The Times Business Comment

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"Royal Mail workers should see red over CDC pension plan"

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Royal Mail has spent many months lobbying for new legislation to allow "collective defined-contribution" pensions for its 140,000 workers. The government's public consultation ended last week.

Despite cheerleading from highly paid consultants, the proposed scheme is structurally flawed. It raids younger employees' pension savings to pay older employees' pensions. And sorting this isn't just about fairness. Unless it is fixed, there will be a barrage of "mis-selling" claims against such schemes and the government itself, with taxpayers on the hook to pay compensation.

CDC pensions aim to sit between defined-benefit pensions — with an employer guaranteeing a pension for life based on salary and years of service — and individual defined-contribution pensions, with no guarantee. A CDC scheme sets a "target pension", raised or lowered in line with the value of assets, which are held collectively, rather than individual defined-contribution accounts. Its fans claim that such collective "inter-generational risk-sharing" produces a higher average target pension than a DC pension.

How does the Royal Mail scheme "take from the young to give to the old"?

Most of a DC pension pot at retirement is from long-term investment returns, not the initial cash contributions, so a younger person should have a higher pension than an older person saving the same amount.

But take two Royal Mail employees both earning the same, in the CDC scheme for five years, drawing their pension at 67 and living to 90. One joins aged 22, giving them 45 years of investment returns to 67, and the other joins at 62, with only five years' investment returns.

Although the 40 years' extra investment returns give the 22-year-old a much higher DC pension, the Royal Mail CDC target pension is the same for both at 1/80th of salary. The 22-year-old gets no more than the 62-year-old.

The CDC scheme pays a pension to the older member, even after their DC pension pot would have been spent. But there is no CDC magic; it simply takes a large part of the younger member's pension pot.

Once Royal Mail spells out to employees that a flat-rate target pension is a con for younger members, why would they choose the collective plan over plain vanilla defined-contribution?

New legislation should require CDC target pensions to be age-related. If the average is 1/80th, the target pension age 22 is higher — say, 1/40th — and age 62 is lower — 1/160th.

CDC schemes can use the "expected return on assets" to value target pensions, but this understates the value of target pensions and means that pensioners will be paid more than their share of assets — another structural transfer from young to old. CDC schemes should have to use a prescribed bond rate to value target pensions.

A CDC scheme holding, say, 90 per cent equities, which don't match target pensions, is much riskier for members than holding 90 per cent long-dated bonds. These schemes should have to "stress test" their assets to show this risk.

The Royal Mail scheme plans to hold 100 per cent equities for members up to age 67. There is no explanation of what happens if this huge bet fails, other than to keep on betting and hope for the best.

CDC may have some (modest) benefits versus DC pensions, but unless the structural flaws are sorted it will fail and the only winners will be lawyers bringing mis-selling claims.

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