Articles

THE REALITY OF PENSION SHARING – PART TWO

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This is the second of two articles written from the viewpoint of the pensions expert, based on considerable hands-on experience of dealing with the treatment of pension rights on divorce. In the first article at [2003] Fam Law 517 we explained that our experience has left us concerned about the whole operation of this legislation, and the results that can currently be produced. As we explained we are actuaries and pensions experts. As such, we are seeing an area of great complexity dealt with all too frequently in a simplistic fashion. In a number of cases, this will produce serious untoward, and probably unexpected, financial effects.

In the first article, we looked at the problems encountered in getting the information and then arriving at a decision as to how the pension rights should be taken into account. In this article, we will examine the problems that arise in the final stages – drafting the order and implementation. In particular, we will look at the specific problems that exist because of the requirement in the legislation to specify a date of the pension valuation (the date of the cash equivalent transfer value (CETV)) in the pension sharing order, whereas the share cannot be actioned until the scheme has all the relevant papers served on it and recalculates the CETV at the point of actual transfer, applying the percentage to this new value. This is what is sometimes referred to as the 'moving target syndrome'.

THE IMPORTANCE OF THE CETV DATE

Parliament tried to avoid expensive expert-witness involvement in the valuation of pension funds by making it a requirement that the rights are valued on the basis of the CETV to which the member would be entitled if his employment were terminated or he left the scheme on a stated date. However, the regulations provide two different dates on which the pension has to be valued:

- Regulation 3(1)(a) of the Pensions on Divorce etc (Provision of Information) Regulations 2000 (SI 2000/1048) states that, where a court exercises its powers to make a pension sharing order, the benefits shall be valued as at a date to be specified by the court (being not earlier than 1 year before the date of the petition and not later than the date on which the court is exercising its powers).
- The pension scheme must be sent a copy of the order, which will set out the percentage of the CETV allocated to the member and the former spouse respectively. The pension scheme needs to discharge its liability in respect of the pension credit within a period of 4 months beginning with the day on which the order takes effect or, if later, with the first day the pension scheme is in receipt of the order, the annexe, the decree of divorce or nullity and information prescribed by reg 5 (date of birth and national insurance number).

However, the Welfare Reform and Pensions Act 1999 allows the pension scheme to recalculate the CETV on whatever date they choose within this implementation period.

There is, therefore, a delay between the value in the order and the value used to implement the order. This delay can be further prolonged if there is a winding-up application in respect of the scheme or the scheme requires their charges to be met first.

There are two categories of issues that arise because of the use of a specified date for the CETV in the order that is then recalculated on implementation:

- the financial effects of the time lapse; and
- the changed situation of the scheme member or the scheme.

The problems that can occur as a result are such that to ignore them can lead to unfortunate, and sometimes ridiculous, results. As an example, we have been involved in a case where a husband intended to share 50% of his pension at the date specified in the court order. Had the lawyer not involved us, the actual result would have been to leave the husband with no pension whatsoever, since the value of the pension rights at the date of implementation was less than half the value at the date of the order.

THE FINANCIAL EFFECT OF THE DATE ISSUE

What should be happening?

The divorcing couple's assets are valued as a snapshot during divorce proceedings and these values, provided in disclosure, are used by the parties and the court to reach a settlement. That is accepted practice. Any increase or decrease in the value of any particular asset between the date used in the order and the date the asset is transferred will usually not be taken into account when determining what amounts to fair sharing. This issue has frequently been addressed, particularly in relation to matrimonial homes.

It is essential that, for consistency, this same approach of valuation, as at the time of the order, and subsequent fair division at the time the asset is transferred should be applied to pension rights.

The legislation lays down clearly how the pension rights belonging to each party should be valued at a specified date, and that value is commonly referred to as the CETV. However, it is very important to realise that the asset is actually the pension rights – typically expressed as an amount of pension or lump sum – and that the CETV is the value of those assets. It is vital to appreciate the difference between these concepts. The CETV itself is not the asset.

At first sight, what should be done appears to be straightforward. All that seems to be necessary is a simple process:

- the amount of the CETV to be shared at the date required by reg 3(1)(a) should be determined; and
- an instruction should then be sent to the pension scheme to implement this as a percentage.

Unfortunately, this does not produce the results intended by the legislators.

Why is this happening?

The pension scheme can only carry out the pension share as a transaction on the current value of the pension rights. But the lawyer and the courts have determined the amount to be shared based on an old value of the pension rights calculated being no earlier than 1 year before the date of the petition and no later than the court order, an old CETV by the time the transfer is effected.

It is an absolute rule of finance that monetary values at different dates are effectively different currencies. The pension scheme is effectively being asked by the lawyer to subtract that amount to be shared, calculated from the old CETV from the pension scheme's current CETV to create a pension share now. Mathematically and financially, this is a nonsensical request and can lead to results that are often unintended and sometimes bizarre.

Transferring pension rights is not like transferring saleable assets. When the pension scheme receives an instruction to carry out a pension share, it will carry this out in strict arithmetical terms. It does not normally look at the significance of the instruction. The only objective of the scheme administrator is to ensure that the benefits set up for each of the parties reflect that instruction in mathematical terms, regardless of its wider significance.

Because the pension scheme is being asked to carry out a transaction that is intrinsically unsound, the result of this transaction will also be unsound. The actual effect is that the resulting pension share will unavoidably take account of at least some of the changes that have occurred since the specified date in the court order, because of the use of the current CETV by the pension scheme administrator in part of the calculation. This is exactly contrary to what the lawyer is trying to achieve.

What is the effect?

The pension scheme receives an instruction to implement the pension share as a percentage. Because of the impact on the calculations caused by the scheme administrator using a current CETV, it produces results that can be other than those intended.

The percentage to be shared has been derived from the old CETV, but the scheme must apply it as a percentage of the current CETV. This clearly gives the spouse a share based on current values rather than those used during the negotiation.

What is the answer?

The underlying principle must still be to use the value as at the specified date in the order and then apply the ordered percentage between the parties, so that any change in the value between the specified date in the order and the date of transfer is not taken into account when implementing the share. Basically, the effect of the share should be to put both parties in the position they would have been in had the pension share been effected at the specified date in the court order. By this we mean that the pension rights, which it was agreed should be shared, should not change.

The answer to the problem lies in careful drafting of the order to ensure that this result is achieved.

How is this achieved?

At the time the order is drafted, the intention of the pension share should be clear. The pension scheme will only want to know the percentage being shared as at the date the share is put into effect. The scheme administrators will not normally be interested in a long story about what the couple are trying to achieve.

The percentage in the order will need to anticipate any changes that will take place between:

- the date of the negotiation (probably the date when the matrimonial home was valued, which should also be approximately the date of the CETV); and
- the date when the pension scheme carries out the implementation (strictly speaking the regulations require this to be within 4 months of the receipt by the pension scheme of the correctly completed order – see the final paragraph in this section).

This can be done in two ways:

- in the order, use the phrase 'that percentage which, when applied to the CETV, results in an amount of £X'; or
- ask an actuary to anticipate the change between the two dates and ask him to calculate a percentage for the order that achieves the intended result.

The first method is much to be preferred; it is so much simpler (and cheaper) than the second. The snag is that some pension schemes get on their high horses and refuse to implement the simple calculation, reasoning that 'if Parliament had intended us to use a fixed sum they would have made provision for it'. (In Scotland, provision is made for either a percentage or a fixed amount.)

CHANGES BETWEEN NEGOTIATION AND IMPLEMENTATION

What changes can occur?

There can be an interval of many months, sometimes much more than a year, between the date at which the value used for the couple's agreement, and the date at which a pension share are put into effect. The pension scheme is a moving target, not just with regard to the value, but also in respect of what state the benefits will be in.

During this interval there can be many changes in the status of both the member and the pension scheme itself. The member might leave the pension scheme or retire. He might get a promotion. Additionally, either party might die before the pension share is implemented. On the other hand, the change could be completely outside the control of either of the parties. The pension scheme might close. Its benefit structure might be altered significantly. Its funding level might be affected by stock market changes – a particularly relevant issue at the moment.

These changes can have a major effect on the pension rights arising from a pension share, and a court order should be made in such a way as to deal with these contingencies. In some cases, it may be possible to be specific as to what should be done in these eventualities. In other cases, an arbitration clause might well be appropriate.

The list of possibilities as to changes that might occur is very long indeed. We will concentrate on some of the most critical. It is very important that court orders take these possible circumstances into account.

Leaving

The scheme member might change employment. As a consequence, his benefits in the scheme could move into a preserved state, or they may be moved to another scheme, possibly of a very different type. Indeed, this latter possibility can happen even without a change of employment.

The effects of this can be very varied indeed. The main point is that the order should have an undertaking that the scheme member does not change employment until the share is implemented or else the pension may now look very different, with radically different consequences for the member's spouse.

Retirement

What would happen if the scheme member retired between the specified date in the order and the date of transfer? The retiring member will almost certainly take advantage of the option (or the right) to take a tax-free lump sum in lieu of some of the pension. This has three main effects. First, the retirement lump sum can only be taken once so that, after the share, his spouse will not be able to take advantage of this benefit, something she may well have been relying on. Secondly, all the pension rights will be fully taxable rather than a portion being received tax-free in the form of a lump sum. Thirdly, the CETV of the remaining benefits will be significantly reduced. Indeed, they will be further reduced if a significant time lapse occurs and a number of pension payments are taken.

The order should have an undertaking that the scheme member does not take retirement until the share is implemented.

Increased salary

If the scheme member is an active member of a defined benefits pension scheme, he will be accruing more rights with each day's service. There will also be a sudden and significant increase in his CETV on obtaining a salary rise. The net effect is that it is normally impossible to predict what such pension rights will be worth at a future date. Accordingly, any decision to share a percentage of rights will automatically be giving the benefit of these changes, which occurred after the specified date, as part of the share.

The scheme member may wish to use as up-to-date a CETV as possible close to the date of the order if the objective of any settlement is to provide his spouse with a particular amount. The drawback is that the pension asset is revealed as increasing in value over a relatively short period of time.

Death of either party

An agreement might be drawn up in which the pension share was essentially the balancing item. If the scheme member dies, there will be no pension rights to share. There is not even certainty as to whom the spouse's pension will be paid. Many schemes these days will pay this to the partner at the date of death, particularly if there are children. A separated wife can have no certainty about what the scheme will do. It will depend on its rules at the date the member dies. Lump sums will virtually always be paid at the discretion of the trustees and the spouse of the member certainly cannot rely on that as a guaranteed source for settlement.

Conversely, if the spouse of the scheme member dies, that party may have accepted significantly less of the marital assets in the expectation of the pension. As this will never have been implemented, the estate of this party will have lost out.

Changes in the pension scheme

This is the most complex area of all, and the area where real damage can be done to either party. The following is not an exhaustive list:

- closure of the scheme;
- change in the benefit structure of the scheme;
- alteration in the funding level of the scheme; and
- introduction or removal of discretionary benefits.

It is very important to realise that each of the parties to the pension share will have expectations, probably rather simple expectations, as to what the effect of the share will be. Any of these changes can have a radical effect on the outcome for one or both parties.

The regulators of the financial services world have consistently taken the view that an expectation created in an individual should be achieved. They certainly expect individuals to be fully informed and to be given a clear understanding of the nature of the transaction they are undertaking, what the possible results are, and what the risks are. The fact that there is no clear regulation of pension sharing transactions at present should not be a source of comfort, as retrospective action has become a feature of financial services regulation in recent years.

TRANSFERS OF PENSION CREDITS TO OTHER SCHEMES

There is another minor jungle of potential confusion regarding the retirement dates of the pensions credit, where usually the beneficiary is the wife.

The government's intention is well known and clear. It wished beneficiaries of pensions credits to be required to take his or her pension between 60 and 65.

In some schemes, this is exactly what has happened. For example, in the police scheme, policemen can often retire at 50 with a full pension. After a pension share, his pension remains payable from the age of 50 while his ex-wife's cannot start until she is 60. There is no flexibility regarding this.

However, owing to a drafting error in the Welfare Reform and Pensions Act 1999, if the transfer is made to a personal pension, the wife can start her pension from age 50. Before one relies on this, be warned that the government has said it will rectify the position. How such rectification would affect cases that had already been set up, but the pension not started, is evidently uncertain. Also, since the change is needed in primary legislation, its timing is uncertain.

POSTSCRIPT – THAT MASKELL CASE

It is not for mere actuaries to opine about legal precedents, but *Maskell v Maskell* [2001] EWCA Civ 858, [2003] 1 FLR 1138 seems to be causing confusion. As we have written elsewhere in this article, pensions are only partly realisable as cash (usually about a quarter of the total value of the pension rights) and that can only (again, usually) happen at retirement. That is completely different from meaning that the pension is only 'worth' about a quarter of the full value. To accept only the cash value will disadvantage the client (usually the wife) considerably. The emphasis on the cash value was dependent on the particular facts of the case due to the husband's short-term needs, largely his immediate need to rehouse himself.

To emphasise the point: it is ridiculous in financial terms to value pension rights only by reference to the tax-free lump sum.

CONCLUSION

In these two articles, we have shown the types of problem that can arise when implementing a pension share. It is a subject that can look deceptively simple, and the actual administrative processes are not difficult.

The difficulty arises because of the nature of pension rights, which are very different from any of the other matrimonial assets. It is only too easy to follow all the procedures, and carry out a pension share in what looks like a common-sense fashion, only to find that the financial consequences are far removed from either what was intended or what the parties to the share expected.

Family lawyers are just that – family lawyers and not pensions experts. They cannot be expected to appreciate all the significant problems involved with pension rights and, as a result, can fail to deal with pension rights on divorce in the best interests of their clients. It is essential to think through the consequences of what is being implemented, as these consequences can be very significant indeed.

What then should the family lawyer do? As we stated in the first article, the golden rule must be to determine what the actual result of the pension share will be for the two parties involved, and then to ensure that they are made fully aware of this. This must be in terms of pensions payable, for ultimately that is what matters in practice. Any decision made by the client must be with full knowledge of the effects of that decision. That must be the responsibility of the family lawyer. If in doubt, seek professional advice.