Many USS members seem to have missed an insidious provision in the new pension proposals. Item number six in the employers’ proposals (on the UCU website) states “Pension increases (for pensions in payment) will be inflation proofed in line with increases in the Consumer Prices Index (CPI) subject to a 5% inflationary cap.”. Item number 7, which refers to pensions in deferment, imposes a harsher inflationary cap of 2.5%. This appears near the back of the formal consultation process.

In this short piece, we explain just why USS members should be extremely concerned about this. There are two separate “hits” involved here for members. The first is the apparently innocuous shift from one measure of inflation (the currently used Retail Price Index, or RPI) to a Consumer Prices Index (or CPI). Bringing up the subject of inflation indices at a dinner party would generally guarantee groans of boredom. But stick with this for a moment. That little change, historically, would have cost you around ¾ of a percent per annum. That may not sound much, but if you retired in April 1988, when the CPI was first calculated, by now your pension would be 15% lower as a result of this apparently mundane change. Although in theory both CPI and RPI are meant to reflect the average person’s exposure to inflation, historically CPI has tended to be lower than RPI, for two reasons. First, the former excludes mortgage interest payments and places a considerably lower weight on housing costs. Second, there is also a difference in the assumptions made concerning consumer behaviour, in that the CPI assumes consumers switch between brands or varieties as relative prices change, whereas the RPI does not. This inevitably means inflation (even excluding mortgage costs) measured by RPI will be higher than that measured by CPI, as the latter assumes you are prepared to trade down. In effect, the USS is now assuming you’re prepared to swap your best cuts of beef for lesser ones, or a decent Bordeaux for a cheap Australian Cabernet Sauvignon, if prices move against you. Whilst the employers may feel this is a reasonable expectation, members (including this one) may have other ideas. Of course, it isn’t inevitable that the historical 0.7% per annum mis-match will continue into the future, but the expectation is clearly that in the long run RPI will be higher than CPI, which is no doubt why employers are keen to make this switch. These arguments may appear to be tedious technical ones, but the likely outcome is simply to make us as USS members considerably worse off. Not altogether unreasonably, in the formal consultation document the employers argue that the Government has decided to change the basis of state benefit indexation from the RPI to CPI, but the fact remains that Factsheet 9 on the USS website currently has “Your pension will be increased annually in the same way as official pensions in the public sector schemes. Increases are the same as the rise in Retail Price Index over the year.” One might make the argument that there is a get-out clause in this, and that the employers have no alternative but to go with the Government’s change in policy. On the other, one might argue that having specifically included a reference to RPI, the employers could have decided in a change of policy that worked in favour of members rather than simply grasping the

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1 For a detailed explanation, see “Consumer Prices Index and Retail Prices Index: The 2010 Basket of Goods and Services, Philip Gooding, Office for National Statistics, downloadable from the ONS website. All inflation calculations given in this article are also derived from ONS indices.

opportunity to reduce benefits, especially as this part of the employers’ proposals was only announced after the Government’s policy announcement.

However, if this aspect of the proposals is bad news the second change proposed is potentially far more dangerous. The proposal to cap increases at 5% may really turn out to matter if the current money-printing activities (a.k.a. “quantitative easing”) of UK and US Governments sparks off another episode of inflation. Take our representative pensioner who retired in 1988. Imagine she had started out with a pension of £10,000. She would, under the current arrangements, now be receiving a pension of £21,045. Under the employers’ proposals, that would turn into a figure of just £17,176. This is because in three of the past 22 years, the 5% cap bites. So with both of these proposed changes in force, she is now 18.4% worse off.

Of course, the extreme outcome from the current financial crisis is that we could head back to the inflation experiences of the more distant past. For example, UK inflation peaked at 26.9% in the mid-1970s, and even by the end of that decade was running at 17.2%. Suppose that our pensioner had retired at age 60 in 1978 (rather than 1988) on a pension of £5,000. Under the existing arrangements, she would now be a 92 year old with a pension of £22,532. As the CPI doesn’t start until 1988, we have to assume that the employers’ new proposed regime applied a 5% limit to RPI (rather than CPI) pre-1988.\(^3\) It turns out our poor old USS member would be having to struggle by on only £13,503, a reduction of over 40% on what she is currently entitled to.

Naturally, these examples assume show the effect of applying the new rules in the long run future, assuming the future might look like the past. The CPI/RPI change applies to existing benefits, so would appear to affect everyone. In the consultation document, it appears that the indexation cap is meant to apply to benefits accumulated after the 31\(^{st}\) March 2011, so our calculations are indicative to the position that may arise in the long term to younger members.

Is it asking too much that the employers’ maintain the existing inflation protection? Actually, not at all. There are mainstream investments that allow them to protect members against inflation perfectly easily. One obvious example of such an investment class is equities (or shares). It turns out that over the long run, dividends on shares increase by just over the rate of inflation (as measured by RPI), meaning that over the long haul a pension fund’s expected income should rise in line with prices. The second alternative is for the fund to invest in the type of Government Debt which enjoys inflation protection, known as “Index-Linked Gilts”. Finally, over the long term one might expect rental yields on property assets to at least increase in line with inflation. Of course, the USS invests in all of these asset classes, as well as so-called “alternative” assets. Unfortunately, it does so rather poorly. In fact, its performance is little short of woeful. It has under-performed its own benchmark over the past year, the past five years, and the past ten years. Specifically, it has under-performed by a full 1% per annum over the past ten years, returning just 2.3% per annum rather than a benchmark return of 3.3%.\(^4\) One cannot help feeling that a better-managed scheme would be able to deliver the benefits which have long been promised to members. Indeed, were it not for the dismal track record of the fund,

\(^3\) Remember this is likely to more generous than the actual proposal, which only offers CPI inflation.

\(^4\) See: http://www.uss.co.uk/Annual%20Reports/Report%20and%20Accounts%202009.pdf
there may well have been no current shortfall to worry about. There may be a reason for a major overhaul of the way in which the fund is run, but there seems little reason to justify the same old regime continuing at the expense of a reduction in members’ benefits.