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Dear RPI Consultation Team

Response to the HM Treasury and UK Statistics Authority ("UKSA") Consultation on the Reform to Retail Prices Index Methodology (the "Consultation") on behalf of the Airways Pension Scheme ("APS")

We welcome the opportunity to comment on the Consultation. This response has been prepared by British Airways Pensions on behalf of the trustee of APS (the "**APS Trustee**").

Summary

We note that the consultation asks questions in two key areas: the technical approach the UKSA will take to bring the CPIH methods and data sources into the RPI (the "**proposal**"), and the date at which the proposal would be implemented. We address both of these areas in our general comments below, together with wider context that might be considered under the "other impacts" part of the consultation (question 5).

We note that the consultation does not seek views on whether the proposal should be implemented but, on behalf of our 21,000 members, the APS Trustee is very firmly of the view that the proposal should not be implemented as it represents an unjust change in inflation linkage of index-linked gilts ("**ILGs**") that consequently undermines trust in the issuance of ILGs by the UK Government. Furthermore, the proposal affects the pension increase calculation for APS pensioners and for millions of pension scheme members across the UK, resulting in a significant transfer of wealth away from pensioners.

Nevertheless, if the proposal does proceed the APS Trustee would strongly support a refinement to redefine RPI as CPIH plus a margin (with a subsequent consultation on setting the margin) and for the proposal to be implemented in 2030 rather than in 2025.

Background

APS is a defined benefit pension scheme established in 1948 for employees of the then various airline companies now within the British Airways plc group. As at 31 December 2019, the assets of the scheme totalled £7.5bn for a membership of over 21,000. The scheme has a corporate trustee company with 8 Trustee Directors (4 Employer Nominated Directors and 4 Member Nominated Directors). In 2018, Roger Maynard was appointed as independent trustee chair.

As for many other defined benefit schemes in the UK, APS provides the majority of its scheme members with revaluation and indexation of pension benefits in line with the Pensions Increase (Review) Orders ("**PIRO**"). PIRO was set using the Retail Prices Index ("**RPI**") until the increase applied in 2010 after which it has been set using the Consumer Prices Index ("**CPI**"). Following this change, the APS Trustee decided in 2011 to target a return to RPI revaluation and indexation by using discretionary increases. Following long-running litigation and a settlement agreement reached with British Airways plc and sanctioned by the High Court in 2019, the APS Trustee is now able to award a discretionary increase each year above the PIRO increase to bring overall increases up to a maximum of the increase in the RPI.

There is a very strong expectation of the APS Trustee and the members of APS that overall the revaluation and indexation will be equal to changes in the RPI, as it stands today, and a clear understanding of the additional value given to member benefits through RPI-linkage as opposed to the current CPI-linkage of PIRO.

Given the inflation linkage of the APS benefits, inflation is a significant exposure for the Scheme with **REDACTED** of its liabilities linked to inflation. As such the APS Trustee, like many other defined benefit pension schemes, specifically introduced a policy to hedge its inflation exposure. This is in line with investment guidance issued by The Pensions Regulator in 2019 to trustees of defined benefit pension schemes.

The majority of the hedging in APS is carried out through bulk annuity insurance contracts and physical assets, namely ILGs. ILGs are currently only issued by reference to the RPI. Indeed, together the Scheme and the New Airways Pension Scheme (the other main defined benefit pension scheme for current and former employees of the British Airways plc group) currently hold[1] c.1% of all ILGs in issuance.

General Comments

The consultation document notes that the RPI is used throughout the economy and the government welcomes information on the potential wider impacts of the UKSA's proposal. As highlighted in the consultation document, the RPI is widely used by defined benefit pension schemes, both in revaluing defined benefit liabilities and through inflation-linked assets (for example ILGs, index-linked corporate bonds, property, inflation derivatives and infrastructure).

Indeed, we believe that defined benefit pension schemes will be the group most adversely affected by the proposed change, with assets of c.£1.7 trillion backing liabilities of c.£1.9 trillion[2]. Naturally the precise consequences vary by scheme but will affect scheme members, the overall funding position of schemes and the corporate sponsors of schemes.

In relation to UK defined benefit pension schemes we would highlight the following key areas of impact of the proposal:

1. Members with benefits linked to RPI will receive lower benefits than previously expected as CPIH is expected to be lower than RPI (example APS member pension sizes are included below, for context).
2. In many cases, pension deficits will increase substantially[3]. Many pension schemes have hedged CPI-linked benefits using RPI-linked investments such as index-linked gilts, inflation derivatives and bulk annuity contracts, based on a clear understanding that the likely difference between the measures is around 1% pa. The proposal will therefore result in a fall in the value of these schemes' assets but without a corresponding fall in the value of their liabilities.
3. As a consequence of the second item, additional cash contributions from the companies sponsoring the affected pension schemes will be needed to fund a larger deficit, thus leading to increases in deficit repair contributions. This will impact UK employers at a time when they already face severe challenges from COVID-19, with a likely negative impact on the wider UK economy.
4. There will be lower tax payments to HMRC, firstly in respect of income tax as people's pensions will fall and secondly in relation to corporation tax due to the additional deficit repair contributions referred to in point three above.

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[1] Or are exposed to through derivatives. Based on 6 April 2020 figures.

[2] Source: The DB landscape – Defined benefit pensions 2019, The Pensions Regulator.

[3] APS is fortunate to not be in this situation but is keenly aware of the risks facing many other UK DB pension schemes.

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5. Defined benefit pension schemes and other institutional investors who purchased ILGs on the understanding that these provide indexation in line with the RPI will receive lower returns on their investments than expected and planned for. This will undermine trust in the issuance of ILGs by the UK Government and potentially affect the willingness of institutional investors to purchase other instruments issued by the UK Government in future. Indeed, paragraph 9 of the consultation says: "This is an important principle in the UK statistical system, which seeks to maintain public trust in the broader macroeconomic framework." If those who have invested in ILGs (with this group effectively including defined benefit scheme members) see their return, e.g. their pension, decrease by around 1% pa compared to the current expectation then public trust in the broader macroeconomic framework will surely be lost.

The first two of these key points are expanded on further below.

<u>Member benefits will be reduced</u>

Replacing the RPI with the CPIH will have a material effect on the benefits paid to millions of defined benefit scheme members across the UK.

Overall this fall in expected value of retirement benefits will affect members' financial planning and long term saving plans, in many cases where they will have little or no time pre-retirement to recoup lost pension expectation. This could potentially increase dependency on state pension benefits and incidence of pension scams as members look for other ways to achieve the retirement benefits they had come to expect.

We have illustrated the size of current pensions for pensioner members and dependants of APS below. As per many other defined benefit pension schemes, many APS pensioner and dependant members are not in receipt of substantially-sized pensions and do not have the luxury of receiving lower pensions than they were expecting in the future due to the proposed changes. The proposal would have a proportionately material impact on the expected size of these pensions.

	Total annual pension	
	Pensioners	**Dependants**
Lower Quartile	REDACTED	REDACTED
Median	REDACTED	REDACTED

Note: pensions in payment as at 6 April 2020, dependant figures as at 31 March 2020.

<u>Pension deficits will increase</u>

As stated above, in many cases, pension deficits will increase where RPI-linked ILGs have been purchased to hedge CPI-linked benefits. In many cases, hedging CPI-linked liabilities with RPI-linked instruments has been the only feasible option for investors given the lack of CPI-linked instruments and the disproportionately high costs and lack of liquidity for those that are available. Furthermore, we are not aware of any market of size in CPIH-linked instruments.

Accordingly, pension schemes (and other institutional investors) will have purchased ILGs on the reasonable expectation that the inflation indexation would continue to be linked to the RPI under the prevailing calculation methodology. This expectation has been strengthened by a number of reviews which concluded that, despite known issues with the RPI measure, it should not be changed. In particular, we would highlight that both the Government and the UKSA have previously been supportive of the continued use of RPI in legacy situations, for example:

- A letter received by the Association of British Airways Pensioners[4] from the Bank of England dated 30 June 2011 stated, "The Bank considers CPI to be a good price index for the purposes of monetary policy. It has, however, expressed no view and made no recommendation on the appropriate price index for the purposes of updating pensions." Since then no evidence of any study by the Bank of England into the impact, for example, on pensioners has been presented.

- The National Statistician recommended, and the Board of the UKSA accepted, in response to her consultation on improving the RPI in 2013, that the formulae used in the RPI should remain unchanged. This recognised that "there is significant value to users in maintaining the continuity of the existing RPI's long time series without major change, so that it may continue to be used for long-term indexation and for ILGs and bonds in accordance with user expectations." There is no reason to believe that this statement is any less true today.

- In HM Treasury's response to the UKSA's consultation in 2015 on "Measuring Consumer Prices: the options for change", it signalled its continued support for RPI, noting "The Government remains committed to using RPI e.g. in existing ILGs which currently run out to 2068".

This set a very clear expectation that future changes would not be made to RPI in light of previous uncertainty.

Throughout this period, CPI (of which CPIH is a close variant) has been a widely used measure of inflation for other purposes and one that has been known generally to be around 1% pa lower than RPI. Given the clear difference in size of inflation between these different measures, there will have been a conscious decision taken to confirm the continued use of RPI.

[4] https://www.abaponline.org/

At the same time as making the statements quoted above, and while CPI and CPIH have both been in existence, the Government has continued to issue significant volumes of ILGs linked to RPI. Gilt holders could therefore have reasonably expected for the distinction between RPI and CPI / CPIH to continue going forward. The proposed changes would, however, effectively rewrite the rule book retrospectively in respect of these issuances.

This issue is not isolated to ILGs, but also affects the inflation swap market and insurance markets.

The investment decisions taken by the APS Trustee, along with contributions from APS members and British Airways plc, have led to a current APS funding position that is expected to be sufficient to provide for RPI-linked pension increases in future. Additionally, the majority of the Scheme's assets have been specifically planned to be RPI-linked via ILGs or bulk annuity insurance contracts. Indeed, these bulk annuity insurance contracts (which make up over £5bn of the assets of APS) were purchased for a price based on the long-term expectation of the RPI. If the RPI is amended to bring in the CPIH method and data sources then, as per the bulk annuity contracts entered into by many other defined benefit pensions schemes, it would be difficult to readdress the shift in value as the proceeds of the contract will be based on the redefined, lower RPI without a commensurate revisiting of the price paid when the contract was struck.

At the scheme level, under the proposal APS would see its assets and expected benefit payments decrease by nearly **REDACTED**. This burden would fall entirely on the membership with its 21,000 pensioners receiving benefits with a lower value than previously expected. This will affect members' financial planning and long-term income, representing a significant and unexpected wealth transfer from pensioners to insurers and the UK Government.

Looking across to other schemes, under the current proposal, the schemes that would benefit the most are those which have unhedged RPI-linked benefits. Given TPR has very actively encouraged schemes to manage inflation risk by increasing hedge ratios as much as possible, this seems like a perverse outcome. Indeed, we are aware of some schemes having received advice to reduce their inflation hedge ratios as a result of the uncertainty introduced by the proposal. This is clearly not a good outcome for the members of these schemes and potentially, at an extreme, the Pension Protection Fund.

Avoiding the negative impact

We prefer that the proposed RPI reform is abandoned. If it is not abandoned, we would encourage the Government and UKSA to consider an alternative approach to redefining RPI, whereby RPI = CPIH + x (these variables are all annual growths), where the margin x is to be agreed based on a fair value assessment of the evaluated difference between RPI and CPIH annual growths. This would:

- avoid the negative impact referred to above;
- help to mitigate the adverse impact on investors from receiving lower income streams from their assets than expected (including defined benefit pension schemes and their millions of members in the UK);
- maintain the integrity of, and confidence in, the gilt market and avoid unintended value transfer, such that defined benefit schemes, APS included, would continue to be willing purchasers of issuance of ILGs in future;
- avoid dislocation and unintended consequences in other RPI-linked contracts, including inflation swaps, RPI-linked corporate bonds and other commercial and property contracts with RPI-linkages; and
- achieve the Government's stated aim (of addressing the statistically inaccurate RPI methodology) but also ensure that there is no unfair transfer of wealth.

Should the proposal go ahead, it should be no earlier than 2030 (to reduce the wealth transfer from pensioners and others). This would however still lead to a materially negative impact on APS and its 21,000 pensioners.

The current uncertainty around whether any changes will be made and, if so, where within the 5-year implementation window, will lead to pricing anomalies and a lack of investor confidence. We would suggest that the timing of any changes should be transparent and communicated without undue delay. The UK Government needs to avoid the poor communication and ensuing confusion and litigation that followed the announcement of the raising of the Women's State Pension Age from 60 to 65.

Finally, we would expect additional consultations in the future, depending on the outcome of this Consultation, to address any unintended consequences of the proposal.

Confidentiality

We are happy for British Airways Pensions to be listed as a respondent to the consultation and for this letter to be shared within HM Treasury and the UKSA.

We are also comfortable with extracts from this letter being published as part of the HM Treasury and UKSA response to the consultation, provided any background information or direct references to APS, including financial information and figures, are not published.

We hope the above is helpful. If you have any queries or would like further information please direct any reply to the Trustee Executive at the address set out above.

Yours faithfully

Roger Maynard
Chair of Airways Pension Scheme Trustee Limited