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Rising costs put last nail in the coffin of final-salary schemes

Serious money

Businesses are overhauling their pensions provisions, forcing staff to find new ways to prepare for old age, says **David Reid**

THEY were once taken for granted but final-salary pension schemes have had their day, something that is going to have ramifications for all our retirements.

As well as banks, life and pension firms are closing their final-salary schemes to new staff, and are asking existing employees to contribute.

The costs are rising and have been doing so for several years. Schemes have had to cope with having to implement the requirements of the Pensions Act; the increased cost of paying pensions because of our longevity; poor investment returns of schemes' funds over recent years; and the extra £5 billion per year that the Chancellor started taking from pension funds after the 1997 Budget. All this has seen the cost to many employers rise from around 10% of payroll per annum to well over 20% in the last few years.

For SMEs, such schemes are becoming unaffordable, and the long-term costs unknown. Couple this with the new accounting standard FRS17 – which will include the pension scheme's surplus or deficit on the balance sheet – and final-salary schemes have become a less attractive way for employers to provide retirement benefits to their staff.

There is, however, another serious result of the increasing costs of a final-salary scheme: what happens when the employer goes into liquidation?

As a result of increased costs and lower than expected returns, there can be less money in the fund to pay for benefits that are now vastly more expensive than before. When a company goes bust and the pension scheme is in deficit, there is today no employer to bail it out.

A pension scheme is not even a preferred creditor, so there is little chance of recovering anything from the employer.

The government hopes to tackle this with its pensions protection fund (PPF), and funded by a levy on occupational schemes, which is to be brought in by April 2005.

The trouble, however, is that financially secure schemes that have little need for the PPF will end up supporting those that fail, and the levy is yet another factor that will force up the cost of running a final-salary scheme.

The government also intends to implement the Inland Revenue's proposals for the simplification of the taxation of pensions.

From April 2006, there will be one regime available for defined contribution schemes, broadly similar to a personal pension. But the level of allowable contributions has increased, so more can be paid into a pension over a shorter period. In defined-benefit schemes members will have scope for more flexible retirement options.

Any change that simplifies the current legislation and makes it more understandable is certainly welcome. But both the government and the industry must do more to tell people what they can expect to receive from the state on retirement.

There is an over optimistic assumption as to what the state will provide, despite the fact that the benefits from the state have been eroded by successive governments. Also, given shifting demographics, there is no guarantee that the existing level of state benefit will be maintained.

The closure of so many pension schemes and the reduction of state benefits, means the responsibility and risk of providing retirement benefits has shifted from employers and the government towards the individual.

Apart from seeing Gordon Brown reverse his policy of taxing pension funds, there should be greater incentives from the government for individuals and employers to save for retirement.

The fact that we have an increasing number of final-salary schemes closing their doors, along with the problem of stakeholder pensions not attracting the numbers hoped for by the government, means we have a generation of workers heading for a retirement well short of their financial expectations.

Despite the continuing attraction of the tax relief available to pension contributions, a retirement fund does not necessarily mean a pension.

It is a basket of assets that can be used to provide an income to sustain you through what will probably be, as life expectancy rises, a very long retirement. It could be a combination of pension funds, property, savings, investment plans and thanks to the previous generation's more frugal approach to personal finance, inheritance.

A retirement fund should possibly be the largest asset an individual holds, yet it's importance usually appears down the household's list of priorities, where the cost of the mortgage, the loan for the car and credit card repayments take precedence. "What if I get hit by a bus tomorrow?" may be a common argument, but, thankfully, that's unlikely to happen and we will reach our retirement.

This is not a problem that's going to go away. The answer is to start funding as early as possible so when the day comes you will be secure in the knowledge that you'll be able to afford that trip round the world.

David Reid is a director of independent financial advisers Principal & Prosper

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In recognition of our expertise within this market sector, Principal & Prosper were invited to give our views on Final Salary Schemes and the implications for employees, who are being forced to find new ways of planning for retirement. David Reid of P&P highlighted the plight of many and warned that the Government's 'white paper' wouldn't provide the solution; it might even exacerbate the situation.

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