



***Responding to the Government's consultation on the impact of using CPI as the measure of price increases in the private sector...***

## **ON GROUNDS OF EQUITY, ACA SAYS PRIVATE SECTOR SCHEMES SHOULD HAVE THE SAME ABILITY AS PUBLIC SECTOR SCHEMES TO APPLY CPI INDEXATION**

**7 March 2011 – The Association of Consulting Actuaries (ACA) is agnostic over the choice between the Retail Prices Index (RPI) and the Consumer Prices Index (CPI) as an appropriate inflation measure for setting pension increases and revaluation. Our concern however is that in its pension increase legislation, the Government has chosen one approach for public sector pensions and a different one for private sector pensions, based largely, we believe, on semantics and the result of a historical accident rather than a genuine difference between the two sectors. If the government believes that CPI pension increases are the way forward, it should have the courage of its convictions and make the same changes apply in the private sector.**

“Public sector pension schemes, and many in the private sector that are linked to the public sector (for example non-departmental public bodies or former nationalised industries), have experienced a one-off valuable reduction in liabilities through the move from RPI to CPI. Many employers in the private sector are being denied this despite being in essentially the same position as employers in the public sector,” says **Charles Young, Chairman of the ACA Pension Schemes Committee.**

Quality employer-sponsored pension benefits are under an increasing threat. As surveys conducted by the TPR, ONS, NAPF, the ACA and many others have shown private sector employers are increasingly closing their defined benefit pension schemes to future accrual, transferring current scheme members to lower cost defined contribution arrangements. If the government changes private sector schemes to make the move to CPI that it has made, without consultation, for public sector schemes, with pension increases for all service based on the CPI instead of the RPI, this would typically reduce scheme liabilities by 4% to 8%, depending on a scheme's maturity. This is a significant difference, which would remove some of the cost pressure on employers from their defined benefit pension schemes and may encourage them to keep these schemes open for longer.

The ACA's concern particularly relates to pension increases for pensions in payment, and less to deferred pension revaluation, as we explain below. A statutory minimum pension increase, known colloquially as Limited Price Indexation, inflation capped at 5% p.a., was introduced as a requirement for pensions accruing from 1997. The legislation that introduced the requirement allowed two slightly different versions of wording in the scheme rules to document the change:

- Schemes could adopt the statutory pension increase rules, with pension increases explicitly following the statutory minimum level. This would not only embody the general principle of increases in line with RPI capped at 5%, but would tie the scheme to all aspects of the published minima, in practice based on the index measured from September to September, implemented each April, and so on. In these circumstances, we understand that the move to CPI will be automatic.

- Alternatively schemes were able to put in their own scheme specific formula for increases, as long as this was based on RPI with a 5% cap.

At the time, our view is that all in the pensions industry would, in 1997, have viewed these two different pieces of wording as substantively the same, both effectively linking pension increases to a capped RPI measure. At the time, there was no concept that a different inflation index might be developed to replace the RPI. Quite a large proportion of schemes chose the second route. Many, we believe, wanted to maintain practices that they had previously adopted for pension increases granted on a discretionary basis, using a different reference period from the September to September period to set their annual increases, or giving increases on a different date, typically their scheme accounting year end, rather than moving into line with all aspects of the statutory rules. In some cases, trustees and companies (or their legal advisers) may have chosen the second route simply so that their scheme documentation contained a more complete description of the benefits that the scheme provided, without the need to cross-reference the legislation.

While it is not impossible, we believe that there are very few schemes indeed, if any, where a conscious decision was taken to align scheme increases with the RPI rather than whatever inflation measure happened to be chosen by the government from time to time under section 51 of the Pensions Act 1995.

The position can be contrasted with the position on pension revaluation for deferred pensioners. Here, there was no choice of documentation approach analogous to the choice available under section 51 of the Pensions Act 1995. Any deviations from the standard minimum would reflect a deliberate decision to give higher benefits than those required under legislation. Our experience is that the vast majority of schemes have used the statutory minimum formula, and revaluation will automatically switch to the CPI. We believe that there are few, if any, schemes that had deliberately negotiated revaluation linked specifically to the RPI rather than to a more general measure of inflation.

The demonstrable fact that few schemes chose to link deferred pension revaluation specifically to RPI does not necessarily imply that most schemes unintentionally linked pension increases to RPI. Companies may well be more generous with terms for their pensioners than for those former employees who are now deferred pensioners. But it certainly doesn't suggest that deliberate linkage to the RPI was on employers' and trustees' minds when they documented their pension increase rules. We believe that, for the great majority of schemes, any specific linkage to the RPI was a matter of historical accident rather than a deliberate choice.

If schemes documented their pension increase rules using the first of the two approaches outlined above, they will now automatically move to the CPI measure rather than the RPI measure that was previously implicit in the rules. They will use this measure for increasing all pensions, relating to past and future periods of employee service. If instead they documented the change using the second approach, most will be unable to move to a CPI measure for pensions accrued for past periods of service.

The ACA says this difference is unfair. The same automatic change ought to apply to private sector schemes that have documented their pension increases under the second approach. Any references in scheme rules to the RPI should be replaced with the CPI automatically, with two exceptions:

- The first exception is for any scheme where there is documentary evidence (for example, trustee meeting minutes) that a deliberate decision was made that pension increases should be specifically linked to the RPI if, at any subsequent date, statutory increases deviated from the RPI measure;
- The second exception is where the employer and trustees agree to retain existing rules.

In all cases where a move to CPI is made under this approach, there should be a requirement **on this occasion only** for employers to consult scheme members over the change. This seems more appropriate to us than the approach in the public sector, where there has been no such consultation.

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**About the Association of Consulting Actuaries (ACA)**

The **Association of Consulting Actuaries (ACA)** is the representative body for consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body. The ACA has 1,750 members working in around 75 firms. ACA Members are all qualified actuaries and all actuarial advice given by members is subject to the Actuaries' Code. The ACA forms the largest national grouping of consulting actuaries in the world.