ACA Conference

The move to CPI indexation

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Inflation

Risks, challenges and opportunities

- Pension increases are a huge part of benefit
  - Revaluation (in deferment)
  - Indexation (in payment)

Pension | Revaluation | Indexation

- Measuring inflation is hard!
  - Various measures exist
  - Differences are very material
- Unfortunately this is a legal mess
  - Polarised opinions, and still working through the courts
  - Decisions turn on really subtle differences in wording

Note: get legal advice, and stay up to date

Some of the RPI/CPI legal cases

Not all of these have adopted CPI!

Agenda

- **Inflation**
  - RPI, CPI, CPIH
- **Case studies**
  - Scheme rules – the devil is in the detail
- **The investment implications**
  - Inflation hedging
  - Case study – moving from RPI to CPI

RPI is not a good measure of inflation, don't just take my word for it…

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.

John Pullinger
National Statistician

It is unlikely that scheme rules were ever intended to tie trustees to an index the National Statistician has described as flawed.

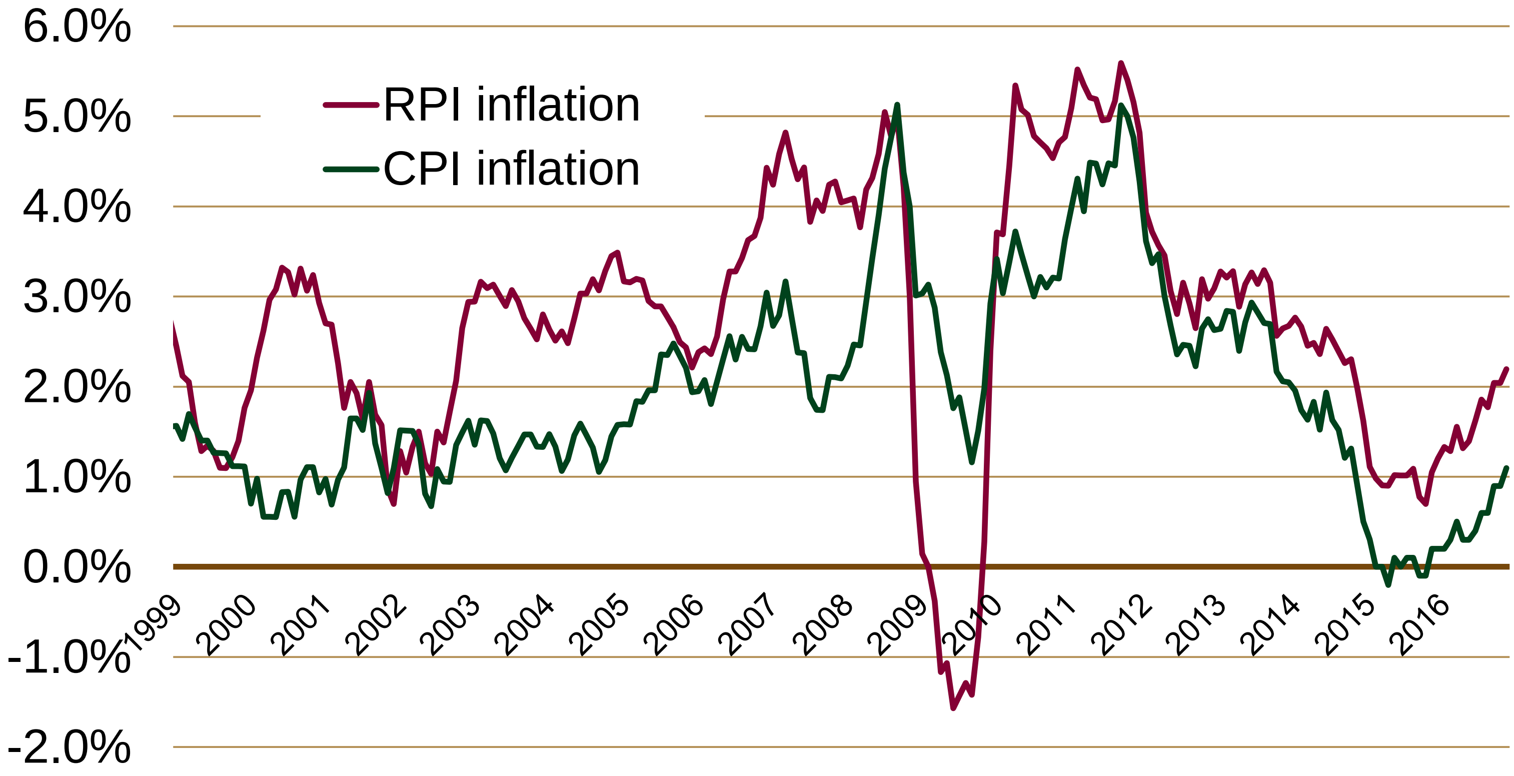
Bob Scott
ACA Chairman

The RPI is not fit for purpose and should not be used except where existing legal contracts – for example index-linked gilts – demand it

Paul Johnson
Director of the Institute for Fiscal Studies

1 Letter to Sir Andrew Dilnot CBE, Chair of the UK Statistics Authority, "Shaping the Future …", John Pullinger, 9 March 2016
2 "UK Consumer Price Statistics: A Review", Paul Johnson, January 2015
3 ACA Press Release 10 October 2016

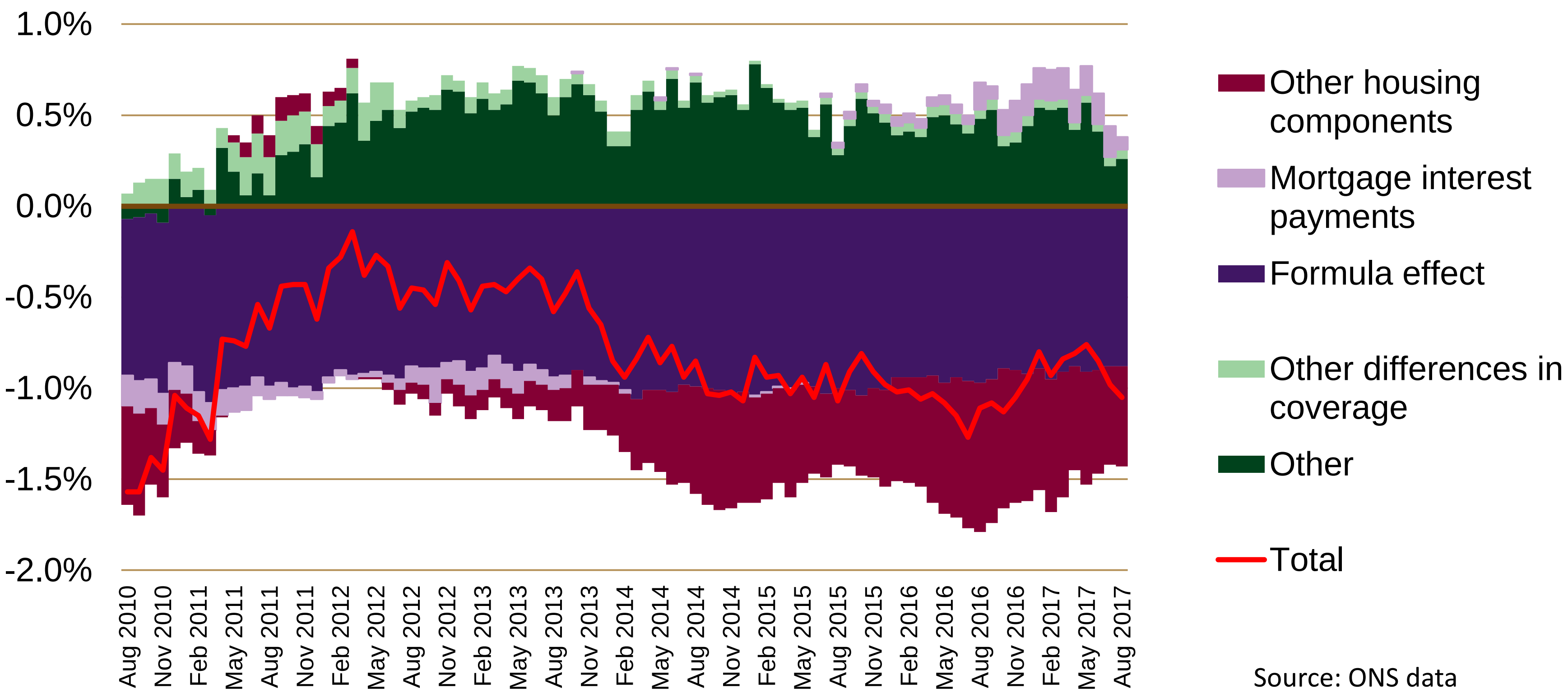
Measures of inflation



Source: ONS data

RPI and CPI – breakdown of differences

Housing and the "formula effect" are key differences



Source: ONS data

What's CPIH?

CPIH is:

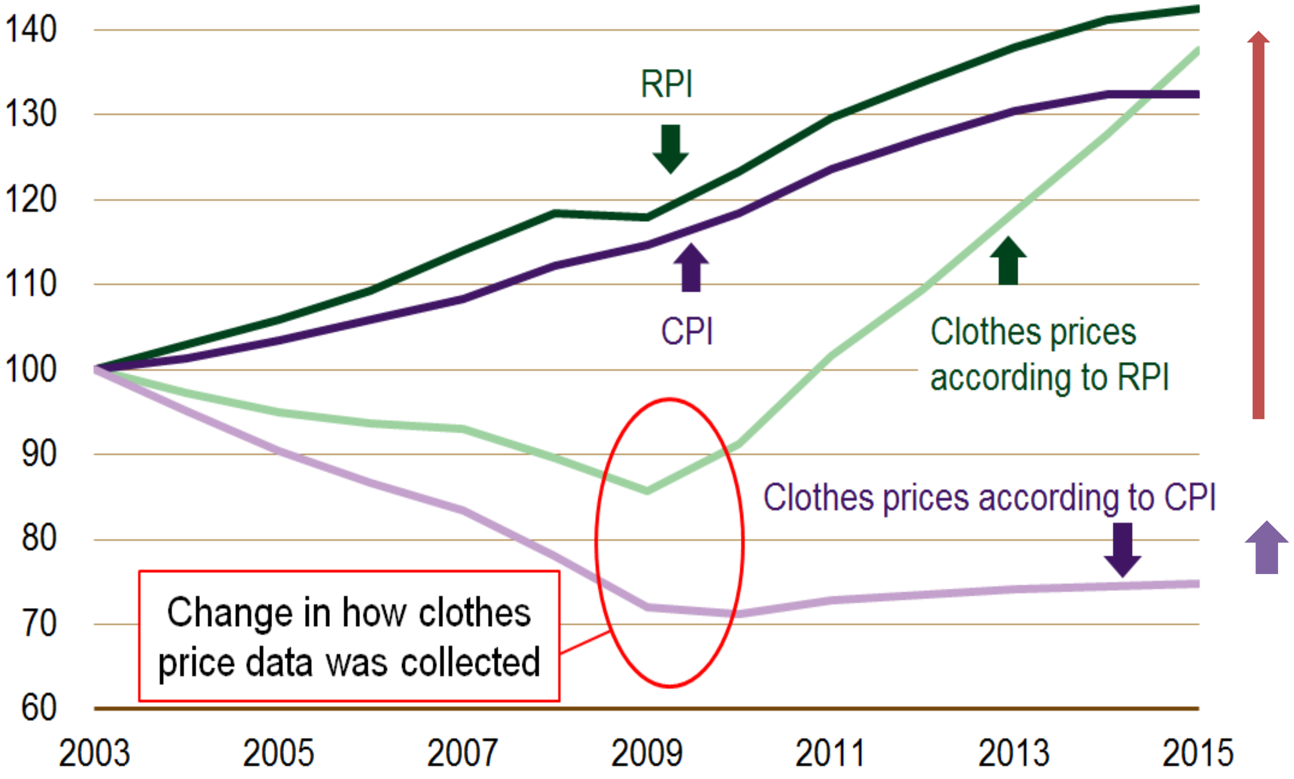
- 16% owner occupiers housing costs (using rents as a proxy)
- the rest is identical to CPI

BUSINESS NEWS | Thu Nov 10, 2016 | 10:46am GMT

UK to adopt CPIH as preferred inflation measure in March 2017

The RPI and CPI difference

The "formula effect" is at its greatest for clothes



RPI clothes prices c10% per year

CPI clothes prices c1% per year

How to calculate inflation

And why RPI is different to CPI

	A	B	C	D	E	F
1						
2		2015	2016	Ratio		
3	Red dress	£20	£30	150%		
4	Blue dress	£25	£40	160%		
5	Green dress	£40	£20	50%		
6	Yellow dress	£30	£25	83%		
7		£115	£115			
8						
9			CPI inflation uses	0%	=GEOMEAN(Ratio)-1	
10			RPI inflation uses	11%	=AVERAGE(Ratio)-1	

- How bad could this get?
  - Isle of man (+5%)

Case Studies

Some of the RPI/CPI legal cases

Not all of these have adopted CPI!

QinetiQ

Arcadia

BRITISH AIRWAYS

Believe in children
Barnardo's

THALES

Does Section 67 prevent moving to CPI?

Answer: it depends!

- Lots of legal cases on this very point
  - Including at the Court of Appeal
  - Seem unlikely to be over-turned

- **Without a law change, benefits cannot be reduced**
  - **But often promise was inflation … not RPI**

- Legal conclusion
  - If rules are explicitly locked into RPI, have to use RPI
  - If rules permit choice (eg by company or trustee) then that choice can be exercised in favour of CPI

Pension increases

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Can be a controversial and emotive issue

BA: Trustees had no power to make amendment

Airways Pension Scheme (APS) trustees did not have the authority to make an amendment to the scheme rules, a...

Law And Regulation

BA case: APS actuary defends advice that an increase was 'reasonable and prudent'

The Airways Pension Scheme (APS) actuary has defended his advice to trustees that awarding a discretionary...

Law And Regulation

BA case: Increases can be awarded when a scheme is in deficit, says APS actuary

Granting discretionary increases was not necessarily precluded by the scheme being in deficit, the Airways Pension...

Law And Regulation

BA: Trustees' actuarial advice was too precise

The Airways Pension Scheme (APS) trustees received advice that was too precise to be a prudent recommendation,...

Law And Regulation

BA trustees: We had a unilateral power to amend scheme rules

Trustees of the Airways Pension Scheme (APS) had a unilateral power to amend the scheme rules, their lawyer has...

Law And Regulation

BA trustees: Leading counsel called increase amendment an 'elegant solution'

Amending scheme rules to allow for discretionary increases provided an "elegant solution" to the indexation...

Law And Regulation

British Airways: Trustees went ahead with increase after TPR warnings

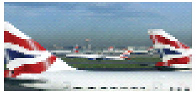
British Airways' (BA) scheme trustees approved a discretionary increase above the rate of the Consumer Price...

Law And Regulation

BA trustees: Advisers did not succumb to pressure

Advisers to the Airways Pension Scheme (APS) did not succumb to pressure from trustees to deliver a framework in...

Law And Regulation



British Airways: APS trustees wanted scheme to be in deficit

Trustees of the Airways Pension Scheme (APS) believed it would be a "lost opportunity" if the scheme ran a...

Law And Regulation

British Airways: APS trustees felt subject to 'four-pronged attack' and turned on advisers

British Airways' (BA) scheme trustees turned on their advisers and put pressure on them to change their advice,...

Law And Regulation

British Airways: Trustees were 'inflexible' and ignored advice

Trustees of a British Airways (BA) pension scheme have been described as "inflexible" after being accused of...

Law And Regulation

British Airways: Trustees granted members 'gratuitous and unearned' benefits

Trustees of the British Airways pension schemes have been accused of trying to grant

What is the duty of the Trustees?

"To acting in the best interests of the members"

... to define the trustee's obligation in terms of acting in the best interests of the beneficiaries is to do nothing more than formulate in different words a trustee's obligation to promote the purpose for which the trust was created.

Judge Sarah Asplin
MNRPF v Stena Line

MNRPF v Stena Line, Asplin J Merchant Navy Ratings Pension Fund Trustees Ltd v Stena Line Ltd & Ors [2015] EWHC 448 (Ch) at 228

Case studies

1. Buy-out case study
   - Trustees' view was CPI
   - Insurers' view was it's not clear

2. *Replacement* case study
   - Both Trustee and Company wanted CPI
   - QC's view was RPI not replaced

3. Trustees: *"We can change, but should we change?" case study*
   - Company view was RPI discredited and change substantially reduces deficit
   - Trustee view is that some incentive should be provided

The investment implications

Hedging "inflation"

It's much harder than you might think

- Which inflation?
- With what caps and collars?
- According to whose model?
- Note: To hedge CPI, most schemes use
  - RPI hedge (and simply accept the basis risk)

Simple case study

Inflation-linked before retirement, Inflation(0,5) in payment

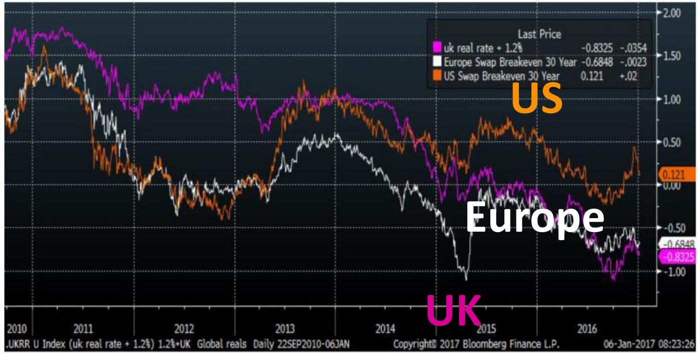
RPI	CPI
Assets £540m	Assets £540m
TPs £720m	TPs £610m
Funding level 75%	Funding level 89%
Interest rate hedge 60%	Interest rate hedge 75%
Inflation hedge 60%	Inflation hedge 69%

"Inflation hedging is really expensive in the UK"

- International client
- Yes, RPI is expensive
- But inflation hedge isn't!

Real yield (UK RPI based)

Real yield (UK CPI based)



Summary

Inflation

Risks, challenges and opportunities

- Pension increases are a huge part of the benefit, but measuring inflation is hard!
- The legal situation is more clear following the Barnardo's decision, and more recent cases (such as Thales) but still lots of inertia and opinions are still somewhat polarised
- There are very significant investment and real-world implications
- Actuaries need to be very careful using terms like “inflation” and “real”
- Questions: should actuaries have a view on whether RPI is creditable?

Any Questions?

Appendix

Are holders of RPI linked bonds protected?

- Legislation requires fundamental changes to be referred to Chancellor (Section 21)
- Some bonds contain no obvious protections (mainly the more recent ones)
- Other bonds have a put option allowing you to sell bond back to the government at its indexed par value. But the bonds are worth more than that anyway – so the protection may have little or no value
- Other legal arguments might emerge

Many factors impact on the scenario

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Company situation

- Financial distress
- Regulatory pressure (eg for an insurer, this is a potential management action)
- Have advisers raised this, or is there an interested non-exec on the board?

Stakeholders' views

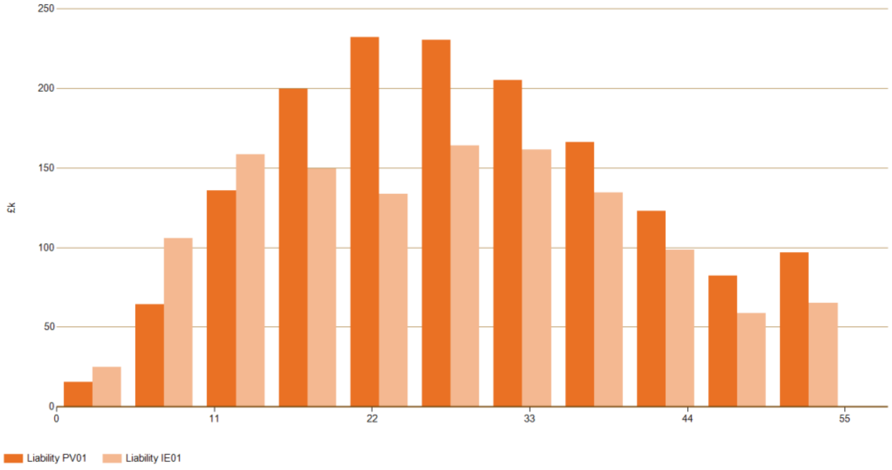
- CEO / CFO
- Trustees
- Advisors
- Willingness of pensions experts in company to raise the issue (sometimes conflicted parties)
- Relationships (eg willingness of the parties to negotiate)

Rules/legal

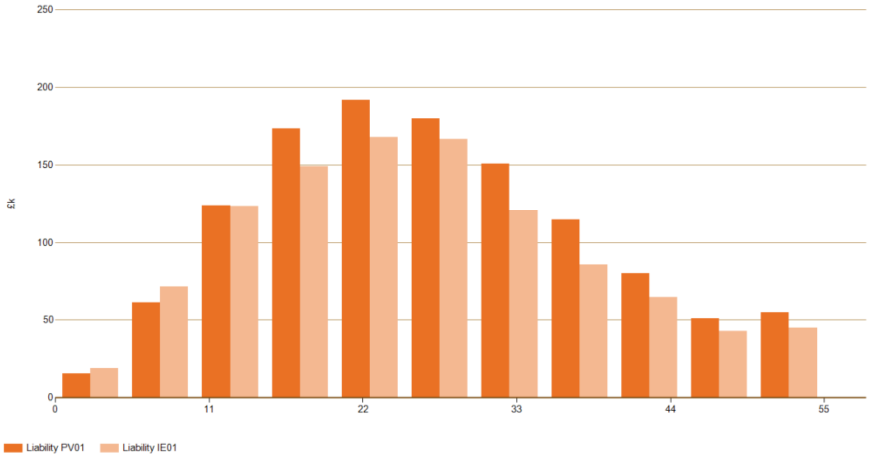
- Pension increase rule wording
- Other powers in the rules, eg amendment power
- What was said to members?

The inflation model used is really important

Before (RPI)



After (CPI)



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