional indexation (NL)

Insurance settlement

Opportunistic insurance:
  - competitive price
  - medically underwritten

Winding up lump sums

Distressed scenarios:
  RAAs
  transfer to scheme with reduced benefits
Main developments — so far …

22 June 2010
Govt announces public sector increases in line with CPI

Pensions Act 2011
Amended s.51; no CPI underpin

14 March 2012
Qinetiq judgment

14 March 2013
RPI no longer national statistic

8 January 2015
Johnson report

9 March 2016
National Statistician’s letter to Chair of UK statistics Authority

31 March 2017
Thales Judgement

8 Dec 2010
Govt consultation on private sector schemes

1 January 2011
CPI revaluation order

6 April 2012
60 day pension consultation changes

31 July 2014
Arcadia judgment

2015/2016
Barnardo’s High Court and Court of Appeal

20 February 2017
Green Paper Paras 271-288

Early 2018
White paper?
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

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<thead>
<tr>
<th>Scheme Rule</th>
<th>Outcome</th>
<th>Comments (high level)</th>
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<tr>
<td>&quot;Index of Retail Prices published by the office of National Statistics or any other suitable cost-of-living index selected by the Trustees&quot; (Qinetiq)</td>
<td>Trustees have a power to switch to CPI</td>
<td>This is clear power of selection: &quot;any other… index… selected by the trustees“&lt;br&gt;Switch can apply to rights already built up.&lt;br&gt;Section 67 not infringed: right to RPI (or other) uplift only crystallises when each year’s annual uplift is determined</td>
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<tr>
<td>&quot;Government's Index of Retail Prices or any similar index satisfactory for the purposes of the Inland Revenue&quot; (Arcadia)</td>
<td>A power of selection jointly held by the trustees and the employer</td>
<td>It is not immediately clear that there is a power of selection.&lt;br&gt;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.&lt;br&gt;Followed Qinetiq on Section 67 issue.&lt;br&gt;HMRC test not a barrier.</td>
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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

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<td>&quot;General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees&quot;</td>
<td>The Trustees have a power to select a new index… <strong>but</strong> only where RPI has first been officially &quot;replaced&quot;.</td>
<td>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 &quot;replacement&quot;), rather than a two-stage test (requiring RPI to have been officially &quot;replaced&quot; first). Again, no s.67 issue.</td>
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The journey so far - Thales

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| **CARE Rules**: "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."

**TOPS Rules**: "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."

(Thales) | The power of selection was engaged but they could only select the nearest alternative index, which was RPI as amended. | **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

The High Court judge held that the recent change to the housing price component of the RPI did result in RPI being "materially changed."

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).

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.
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"?)
“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

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

“…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 RPI.

Johnson Report
January 2015

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

“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
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?