How could CPI indexation affect pension income?

Introduction

The Government has announced changes to the way payments from Occupational Pensions and S2P are to be increased in line with inflation each year. This briefing note explores the potential impact of the changes on the pension income of individuals.

RPI and CPI measure inflation

For many years the most commonly used measure of UK price inflation has been the Retail Prices Index (RPI), which measures the rise in the cost of a predetermined basket of goods, which includes housing costs.[1]

However, since 2003, the official UK measure of inflation has been the Consumer Prices Index (CPI), which uses a similar basket of goods to measure inflation but excludes housing costs.

CPI rises more slowly than RPI

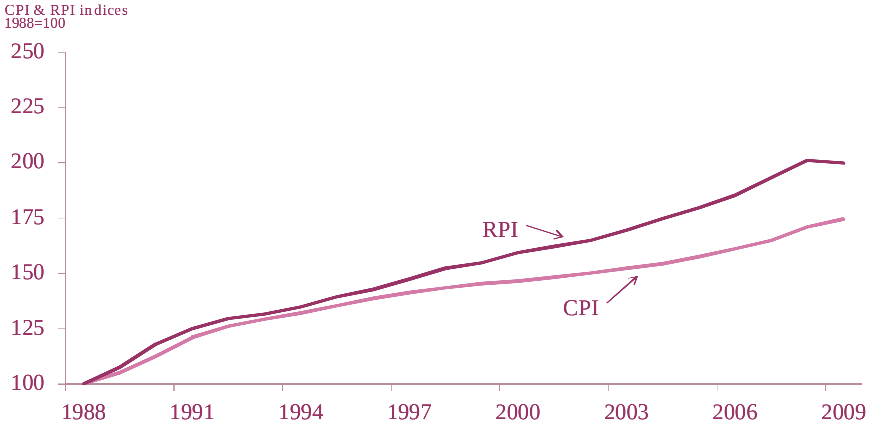
CPI generally increases more slowly than RPI because the indices use different averaging formulae. The RPI uses the 'arithmetic mean' ***(sum of n items)/n*** while the majority of items in the CPI use the 'Geometric mean' $\sqrt[n]{x_1 x_2 \ldots x_n}$. The Geometric mean allows for trends in ***price switching*** (when, as a result of changes in price, people switch from their usual brand to one of a lower price on the same good).

Over the last 4 years, the 'formula effect' has accounted for between 0.5% and 0.9% difference each month.[2]

CPI's exclusion of housing costs also influences differences between the two indices because housing costs usually rise more quickly than the costs of other consumer goods.

Chart 1: RPI has recently increased more quickly than CPI

CPI and RPI indices 1988 to 2009, rebased at 1988 = 100



Source: ONS time series data - www.statistics.gov.uk/statbase/tsdtables1.asp?vlnk=mm23

The average price of consumer goods occasionally rises more quickly than housing costs (e.g., September 2009). During these periods, CPI might rise more quickly than RPI, however in the long term CPI is assumed to increase annually by 2%, compared to 2.87% for RPI.[3]

DB schemes and S2P have traditionally been RPI indexed

Defined Benefit (DB) pension schemes, both in the private and public sector, have traditionally used the RPI to calculate yearly increases in payments to pensioners and yearly revaluations of the entitlement that deferred members have built up (though private sector pensions have capped RPI at 2.5%, from 2004). RPI has also been used to calculate increases in State Second Pension (S2P) payments.

The Coalition's 2010 Emergency Budget introduced changes to public sector pension and S2P uprating

The Coalition Government announced in the 2010 budget, that from April 2011, payments from state benefits, public sector pensions and S2P would be indexed to CPI increases, rather than RPI increases.

The Government is required by legislation to index benefits to an 'appropriate measure' of inflation. Their rationale for the change is that they believe CPI better reflects changes in living costs for pensioners, many of whom are owner-occupiers (and unaffected by changes in housing costs) while renters on low incomes are protected from the impact of changes in housing costs through housing benefit.[4]

While it is true that many pensioners are owner-occupiers, 7% of pensioners currently live in a home with a mortgage and 21% of pensioners live in rented accommodation. Many of these pensioners will not receive Housing Benefit - only 13% of total pensioners currently claim Housing Benefit.[5]

Pensioners who pay towards rent or mortgages are likely to be affected by changes in housing costs and could be negatively impacted if their income does not also keep pace with changes in housing costs.

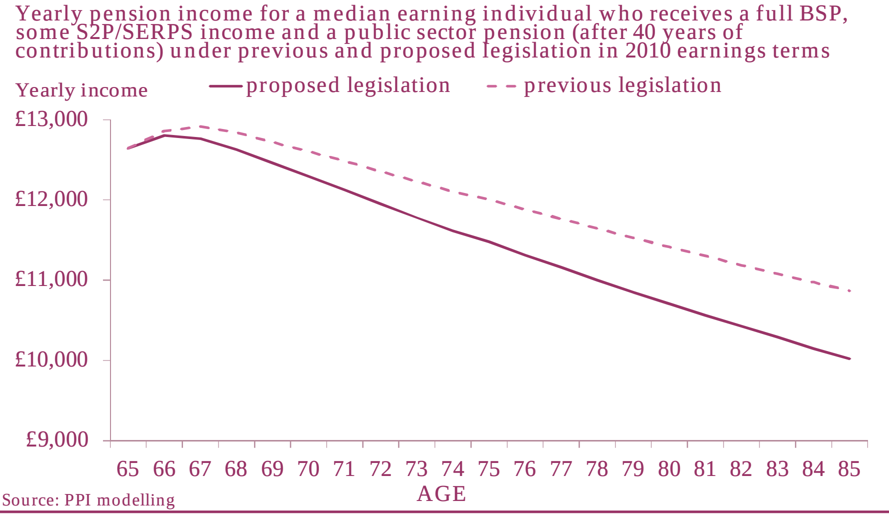
There are existing RPI based indices which exclude housing costs, for example RPIX excludes mortgage payments, and was used as the Bank of England inflation target until 2003. ROSSI excludes rent, mortgage interest, council tax and housing depreciation and has been used to uprate means-tested benefits.

Is the CPI a better reflection of inflation for pensioners?

Neither index produces a perfect calculation of inflation, but both indices have strengths. For example, the RPI better reflects changes in housing costs, while the CPI reflects trends in price switching.

When assessing the relevance of the indices for pensioner inflation it must be taken into account that RPI and CPI represent average inflation for all UK consumers, while pensioners experience greater than average inflation at times because pensioners are more likely to spend on basic goods which can increase more quickly in price than other goods.[6]

Chart 2: Income from public sector pensions may reduce in future as a result of a change to CPI indexation



Source: PPI modelling

The ONS monitors both indices and makes frequent changes to the baskets of goods, the survey coverage, and the calculations in order to improve the accuracy of the indices' reflection of inflation. It is possible that the CPI will start to include housing costs in the future.[7]

Private sector pensions could also be indexed to CPI

In July 2010 the Government announced that from April 2011, private sector Occupational Pension schemes, the Pension Protection Fund and the Financial Assistance Scheme could use CPI to calculate increases in payments to pensioners and for revaluations of deferred entitlement.

Some schemes have RPI written in to scheme rules

Some schemes' rules allow payments and revaluations to be indexed to the 'statutory minimum'. However, between 60%[8] to 80%[9] of schemes have rules which require indexation by a minimum of RPI.

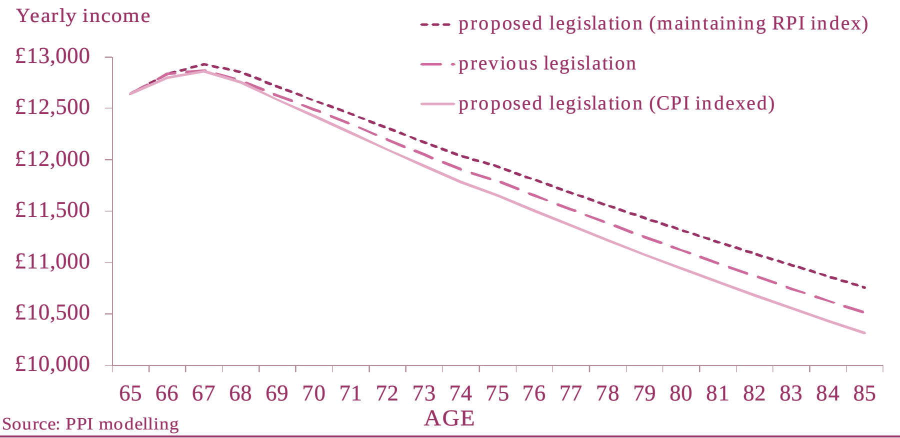
One option would have been for the Government to give schemes whose rules require indexation by RPI, powers to override or modify scheme rules. However, due to concerns regarding legal barriers and a desire to help maintain confidence in schemes, the Government has announced that they will not allow override or modification powers.[10]

The potential legal barriers stem from the 1995 Pensions Act, which legislates against any modification to a pension scheme which devalues or otherwise affects already accrued entitlement.

Some representative organisations have put forward the argument that pension entitlement built up by people before April 2011, was built up under the as-

Chart 3: Income from private sector occupational pensions may reduce in future, depending on employers' responses to the policy

Yearly pension income for a median earning individual who receives a full BSP, some S2P/SERPS income and a private sector occupational pension (after 40 years of contributions) under previous and proposed legislation in 2010 earnings terms



Source: PPI modelling

sumption that future pension payments (and entitlement) would be increased (or revalued) by increases in the RPI. Therefore, they argue that the expectation of inflation-based increases by RPI are part of the accrued rights people have built up.

Therefore, if modification powers were allowed, there could be legal actions against schemes who have RPI written in to scheme rules, if they change the indexation of pensions in payment or deferred entitlement built up before April 2011.

It is not known how many of the 20% to 40% of schemes who do not have RPI indexation in their rules, will switch from using RPI to CPI, nor how many of the remainder will attempt to vote to change their scheme rules.

A switch to CPI could help the survival of DB schemes

Many DB schemes in the private sector have been closing due to funding difficulties. The new proposals could reduce scheme liabilities for both existing and future members and the levy that schemes must pay to the Pension Protection Fund, possibly making it easier for some schemes to survive in the long term and continue offering DB pensions to their employees.

Public sector workers are likely to receive lower income from their pensions in future

If the proposals for public sector pensions are enacted in April 2011, public sector pension income will be indexed to CPI in future. If inflation continues at current expected levels (this analysis assumes average yearly increases of 2% for CPI and 2.87% for RPI), uprating by CPI instead of RPI could reduce the total yearly income that a median earner (with 40 years of membership in a public sector scheme) receives from their state and public sector pensions by 4% per year at age 75 (10 years after retirement) and by 8% per year at age 85 (20 years after retirement) in 2010 earnings terms (Chart 2).

People may receive less income from private sector Occupational Pensions depending on employer behaviour

If proposals for private sector Occupational Pensions are enacted from April 2011, employers who are not required by scheme rules to index pension payments to RPI will have the choice whether to index payments to CPI or RPI in future. It is not known how many employers who can switch from RPI to CPI would do so.

If it is assumed that a median earning man has a private sector occupational pension, full BSP and some S2P and his employer switches from RPI to CPI indexation his total yearly pension income could be reduced by 2% at age 75 and by 4% at age 85 in 2010 earnings terms (Chart 3) from what it would have been if RPI indexation had remained.

However, if his employer continues to index his pension payments to RPI (capped at 2.5%) his total yearly pension income will be higher than it was under the previous Governments legislation as a result of the BSP triple-lock, by 1% at age 75 and by 2% at age 85.

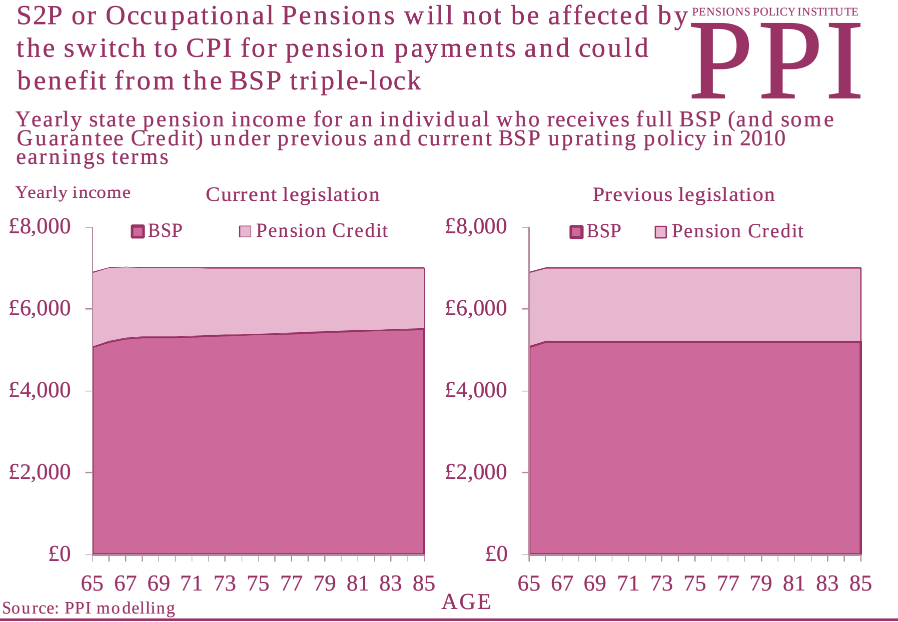
Deferred members would be affected by a switch to CPI indexation

The new rules will also affect deferred members (who leave their scheme before retiring) who would previously have had their entitlement revalued (increased) each year in line with RPI. Future revaluations could now be calculated each year relative to the rise in CPI, causing deferred members to receive a lower starting pension than they would have under the previous arrangements. A median earning man, with 15 years entitlement, who leaves his private sector scheme at age 40 could see his starting pension income reduced by around 20% at age 65, from what it would have been under RPI uprating (capped at 2.5%).[11]

People could receive higher income from BSP in future

While the switch to CPI indexation may reduce income from S2P and Occupational Pensions, other Coalition Government legislation is likely to mean people receive higher income from the Basic State Pension (BSP) in future. The previous Government legislated that BSP would be uprated in line with earnings from 2012. The current Government has pledged that the BSP will be 'triple-locked', from April 2011, meaning it will increase yearly by the greater of the increase in earnings, prices (CPI) or 2.5%. This could result in faster growth over time of the BSP rate than if it grew only by the rise in earnings.

Chart 4: People who do not receive any income from S2P or Occupational Pensions will not be affected by the switch to CPI for pension payments and could benefit from the BSP triple-lock



Source: PPI modelling

A median earning man with a full BSP and no additional state or private pension could receive around 3% more total yearly Basic State Pension at the age of 75 and 6% more at the age of 85 in 2010 earnings terms (Chart 4) as a result of the triple lock than he would have received under previous policy.

People who receive pension income solely from the BSP will not have their pension income affected by a change to CPI indexation and are likely to receive higher income from their BSP than they would have under the previous Government's legislation. However, they may receive the same total pension income from the state if they receive Pension Credit. Pension Credit will top up state pension income to the same guaranteed level under both previous and current legislation.

However an individual who receives income from BSP and S2P could see their BSP income increase and their S2P income decrease as a result of the proposed changes. The overall impact the policies will have on a person's income will depend on the proportion of pension income they receive from BSP and the proportion from S2P.

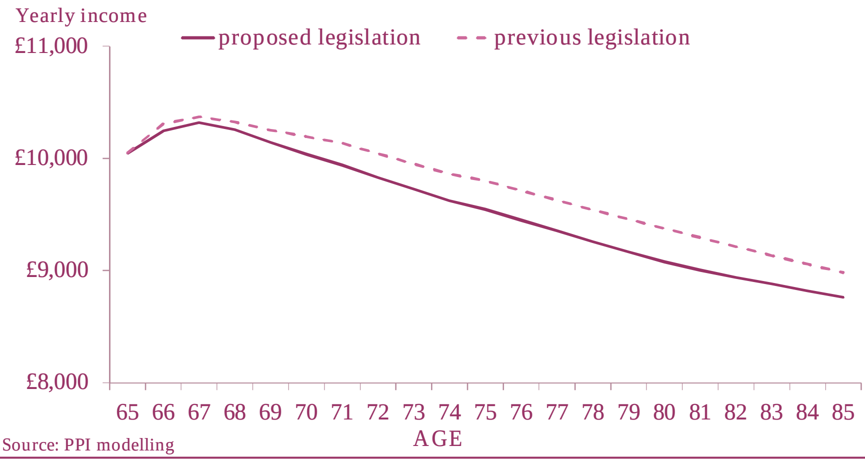
A median earning man with full BSP, who has been accruing SERPS/S2P since it's inception in 1978, could receive around 3% less in total yearly pension income at the age of 75 and around 2% less at the age of 85 than under the previous legislation (Chart 5). Under the proposed legislation, he could start receiving Pension Credit from age 80.

The proposals are more likely to affect the pension income of median to high earners

The proposals are more likely to

Chart 5: Individuals who only receive pension income from BSP and S2P could see their real pension income reduce over time

Yearly state pension income for a median earning individual who receives a full BSP and some S2P/SERPS income (after 40 years of contributions) under previous and proposed legislation in 2010 earnings terms



Source: PPI modelling

affect the pension income of people with additional state and occupational pension entitlement. Median to high earners are more likely than low earners to receive a significant proportion of their pension income from additional state and occupational pensions.

People who receive the majority of their pension income from the BSP or from private pensions (in the form of an annuity or drawdown) will not see as dramatic a change to their pension income as a result of the proposals, and are likely to receive higher pension income in future than they would have under the previous Governments legislation as a result of the 'triple-lock'.

However, low earners, who are more likely to have low or no additional state or occupational pension entitlement, may still be affected by the changes to indexation if they are in receipt of state benefits, such as Attendance Allowance, which will also increase in line with CPI from April 2011.

Conclusion

The Government has proposed to index increases in payments from public sector pension schemes and S2P to CPI in future, and to allow private sector DB schemes to switch to CPI indexation for pension payments and revaluation of deferred entitlement (if scheme rules allow). The new proposals are likely to lead to lower income from S2P and some occupational pensions in future, and could reduce the total yearly pension income for a median earner who receives income from BSP, S2P and a private sector Occupational Pension, by around 4% at the age of 85 (20 years after retirement) if his employer decides to index payments to CPI.

The proposals are more likely to affect the pension income of median to high earners than low earners who are likely to receive a higher proportion of their pension income from the BSP. People who receive a high proportion of their income from BSP are likely to receive higher pension income in future than they would have under the previous Governments legislation as a result of the 'triple-lock' for the BSP.

The new legislation has the potential to help some future pensioners by reducing scheme liabilities and assisting in long term Occupational Pension scheme survival.

[1] Housing costs includes rent, mortgage interest payments and council tax rates
[2] ONS Focus on Consumer Price Indices, September 2010, table 1.4
[3] Bank of England & DWP assumptions
[4] Hansard written ministerial statements: 8 July 2010 : Column 15WS
[5] ONS, DWP (2010) ***Households Below Average Income***, tables 6.1, 6.2
[6] www.ageuk.org.uk/latest-news/archive/inflation-leaves-over-55s-600-pounds-a-year-worse-off/?paging=false
[7] Consumer Prices Advisory Committee 2010 Annual Report
[8] NAPF (2010) Press Release: ***Pension funds seek clarity on inflation switch, Dec 08***
[9, 10] DWP (2010) ***The impact of using CPI as the measure of price increases on private sector occupational pension schemes*** and
[11] PPI modelling

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