Articles

THE REALITY OF PENSION SHARING – PART ONE

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Family lawyers have been dealing with pension rights on divorce since the introduction of the Matrimonial Causes Act 1973. For more than 30 years, when the court made a financial provision order on divorce, the treatment of pensions rights remained purely at its discretion. Recently, Government has made two attempts to improve the treatment of pensions issues on divorce: the Pensions Act 1995 introduced earmarking (or attachment) orders and the Welfare Reform and Pensions Act 1999 brought in pension sharing.

We have been involved in providing advice, throughout the whole of the UK, on the practicalities of carrying out a pension share. Our experience has left us concerned about the operation of this legislation, and the results that are currently being produced. We are not acting as lawyers. Collins Actuaries are actuaries and pensions experts. As such, we are seeing an area of great complexity dealt with all too frequently in a simplistic fashion, which will, in a number of cases, produce serious untoward, and probably unexpected, financial effects. To give an example, we have seen cases where the intention had been to give away as a pension share about half of the value of the scheme member's pension rights, but the reality of the implementation was to give the spouse only about a quarter.

In these two articles we will be assuming a basic knowledge of the legislation and regulations regarding both the valuation of pension rights for divorce purposes and also the operation of pension sharing. We will explain why things can go very wrong – in many cases without family lawyers even being aware of a problem until long afterwards – and will give some examples of the types of problems that can, and do, occur. In this article, we will look at the problems encountered in coming to the point of decision as to how the pension rights should be taken into account. In part two, which will appear in the August issue of *Family Law*, we will focus on the problems arising at the implementation of a pension-sharing order. We will look, in particular, at the specific problems relating to the legislation's requirement for the order to use a cash equivalent transfer value (CETV) calculated at a date not more than 12 months from the date of the petition. This becomes a problem because the pension scheme is required to carry out the transfer some considerable time after the date of the order, using a new CETV calculated at the time of the actual transfer.

WHY ARE WE CONCERNED?

Many family lawyers are failing to deal with pension rights on divorce in the best interests of their clients. They are unable to appreciate the significant problems involved with pension rights. With pension rights these problems can be very significant. On a daily basis, we see two different types of situation where family lawyers are going wrong because they are dealing with a complex set of rules surrounding pensions and need expert assistance from the outset with disclosure of assets through to implementation.

When we receive an instruction to implement a share for a fixed percentage, the lawyer has appreciated some of the problems associated with carrying out the implementation, and is seeking specialist assistance for this. In almost every such case, if prior advice has not also been taken, we find that he has advised the client on the basis of flawed or inadequate information about the pension rights, and the decision on the amount to share has been based on this advice.

Sometimes our advice is sought on the nature of the pension rights, and our report is used as the basis on which to agree a division of the assets and the resultant amount of any pension share. However, the lawyer then takes on the task of liaising with the pension scheme for the implementation. While there is a proportion of cases where this will work, there are pitfalls, and we have seen some unfortunate outcomes where the effect of the resultant pension share was far from what might have been expected. It sometimes led to serious potential financial disappointment for one of the parties. This could lead to the disappointed party seeking redress from his legal adviser.

PENSION RIGHTS: WHAT IS SO PROBLEMATIC?

What is actually so different between pension rights and other assets? Pension rights are an entitlement to certain future financial benefits within a pension scheme. The scheme may be personal, may be that of an employer (public or private sector) or may be a state scheme. In all cases, however, it is an entitlement to future payments that are dependent for their commencement and continuation on stated conditions, and that will be paid over a long period of time. This asset cannot be sold, cannot be exchanged for cash in any way whatsoever (apart from the proportion that can be taken as tax-free cash at retirement) and cannot be assigned for value.

This makes the whole nature of pension rights very different from that of other assets. Pension rights also have very important features. Each extra day worked by the scheme member, and each increment in salary may produce extra pension rights. This means that the value continues to develop. This does not happen with most other assets. While a house may change in value, it does so primarily because of market value changes. The actual fabric of the house does not, in itself, grow.

The value of pension rights is constantly changing. Again, the comparison with the house is interesting because, while both change as the market changes, the value of the pension rights can change for reasons that will be completely unintelligible and unpredictable to the layman. This can apply in both directions. One obvious example of this may be changes in stock market values, but there are many others, such as changes in medium-term interest rates, changes in actuarial practice and professional guidance, changes in legislation or regulations, changes in the funding level of the pension scheme, changes in the investment policy of the pension scheme and many more, including, simply, the passage of time.

The value of the pension rights is not clear cut. There may be arguments between professional valuers as to the value of a house, but not as to what part of it is assessed. Omitting the value of, for example, discretionary benefits, is akin to valuing a house without its kitchen. The scheme will always use the CETV at the date of implementation in carrying out a pension share, but the effect of this can often be surprising, and very significantly different from expectations.

There are four different stages to the treatment of the pension rights in a divorce settlement:

- getting the information;
- understanding the information;
- deciding what to do;
- implementation.

The remainder of this article looks at the issues that occur up to the decision point, and in the next article we will look at the difficulties in the last stage.

GETTING THE INFORMATION

There are two golden rules when starting to consider the pension rights:

(1) Get a full employment history from each partner.
(2) Do not make assumptions that any pension asset will be too small to be worthwhile.

Where an individual has been in employment earning more than about £4,000 per annum (in current money terms), there will always be pension rights in respect of that employment. These will usually be in personal or employer pension schemes. If these do not exist, or are inadequate, there will be benefits in the state earnings related pension scheme (SERPS) or the state second pension (S2P). This means that almost everyone who has been in paid employment at any time since 1978 has pension rights of some sort. These should be taken into account as part of the couple's assets.

In our experience, family lawyers are frequently failing to take account of benefits in SERPS or S2P. This can be risky, professionally. Where a person has been 'contracted in' to SERPS for any reasonable period, the value of the benefits is very likely to exceed £20,000. We have seen values as high as £125,000. It must be stressed that these high values are not in respect of high earners. Indeed, in current money terms, SERPS takes no account whatsoever of earnings in excess of about £30,000, thus treating all who earn over this the same. A particular point to note is just how valuable these benefits can be for low earners. Indeed, in many marriages, the wife may have had a series of low-paid jobs in apparently non-pensionable employment, and actually have acquired significant rights in SERPS, often more than her husband who has been in 'contracted out' employment.

It is also unsafe to assume that there are no benefits in SERPS/S2P if someone has been in 'contracted out' employment. This may seem illogical, but SERPS/S2P pays for some of the inflation proofing of the contracted-out pension rights rather than the pension scheme itself. Thus, a value exists for this aspect of these rights. We have seen cases where this limited value is in excess of £25,000 for a person close to retirement. Again, and for the same reason, these high figures can be in respect of moderate, rather than high, earners.

The other mistake that we see frequently is a focus on the current employment, with the mistaken assumption that pensions either did not exist in previous employments or were transferred into the current employer's pension scheme. The employment history is the key to this. Periods of employment or self-employment for which no pension value is known should always be investigated. Preserved pensions with former employers can be surprisingly valuable. For many years now, the pension scheme has been obliged to revalue these pension rights each year in line with price inflation. This has the effect of ensuring that the value does not become trivial through inflationary changes, as has happened with some older investments such as life assurance policies or 'frozen' deferred pensions from the era before these became inflation protected.

UNDERSTANDING THE INFORMATION

Pension schemes are obliged to supply information to the family lawyer in respect of pension rights for which a pension share might be contemplated. This information is spelt out in the Pensions on Divorce etc (Provision of Information) Regulations 2000 (SI 2000/1048). It is not sufficient simply to request the scheme's valuation, the CETV. This additional information is vital to an understanding of the pension rights under consideration. Among other things, it will reveal the effect of the state of funding of the pension scheme on the value quoted (a major problem at present, with more than 75% of private-sector pension schemes being underfunded), and how the pension scheme will treat any discretionary benefits. How these affect what to do is considered in more detail later in this article.

Even with the CETV, we see frequent errors in quoted CETVs. Remember that the pension scheme will not be paying out on the basis of any CETV it quotes to the lawyer, even if the end result is a pension share. Our experience is that less care is being put into the production and issue of these values than would apply to a CETV that might lead to an actual transfer out.

DECIDING WHAT TO DO

When pension sharing was introduced, the Government was very keen to see it used. Because it would provide pension benefits to divorcing wives, future reliance on state benefits would be reduced. However, the decision as to how to treat the pension rights has to be made in the context of the treatment of all the assets of the marriage. The net result will frequently be some combination of offsetting part of the value of the pension rights against some other assets, and sharing the balance of the pension rights.

We are often asked which is better: offsetting against other assets or sharing. Neither is better. Both are acceptable and sensible ways of dealing with the pension assets. Which will be used in any particular case, and the degree to which each will be used, will depend on the circumstances of the case. There is a third alternative: an attachment or earmarking order. We will not cover this in detail in this article. Suffice to say that there are virtually no circumstances where this would be better than a sharing order for the pension-scheme member. If a lawyer were considering using such an order, he would be well advised to take professional advice before doing so.

Many clients will have more than one pension right. Indeed, probably most clients will have, once the SERPS benefits are considered. If a decision has been made to share, the next major decision is about which pension(s) to share. It is obvious that by sharing only one pension right, the administration costs will be lower than sharing several. This, however, is not the whole problem. It is not even the major problem. It may seem paradoxical to the pensions layman, but it is possible to achieve the same result for the receiving spouse, with very different results for the scheme-member spouse, depending on which pension right is shared. A very simple example based on a case we recently dealt with will show this.

Mr X and Mrs X were both in their early seventies. Mrs X had no pension rights but Mr X had two pensions, both in course of payment from different private-sector schemes. The first was for £6,500 per annum with a quoted CETV of £78,000, and the other was for £4,900 per annum with a quoted CETV of £73,500. Both pensions increased in line with inflation. The agreed aim of the share was to give Mrs X £50,000 out of the value of the pension rights as a pension share. The following table shows the results to Mr X, depending on where the share is affected.

	Reduction in Mr X's annual pension
Scheme 1	£4,167
Scheme 2	£3,333

What is important to both parties is the amount of pension they will receive each year in the future. The CETV is a figure of no importance to them whatsoever, as they can never have it available to them as cash. It is merely a tool for the pension scheme to work out the share and, because different schemes calculate this value in different ways, radically different results can be achieved. It is vital to seek specialist advice whenever there is an option over which pension rights to share. The example above shows that there can be a difference where any two schemes are involved if the basis of calculation of the CETV differs.

There are, however, some situations where choosing the wrong scheme will lead to serious consequences that may not be obvious to the pensions layman. These are:

- where one pension right is in a final-salary scheme and the other is in a money-purchase scheme (which includes personal pensions);
- for personal pensions, where one is invested in a with-profits fund, and the other is in an investment-linked fund; and
- where any of the pensions are in an underfunded scheme, or are invested in an organisation with financial problems (eg Equitable Life).

CONCLUSION

The decision being made is about a set of pension rights stretching well into the future. As stated above it is very important to realise that the final result is not about an amount of the CETV. This is just a means to achieve an end. While the CETV is a capital value that can be put on the pension rights, the real assets are the pension rights themselves: payment of pension that will be received. That is the only way in which the bulk of these rights will be delivered.

Pension sharing is actually a financial transaction. Indeed, in many cases it will be a major financial transaction for the two individuals concerned, possibly the biggest they will ever transact. It appears to be the only such financial transaction that currently is not regulated by the Financial Services Authority, an exception that it is difficult to imagine the authorities allowing to persist. It must be good practice, therefore, to take precautions when dealing with a pension share, and to all intents and purposes handle it as if it were regulated. There is a long history of the financial authorities blaming the adviser retrospectively when the scandal blows up, rather than accept their own deficiencies.

What then should the family lawyer do? The golden rule is to determine what the result of the pension share will be for the two parties involved, and then to ensure they are made fully aware of this. Where a decision is made by the client with full knowledge of the effects of that decision, the adviser must have done his duty. Indeed, the very act of getting this information will reveal to the family lawyer the pitfalls described above. If in doubt, seek expert advice. In the follow-up article in the August issue, we will look at the further problems that arise during implementation.