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Pensions briefing

RPI and CPI – Ten things you should know

Briefing

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What is the background to the use of RPI and CPI in uplifting pension payments?

Legislation requires that preserved benefits held by deferred members of defined benefit (DB) pension schemes who left pensionable service on or after January 1, 1991 must be revalued to offset the effects of inflation between the date the member leaves service and the date he draws his pension. This is known as revaluation.

Similarly, since April 6, 1997, most DB schemes have been required to increase pensioners' pensions in payment by a minimum amount each year. This is known as indexation.

Both revaluation and indexation increases are subject to a specific percentage cap which is calculated using limited price indexation (LPI). This means the percentage increase to benefits is usually the lesser of the annual increase in whichever inflation index is used and (since April 6, 2005) 2.5 per cent.

Legislation does not stipulate how inflation is to be measured for the purposes of either revaluation or indexation. Instead, the Secretary of State is required to make an annual order specifying the rate to be used and, historically, the index used was the retail prices index (RPI). RPI has its origins in the "cost of living index", which was first published in 1914, with the modern RPI being published in 1956. The Consumer Prices Index (CPI) was introduced in 1997, following the EU's harmonisation of the existing index of consumer prices. RPI and CPI each take into account a different "basket of goods" and involve a different mathematical formulation in measuring inflation. CPI generally, to date, has produced a lower figure. However, neither index can accurately reflect the "cost of living" for actual scheme members, as this can be higher or lower than inflation depending on their level of consumption of various goods and services.

From April 2011, the then Government decided to switch to CPI rather than RPI to calculate increases in social security payments and public sector pension benefits. The switch from RPI- to CPI-based calculations was subsequently extended to the minimum statutory increases required for private sector pensions. However, the Government did not introduce an overriding or modifying statutory power allowing schemes to switch automatically to CPI-linked indexation or revaluation where RPI was "hard-wired" or written into the scheme rules.

The remainder of this briefing looks at how the Courts have answered various questions arising when schemes have attempted to switch to CPI instead of RPI to calculate increases.

How does section 67 of the Pensions Act 1995 affect the replacement of RPI for CPI for indexation and revaluation purposes?

This question was addressed in *Dank and others v QinetiQ Holdings Ltd and another* [2012] (QinetiQ). The scheme rules provided that the applicable index to be used for both indexation and revaluation was the "Index of Retail Prices … or any other suitable cost of living index selected by the trustees." The rules, therefore, permitted the trustees to choose an index, such as CPI, instead of RPI.

The indexation rule provided that pensioners would have their pensions increased on April 1 each year. The revaluation rule operated so that the increase would be calculated upon the deferred member reaching the scheme's normal retirement age, or the date of early retirement if this was earlier.

The Court held that

- In respect of pensions in payment, members had an entitlement only to a specific rate of increase on and from April 1 in each year. Prior to that date each year, the member had an entitlement only to an increase by reference to an index which the trustees had the power to change. Once an index had been determined on April 1, it could not be changed for that year without it being a detrimental modification, and therefore being voidable under section 67 of the Pensions Act 1995 (section 67). However, it could be altered before the following April 1 without falling foul of the legislation; and

- Deferred members had no right to revaluation increases until they reached normal retirement age (or an agreed early retirement date). Until the calculation was carried out, the member had a right only to revaluation by reference to an index that the trustees could change. Section 67 would not, therefore, prevent the index being changed prior to a member's normal retirement age. However, once the calculation had occurred, this crystallised the right to whichever index had been used.

The result of this approach is that, in the case of two given deferred members, one taking an early pension just before the trustees changed the index from RPI to CPI and one just after, the first member's pension would be revalued by reference to RPI and the second by reference to CPI, notwithstanding that both members' benefits may have accrued when the index was RPI. The Judge noted that " … the unfairness is the result of the fact that the value of neither member's pension is crystallised until the date on which the … revaluation actually takes place … ".

The subsequent decision of the High Court in *Arcadia Group Ltd v Arcadia Group Pension Trust Ltd and another* [2014] (Arcadia) and of the Court of Appeal in *Barnardo's and Others v Buckinghamshire and Others* [2016] (Barnardo's) endorsed this approach to section 67, where the Judge concluded that " … members have a 'subsisting right' to increases and revaluation consistent with the definition of 'Retail Prices Index' but not to increases and revaluation specifically by reference to RPI" in situations where the rules provide that a different index can be substituted. In Barnardo's, there was a further appeal to the Supreme Court, but on issues other than section 67, and these are discussed below.

Can different costs of living indices be used for different purposes?

In *QinetiQ*, it was argued that "Index" must mean only one index.

The Court rejected this approach and held that the definition of "Index" in *QinetiQ* could mean RPI for some periods or purposes and CPI for others. The Judge noted that this was not only because the law recognises that the singular includes the plural, (that is, "Index" can also be read to be "Indices") but also that the words "for particular periods or purposes" could be read into the definition of "Index". An alternative conclusion would make the scheme cumbersome, unworkable and inconsistent with business common sense. It could also, in many situations, act to the detriment of scheme members.

Does a definition of RPI as "the Government's Index of Retail Prices or any similar index satisfactory for the purposes of HMRC" allow another index, such as CPI, to be used instead of RPI?

The cases demonstrate that whether the trustees have the power to use CPI instead of RPI for revaluation and/or indexation purposes depends upon the precise wording in the rules.

In *Arcadia*, the rules provided that the relevant measure of indexation was "Retail Prices Index [(or any replacement of that Index)]". "Retail Prices Index" was in turn defined as "the Government's Index of Retail Prices or any similar index satisfactory for the purposes of HMRC."

The Court held that these rules allowed the trustees to choose an alternative index to be used other than RPI, as

- The definition of "Retail Prices Index" did not provide that a similar index could only be adopted if RPI itself was discontinued or replaced. To interpret this otherwise would be to read words into the definition of "Retail Prices Index".

- It was apparent that there was some power of selection between indices. If, for example, RPI had been discontinued and HMRC suggested that either of two other indices would be appropriate, it could not be supposed that no one would have the power to choose between the indices.

- The fact that the label "Retail Prices Index" was used rather than a more neutral term was not determinative; it was clear from the definition of that expression that the possibility of another index was expressly provided for.

Is CPI an index that is "similar" to RPI and "satisfactory for the purposes of HMRC?"

Depending on the wording of specific scheme rules, it may be that the trustees have the power to choose an alternative index, provided that alternative index is "similar" to RPI and/or "satisfactory for the purposes of HMRC". The Court in *Arcadia* considered whether CPI would satisfy these conditions.

The parties accepted that CPI was a "similar" index to RPI and this point was not, therefore, considered further. Equally, HMRC had confirmed in an email that CPI is a satisfactory measure for the purpose of indexation and therefore this did not need to be decided.

Who has the power to choose which index applies where the rules do not specify one?

In cases like *Arcadia*, it may be that the rules do not stipulate who has the power to determine which index applies.

In *Arcadia*, the Court considered the rules of the scheme as a whole, under which the principal employer could not alter any of the members' benefits without the trustees' consent. The Judge said that the trustees " ... can be seen as natural spokesmen for the scheme ... [which] suggest[s] that they were intended to be involved in any exercise of the power of selection".

The power of selection was, therefore, held to be vested in the principal employer and the trustees jointly.

Can CPI be used instead of RPI if the rules provide that either RPI is to be used " ... or a replacement adopted by the Trustees ... "

In *Barnardo's*, the schemes rules provided that, broadly, indexation and revaluation should be increased using the "prescribed rate", which was defined as the lesser of 5 per cent and "the percentage rise in the Retail Prices Index (if any) ... ".

"Retail Prices Index" was defined as the "General Index of Retail Prices or any replacement adopted by the Trustees without prejudicing Approval". A second sentence expanded this definition and referred to the "replacement or re-basing" of the Retail Prices Index.

The High Court held that the scheme rules did not give the trustees the power to switch from RPI to CPI for revaluation or indexation, so long as RPI remained an officially published index.

In November 2016, the Court of Appeal (CA) upheld the first instance decision. The CA stated that pension increases were determined by reference to the Retail Prices Index, as defined above. The CA held by a majority that the natural meaning of the first part of the definition was that a "replacement" of the RPI had to precede the adoption of any such replacement by the trustees. The second sentence, referring to replacement and re-basement of the RPI, was helpful in interpreting the first sentence of that definition.

The CA's view was that RPI could only be "re-based" by the authority responsible for publishing it, and the same person had to carry out both the "replacing" and the "rebasing". The term "replacing" had the same meaning in both the first and second parts of the definition. It followed that any "replacing" could only be carried out by the authority responsible for publishing the RPI and that, without its official replacement, there was no other "replacement" which the trustees could adopt instead.

In November 2018, the Supreme Court dismissed a further appeal. It upheld the CA's decision that the correct interpretation was that the definition of RPI involved a two-stage test, and meant "the RPI or any index that replaces the RPI and is adopted by the trustees".

Barnardo's highlights the constraints that may arise from specific historic drafting. Employers' attempts to adopt CPI may encounter problems which need to be examined on a case-by-case basis where the scheme has retained a link to RPI.

When does RPI become an "inappropriate" method of increase?

In *British Telecom v BT Pension Scheme Trustees* [2018] the High Court considered whether a switch from RPI to CPI could be introduced for revaluation. The BT Scheme rules provided that "The cost of living will be measured by the Government's published General (All Items) Index of Retail Prices or if this ceases to be published or becomes inappropriate, such other measure as the Principal Company, on consultation with the Trustees, decides."

BT argued that it was its own decision whether RPI had become inappropriate, or not. However, the Court's view was that the decision involved an objective test and there was no power for BT to make such a determination. In addition, the Court held that the use of RPI was not an inappropriate measure to use in protecting members' benefits from increases in the cost of living.

In December 2018, the CA dismissed BT's subsequent appeal, and upheld the High Court decision. Whether RPI was inappropriate was an objective state of affairs, which was inevitably fact-sensitive and a matter of evaluative judgment. In default of agreement by the employer and the trustees, the question had to be decided by the Court.

The Supreme Court denied BT permission to appeal in July 2019.

The ability of a scheme to swap from RPI to CPI as an inflation measure for benefit increases turns largely on the specific facts of the case and the drafting of the scheme's own rules.

What if RPI is materially altered – can a different Index be used?

In *Thales UK v Thales Pension Trustees* [2017] the governing documentation of the pension scheme provided "if the Government retail prices index for all items is not published or its compilation is materially changed, the Principal Employer, with the agreement of the Trustees, will determine the nearest alternative index to be applied."

Thales argued that RPI had been materially altered by the introduction of the house prices index into RPI. The High Court agreed with Thales that RPI had been materially altered as a result, and that the principal employer, with the agreement of the trustees could determine the nearest alternative. However, the Court determined that the nearest alternative to RPI was not CPI, but RPI as materially changed. Although RPI had materially changed, due to the specific wording of the Thales scheme rules, RPI remained the appropriate Index.

What next?

Many schemes continue to be interested in adopting CPI as a means of reducing scheme liabilities and improving the scheme's funding position, as it (to date) has generally produced a lower uplift to benefits than RPI. The ability of schemes to use CPI instead of RPI clearly depends upon the precise wording of the rules and the respective powers of the principal employer and the trustees in making any necessary amendments. Many schemes' revaluation provisions are drafted in terms of reference to the relevant legislative provisions and where this is the case, amendments relating to deferred benefits will not be required. However, indexation provisions are often set out in more detail, and in some cases may refer specifically to RPI. Where rule amendments are required to adopt CPI, any restrictions in the scheme's power of amendment will need to be taken into account, and CPI-based increases may be possible in respect of future service only.

Given that there are many variations on increase and revaluation rules, it is likely that questions such as those outlined above will continue to come before the Courts. Whilst general principles can be drawn from these cases, they may be of only limited use for schemes with as yet untested RPI definitions.

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