Reform to the retail prices index methodology

Submission by Prospect to HM Treasury & UKSA

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Introduction

Prospect is the trade union representing skilled professionals and technicians in the public and private sectors. Our members have been engaged with the discussions on changes to the RPI methodology over the last decade. Our members have an active interest in the future of this particular index. RPI is still used as the uprating index for many defined benefit pension schemes and also wage negotiations. There is concern that the proposed change will have a detrimental impact on member incomes. Our response will outline our concerns and suggest how we think ONS should approach changes to the RPI methodology.

Do you agree that this approach is statistically rigorous?

Prospect does not agree with the proposed reforms of the RPI index methodology suggested by the UKSA. The problems with the RPI index were identified nearly 10 years ago. As the consultation document makes clear, the weaknesses of RPI were identified when the method for collecting the price of clothing items was changed. But rather than fixing this problem, following a consultation in 2012, ONS changed the designation of RPI so it was no longer identified as a national statistic.

The RPI index is the oldest and most trusted prices index and has some advantages over the CPI family of indexes. It was developed to give a measure for price rises across a broadly representative sample of average price rises across the economy as a whole. As Annex A outlines, the index includes a measure for housing costs and Council Tax and it excludes the highest paid and pensioners. By contrast the Consumer Prices indices were developed for a different purpose. CPI was a macroeconomic tool used to provide a common methodology for measuring prices across the European Union. It was because CPI was not considered to be a representative measure for uprating benefits, wages and other similar purposes that ONS developed CPIH. CPIH is fundamentally based on the methodology of the CPI with some additional items added, the principal one being Owner Occupied Housing (OOH) costs.

Although CPIH includes housing costs, Prospect is not convinced that this index is a good replacement for RPI. The index retains the main features of the CPI, which includes a population sample for the whole economy. Housing costs are based on imputed rents rather than costs that are measurable, such as mortgage interest rate payments, house depreciation costs, building insurance and other tangible housing costs. It has always been Prospect's view that there is a fundamental difference between these costs and housing rents. CPIH also relies on a different source of data, the UK national accounts rather than the Living Costs and Food Survey. All of these factors are important differences between the two indices. For these reasons Prospect does not believe that incorporating the CPIH methodology into RPI is statistically rigorous.

Prospect strongly agrees with the central conclusion from the House of Lords inquiry on 'Measuring inflation' that the UK Statistics Authority has a duty to "promote and safeguard the quality of statistics, which includes their impartiality, accuracy and relevance, and coherence with other statistics.[1]" In our view the wholesale replacement of the methodology used in one index with another does not achieve this aim. Instead the focus of the UKSA and ONS should be on resolving the problems identified in the RPI index.

As the inquiry notes, the main problem with RPI arises from a change in the collection of price quotes for clothing. Prospect believes that this is the problem that should be fixed and agree with the aforementioned House of Lords enquiry which states that "The programme of periodic methodological improvements should be resumed.[2]"

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[1] "Measuring Inflation", HoL para, 118.
[2] "Measuring Inflation", HoL para, 116

Impact on holders of index linked gilts

Our focus here is on pension schemes that our members will be part of and ultimately how this will affect them.

Many pension schemes use RPI-linked assets, such as index linked gilts, as part of Liability Driven Investment strategies to match RPI linked liabilities. Historically RPI has consistently risen at a faster pace than CPI or CPIH so to align the indices will reduce the value of future cash flows from the gilts and the price will fall.

Many pension schemes still have pension increases linked to RPI which means that if the change goes ahead, increases in the future will be lower. The impact on individual schemes will differ depending on the proportion of liabilities that are linked to RPI but this could lead to an increase in the schemes funding level although this is unlikely to be the norm. An example of where this could happen is if a scheme is heavily invested in equities without much inflation hedging, the value of their assets is unlikely to change to a significant extent and they could see a reduction in the value of their liabilities due to decreasing member benefits.

For pension schemes, the main investment related impact of the switch to CPIH will relate to index-linked gilts and RPI-swaps. This will generally result in reduced funding levels for schemes as they will receive less than expected due to the change. As already explained, RPI linked gilts will reduce in value because of a switch to CPIH methodology. RPI swaps are used by pension schemes to hedge against inflation and this works by the pension scheme paying a set amount to the counterparty, in exchange for ongoing payments linked to the increases in RPI. This will impact pension schemes and their funding level because they are likely to still be paying the pre-agreed fixed amount to the counterparty, but will be getting a significantly lower return due to the proposed RPI amendments.

The later that any change is made, the more time schemes will have to plan for this and adjust as much as possible. Our main concern in this area is that these proposed changes will result in pension scheme deficits increasing. Open defined benefit (DB) schemes are already rare due to the cost of providing these benefits and many employers are considering closing these schemes. With this added funding pressure and the current financial climate, there are likely to be further DB scheme closures which will result in inferior pension schemes being offered and ultimately mean that a greater number of people will have an income in retirement that is insufficient.

The consultation makes no mention of compensation being payable for those impacted by this change. Assuming no compensation is paid, the most affected will be pension schemes hedging CPI-linked liabilities with RPI-linked assets and individuals with RPI-linked pension benefits.

Other impacts of the proposed change

The impact will be felt most by our membership whose pension benefits are uprated in line with RPI during deferment and retirement.

Fixing RPI so that it correctly reflects household expenditure is important to delivering pension promises that include RPI indexation. Many defined benefit pension schemes increase pensions in payment in line with RPI. When these pensions were earned the employers and employees fully expected that RPI indexation would insulate pensioners from the risk of inflation. In order to fulfil this pension promise RPI must continue to be published and be amended to reflect inflation in the cost of living of households.

Huge volumes of our membership have been forced out of defined benefit schemes and into inferior defined contribution arrangements. This has transferred the responsibility and risk of funding retirement benefits from the employer to the individuals themselves.

Annuities are still the only method that individuals in defined contribution schemes have to secure a pension for life that is increased in line with inflation. Although the use of annuities

has decreased, they still play a vital role in providing members with security in retirement. In 2018/2019 alone, over 10,000 escalating annuities were sold[3] and a significant amount of these will be linked to RPI. This figure is for one year only therefore thousands more annuity contracts would have been purchased before this time which will be increasing in line with RPI. These would have been purchased with a legitimate expectation that they increase in line with an inflation measure that is historically higher than CPI or CPIH. If this proposal goes ahead, the increases to their pension going forward will reduce and they will not be getting the product that they purchased.

It is also important to consider that the amount of pension annuity holders receive will have factored in using RPI as the inflation measure so the starting amount of pension would have been lower to include this inflation linking. This is simply not fair on these policy holders who will ultimately have overpaid for their pension product and it is only right that they should be compensated – a point that is not raised or mentioned in the consultation document.

As well as annuities that are RPI linked, there are a significant number of defined benefit pension schemes that still use RPI for uprating purposes. Prospect has a large number of members who have benefits within a defined benefit pension scheme that uprates pensions in line with RPI.

Our research has shown that for a pensioner retiring in 2020 at age 65, by the time that they reach age 86, their yearly average pension income under RPI uprating would have decreased by 15% if the change took place from 2025 or by 11% if the change took place in 2030. These pensioners would have a legitimate expectation that their pensions will increase in line with RPI and indeed a number of pension scheme members have battled through the legal system to ensure that pension scheme trustees and employers cannot change the inflation measure for uprating, where the scheme rules state that RPI must be used. To undermine this by amending RPI to mirror CPIH is simply wrong. We therefore argue that the only fair course of action to take is to fix the issues with RPI and to ensure that members receive the pension benefits in retirement that they have been promised and rely upon.

Outside of the pensions industry, RPI is used in an unknown number of private contracts, as is acknowledged within the consultation. Changing RPI will create winners and losers. On the one hand, rail customers and students (repaying student loans) are likely to benefit from the proposed change. However, these benefits could and should be delivered by policy changes. Indeed, it is possible that such benefits might be negated by policy changes now, or in the future. Consequently citing such benefits does not justify the proposed changes. On the other hand, as discussed above, pensioners in receipt of RPI linked pension payments and pension schemes invested in index-linked gilts will be amongst the losers.

RPI is still widely used in the economy at large and in our day-to-day work during pay negotiations. It therefore follows that if the RPI is effectively replaced by CPIH, then this will have an additional impact in that pay deals are likely to be concluded at a lower value which will have wider economic impacts.

Conclusion

Given all the circumstances and the points that we have raised, Prospect believe that the UKSA should commit to fixing the known issues with RPI rather than rebranding CPIH as RPI. The UKSA, through this consultation, wish to impose the CPIH, a measure the statistical establishment seems to favour but which has little public credibility or confidence. Given the way CPIH falls short of the ONS's own plans to develop a household measure of inflation, adoption of it under the label of the RPI, will fail those users requiring a household measure of inflation.

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[3] FCA Retirement income market data 2018/19