Briefing

RPI reform: the impact on LGPS fund valuation assumptions

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On 25 November 2020, the Chancellor responded to the consultation on the reform of RPI, confirming that he will not provide consent for reform prior to 2030, meaning that the proposed alignment of RPI to CPIH will take effect from 2030 at the earliest.

It is expected that RPI will be on average 1% p.a. lower than otherwise from 2030 as a result. Although the majority of LGPS benefits are linked to CPI inflation rather than RPI inflation, we derive our assumption for future CPI inflation from market implied RPI inflation and therefore need to consider how the impact of this announcement and the planned reform of RPI affects your fund's valuation assumptions.

As part of the consultation response, the Treasury also confirmed that investors will not be compensated for the expected reduction in post-2030 coupon payments, meaning the change in RPI is expected to reduce the payments due from RPI-linked investments from 2030, such as index-linked gilts (ILGs). This will also need to be taken into account by Funds that hold these assets.

Deriving future assumed CPI inflation

As there is no deep and liquid market in CPI-linked investments, we cannot observe future expectations for CPI inflation reliably in the market. Therefore, as CPI is expected to be below RPI, we look at future expectations for RPI which can be observed in the market and make a deduction to arrive at our CPI assumption.

Our current CPI assumption was set prior to the consultation on the reform of RPI. Perhaps, rather surprisingly, there was little reaction by the market after the Chancellor's recent announcement, suggesting that reform had been anticipated and had already been reflected by the market in the yield available on RPI linked gilts. Therefore, our existing assumption for CPI could potentially understate future CPI inflation, and potentially understate the value of the liabilities as a result.

Current approach

We currently derive future assumed CPI inflation based on market implied RPI inflation, less a deduction of 1.0% p.a. to account for differences between the two indices (i.e. the formula effect). Market implied RPI inflation is taken to be the 20 year point on the Bank of England (BoE) implied inflation curve which is constructed using the difference between the yields on fixed interest and index linked gilts.

Potential new approach

As we now expect the method for calculating RPI to change from 2030, bringing RPI in line with CPIH from this date, we would suggest taking the term structure of RPI yields (i.e. how RPI is anticipated to change over time) into account and particularly how this is likely to interact with the typical term of an LGPS fund's liabilities. In particular, it is worth considering what the "single equivalent" rate would be – this is essentially the average RPI yield (weighted by the cashflow profile of the fund).

Based on a typical LGPS fund with a liability duration of 20 years, we note that the 20 year point on the BoE implied inflation curve has been consistently 0.1% p.a. – 0.2% p.a. higher than our calculation of the single equivalent RPI rate. This is due to the prevailing shape of the yield curve compared to the cashflow profile of the fund. As the shape of the yield curve is now more important given the announcement, we would propose to allow for this until the next valuation, although the shape of the yield curve will need to be monitored to ensure this adjustment is still reasonable.

Following the Chancellor's response to the consultation, the market movement in gilt-implied RPI inflation rates applying after 2030 was muted. Our view is that gilt-implied inflation rates applying after 2030 are potentially currently distorted by supply and demand factors, particularly at longer terms. We believe it would be reasonable to adopt an inflation risk premium (IRP) of up to 0.3% p.a. overall. If your fund holds a Liability Driven Investment (LDI) portfolio as part of the investment strategy, it may be inappropriate to allow for an IRP, given the portfolio's link to actual market pricing.

Finally, considering the gap in theory between future RPI inflation and CPI inflation, we believe that the difference between CPI and CPIH in future is negligible and we are therefore minded to assume that from 2030 RPI will be in line with CPI. Prior to 2030 we believe the existing formula effect of 1% p.a. will remain. If we apply this across the average LGPS fund cashflow profile, this equates to an average overall gap of around 0.25% p.a. - 0.4% p.a.

Overall, this leads us to propose that a best estimate long-term CPI inflation may be in the region of 0.7% p.a. - 0.8% p.a. lower than the 20 year point on the BoE implied RPI inflation curve, if we were to set a valuation assumption today. If your fund has an LDI portfolio then it may be appropriate to reflect a lower gap. As we get closer to 2030, the gap will continue to reduce to ultimately zero.

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beyond the expected

Impact on the discount rate

Your fund's discount rate is derived by calculating an expected return on each asset class and taking a weighted average of these returns based on the proportion of assets invested in each asset. On the funding basis, we deduct a margin for prudence.

> The expected return on equities, property and some alternative assets is assumed to have correlation with CPI inflation and, in particular, we assume that the future return on these assets equate to CPI plus x%, where the x% may change in line with other market information (as is the case with equities), or be fixed in nature (as is the case with property).

Any changes to the derivation of CPI will therefore feed through to the calculation of these expected returns automatically. There are, however, other asset classes that are not assumed to be linked to CPI inflation so the assumed expected return on these will not automatically be affected. Therefore, any changes to the liabilities as a result of the changes to the CPI assumption above may be partially offset by changes to the discount rate.

We also may need to consider whether the expected return on any index-linked gilts held by the fund will change and whether this needs to be reflected in the discount rate calculation.

The table below sets out the illustrative impact on the CPI assumption and the discount rate for a given percentage of assets future returns being linked to CPI, as well as the illustrative percentage impact on an average LGPS fund's liabilities.

> The cost of future accrual, part of which is paid for by the employer's primary rate, would also be anticipated to increase in the first two scenarios and to a slightly greater extent due to the longer average expected time to payment of benefits.

% of assets linked to CPI	Illustrative impact on CPI / discount rate assumption	Illustrative % impact on liabilities
50%	Increases CPI by 0.3% p.a. / Increases discount rate by 0.15% p.a.	Increase in liabilities of 3%
75%	Increases CPI by 0.3% p.a. / Increases discount rate by 0.225% p.a.	Increase in liabilities of 1.5%
100%	Increases CPI by 0.3% / Increases discount rate by 0.3% p.a.	No impact

Implementation and next steps

We will be revisiting assumptions at the 2022 valuation and will certainly be taking the reform into account when we set our RPI and CPI assumptions. That said, given the reform is almost certain to go ahead, making allowance for the reform in the assumptions in the funding and minimum-risk bases now would be sensible and reduce the number of step changes required at the next valuation.

> In particular, this would mean making the change for whole fund updates, new employer calculations (allowing for smoothing) and exit calculations. We would note that a minor amendment to the Funding Strategy Statement is likely to be required, although we suspect these could be included along with any changes as a result of the publication of the guidance on employer flexibilities.

We would welcome the opportunity to discuss making these changes to the funding and minimum-risk basis with you and, in particular, we can provide more information on this issue by providing a specific note in respect of the impact on your fund's liabilities, perhaps as part of a whole fund update.

The accounting basis is considered separately and we will communicate any changes within the usual briefing note, taking into account increased audit scrutiny of the accounting assumptions.

We would be happy to discuss with you the way forward for your fund.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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