The slow demise of RPI

Considerations for pension funds and long income property

Part of Alpha Real Capital's Cashflow Driven Investing series

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In response to the well documented downfall of RPI, and the arguments for it to be aligned with CPIH, the Treasury launched a consultation at the most recent budget to assess the change further. Whilst the Treasury's focus is mostly on index-linked gilt markets, the impacts of a change on the long income property market shouldn't be ignored.

The case for changing the Retail Prices Index (RPI) inflation measure calculation has been argued for much of the last decade. The primary issue put forward regarding RPI is that it overstates inflation due to the underlying formula used to calculate it. It is believed RPI is overstated by c.0.7%[1] due to this 'formula effect'[2] alone.

The impact of the 'formula effect' became especially notable in 2010 following a change in how clothing prices were reflected in the basket of goods and services by the Office for National Statistics. The year on year inflation calculation of women's outerwear spiked from below -10% in 2009, to over 15% in 2011[3].

Following several reports produced and communications made by various bodies and organisations over the period since, in March 2019 the UK Statistics Authority (UKSA) proposed to the Treasury an alignment from RPI, given its inadequacies, to the Consumer Prices Index including owner occupiers' Housing costs (CPIH). The government's response later in the year acknowledged the shortcomings of RPI and accepted there would be an eventual move to an alternative index, however the Treasurer made clear this change would not occur before 2025. In this paper, mentions of alignment or convergence of RPI to CPIH refer to the change in the underlying methodology.

At the most recent budget, the UK Treasury launched a consultation to determine the impact of the timing of an alignment, ranging from 2025 to 2030, after which the UKSA no longer needs authorisation from the Treasury to implement the change. The consultation also asks for feedback on technical matters concerning the proposal, such as the statistical rigour of the proposed approach and other broader impacts the change might have. The consultation is open until late April, and the results are expected in mid-2020.

Most notably, the Treasury and the UKSA are most focused on the impact that the alignment will have on index-linked gilt holders. Whilst they are aware that there will be wider impacts of a change in methodology than just gilt markets, such as the long income property market where many leases are linked to RPI, these impacts are ultimately unlikely to be deemed relevant in any decision. They are welcoming responses to outline these wider impacts, but clearly mention they will most likely only be used to inform future policy decisions.

Summary

- As a result of underlying issues in the calculation of RPI, several official bodies, including the government, appear to support an alignment of RPI methodology to that of CPIH between 2025 and 2030.
- The proposed move is being interpreted as a transfer of value from those who hold RPI-linked securities, to issuers of RPI-linked securities. The most prominent example of this is a transfer of value from pension schemes to the government.
- The proposed alignment of RPI to CPIH has already been partially reflected in traditional gilt and swap markets, although the impact on long income property is harder to quantify.
- For RPI-linked long income property, the potential outcomes as a result of an alignment will depend on the terms within the lease and range from a full convergence of rental uplifts to CPIH, to no change at all.
- Pension schemes with RPI-linked liabilities shouldn't see any deterioration in funding level, but those with CPI-linked liabilities will be impacted if they are currently using RPI-linked assets to hedge their liabilities.
- The government launched a consultation at the most recent budget which is open until late April 2020 to shed more light on the potential impact, with the results expected in mid-2020. Although their focus is on index-linked gilt holders, the outcomes of the consultation remain very relevant to long income property investors.

1 Office for National statistics, 2019

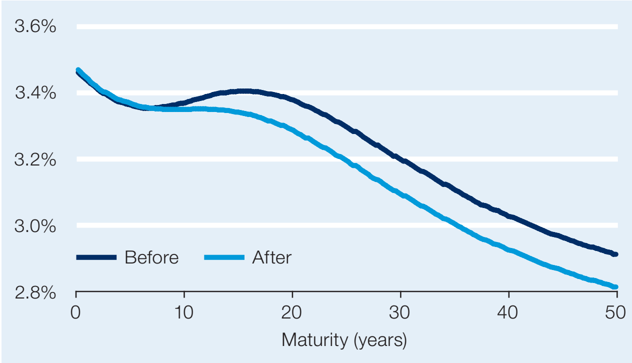
2 One of the formulas used in the calculation of RPI is the Carli formula, which uses an arithmetic mean. In the CPIH calculation, the Jevons formula is used in place of the Carli, which uses a geometric mean. The Carli formula has an upward bias relative to trend in average prices. After a price rise of an item, even if the item returns to its' original price, the Carli doesn't, whereas the Jevons reflects the reversion of the price.

3 Office for National Statistics, 2018

Market impact

The 'wedge', or the difference between RPI and CPI, has historically been approximately 1%, although more recently since the financial crisis, it has been c.90bps. Following the announcement by the treasury in September 2019, RPI forward expectations fell by c.10bps after 2030, a movement which was consistent with changes in inflation swaps and gilt prices. Clearly, market movements did not fully reflect the long term difference between the two inflation metrics, which may be explained by the notion that a certain level of the change had already been priced into markets, as RPI swaps have displayed a downward trend since the early 2010s. Further, it is unlikely to be fully priced in given uncertainty regarding the final outcome.

Figure 1: RPI curve before and after September 2019 announcement



Source: Barcap, September 2019

Impact on long income property

RPI-linked long income property such as ground rents or traditional long leases (e.g. sale and leasebacks) should expect several outcomes as a result of the convergence. These range from a full convergence of rental uplifts from RPI to CPIH, to no change at all, depending on the specific wording in each lease and, in the event of a dispute between landlord and tenant, the findings of an independent arbitrator. A review of the lease terms of existing assets is recommended to determine the expected impact on rent reviews.

In the case that rental uplifts in a lease alter from RPI to CPIH, the ongoing income received by the landlord and the capital value growth of the asset will decrease. Despite the expected negative impact on the total return achieved by the asset, the lower rent the tenant will have to pay translates in a higher affordability of rent to the tenant. This results in an increased level of income protection for the asset owner, as the ability of the tenant to make the rental payments increases.

Despite the increased income protection from a pure cashflow basis, the effect that a full convergence of a lease to CPIH, the most prudent scenario possible, in 2025 on an example long lease asset, can be assessed through the internal rate of return (IRR) achieved. The expected decrease in IRR ranges from c.0.05%, to c.0.20%[4] per annum, and the extent of the impact is dependent on the term of the lease. A longer lease term results in an expected larger IRR fall, as does having annual uplifts rather than 5 yearly uplifts. A narrower range between the cap and floor also results in a lower impact on IRR. Given a 2030 convergence, whilst the same impacts apply as with the 2025 convergence, returns are more robust if any change to CPIH occurs five years later.

On a ground rent asset with a lease term of 125 years, the expected impact is greater. Given nearly all of the IRR on a ground rent lease is derived from the long term, inflation-linked cashflows, a 0.90% reduction in the uplift will have significantly more impact than on a sale and leaseback asset where terminal capital value still has a large effect on the total return. A 2025 convergence on a 0% floor and 5% cap ground rent results in an expected 0.70% reduction in IRR, and a 0.60% reduction from a 2030 convergence[5].

Post the various announcements, long income assets continue to be marketed with RPI-linked rent reviews. A review of the lease terms is recommended to check the position in terms of convergence, and for pricing any adjustments accordingly.

> A review of the lease terms of existing assets is recommended to determine the expected impact of the convergence on rent reviews.

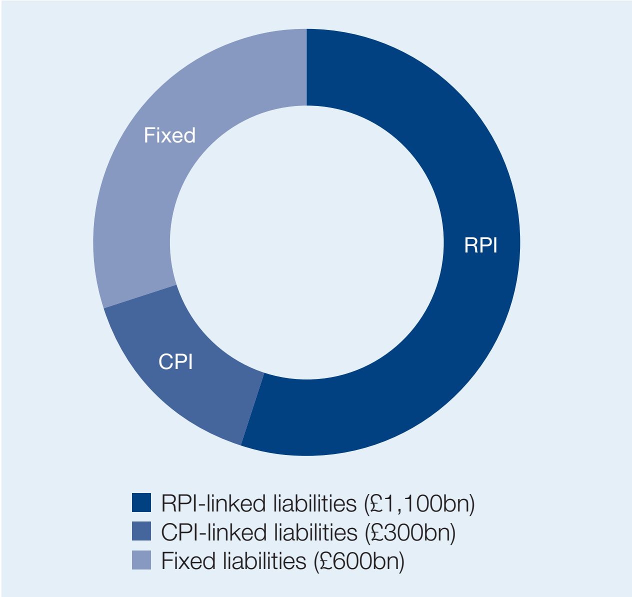
4 Alpha Real Capital analysis
5 Ibid

Impact on pension schemes

The primary impact of any convergence would be on pensioners, whose benefits would be indexed to CPIH, rather than the higher measure, RPI. This would result in a lower income received by pensioners during their retirement. From a wider industry perspective, the expected return impacts from any convergence to CPIH on a defined benefit pension scheme should be viewed in the context of how the assets perform versus scheme liabilities. Liabilities currently uplifted by RPI could change to CPIH uplifts. That is to say, even if there was a full convergence of leases to CPIH uplifts, the liabilities they are intended to match will also decrease by the same percentage. Where leases do not, or only partially, converge to CPIH, a net financial gain could be attained given that rental uplifts will be increasing more relative to CPIH-linked liabilities. As a result, this should contribute to an improved funding level over time.

For schemes with mostly CPI-linked liabilities using RPI-linked assets to hedge however, they would expect to see a deterioration in funding level. This occurs as the asset performance decreases in nominal terms as a result of the convergence, but liabilities do not follow suit given they are already linked to CPI. In the UK, c.£300 billion of the £2 trillion pension scheme liabilities are CPI-linked. The majority of liabilities are linked to RPI however, so assets should go some way to alleviating funding deficits.

Figure 2: UK Pension Scheme liabilities inflation linkage



Source: KPMG, 2018

Conclusion

The prospect of a convergence of RPI to CPIH is looking increasingly likely, and the consequences can partially be seen in the government bond, and inflation swap markets. Whilst the impact the alignment will have on the long income property market is harder to quantify, investors in the asset class should be aware of the range of outcomes they could face. Pension schemes, especially those with a high proportion of CPI-linked liabilities, should be aware of their current hedging arrangements, and assess how their funding level looks set to progress over the next decade. Although the Treasury and the UKSA made it clear their focus is on the index-linked gilt market, it is important for long income property investors to remain aware of the potential alignment and its effects, and await the Treasury's findings from the consultation come mid-2020.

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