CFA Society
United Kingdom

6 March 2020

Rt Hon Rishi Sunak MP,
Chancellor of the Exchequer (via email)

By Email to: Action.Chancellors@hmtreasury.gov.uk

Dear Chancellor,

CFA UK Perspective on Potential Reform of UK Index-linked Gilt Market

The CFA Society of the UK (CFA UK) is looking forward to contributing to the consultation on RPI reform, anticipated on 11 March.

The maintenance of an orderly market and proper market standards are important components of our Society's mission to create a better investment profession for the ultimate benefit of society. Therefore, we believe that in issuing that consultation the UK Government needs to seek input that will enable it to make a balanced assessment of whether a change of index is necessary and beneficial for society. In doing so, the consultation should both (i) cover why RPI might be considered sub-optimal and (ii) evaluate the cost versus the benefit to society of using [and changing to] a replacement index (CPIH or CPI).

We believe that your consultation should include an explanation of, and an invitation to comment on, how drawbacks of various reform approaches may be nullified or at least mitigated. We recognise that this has the potential to be a very material change at a time of regulatory uncertainty, particularly in UK financial markets, and we believe therefore that the approach needs to be thoroughly considered.

To this end, we suggest that input should be sought not only from index-linked gilt investors but also from other financial market participants and beneficiaries holding contracts that reference RPI to ensure that the UK Government can fully evaluate the costs and any otherwise unforeseen consequences of such a change. Clearly, this includes a wide range of stakeholders ranging from recipients of the state pension, holders of national savings certificates through to utility companies whose revenue is linked to the RPI+X formula.

If the UK Government is to proceed with a reform replacing the existing RPI calculation with a CPI-based calculation it needs to do so in full knowledge of the direct and indirect consequences across all financial markets and within a framework that provides a fair and transparent outcome for all stakeholders in RPI-based assets and contracts. We are mindful that many investors hold RPI-based assets because they have been encouraged to do so as a hedge for their inflation-linked liabilities (CPI or RPI) as part of a prudent risk management approach.

As an issuer, the UK Government will of course wish to set the highest standards of behaviour in markets, acting with fairness and transparency with investors. Whilst the UK

Government has the power to unilaterally impose a solution onto the index linked gilt market, such an action could have damaging consequences for its future status as an issuer in world markets if it was seen to be acting to unilaterally reduce its debt payments. We would be concerned if such a move then attracted legal action against the Government.

If it were decided that RPI should be replaced by CPIH in future without any adjustment, as proposed by Sir David Norgrove, Chair of the UK Statistics Agency (UKSA) in March 2019[i], this could result in the novation of any existing contracts that lack grandfathering provisions, and may be open to legal challenge. It is likely to represent a material reduction in expected income for millions of investors, particularly UK pensioners and UK occupational schemes. Unless measures can be implemented to ensure that the contractual payments are of equivalent value before and after the change, some investors will lose out and that is a serious drawback to this proposal.

Defined benefit pension scheme assets had exposures to UK index-linked gilts of over £1 trillion as at the end of 2018[ii]. Published estimates of the value of the losses UK pension funds would incur as a result of receiving lower payments from the Government on its index-linked gilts, should the indexing switch to CPIH, vary but are substantial[iii,iv,v]. With potential losses of this scale (and higher when other RPI-linked assets held by UK pension funds are taken into account), we believe the UK Government needs to look to consult on mechanisms for the fair treatment of investors as part of a change in reference index. One approach to consult on would be the application of a spread over CPIH that would compensate existing investors for the lower rate of adjustment implied in the CPI versus the RPI index, akin to the fall-back mechanism agreed in relation to the Libor to Sonia switch. However, we believe the consultation should seek input on the pros and cons of other approaches too, so that the best solution for this transition can be found.

The RPI index affects not only domestic and foreign investors in the index-linked gilt market; it also affects pension payments and it drives contractual payments in multi-trillion pound derivative markets, in certain corporate bonds, within infra-structure debt, real estate leases and ground rent contracts. Many of these contracts are long-term; some with maturities out to 30-years and beyond. Some of these contracts contain provisions that allow for re-indexation costs to be passed on[vi] - but equally many of these contracts do not - and a step-change in the expectations of future RPI (if it was taken to equal CPIH), or the abolition of RPI publication altogether, creates the potential conditions for widespread market disruption.

We accept that opinion amongst statisticians leans towards CPIH being a better measure of inflation than RPI, however, CPIH has been consistently c.1% per annum lower than RPI since 2010. The c.1% gap between CPIH and RPI is partly a function of the two indices having different baskets of goods, but the main source of differential lies in the mathematical certainty derived from their respective methods of calculation - RPI using an arithmetic averaging method and CPIH using a geometric averaging method. Based on the historic data available, a material differential can be expected to continue into the future, with CPIH expected to be materially lower than RPI. Terms for a surrender of RPI gilts for CPI gilts would be further complicated by the fact that the precise differential in value cannot be calculated. It depends on both the future basket inputs of the two indices and, importantly, the variability in future inflation.

We look forward to participating in a consultation that seeks appropriate input on how to address all of these challenges and would be happy to discuss this in further detail.

CFA Society United Kingdom

Yours sincerely,

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With thanks to contributions from:

Natalie Winterfrost, CFA
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Bill Harer
Alistair Jones

and for overview from the CFA UK Pensions Expert Panel, the CFA UK Professionalism Steering Committee and the CFA UK board

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[i] Letter to the Chancellor, Rt Hon Philip Hammond MP, dated 4 March 2019 (Link: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/829170/20190304_SirDavidNorgrove_to_Chancellor__RPI_.pdf);

[ii] The Liability Driven Investment Annual Survey 2019, XPS Investment (Link: https://www.xpsgroup.com/media/1940/ldi-april.pdf);

[iii] The Pension Protection Fund's ("PPF") 2019 Purple Book reports (Page 7, Figure 2.2) UK Defined Benefit schemes' total liabilities of c.£1,600 billion on a S179 basis. Page 32 shows a 0.1% increase in real yield (equivalent to 0.1% drop in inflation indexation) would result in a £9 billion reduction in these liabilities. Extrapolation produces a £90 billion loss from a 1% drop in indexation (Link: https://www.ppf.co.uk/sites/default/files/2020-01/Purple%20Book%202019.pdf);

[iv] Insight Investments - "We estimate that the impact of the proposed RPI reform on the total value of the index-linked gilt market would be a reduction of c.£90bn" (Link:

https://www.insightinvestment.com/globalassets/documents/regulatory-updates/uk-proposed-changes-to-rpi.pdf);

[v] Bank of America Merrill Lynch (BAML) estimate a £94bn loss using a February 2025 change date in a report of 21 November 2019 entitled: "The right way to decommission RPI";

[vi] For one leading example, see page 101, paragraph 9 (c)(iii) of Network Rail's Debt Issuance prospectus (Link: https://cdn.networkrail.co.uk/wp-content/uploads/2016/11/Infrastructure-Finance-Multicurrency-Note-Programme-Information-Memorandum.pdf).

Appendix 1: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.