Briefing Note Number 133 - How does high inflation impact pension schemes and their members, and how might inflation change in the future?

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PENSIONS POLICY INSTITUTE

PPI

PPI Roundtable

How does high inflation impact pension schemes and their members and how might inflation change in the future?

Round table write up

The Pensions Policy Institute (PPI) held a Roundtable on Thursday 29th September 2022. The objective of the Roundtable was to launch and discuss **Briefing Note Number 133 - How does high inflation impact pension schemes and their members, and how might inflation change in the future?** The Briefing Note investigates the impact of inflation and cost increases to DB pension schemes and pensioners, whilst also setting out the Government's plan for indexation over the next few years. This project was kindly sponsored by Insight Investments.

Key research findings were presented by Daniela Silcock (PPI), and David Hooker (Insight Investments) provided additional data on high global inflation levels. Over ten people attended the event, representing interests across industry. Sarah Luheshi (PPI) chaired the Roundtable.

Presentation of key findings and responses to the research:

Daniela Silcock (Head of Policy Research, PPI), presented the key findings from the research:

Large spikes in inflation are having a dramatic effect on the cost-of living for people of working age and pensioners. The Consumer Price Index (CPI) is expected to rise from 0.9% in 2020 to 7.4% in 2022, whilst the Retail Price Index (RPI) is predicted to increase from 1.5% in 2020 to 9.8% in 2022. Rises may continue in the first quarter of 2023, with predictions that CPI could go above 18% and RPI could reach 21%.

Pensioners are distinctly affected by inflation spikes due to different patterns of spending than the general population. For example, PPI research suggests single and older pensioners are hit hardest by cost-of living increases due to spending more on housing and energy. Pensioner's income is also not rising in line with the increase to prices, as it may be linked to a particular index (State Pension and Private Pension). As people of working age can ask for a promotion, ask for a raise or change jobs, pensioners have less opportunities to improve their standard of living.

DB pension schemes in the private sector cap benefit rises at a certain percentage above the increase in the relevant index. Around 90% of private sector DB schemes cap inflation increases at around 5%, whilst some cap as low as 2.5%. When inflation exceeds 5% during times of economic turbulence, DB income increases more slowly than the increase to prices. RPI year-on-year increase reached 6% in November 2021, whilst CPI year-on-year increase reached 5.1% in October 2021.

From 2030, the government intends to reform RPI by bringing in the methods and data used in the calculation of CPIH. As a result, RPI will increase more slowly than previously. Members of DB schemes will be impacted by these changes due to the way schemes are invested, and because many schemes use RPI to uprate pensioner benefits. Such changes may reduce the spending power of DB pensioners as RPI is increasing up to 2.6% more quickly than CPI per year. Members who defer for ten years from 2020, and take their benefits at age 65 in 2030, could receive a pension at retirement at around 12% less for man and 13% less for a woman than they would before RPI reform.

Inflation spikes combined with changes to RPI could lead to more uncertainty in the future for both pensioners and pension schemes. In April 2021, the trustees of BT, Ford and Marks and Spencer (M&S) sought a judicial review of the RPI reform due to impact on pension schemes and their members. However, this application was rejected on the 1st of September 2022. Some economic difficulties arising from prices and incomes increasing at different rates, will be reduced for pensioners as RPI and CPI will increase at the same rate in the future. As CPIH is the current lead measure of inflation, it is being continuously improved by the ONS through the incorporation of new and robust sources of alternative data. Household Indices may offer an alternative measure for all household benefits and pension uprating.

David Hooker (Senior Portfolio Manager, Insight Investments), then provided analysis from Insight Investments on the current high inflation levels against a backdrop of COVID-19, trade agreements and the outbreak of war.

Global inflation shock has been driven by increases to the prices of food and beverages, transport and household goods. In response, Central banks have adopted inappropriate monetary policies to deal with supply chain issues by using outdated models that don't factor in issues such as:

- **COVID-19 lockdowns**: A series of lockdowns in China, the world's largest manufacturer, have reduced production levels which have ultimately affected global supply issues.
- **Tariffs**: United States tariffs imposed under the presidency of Donald Trump in the first half of 2018 on imports from the European Union, Canada and Mexico.
- **Brexit**: United Kingdom's withdrawal from the European Union in January 2020, exiting the European Single market and Customs Union, resulting in consequent trade barriers.
- **Ukraine war:** Dramatic rise in oil and gas prices in response to conflict with Russia and the subsequent international response. Global food supplies also impacted by the outbreak of war, as Ukraine is one the largest global producers of wheat, corn and other grains.

Data suggests global inflation might be approaching its peak whilst supply chain pressures are diminishing, shipping costs are decreasing, and global shortages appear to be ending. However, this recovery might be hindered by stagnation in the labour market. More specifically, UK unemployment levels have reached a record 50 year low whilst job vacancies have reached a record high and wages continue to grow. Factors that may affect inflation in the long term may include:

- Globalisation
- Technology
- Demographic shifts
- Carbon transition

Panel discussion and Q&A session

The following points were raised in the Roundtable discussion. The session was held under the Chatham House Rule and the views expressed do not necessarily reflect the views of the Pensions Policy Institute or the sponsor (Insight Investment):

Negotiations over an increase to annual benefits? Discussions with DB pension schemes over an increase to annual benefits haven't gathered momentum due to industrial action. Currently in the UK, disputes over wages, jobs and working conditions has resulted in union-led strikes across a number of sectors. In this context, debates around increasing pension income are overshadowed by ongoing disagreements over worker's rights.

How much do pensioners understand about inflation increases to DB schemes? In light of rising inflation levels, do members of DB schemes understand the impact upon their annual benefits? Complaints over changes to annual benefits increase after direct contact with the

DB scheme, as opposed to news coverage of rising inflation rates. Switching from RPI-linked benefits to CPI linked benefits raised concerns among DB pension scheme members. Communication issues, combined with a lack of knowledge surrounding inflationary risks to benefits, is a persistent issue for pensioners.

How do pension funds respond to high inflation levels in other countries than the UK? Pension schemes around the world tend to use similar calculations for annual benefits. However, there are different laws in safeguarding pensions against cost-of-living raises among some countries. In the Netherlands, both private pensions and state pensions are indexed to inflation thus offering protection for scheme members. Whilst in the German pension system, payments must rise in accordance with the Consumer Price Index (CPI) every three years. Most private pensions in the United States are not protected against cost-of living adjustments and high inflation levels, whilst state and local government pensions offer annual increases.

Should we reconsider the structure of DB pension schemes? DB pension schemes in the UK are currently in discussions around restructuring, considering the impact of inflation upon annual benefits. More specifically, the 5% cap on annual benefit increases is being considered as inflation levels are skyrocketing. Discretionary benefits are being considered for certain DB pension schemes, to protect against high inflation.

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