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"Royal Mail's CDC pension plans need a dose of realism"

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Can a "collective defined-contribution" pension bridge the gap between defined-benefit — an employer guaranteeing a pension — and defined-contribution — each individual taking their own investment and longevity risk, with no guaranteed pension?

Royal Mail certainly thinks so. As part of seeing off threatened strikes, it has agreed with the CWU union to replace its separate defined-benefit and defined-contribution pensions with a CDC pension for all 130,000 employees.

The trouble is, there is no legislation for CDC, and the Department for Work and Pensions has warned that "consulting on, drafting and passing this legislation would require at least two to three years' work". Given other pension priorities and the limited demand for CDC, "it is not the government's intention to proceed with the wholesale rewriting of pensions legislation".

The department is right to be cautious. Legislation for an entirely new, untested type of pension must be absolutely watertight to avoid creating new problems. And it should not be bullied by Royal Mail or lobbyists.

CDC fans do a lot of arm-waving when asked to explain CDC — they must go beyond theory and produce practical details showing all the nuts-and bolts.

A CDC plan would set a "target pension" for each member, adjusted up or down as the value of assets changed. Lobbyists claim that it can deliver average pensions, say, 10 per cent higher than defined-contribution schemes by smoothing fluctuating investment returns via "intergenerational" risk-sharing.

But this higher average pension is simply because CDC takes higher investment risk, holding a higher proportion of equities and a smaller proportion of bonds. If an individual defined-contribution saver was happy with the same investment risk, they also would, on average, get the same higher pension.

Moreover, can higher CDC investment risk really be shared fairly among different generations to produce a higher pension? Such “intergenerational risk-sharing” looks suspiciously like a Ponzi pass-the-parcel from older to younger members. Each generation may be happy to take the risk for an older generation if they, in turn, can pass the risk to a younger one.

CDC fans should explain what happens when there are no new members and the youngest generation is left holding the parcel?

By definition, the first, oldest CDC generation, has taken no risk for an older generation, but the youngest generation takes risk twice, for itself, and the penultimate generation. End-to-end the oldest generation gains at the expense of the youngest.

Meanwhile, Royal Mail claims that rather than delivering a slightly higher pension than DC, its CDC will provide “a similar level of member benefits” to DB. Annual company and member CDC contributions would be 20 per cent of salary, half the cost of the present Royal Mail defined-benefit pension, so a DB-like pension can only be achieved by taking uber-aggressive investment bets. Royal Mail, and the CWU, must explain to employees what happens when these huge bets fail.

The annual contribution is the same for all members, regardless of age, building-in a huge structural cross-subsidy from younger to older Royal Mail employees, which again must be properly explained.

If the government does allow CDC, Britain should use well-established Dutch rules (where CDC is standard) to maximise fairness between generations. Dutch CDCs discount “target pensions” to a present value using prescribed market bond yields, with annual inflation increases allowed only if there is a cushion of assets versus liabilities. Any shortfall must be corrected within five years, by cutting target pensions and pensions-in-payment.

Under these rules the Royal Mail CDC annual contributions could only support “target pensions” of just half the present DB pension.

If CDC stands any chance of working, we need both proper regulation and realistic expectations of what it may deliver in practice, not the overblown claims of Royal Mail.