

# Pension Splitting *for Divorce*



Dear Reader,

Perhaps I should start by explaining who we are and what we do, and most importantly of all why you might want to use us. The Company was established specifically to provide legal practitioners with a reliable and efficient source of the type of pension valuation now needed in ancillary matters. The catalyst for this was the need during my own divorce to find a company that could do this work, and, despite thirty years service in the pensions industry I had trouble in finding someone at all.

The consideration of pensions in divorce is a relatively new process, perhaps this is why companies that specifically offer to carry this out are few and far between. In practice this then falls either to actuaries practicing in pensions or to pension consultants who practice in the same area. Independent Financial Advisers' have a role to play in the process but theirs is mainly restricted to post split advice in advising clients either how to make good the loss of pension or how to deal with the receipt of a pension share as generally they are unlikely to be sufficiently qualified or have sufficient expertise in this complex area.

We as Pension Consultants are professionally recognised as such by The Society of Pension Consultants of which we are, along with most of the pension's actuaries and Pension Lawyers, members. We work under the same guidance as actuaries and adopt exactly the same standards for our work.

Since 1996 it has been a requirement that the pension is taken into account during ancillary matters, quite rightly so since it is quite often the second largest matrimonial asset and not infrequently the largest of all. Initially, only a few years back, the only means of splitting the pension were both clumsy and quite often unfair. However these issues have now been largely addressed and now also fit in well with the modern clean break solution often favoured by the courts. It is now, I believe, possible to reach a fair settlement.

The most important concept of splitting a pension hinges upon a fair split being achieved for both parties. A good definition of a fair split being: "An amount that is of equal value to the cost of replacing the benefits that have been lost, calculated using reasonable assumptions". Far too much credence appears to have been given to the transfer value, the CETV, a value that in reality is of little real use as it was never intended to be used for this purpose.

The following three pages give examples of the situations that can occur with members of the more common types of pension and illustrate why the CETV is often of little real use. These examples seek to demonstrate that receiving professional unbiased help is not only essential but is neither prohibitively expensive or difficult to obtain.

We are a small and flexible company and invite your comments and opinions, we look forward to working with you and will attempt in any way possible to make this a trouble free and simple process.

Lastly I would like to thank you for taking the time to read this; I hope it proves useful.

I look forward to speaking to you.



Philip Lewis Dip PFS

## **Example 1 – Public Sector Scheme – The Police, member is male & joined the scheme at 18**

The transfer value of the Police Pension Scheme more often than not greatly understates the true value of the scheme; this is because, by law, like all schemes, the CETV must be calculated as if the member had left service on the date that the calculation is carried out. Whether or not they are still a member of the scheme or likely to continue to be a member is not relevant to the calculation.

The police scheme allows members with 25 years' service to retire early at the age of 50, this benefit is obviously of enormous value but the value of this does not form part of the CETV calculation until the day it is actually earned. This is further complicated by the fact that members of the scheme do not accrue benefits uniformly. The scheme is, on the face of it a straightforward 60ths scheme and members do in fact accrue one sixtieth of pension but only for the first twenty years of service, as once this milestone is reached each additional year then counts double, meaning that members reach their full pensions entitlement after 30 years service and at this point cannot accrue more. Because of this the scheme rules allow them to retire immediately, in fact it is difficult to envisage circumstances in which they would not.

This means that if a member of the scheme notionally leaves service before completing 25 years service, i.e. requests a CETV for divorce purpose, then because on that day they can only take their retirement benefits at age 60, no account is taken of the fact that if they were to remain in the scheme they would receive much higher enhanced benefits. This means that no value is put on these increased benefits because on the date that the calculation was carried out there was no entitlement to receive them. The fact that member may have no intention of leaving the scheme does not affect the calculation; therefore its value is not reflected in the CETV. Of course if they remain in the scheme they will accrue more service, when this reaches 25 yrs they will become entitled to retire at a much earlier age. It is in fact possible to retire on the maximum full pension as early as age 48 which of course is a most valuable benefit.

Put simply the CETV ignores the value of all future enhancements if on the day of calculation the member is not contractually entitled to them, this applies even if entitlement is only one day away.

### **If the significance of this is missed a horrendous result can occur, most easily shown with an example.**

Let's assume our mythical officer gets divorced before twenty five years service have accrued, by chance in fact the calculation is carried out the very day before, so on this day the pension earned will be **£16,666**, and the calculation is 24yrs 364 days i.e. actual service, divided by 30 yrs which is the total potential service to accrue full pension, multiplied by the maximum pension obtainable which is two thirds of his current salary of £30,000, this pension would be paid at age 60.

If the calculation had been carried out a day later the situation dramatically changes he now in fact becomes entitled to slightly less pension, **£15,000** in fact but this payable from age **50** not **60**, the calculation changed to 30 yrs (20 yrs plus 2 X 5yrs of actual service) divided by 60 (60<sup>th</sup> scheme), multiplied by £30,000 (salary), but the pension is now payable from age **50**.

### **If a 50% pension share was given should his ex spouse get, 50% of the former, or 50% of the later?**

Perhaps an even easier way to see the effect of this is from the capital values, the CETV's. These would be approximately **£170,000** the day before 25 yrs service and **£260,000** the day after, a quite staggering increase of **53%** in just one day, for the pension share to be fair it can be adjusted accordingly and probably should be when a member in a scheme is close to benefit breakpoints such as these.

## Example 2 - Private sector scheme, member is male, retiring at age 62, the CETV is £560,000

This member has accrued a pension of £40,000 per annum, the pension is inflation-linked and the scheme normal retirement age is 62. The current CETV is £560,000 and, like most private sector schemes the scheme only offers an external option to the spouse receiving a Pension Share. The spouse has no other option.

### If a 50% Pension Share of the CETV were to be implemented: -

He would keep a pension of **£20,000** per annum, i.e. half of the accrued pension and this would, be payable immediately, because at the age of 62 he has reached the scheme retirement age.

She would receive a pension credit of £280,000, half of the CETV, and because the scheme does not offer membership to her **must** transfer this out of the scheme and invest it in her own pension arrangement. If she does not make a decision the scheme trustees will most likely make the decision for her, they can transfer her share away into a pension in her own name, but chosen by them. Effectively they expel her from the scheme. However when she draws her pension she may find that she is only able to purchase a pension of just over **£10,500** per annum, she knows that she received half the pension value (in fact that is exactly the problem, she received half of the CETV, not half the pensions value), of a £40,000 pension so was expecting a pension of £20,000 or close to it. She does not understand why she won't, and she wants to know why.

*The answer is that the CETV does not truly represent the value of the scheme; it doesn't because it was never intended to. Now this doesn't matter so much to a member who leaves because they have a choice, they will receive a CETV but do not have to take it and most of them don't. There were however a few years ago a group of leavers who found out to their cost that the CETV could not, on a reasonable basis, match the same benefits of the scheme. Because remaining in the scheme had been an option but they had been advised to transfer out, they complained. Their complaint was that the advice was wrong and that it was flawed, because they would be worse off. The FSA agreed with them, this became known as the pension misseling scandal. The root cause of this was the inability of the CETV to match the benefits of the scheme.*

*Unfortunately however in the case of a divorce share the spouse receiving the credit has to transfer it away, there is no advice whether to or not because there is no choice. The only solution is a simple one, the spouse needs to receive a greater share, because by giving a share greater than 50% to the spouse the eventual pension incomes can then be equalised. The question of course is by how much should it be increased?*

*In this example, retirement is imminent so most of the unknown factors, such as growth and inflation in the future have been eliminated; it is then easy to see that the CETV is simply not high enough to buy equivalent benefits to those offered by the scheme. Only in the most extreme circumstances, such as serious ill health will the value of a CETV given close to retirement purchase a pension equal to or greater than that offered by the scheme, and this is well known in pension circles. To a greater or lesser extent this is also true where retirement is further away, it is however more difficult to see but the effect can be equally great.*

*The original purpose of the CETV was to calculate the liability of the scheme for the employer and this is still its primary purpose today, it should, therefore also be borne in mind that the lower the CETV the lower the liability on the employer and employers, generally, seek to keep liabilities down rather than up.*

*There are however more contributory reasons, some of which appear below.*

**Costs**, if a provider receives £100,000 you will not get an annuity based on this full amount because the provider needs to make profits, this is taken into account when setting and calculating the annuity rate.

**Current** market conditions have lead to an avalanche of money into gilts as they are seen as a safe haven in uncertain times, this has driven yields so low that many are now returning a negative yield to taxpaying investors. Annuities are backed by gilts so they reflect the current gilt yield, i.e. they too are at a historical low.

**Life Expectancy**, on average women live longer than men, therefore each pound of pension purchased for a woman costs more than that for a man of the same age simply because it is expected to be paid for longer.

### Example 3 - Something simple, a straightforward money purchase scheme, in theory.

Taking the simplest case possible, a money purchase scheme with no guarantees or additional benefits. The value then is simply the sum total of its investments which are easy to see as the sole pension asset comprises of cash held in a Bank. Both spouses are the same age, in fact 65 and are about to retire, this is the only pension asset and the account is held in his name, it is a private personal pension.

In theory perhaps an ideal case for offsetting, his pension fund against the other matrimonial assets and this is a common solution and for a number of years the only solution. The pension fund is worth £500,000 which coincidentally is the same as the house, for these purposes, there are no other assets, so offsetting asset (the pension) against the other asset (the house) seems quite straightforward and fair.

In theory this is correct and fair, after all how can £500,000 of pension value against £500,000 of property not be?

However when faced with reality and time to think he may come to the conclusion that this is not so, he may come up with the following reasons.

**He has a pension but nowhere to live, he has no funds available with which to buy anywhere either, conversely of course his ex spouse has the opposite problem.**

**With little or no cash, and nowhere to live, obtaining a mortgage may be difficult, or even impossible.**

**The house can be sold, and whatever it sells for no tax would be payable, it can also be sold at any time.**

**Property can be used as security; loans can be raised without it being sold, but pensions cannot.**

**He is in fact 42 so can't access his pension at all for at least another 13 years.**

**Pension legislation can, in effect, be retrospective; the minimum retirement age rose recently to 55 and it might rise again.**

**When the pension is paid only 25% of it will be tax free, which leaves 75% which will be subject to tax.**

The above points demonstrate that the pension value compared against other assets is not simply the value of the fund, in making this comparison gross is compared to net which can never be right and the time premium of money (a bird in the hand is worth two in the bush) has been ignored. When offsetting the value of the pension used in the calculation should be compared to other assets on a like for like basis, gross to gross or net to net and the fact that is not available and cannot be used in any way should also be taken into account.

Two other courses of action could have been taken, both require a calculation, firstly the true value of the pension can be assessed **in relation to the other assets**, in other words its value can be reduced to take account of taxation and the time premium of money. In this oversimplified instance this would not work but only because there are no other assets, if there were then these could be exchanged accordingly.

Secondly the pension could be split and the house sold, the house being easy to deal with as it could be sold and the proceeds simply split between the two parties. The pension likewise could be split but the result of splitting the capital value, the CETV in a 50/50 share would be as follows:

**She would receive a pension of £10,325      He would receive a pension of £11,475, 11% more than her pension, hardly fair for his ex spouse.**

However a pension of **£10,869 for each** is quite easily achieved by adjusting the split, in this example splitting the fund 53% to her and 47% to him will achieve equalisation of income, or put another way she needs **£26,376** more than her former spouse does to achieve the same level of income which is the target we are seeking.

**Ps4d Ltd is pleased to accept instructions on the following most common basis, of course should you have different requirements then please do ask as we think flexibility is key.**

**Party Expert Reports, acting and representing a single party.**

**Single Joint Expert Reports with an overriding duty to the Court, the instruction of joint experts is encouraged by the Court and is becoming increasingly common in England and Wales.**

**We will also be pleased to accept instruction to appear in Court to give evidence as an Expert Witness should this be required.**

**Second expert witness opinion for any situation, where a second opinion is required.**

Where mediation is being used in the resolution of dispute which it increasingly is, we will be pleased to be asked to attend such a hearing. However the instructing solicitor will have to make clear exactly what role that we, as appointed expert will be expected to play in the mediation as no fixed formal procedural rules govern the conduct of mediation and therefore the meaning that the role of the expert will vary from case to case.

The cost of this service is determined by the types of scheme and by their complexity. However, the cost to ascertain true value is small and inexpensive when taken into context of the amounts involved and the risks associated with getting it wrong.

Each case receives a full written report which will detail the information obtained, how it was considered, and the rationale and reasoning behind the conclusion of the report.

**Public sector scheme analysis            £750.00**

**Private Sector Defined Benefit            £500.00**

**Money Purchase Scheme                    £300.00**

**Court Appearance Fees                    £500.00**  
(per half day plus travel expenses)

This fee scale above is equally applicable whether consulted as joint expert or single instruction.

Fees are per scheme but multiple money purchase schemes for one member can be treated as one scheme for fee purposes.

Fees become payable upon delivery of the finished report.

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