RPI Consultation Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

+44 20 7831 0898
imran.razvi@theia.org
hugo.gordon@theia.org
theia.org
@InvAssoc @The Investment Association

15 May 2020

Dear RPI Consultation Team

RE: Investment Association response to Consultation on the Reform to RPI Methodology

The Investment Association[1] welcomes the opportunity to respond to the HMT/UKSA consultation on RPI reform. Our members manage over £7.7 trillion of assets on behalf of their clients in the UK and around the world, including significant portfolios of index-linked gilts and other asset classes and investment strategies that rely on the use of RPI-linked instruments. This consultation is therefore of great significance to our members and their clients.

We recognise the UKSA's concerns over the methodological flaws in RPI and understand the objective of the UKSA in seeking to ensure the integrity of UK inflation statistics. Our response is focused on the impacts of the proposed reform on affected investors and a possible option for mitigating these impacts. We have five key messages:

1. A wide range of investors will be affected: index-linked gilts and other RPI-linked assets are widely used in investment strategies followed by both retail and institutional investors. The impacts of RPI reform are broad and deep in terms of their effect on corporates and institutions and will be directly felt on the long-term savings and pensions of millions of individuals.

2. The impact on the index-linked gilt market will be large: roughly £670bn of index-linked gilts are due to mature after 2025, of which £570bn will mature after 2030.

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

With coupons and redemption prices linked to RPI, the proposed reforms would impact both future cash streams, as well as the market price of the affected gilts. Holders of these gilts are expected to suffer value loss over time – for every £10m invested in RPI-linked gilts, holders could see a total loss in asset value of £1m if the reforms occur in 2030, or £2m if the reforms occur in 2025. Investors have purchased RPI-linked gilts at a fair price and with an expectation that RPI would be paid – even after RPI was deemed a flawed measure – in part because few alternatives exist. Such a change in terms of contracts after issuance could impact confidence in the gilt market.

3. The Defined Benefit (DB) pensions sector is particularly affected: with around £470bn invested in index-linked bonds and exposures of approximately £350bn in inflation swaps and gilt repos used to hedge inflation-linked liabilities, DB pensions are the single-biggest affected investor group. While impacts vary at scheme level, the overall consequences of the proposed reform to RPI are likely to be lower pensions, a worsened position in terms of scheme funding and, in some cases, a greater call on additional contributions from corporate sponsors.

4. The impact of RPI reform extends beyond the index-linked gilt market: RPI is deeply embedded in the wider financial markets and economy and there are a range of other asset classes and financial instruments that have a link to RPI, such as inflation swaps, real estate, infrastructure and listed and private corporate debt. For example, tariffs earned by onshore wind and solar assets (feed-in tariffs or renewable obligation certificates) are indexed to RPI, as are many of the long-term leases in the real-estate sector. Aligning RPI with CPIH will affect both the income streams from these assets and their values**.**

5. The adverse consequences of RPI reform on investors can be mitigated: the best way of reconciling the need to ensure the integrity of UK inflation measures while mitigating any adverse impacts on investors is to redefine RPI as being equal to CPIH + x, where 'x' is a margin broadly equal to the average difference between RPI and CPIH, calculated over a pre-agreed and observable period. This adjustment aims to ensure that the results are deemed to be fair and equitable to all parties and avoid creating any perception or misinterpretation that the reforms create winners and losers, which may have legal consequences. To this end the margin should be established by a further impartial public consultation conducted by UKSA and HMT. If this process is carried out in a transparent fashion, we believe that transition away from RPI will occur in a manner which all parties perceive as fair and equitable.

We hope our response is helpful and we would be delighted to discuss it further.

Yours sincerely,

Imran Razvi
Senior Policy Adviser,
Pensions & Institutional Market

Hugo Gordon
Policy Specialist,
Capital Markets

Assessing the impact of RPI reform

Which investors are affected by the proposed change?

1. The proposal to align RPI with CPIH will impact upon a broad range of investors who hold index-linked gilts and other assets that are linked in some way to RPI. In particular:

    - Index-linked gilts are widely held by institutional investors such as DB pension schemes and insurance companies, typically for matching their liabilities, which are also, at least in part, RPI-linked. These investors will also therefore see the liability side of their balance sheet affected. We discuss the DB pension sector in more detail below.

    - Index-linked gilts are also commonly used in funds held by retail investors and Defined Contribution (DC) pension schemes that are investing in Fixed Income and Multi-Asset Strategies.

    - RPI is deeply embedded in the wider financial markets and economy and there are a range of other asset classes and financial instruments that have a link to RPI. Aligning RPI with CPIH will affect both income streams and possibly also the value of these assets. The impacts on these wider asset classes are discussed in more detail below. Both institutional and retail investors will have exposure to these asset classes via direct holdings and holdings in funds.

2. We discuss the case of the DB pensions sector below, because of its size and the extent of the impacts it faces, but more broadly, it is important to appreciate that retail investors and DC schemes (where investment risk is borne directly by the underlying scheme members) will see direct impacts on their portfolios, which will feed through to their plans for long term saving and retirement.

The impact of the proposed reforms on the Index-Linked Gilt Market

3. The pool of index-linked gilts expected to be affected by these reforms is very significant. Roughly £670bn of index-linked gilts are due to mature after 2025, of which £570bn will mature after 2030.[2]

4. With coupons and redemption prices linked to RPI, the proposed reforms would impact both future cash streams, as well as the market price of the affected gilts. As a result, holders of these gilts are expected to suffer value loss over time – for every £10m invested in RPI-linked gilts, holders could see a total loss in asset value of £1m if the reforms occur in 2030, or £2m if the reforms occur in 2025 (see table 3 below).[3]

5. We illustrate here the impact on a specific index-linked gilt:[4]

[2] Aviva Investors.
[3] Pensions Policy Institute.
[4] Insight Investment.

Table 1: Worked example for a single index-linked gilt

Maturity date	2055
Current value	£39bn
Impact of 1% reduction in RPI from 2030	-£8bn
Impact of proposed change on gilt value	-21%

Note: based on gilt yield in November 2019

6. For DB pension schemes, this value loss may, ultimately, result in an increase in deficits and a greater risk of schemes not meeting their pension obligations – this is discussed in more detail below. More generally, it will result in a decreased income stream for all holders of index-linked gilts. This could impact market confidence as investors will have purchased RPI-linked gilts at a fair price over the life of the security.

7. Even recent purchases may well have been made in the knowledge that RPI had already been deemed a flawed measure by the UKSA. Indeed, subsequent to the acknowledgement of these flaws by the Chancellor and the Treasury, the DMO has continued to issue these bonds in the primary market[5]; furthermore, new issuance of index-linked gilts, including to pay for the fiscal response to Covid 19, will continue to be linked to RPI for the next few years.

8. No liquid alternative sovereign backed investment product has been made available in the marketplace leaving investors with little choice but to buy ”flawed” RPI linked bonds. Imposing a change in the terms of contracts after issuance has the potential to impact confidence in the gilt market. We discuss below a solution for the stock of existing RPI-linked gilts that will mitigate any adverse consequences of RPI reform and ensure that confidence in the market remains.

9. Going forward, it is important that a strong CPIH-linked gilt market develops, in order to provide a strong alternative investment vehicle for index-linked bond investors and ensure that gilts are no longer linked to an index that has been deemed to be flawed. Our proposal to move from RPI to CPIH+x will help create a stronger CPIH-linked market.

The impact of the proposed reforms on the Defined Benefit (DB) pensions sector

10. The DB pensions sector is especially affected by the proposed reform of RPI. With assets of around £1.7 trillion backing liabilities of approximately £1.9 trillion[6], the DB sector is a significant part of the UK financial system.

Why is RPI relevant for DB pension schemes?

11. The liabilities of UK DB schemes are linked to inflation in two ways: for deferred members[7], benefits are revalued in line with inflation from the point of exiting the scheme to the point at which the pension can be taken. Once in payment, pensions are uprated in line with inflation.

[5] For example, the UKTi 41s were issued via syndication in November 2019.
[6] The DB landscape – Defined benefit pensions 2019, The Pensions Regulator.
[7] Members who have left the scheme prior to reaching the scheme’s pension age.

12. Inflation protection in UK DB schemes is complex, with statutory requirements that impose caps and floors in inflationary increases interacting with scheme-specific rules on the level of inflationary increases awarded. The complexity does not matter here, but what is relevant is that RPI is heavily used as the inflation index of choice when making these adjustments[8]. UK DB liabilities therefore have a significant amount of RPI-linkage built into them. Replacing RPI with CPIH will therefore have a significant effect on pension scheme liabilities and the individuals to whom these obligations are due.

DB investment strategies

13. When investing contributions to meet their liabilities, many trustees of corporate DB plans have adopted Liability Driven Investment (LDI) Strategies, following best practice in the market as well guidance issued by The Pensions Regulator[9]. LDI strategies involve investing a portion of the scheme's assets in instruments that match the sensitivity of its liabilities to inflation and interest rates as well as generating cash flows.

14. The purpose of these approaches is two-fold: firstly, ensuring the scheme's funding position (the difference between assets and liabilities) is broadly stable, and secondly, that appropriate cash flows are generated at the point needed to pay pensions. In constructing these investment strategies, DB schemes use index-linked gilts and RPI-linked inflation swaps to hedge the inflation-linked elements of their liabilities and generate the necessary cash flows.

15. According to recent research by the Pensions Policy Institute (PPI)[10] DB schemes hold around £470bn in index-linked bonds, the majority of which are likely to be index-linked gilts. In addition, DB schemes hold exposures of around £350bn in inflation swaps and gilt repos. In aggregate, therefore, the exposure of DB schemes to RPI – and any changes to it – is significant, in terms of both assets and liabilities.

Impact on stakeholders in DB pensions

16. There are three key stakeholders in the DB pension sector who will be affected by the change: pensioners, the pension fund itself and the corporate sponsor of the scheme. Furthermore, there are two key determinants of how these groups will be affected: (i) the extent to which scheme liabilities are RPI-linked (as opposed to CPI); and (ii) the extent to which schemes have hedged inflation risk through the purchase of RPI-linked assets. While the impacts are heterogeneous across schemes, there are some general impacts that can be drawn out.

17. <u>Pensioners</u>: where benefits move from an RPI link to a CPI link, revaluation of deferred entitlements and uplifts to pensions in payment will now take place at a

[8] According to data published by the Pensions and Lifetime Savings Association in its 2017 Annual Survey, 64% of schemes uprate pensioner benefits in line with RPI, while around 35% use RPI for revaluing deferred members' benefits.

[9] Investment guidance for defined benefit pension schemes, The Pensions Regulator, 2019.

[10] Briefing Note Number 118: How could changes to price indices affect Defined Benefit schemes?, Pensions Policy Institute (PPI), 2020.

lower rate, such that the expected lifetime income of affected pensioners will reduce. The impacts will be bigger the earlier they take place and will also, on average, affect women more, given their longer life expectancy.

18. Based on CPIH being 1% per annum lower than RPI (i.e. the average difference between RPI and CPIH since 2010[11]), modelling by the PPI[12] indicates that a 65-year-old male pensioner taking his benefits in 2020 could experience a reduction in expected lifetime pension income of 8% if RPI and CPIH are aligned in 2025 and 4% if alignment is from 2030. For a 65-year-old female in 2020 the corresponding figures are reductions of 9% and 5% respectively.

19. For deferred members, the impact is even greater as both the deferred entitlements and pensions in payment receive a lower level of uplift. A member deferring for 10 years, in 2020, and taking their benefit at age 65 in 2030 could receive a pension of between 12% - 17% less (men) and 13% - 18% less (women) than they would have received under RPI indexation, depending on the date of alignment.

20. Note that this type of analysis would also apply to pensioners who had purchased RPI-linked annuities from an insurance company.

21. <u>DB pension funds:</u> How a pension fund itself is affected depends on the extent to which RPI is embedded in its liabilities and how much inflation hedging its trustees have carried out. These investment decisions are in turn a function of the fund's maturity, trustees' risk appetite, existing level of scheme funding and the strength of the employer covenant. The impacts will vary across funds, but the following table highlights the effect at the extremes:

Table 2: Effect of index change by liability-linkage and degree of inflation hedging

	Fully inflation hedged	**No inflation hedging**
RPI-linked liabilities	Assets and liabilities both fall, so funding position is broadly unchanged	Liabilities fall, assets broadly unaffected, so funding level improves
CPI-linked liabilities	Assets fall in value but liabilities are unchanged, so funding position deteriorates, and hedging level reduces	Assets and liabilities are both unaffected, so funding level remains broadly unchanged

Source: Insight Investment

22. As noted in paragraph 15, DB schemes own significant amounts of RPI-linked assets to hedge their inflation risk. This is true even where schemes may have a greater liability exposure to CPI: the market for CPI-linked assets is small and illiquid,

[11] As set out in paragraph 16 of the HMT/UKSA consultation.
[12] Briefing Note Number 118: How could changes to price indices affect Defined Benefit schemes?, Pensions Policy Institute, 2020.

meaning that RPI-linked assets have generally been the most effective hedge for CPI-linked liabilities.

23. Estimates of the impact of RPI reform on the index-linked gilt market vary between a total reduction in value of £60bn - £90bn[13], depending on the timing of the change. The table below shows the estimated loss for different holdings of index-linked gilts, depending on the timing of the change:

Table 3: Loss in value of RPI-linked gilts by value of gilts held and timing of reform

Value of index-linked gilt holdings	Timing of change	
	2025	2030
£10m	-£2m	-£1m
£100m	-£17m	-£13m
£500m	-£87m	-£67m
£1bn	-£174m	-£133m

Source: PPI

24. The estimates here do not take account of any impacts on other RPI-linked assets that pension funds use to match liabilities. The impact on pension funds would be greater still if these effects were taken into account.

25. It is the difference between the inflation linkage in liabilities and that in the matching assets that will cause a deterioration in schemes' funding positions under the proposed reform. While the impact will vary across schemes, given the prevalence of RPI-linked liability matching instruments in the DB sector as a whole and the wide mix of RPI and CPI-linked liabilities, there is a possibility that the aggregate effect of the proposed RPI reform on the sector as a whole is likely to be negative in funding terms. We discuss the implications of this below.

26. When purchasing these assets, trustees have been acting in line with the view of The Pensions Regulator, which has stated that trustees are "*legally required to invest assets backing DB liabilities in a way that is appropriate to the nature, timing and duration of the expected future retirement benefits payable under your scheme*"[14].

27. Furthermore, in purchasing RPI-linked instruments, DB schemes have done so on the basis that these assets would provide RPI-linked returns. Numerous statements by public authorities as far back as 2012, as set out in section 2.3 of the consultation paper, have provided reassurance and certainty for schemes when purchasing these assets. Across the relevant markets, prices paid for these assets have incorporated the expectation that returns would be RPI-linked.

28. As can be seen in table 2, it is precisely those schemes that have acted prudently and in line with their Regulator's guidance that would be most adversely affected by the proposed reform. We strongly believe that schemes that have acted in this fashion to hedge their inflation risk should not be penalised for doing so.

[13] PPI, Insight Investment.

[14] Investment guidance for defined benefit pension schemes, The Pensions Regulator, 2019. See page 64 for guidance on the use of matching assets.

29. Corporate sponsors: The sponsoring employer of a DB pension is legally obliged to provide on-going financial support to its pension scheme. Where deficits arise, the sponsor must make good the deficit in line with a recovery plan agreed with the scheme's trustees and approved by The Pensions Regulator.

30. As with the impact on schemes, the impact of RPI reform on sponsoring employers is not uniform. Where a scheme's funding position worsens, the employer will have to increase contributions to the scheme in order to recover the deficit. On the other hand, if a scheme sees an improvement in funding, the corporate sponsor may be in a position to reduce future contributions, if the trustees agree.

31. We note also that some corporates could be affected both as businesses and sponsors of a pension scheme e.g. a property company whose income from rent is linked to RPI and who sponsors a DB scheme. Thus, changes in the funding position of a pension scheme have implications for the security of members' benefits as well as other stakeholders of the sponsoring employer – employees, shareholders and creditors.

What is the impact of reform on other asset classes?

32. DB schemes and other investors also hold a variety of other asset classes that could be affected by the proposed reform to RPI. We discuss these briefly here.

33. RPI-linked inflation swaps: DB schemes are heavy users of RPI-linked inflation swaps, which are also used in hedging long-term inflation-linked liabilities. Some of these contracts can have maturities as long as 50 years. Under current RPI-linked swaps, DB schemes pay a fixed return in exchange for an RPI-linked return.

34. If RPI is aligned with CPIH, the payments received by the scheme will drop, while the payments it makes to the counterparty will remain unchanged. This could decrease the effectiveness of these instruments in hedging liabilities.

35. Real estate: Long-lease real estate and ground rent contracts are commonly linked to RPI, which has proven an attractive tool for investors seeking to match long-term liabilities. The RPI-indexed long-income market is currently worth approximately £40bn. While newer contracts will contain language allowing an alternative rate to be used, this may not be the case for older contracts. If RPI is replaced by CPIH with no adjustment, it is expected that such long-income assets could lose 20% of their asset value, dependent on duration.[15]

36. Infrastructure: Infrastructure assets are viewed as an effective inflation hedge by investors looking to match long-term liabilities. Regulated utilities, PFI contracts and renewable assets can benefit from income indexation on their revenues that has been historically linked to RPI, with a number of these indexation mechanisms being contractual and, in some cases, in legislation. If RPI is replaced by CPIH without adjustment, an estimated £837bn in future payments for infrastructure projects could be impacted, with a resultant loss in future income of £3.5bn-£8.5bn.

[15] Aviva Investors.

Highly leveraged projects could see their credit-worthiness impacted by such a reduction.[16]

37. RPI-linked listed corporate bonds: It is estimated that £60bn (notional) of UK index-linked corporate bonds could be impacted by the reforms. While the terms of some bonds do contain language relating to significant changes to the index, others do not. Given that some of these bonds mature beyond 2060, if RPI is replaced in 2030 by CPIH without adjustment, the potential asset value loss could exceed £6bn.[17] This will impact market confidence in index-linked corporate debt.

38. A more general point in relation to the corporate bond market is that pension liabilities can have an impact on corporate credit ratings, which will feed through to companies' creditworthiness[18]. The academic literature covering the impact of pension liabilities on corporate credit ratings broadly shows that changes in pension funding levels are associated with bond rating changes, in the directions that one would expect. That is to say deterioration in scheme funding levels can lead to rating downgrades and vice versa[19]. Where corporate sponsors see their scheme funding deteriorate, an indirect effect of RPI reform could therefore be a negative impact on their credit rating.

39. Private corporate debt: The index-linked private corporate debt market is worth approximately £68bn and could see a reduction in income of between £3bn-6bn over the lifetime of the debt. Combined with the impact on index-linked infrastructure project income streams, the total impact on private markets could be over £10bn.[20]

Mitigating the impact of RPI reform on the economy and investors

40. We note the statistical concerns over RPI set out by the UKSA in the consultation and sympathise with UKSA's position in seeking to ensure the robustness of inflation measurement in the UK.

41. However, it is clear that the effects of reforming RPI as proposed will be significant and adverse for investors and the wider economy. Given that investors have entered into RPI-linked contracts on the basis that RPI would continue, we believe that HMT and UKSA should be guided by the principle that arbitrary economic redistribution between different parties should be avoided.

42. We believe that the best way of reconciling the need to ensure the integrity of UK inflation measures while mitigating any adverse impacts on investors is to redefine RPI as being equal to CPIH + x, where 'x' is a margin broadly equal to the average difference between RPI and CPIH, calculated over a pre-agreed and observable

[16] Aviva Investors.
[17] Aviva Investors.
[18] For example, see 'Assessing the impact of pension liabilities on credit ratings' in which the ratings agency Fitch discusses how it takes into account pension liabilities in its' ratings process.
[19] See, for example, Wang, F.A., Zhang, T. 'The effect of unfunded pension liabilities on corporate bond ratings, default risk, and recovery rate', Review of Quantitative Finance and Accounting (2014).
[20] Aviva Investors.

period. The margin should be established by a further impartial public consultation conducted by UKSA and HMT.

43. If this process is carried out in a transparent manner, we believe that transition away from RPI will occur in a manner which all parties perceive as fair and equitable. Crucially, this solution would take account of the use of RPI beyond the index-linked gilt market – the 'RPI = CPIH + x' approach would flow through into the RPI-swap market and wider asset classes that have an RPI link.

44. As an operational matter, the re-papering of contracts that reference RPI throughout the economy will be a costly and onerous piece of work for affected parties to undertake. By redefining RPI as CPIH + x while maintaining the RPI name and continuing to publish the RPI, this should allow such contract re-papering to be avoided.

45. It would also make the reform less sensitive to the timing – meaning that it could potentially happen at the earlier end of the range allowed for by HMT provided that the spread is set at suitable level that ensures fair and equitable treatment of affected parties. As has been demonstrated here, without mitigation the impact on investors is bigger the earlier reform takes place.

46. Finally, as a comparison with a similar reform, we note the way that LIBOR transition is being undertaken, where the replacement will be SONIA + a spread. UK authorities have been clear that the intention is that LIBOR will cease to exist after 2021 and the market has had certainty in this regard[21]. We note also that the FCA has set out clear expectations that customers are treated fairly when transitioning away from LIBOR and that firms must act in the best interest of clients[22]. Finally, and crucially, the transition from LIBOR to SONIA + spread is being undertaken with a wide-ranging consultation across a range of market participants on how to set that spread. We would like to see the same principles being applied in RPI reform.

[21] '[Asset management firms: prepare now for end of LIBOR]', FCA letter to CEOs of Asset Management firms, 2020.

[22] [Conduct risk during LIBOR transition], FCA, 2019.

Response to selected consultation questions

2. What will be the impact on the interests of holders of 'relevant' index-linked gilts (i.e. $2^{1/2}$% IL 2020, $2^{1/2}$% IL 2024 and $4^{1/8}$% IL 2030) of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

3. What will be the impact on the interests of holders of all other index-linked gilts of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

4. What will be the impact on the index-linked gilt market or those dependent on it of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

47. As we have discussed at length in this response, we believe that investors in index-linked gilts will see a loss in both income and value if the proposed reform of RPI goes ahead without any mitigation. The impact will affect not just holders of the 'relevant' index-linked gilts, but the wider market for index-linked gilts. In general, the earlier any reform is carried out, the greater will be the impact on investors.

48. Given the use by DB pension schemes of index-linked gilts in hedging their liabilities, the impact will be felt particularly by this sector, including ultimately the pensioners who rely on these schemes to pay their pensions.

5. What other impacts might the proposed changes to address the shortcomings of the RPI have in areas or contracts where the RPI is used?

49. RPI is deeply embedded in the economy and as discussed in our response, a wide range of asset classes and contracts are linked to RPI. The proposed reform will affect both income streams and asset valuations, to the detriment of investors.

6. Are there any other issues relevant to the proposal the Authority is minded to make of which the Authority or the Chancellor ought to be aware?

50. While we recognise that the jurisdiction of UKSA and the legislative role of the Chancellor in this matter do not extend to cover the wider issues discussed in our response, we nonetheless strongly urge UKSA and HMT to consider these impacts in arriving at a final decision. We believe that the potential for significant adverse impacts is great if these wider issues are not taken into account.

51. Our proposed mitigation of defining RPI as CPIH + x will ensure that investors are not adversely affected by the change, while ensuring that UKSA's objectives of producing a statistically robust and credible inflation index for the UK are met.