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Date: 21 August 2020

Dear RPI Consultation Team

Response to 'A Consultation on the Reform to Retail Prices Index Methodology'

This response to the consultation named above is on behalf of Greater Manchester Pension Fund ('GMPF'), which is the largest Local Government Pension Scheme ('LGPS') fund in England and Wales with approximately 385,000 members, 600 contributing employers and assets of around £25bn. This response is drafted from an administering authority perspective.

Overall, we agree with the premise that from a statistical perspective, RPI is a flawed measure of inflation and that CPIH is a potentially more suitable metric for measuring inflation. However, we have concerns about the potential consequences of introducing the proposed measures, which will likely result in significant financial losses for some investors.

Implementing the proposals would likely result in a reduction in the value of GMPF's assets (due to its holdings of Index-linked Gilts (currently valued in excess of £500m) and RPI swaps), with no corresponding reduction in the value of its liabilities (as the vast majority of LGPS benefit increases are linked to CPI).

In addition, in 2015 GMPF began a programme of investing directly into UK infrastructure. We have now deployed over £470m into a range of UK infrastructure assets, including new-build renewables and rolling stock. We estimate that the proposed index change will reduce the value of this portfolio by £15 – 20 million.

All GMPF employers will be impacted to an extent, with four larger employers likely to experience a more significant impact due to material allocations to either Index-linked gilts or RPI swaps as part of their bespoke investment strategies, which were intended to be lower risk than the GMPF Main Fund. Ultimately, <u>any financial losses in the LGPS will largely be borne by local taxpayers.</u>

We strongly believe that Government and its relevant agencies should have started to issue Index-linked gilts which reference CPI from the point that CPI became the Government's preferred inflation measure and the measure used to increase benefits in many defined benefit pension schemes (including the Local Government Pension Scheme).

Its failure to do this has effectively given many pension funds no option but to buy RPI based Index-linked Gilts and swaps should they wish to create an approximate hedge against higher than expected CPI inflation. This concept of 'matching' assets and liabilities has been implicitly encouraged by the Pensions Regulator for some time, right across the defined benefit pension landscape in the UK.

To avoid prudent investors incurring potentially significant financial losses, our strong preference would be for RPI to remain unchanged, with all new contracts (such as new issues of index-linked gilts) being issued with reference to CPI or CPIH. This would still achieve the intended objectives, albeit phased in over a number of years. If the proposed changes are made as planned, then investors should be compensated to reflect the financial loss suffered as a result of the change.

1. Do you agree that this proposed approach is statistically rigorous?

We are reluctant to condone the statistical rigour of the proposed approach when we do not believe that replacing RPI with CPIH is sensible without having addressed its wider implications. RPI is a distinct metric to CPIH and their differences are already adjusted for in the value of financial contracts. Replacing RPI with CPIH renders those adjustments invalid and the impact is to create winners and losers on a significant scale. We understand that the impact on the totality of index-linked gilt holders alone will be a loss in the region of £100 billion.

We agree that from a statistical perspective, RPI is a flawed measure of UK inflation and CPIH is a more suitable metric for measuring UK inflation. That said, in the pension industry, the rate of growth in RPI is effectively considered to be equivalent to that of CPIH plus a margin plus an error factor. Our actuary broadly concurs with the statement in the RPI consultation document that this margin is on average approximately 1% per annum. Hence, when pension increases are inflated by RPI, the pension increases are not being inflated incorrectly, but rather that the pension increases each year are inflated by UK consumer price inflation plus a margin of around 1%.

We appreciate that addressing the shortcomings of RPI is a matter of importance to the UK Statistical Authority. However, the statistical integrity of RPI in the way that it seeks to justify the proposed changes are not a key issue to us as users of RPI because its characteristics as they are currently understood, warts and all, are already allowed for in our calculations. On the contrary, interfering with RPI as proposed will create significant challenges for many stakeholders including pension schemes. It does not mean that we reject any attempt to fix RPI, however, getting this right will need much more than a change in methodology. The solution will have to answer the more complex question of how to fix RPI in a way that is fair and reasonable to all stakeholders.

It therefore seems much simpler to us if the conclusion of this consultation is not to change RPI. We support the UK Statistical Authority and the Office for National Statistics continuing to "restate its position that RPI is a flawed statistical measure of inflation" until the wider implications of replacing RPI can be properly resolved.

2. What will be the impact on the interests of holders of 'relevant' index-linked gilts (i.e. 2½% IL 2020, 2½% 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?

Holders of the 2020 and 2024 index-linked gilts (ILGs) should not be directly impacted by changes in RPI occurring from 2025 onwards. For the 2030 ILG, the impact will be minimal if the proposed change takes place in 2030 and the impact will increase as the implementation date is brought forward. We understand from our actuary that the impact of a 2025 implementation date would be a loss of c.5% for the 2030 ILG, if implementation means that the growth rate in RPI is lowered by 1% per annum from that date.

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?

The impact on index-linked gilts (ILGs) that mature after 2030 will be material if the proposed change takes place in 2030 and even greater if the change occurs sooner. For example, the longest dated

ILG matures in 2068 and if the growth rate in RPI is lowered by 1% per annum from 2030, we understand from our actuary that the loss on the ILG would be c.30%. If the growth rate in RPI is lowered by 1% per annum from 2025, the loss would be c.35%.

Taking all ILGs in aggregate, other than the three ‘relevant’ gilts, we understand from our actuary that the impact of implementing the change in 2025 will be a loss of over £100 billion and over £80 billion if implemented in 2030. Whereas in some areas of public policy, a phase-in period of five to ten years may be sufficient to minimise the impact on relevant stakeholders, the long-term nature of ILGs means that even a phase-in period of ten years would be woefully inadequate in safeguarding the interests of ILG holders in aggregate. Pension schemes are significant holders of ILGs maturing beyond 2030, which would be severely impacted by the proposed changes. The burden for any shortfall this creates for most pension schemes is expected to lie somewhere between the sponsoring companies and the members of those schemes:

However, <u>in the LGPS, it is ultimately local taxpayers who will be responsible for much of the shortfall, with consequences for employment and economic growth.</u>

The change in RPI will also have a significant impact on RPI-linked liabilities of pension schemes and some pension scheme balance sheets could show an improvement because liability values fall by more than asset values. There will be a lottery effect to this however, with some scheme balance sheets benefiting while others are negatively impacted. The main factors that will influence the balance sheet position are the proportion of liabilities that are CPI-linked versus RPI-linked and the amount of inflation risk hedged through the asset strategy. Ironically, conservative asset strategies are likely to be penalised most. For schemes that do see an improvement in their balance sheet, this will only have arisen because their members’ benefits have been reduced.

There is very little reduction in the value of LGPS liabilities, as the vast majority of LGPS benefit increases are linked to CPI.

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?

In our opinion, voluntarily making a methodology change that could wipe out up to a third of the value of index-linked gilts (ILGs) could potentially have negative consequences for the gilt market. Although it may not have been initiated by the Government, allowing this level of write down to take place could be viewed as an opportunistic way for the UK Government to restructure its debts to its own advantage. We do not know if the global investor community will take this view, but we see it as a risk, the consequence of which would likely be higher Government borrowing costs in the future, not just on ILGs but on all gilts. In the end, the financial system operates on trust and the UK Government’s reputation for treating debtholders fairly could be tarnished if ILG holders suffer significant financial losses from such a change.

There is also potential moral hazard with this proposed change. We do not believe that UK institutional investors buy ILGs because they are perceived as good value or to shrewdly benefit from a 1% per annum extra return arising from a flawed inflation measure. The yield offered on ILGs is materially negative, so much so that some may think it incredible for investors to be buying an investment that is guaranteed to earn a material negative return after allowing for inflation. Nevertheless, many pension schemes have been persuaded over the years to increase their allocation to ILGs because they are the most practical matching asset to pension liabilities linked to inflation. This is an investment decision driven by risk reduction rather than expectations of high returns. If these ILG holders suffer significant losses from the proposed change, it will send the wrong message to the industry because it will have the effect of penalising most those who invested most prudently. This may undo the trend to reduce risk in pension schemes and increase systemic risk in the industry. It could also cast doubt by ILG investors about the credibility of the inflation-linked promise if with the stroke of a pen the inflation measure can be changed at any time. Both these effects could reduce the demand by pension schemes for ILGs.

We do not believe that any attempt to fix RPI inevitably leads to ILG holders having to be penalised. There are various ways this might be achieved, though this does not appear to be within the scope of this consultation. Briefly though, a comparable issue that we see running in parallel to RPI reform is LIBOR reform. Essentially LIBOR as a benchmark interest rate is being discontinued due to certain flaws in its measurement and is being replaced with an alternative interest rate. As the new interest rate is structurally lower than LIBOR, simply substituting one for the other would create significant financial winners and losers on the vast volume of derivative contracts that depend on LIBOR. The derivative market is addressing this by substituting LIBOR in its contracts with the new interest rate plus a fixed margin to minimise the financial impact. This would be analogous to RPI being replaced with CPIH plus a fixed margin e.g. 1% per annum. We think such an approach would be much more reasonable than simply replacing RPI with CPIH with no adjustment. It is not the only solution that should be considered but one of a number of approaches that could be viable.

Alternatively, RPI could remain unchanged, with all new contracts (such as new issues of index-linked gilts) being issued with reference to CPI or CPIH. This would still achieve the intended objectives, albeit phased in over a number of years.

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?

The following are some of the areas beyond index-linked gilts that may affect pension schemes:

- As well as index-linked gilts, some pension schemes (including GMPF in respect of one large employer) use RPI swaps to hedge against inflation risk in pension liabilities. The value of RPI swaps would be impacted in a similar way to index-linked gilts.
- Pension schemes may also be invested in other assets that have linkages to RPI, such as long lease property and infrastructure investments. These tend to be long dated investments so changes that lower RPI could result in material losses for those investors.
- Many pension schemes pay pension increases linked to RPI. Lowering the rate of growth in RPI would lower the future pension increases of those pensioners. Just as in index-linked gilts, the impact varies according to how long the pension is expected to be paid for from the implementation date but is likely to be significant to a vast number of individual pensioners and scheme members that will be starting to draw their pensions in the future.
- Similarly, members of defined contribution pension schemes that have purchased RPI-linked annuities will see a reduction in their future annual increases from the implementation date. Since affected individuals will be unable to amend their choice to purchase an annuity, or associated terms, the value provided by the annuity will be reduced, all other things being equal.
- Over the last ten years there has been a significant move by UK pension funds, encouraged by government, to allocate capital to infrastructure. A key rationale for this move is not only the defensive nature of the assets but also the inflation linked cashflows. A large portion of the UK infrastructure market is exposed to RPI and many underlying contracts explicitly reference the index. The proposed changes to the index will negatively affect the revenue of

these assets, immediately impacting valuations and ultimately reducing the cash flows available to service pension liabilities.

- In 2015 GMPF began a programme of investing directly into UK infrastructure. We have now deployed over £470m into a range of UK infrastructure assets, including new-build renewables and rolling stock. We estimate that the proposed index change will reduce the value of this portfolio by £15 – 20 million.
- Clearly, many other investors would experience a similar effect on their portfolios and there must be a risk that this materially reduces investor confidence in the UK's regulatory and legal environment, with the obvious consequential impact on the Government's ability to secure private capital to support its infrastructure ambitions.

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?

We would like to make it clear that we deeply respect the independence of the UK Statistical Authority and its responsibility for maintaining the integrity of official statistics. We support these principles not merely as aims in themselves but in the context of serving the public good. In our view, rigorously applying these principles in isolation would not be best serving the public good. If c.£100 billion is transferred from ILG holders to the UK Government as just one example of the significant and arbitrary value transfer that would result, we do not expect this to be without consequence to individuals and companies throughout the country.

We therefore urge the ultimate decision makers in this process not to proceed with actions that will result in arbitrary value transfers of this scale.

7. Which lower level or supplementary RPI indices are currently used, and what are they used for?

We do not currently use lower level RPI indices.

8. What guidance would users of lower level or supplementary RPI indices find most useful for the ONS to provide?

Not applicable

Please do not hesitate to get in touch if you wish to discuss any of the matters covered by this consultation.

Yours sincerely,

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