Moved off final salary? You'll be £4,000 a year worse off

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By Paul Farrow
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If a pension could be compared to a motorway, the M6 toll road would be the route for final salary scheme members – their journey to a well-funded retirement is an uninterrupted stress-free ride with their employer paying the toll fee.

Unfortunately, many of these workers are soon going to come off at the next slip road straight onto Spaghetti Junction, where they will have to find an alternative route for their pension saving – a route that will offer anything but a smooth ride.

The reason? Until now, most employers that have called time on their final salary pension schemes – where your pension is based on your salary – have done so to new employees joining the company. The decision has not affected existing workers who have continued to keep hold of these precious pension schemes.

But that is all about to change. Widening pension deficits and the increasing burden on balance sheets are taking their toll on companies.

The cost of maintaining these pensions is getting too much to bear. A recent study by KPMG

found that, for the first time, FTSE 100 companies were likely to spend as much on paying the pension promises to past employees as they are on current employees' benefits – £4 of every £5 spent on defined benefit pensions will be for past liabilities, not new benefits.

This is a reason why a number of companies are dangling carrots in front of former employees to try to persuade them to transfer out of their final salary scheme. For instance, Intercontinental Hotels recently offered former staff a 25pc cash incentive on top of the pension transfer value to take their retirement pot elsewhere.

Watson Wyatt, the actuary, says that while only 9pc of defined benefit schemes have so far closed to existing members, around half expect to have closed by 2012, including blue-chip schemes.

It is going to be a rude awakening because the difference between a final salary scheme and a defined contribution plan can be staggering. Defined contribution schemes are fundamentally different from final salary schemes. The pension you get is dependent on how much you and your employer put into the fund. Investment performance and annuity rates at retirement also come into the equation. To make matters worse, employers tend to contribute far less than the 10pc they typically used to put into final salary schemes.

To give you an idea of the difference I asked the number-crunchers at Mercer to calculate how much it would cost a 50-year-old worker whose final salary scheme is closed and replaced with a defined contribution scheme.

Assuming real salary growth of 1pc per year, someone on a salary of £30,000 age 30 who is moved at age 50 to the defined contribution scheme could expect to receive an annual pension £4,000 lower than they would have received in the final salary scheme. If they want to restore their expected pension, they will have to make additional contributions of 21pc of their annual pay. For most, it will be a destination too far