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Pensions in Divorce

A Guide for Lawyers

PART TWO

supporting technical information

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This guide explains how you should deal with pensions at each stage of the divorce process, from the start of the divorce through to the final settlement. Part One focuses on the practical steps and Part Two provides the technical background as reference.

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The supporting technical information

1. The different pension types

There are currently two forms of State Pensions in Great Britain: Basic and Additional.

1.1 Basic State Pension

Eligibility is based upon qualifying years gained through National Insurance Contributions (NICs) that an individual pays, is treated as having paid, or is credited with.

Credits are granted to those not paying NICs when they are in receipt of other state benefits, such as unemployment and incapacity benefits.

If a divorcee does not remarry before State Pension Age, then they are currently able to substitute their ex-spouse's contribution history for their own, if this produces a higher Basic State Pension.

The age at which those eligible for Basic State Pension can receive it, depends on when they were born. It is 65 for men born on or before 5 April 1959 and 60 for women born on or before 5 April 1950. The State Pension age for women born on or after 6 April 1950 but before 6 April 1955 is rising from 60 to 65 between 2010 and 2020. The State Pension age for women born on or after 6 April 1955 but before 6 April 1959 is 65. State Pension age will increase for both men and women from age 65 to 68 between 2024 and 2046.

1.2 Additional State pensions

This is also called the State Second Pension or S2P. Until April 2002, the Additional State Pension was called State Earnings Related Pension (SERPS).

Under SERPS, the pension received was dependant upon a combination of the amount of NICs paid and earnings.

It is possible for employees to leave the Additional State Pension scheme and this is called contracting out. It can be done either through an employer's occupational pension scheme or through an appropriate personal pension or stakeholder pension.

For those employees contracting out of the Additional State Pension through an occupational pension scheme, both they and their employers pay lower National Insurance Contributions (NICs). In return, the occupational pension scheme provides benefits that are equivalent to or better than the Additional State Pension.

Instead of paying lower NICs, for those employees who contract out through a personal or stakeholder pension, HM Revenue & Customs pay an annual "rebate" into the pension.

Contracted out pensions must provide benefits that are at least as good as those provided by the Additional State Pension. In a contracted-out occupational pension scheme, the part of the pension that replaces the Additional State Pension is called Guaranteed Minimum Pension (GMP). The equivalent in a personal or stakeholder pension is called Protected Rights.

S2P gives employees earning up to a certain amount an additional pension. In effect S2P is an additional flat rate pension for the lower paid.

Valuations provided by the Pensions Service are likely to undervalue to some extent but the difference is unlikely to be material.

There are no specific issues to sharing, attaching or offsetting Additional State Pensions. Unlike many pension-sharing orders, there are no "scheme" charges for implementation.

1.3 Defined Benefit Pensions

These pensions are often called salary related or final salary pensions. Both terms can be misleading.

The pension promise made by the scheme may relate to just some of the member's remuneration package. For example, certain payments, such as London Weighting may or may not be pensionable, depending on the rules that the sponsoring employer set for the scheme. Typically, overtime payments and bonuses are non-pensionable.

Not all defined pensions are final salary schemes. There are numerous bases for defining how the pension is arrived at and not all are directly linked to the member's salary. Some schemes define the benefits based on average earnings, for example over the best few years, others, such as the Armed Forces Scheme have pensions based upon what is called representative pay.

The common feature of all these schemes is that the pension promised to the member is defined in the rules of the scheme.

1.3.1 Accrual rates

Defined benefit pension schemes usually express the pension promise as a fraction of the pensionable pay earned for each year of service. A 60ths scheme will provide one sixtieth of the pensionable pay for each year of service. An 80ths scheme will promise an eightieth of the pensionable pay for each year of service. There are usually maximum pensions that are defined by the maximum years of service that can be earned. For example, a 60ths scheme may have a maximum of forty sixtieths.

Accrual rates are not always flat. Some schemes provide accelerated accruals, so that service in the later years earns more pension than those in the early years. This is common practice in some public sector pension schemes.

1.3.2 Funding

These schemes can be paid for through "contributions" from the employer, the employee, or both. In the private sector, the objective is that the sponsoring employer provides sufficient funding to meet the pension promises.

Public sector schemes can be either funded in the same way as private sector schemes, or unfunded. In which case the pension promises are met as they arise from government revenue.

1.3.3 Under-funding

If at any valuation of the scheme by its actuaries, the scheme's funds are insufficient to meet the anticipated liabilities, technically the scheme is under-funded. By their nature, unfunded schemes cannot be under-funded.

1.3.4 Members additional contributions

Schemes often permit and encourage members to make additional contributions to their pensions. The arrangements vary from scheme to scheme but there are two ways to do this. Not all schemes offer members both options, but they are:

- Purchasing additional pension within the scheme
- Additional Voluntary Contributions (AVCs) sponsored by the scheme

1.3.4.1 Additional Pension

With this form of additional contribution, the scheme provides additional defined-benefit pension benefits, in return for additional voluntary contributions from the member. In some schemes, the employer matches the AVCs paid by the member.

1.3.4.2 Additional Voluntary Contributions

Some schemes provide the option to make additional voluntary contributions into a defined contribution AVC arrangement. So called in-house AVCs. The sponsoring employer may match the additional contributions made by the member. An insurance company or pension provider administers these AVCs. Because they are linked to the main scheme, rules such as those concerning tax-free lump sums are governed by the scheme rules.

1.3.5 Free Standing Additional Voluntary Contributions

As all members of pension schemes can now also have a personal or stakeholder pension, these (FSAVCs) are now largely defunct as far as new arrangements are concerned. For those that remain and have not been converted into stakeholder pensions they are additional pension contributions made into a defined contribution arrangement that is independent of the individual's main pension scheme.

1.3.6 Membership Categories

Whilst the individual remains employed by the scheme sponsor, they remain an active member of the scheme and continue to accrue additional scheme benefits in accordance with the scheme rules. Scheme membership is never compulsory and individual employees may opt-out of scheme membership if they wish.

If a member opts-out or leaves the service of the sponsoring employer, they cease to be an active member of the scheme. Employees who have been in a scheme for less than two years will often lose any benefits accrued although any personal, but not employer, contributions are refunded.

A member opting-out or leaving service with more than two years scheme membership will become a deferred member of the scheme. They retain the scheme benefits already accrued but accrue no additional benefits beyond the increases provided for in the scheme rules. Increases in deferment are typically at a rate lower than inflation.

1.3.7 Closed Schemes

Due to the high costs of maintaining these schemes, many defined benefit pension schemes have been closed by the sponsoring employer or are likely to close. For the deferred members this has little immediate impact.

The implications for active members of a scheme depend on the nature of the scheme closure. In some cases, the scheme – or more correctly the sponsoring employer – decides that active members of the scheme will remain members of the scheme and will continue to accrue benefits; the scheme is only closed to new members. Alternatively, the sponsoring employer may decide that active members will no longer accrue benefits in the scheme, in which case they become deferred members of the scheme and are typically offered membership of a replacement scheme (often a defined contribution scheme). It is therefore possible for an individual to have pension rights in more than one pension scheme that is sponsored by the same employer.

1.3.8 Pension Transferring

Providing they have not started to draw their pension from the scheme, a deferred member has a right to transfer out of a defined benefit pension scheme. The scheme is obliged to quote a Cash Equivalent Transfer Value (CETV) and the calculation basis is defined by statute. From October 2008, transfer values must represent the anticipated cost to the scheme of providing the pension benefits. There is a subtle but important difference between the CETV, and an independent valuation of the benefits it represents.

At the discretion of the scheme trustees, if the scheme is underfunded the CETV may be proportionately adjusted.

The scheme receiving a pension transfer can be either defined benefit or defined contribution. Other than certain requirements that apply to any part of the transfer which results from contracting out of the Additional State Pension, there is no obligation on the receiving scheme to provide any particular level of benefits.

All pension schemes have the right to decide whether transfers-in are accepted and if so on what basis. A defined benefit scheme may accept transfers-in for their active members, but not for deferred members. Defined benefit schemes accepting transfers-in may credit members with additional years of reckonable service, thereby increasing the benefits currently accrued within the scheme.

Transfers-in can also be made to defined contribution schemes.

1.3.9 Public Sector Transfer Club

Special rules apply for members of public sector pension schemes wishing to transfer from one eligible scheme to another. In most cases, the rules mean that service in one scheme equates quite closely to that in another, so this is an important benefit for the member.

1.3.10 Dependants Benefits

Most defined benefit pension schemes include dependants' pensions, payable on the death of the member, pre and post retirement. Who qualifies as a dependant will be defined in the rules of the individual scheme, but in general, a widow(er)s pension is the norm and applies equally to partners in a civil partnership. The definitions of dependants vary considerably and can include financially dependant unmarried partners. Widower's pensions are typically a percentage of the member's full pension and usually payable for life.

Children's pensions are also common features of defined benefit pension schemes. Again, the definitions vary considerably and it is common to limit the total of all children's pensions. Some scheme rules require the children to have been financially dependant upon the member. All have duration limits based on age and continuing in full time education. Like widow(er)'s pensions, those for children are typically a percentage of the members or the widow(er)'s pension.

The divorce or dissolution may have direct effects on important benefits, irrespective of any specific action such as sharing or attachment. For widow(er)'s and dependants benefits, much will depend on how the scheme defines the various classes. It is possible for a financially dependant ex-spouse or partner to remain eligible for widow(er)'s pensions. Equally, children could remain eligible but their benefits could be reduced if the member has other dependants from a subsequent relationship.

1.3.11 Death in Service Benefits

As part of the benefits package, many employers provide death in service benefits. Although not strictly pension benefits, for tax reasons these will often be provided under the pension scheme rules and trust document. Benefits are usually a lump sum payment, which is often defined as a salary multiple, typically four times current salary.

Large employers may self-insure the benefit whereas smaller employers and schemes will usually arrange for the benefit to be provided by an insurer.

Death in Service (DiS) benefits are usually subject to an expression of wishes that the member gives to the pension scheme administrators. Members are free to nominate that the DiS benefits are payable to who ever they wish and this can be a non-relative or even a charity. On leaving the service of the sponsoring employer, the DiS benefits automatically cease.

1.3.12 Lump Sums and Commutation

Some schemes provide a retirement lump sum as a specific part of the retirement benefits. Such lump sums can be defined in terms of salary or pension multiples. It is important to recognise the difference between a lump sum benefit and a commutation. A lump sum benefit is an additional benefit; its existence has no direct effect on the level of pension to which the member is entitled.

A commuted sum is a capital payment that the scheme will give in return for a reduced pension income. Commuted sums are usually discretionary, typically for both the member and the scheme. In most cases, schemes offer poor value to members wishing to commute part of their pension and it is usual for schemes to require some form of medical assessment of the member before the commuted sum is calculated and offered, to ensure that the member is not seeking to select commutation against the interests of the scheme.

1.3.13 Valuation

1.3.13.1 Different scheme valuations

A pension scheme can be valued in a number of ways, depending on the purpose of the valuation and the level of detail required. A pension scheme will be valued in total, normally at least annually, to determine whether it is solvent and the future levels of contributions that need to be paid. The high-level results of this valuation will normally be reported to members and be shown in a company's reports and accounts. Such a valuation may simplify the details of a valuation for individual members, which are not significant to the overall result.

A number of valuations of individual member's benefits can also be performed for different purposes and degrees of effort.

The main distinctions are:

What lives are valued? For an accurate valuation it is necessary to use the actual ages and health of the member and spouse, and hence their actual life expectancy. In practice, most valuations make simplifying assumptions of a fixed age difference between spouses and that both are in average health.

Data used? The pension scheme will normally have accurate personal details, will have the definitive details on the pensionable salary, contribution and other related details, and will hold scheme benefit terms. However extracting this data for external valuation can be difficult.

Reason for valuation? The reason for valuing an asset can affect the price put upon it. For example, the value placed upon a house to get a sale within 6 weeks might be a lot less than that where the buyer can afford to wait for a fair price. Valuing the transfer value of a pension is similar to valuing for an immediate sale. However, the value for the divorce process, where there is no need to upset the pension, is similar to the fair price valuation.

What is valued? For a divorce, it is necessary to value accrued pension rights, ultimately those up to the decree absolute date. In Scotland only those rights accrued during the marriage are valued. For some valuations, the specification of the benefit may be simplified to ease calculation.

Allowance for future salary increases in service? Although only accrued rights are valued, the amount of the accrued right is increased by future salary increases whilst the member is still in service. While it may seem odd that future service affects past rights built up, it should be remembered that defined benefit schemes are designed to reward loyalty and help lock-in staff.

Therefore when valuing past rights on schemes where the member is still employed it is appropriate to allow for future salary increases up to the expected date of leaving employment.

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The following table shows how different valuations vary between these points. It shows those produced by pension schemes, including the Cash Equivalent Transfer Value (CETV) quote. It also shows those produced by Bradshaw, Dixon & Moore for use in divorces.

Comparison table of valuations produced by pension schemes and those produced by Bradshaw, Dixon & Moore for use in divorces.

Valuation	Lives valued	Data relied upon	Reason for valuation	What is valued?	Allowance for future salary increases in service?
Funding valuation	All in scheme	Pension scheme data	Current solvency and future funding requirement	Past and future liabilities versus current assets and contributions	Yes
Cash Equivalent Transfer Value (CETV)	Simplified spouse details	Pension scheme data	Immediate transfer value	Accrued rights – some simplification of benefit specification	No
BDM Express Pension Valuation	Simplified spouse details	Client provided data	Current value of accrued rights	Accrued rights – simplified benefit specification	Yes
BDM Full Actuarial Reports ¹	Actual spouse details	Pension scheme data	Current value of accrued rights	Accrued rights – some simplification of benefit specification	Yes

In addition, Full Actuarial Reports from Bradshaw, Dixon & Moore can optionally allow for the actual health details of the clients. CETVs will normally only allow for a client's health if they have ill-health retired.

¹ Both for valuing schemes for offsetting purposes and for pension reallocation for pension sharing or attachment.



1.3.13.2 Valuation methodology

Actuarial valuations of accrued pension rights using the following general approach.

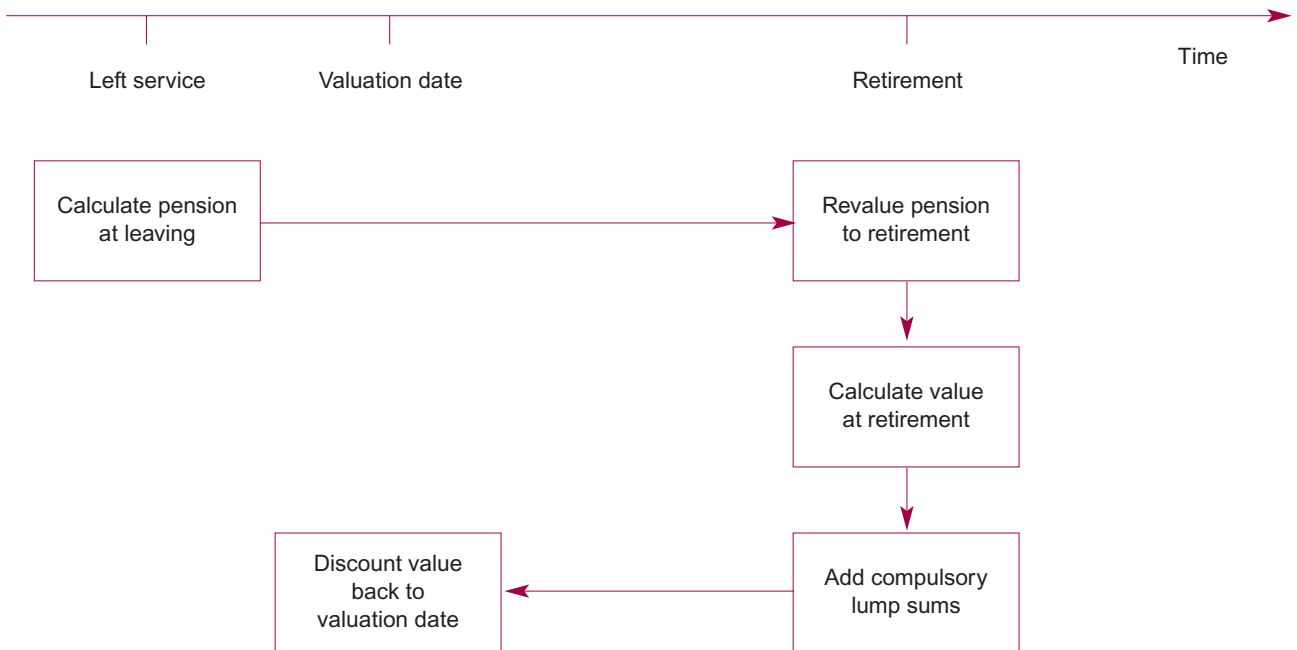
Pensions for past service

1. Calculate the pension accrued at date of leaving service, using the term of pensionable employment, pensionable salary and scheme benefits for the scheme type chosen.
2. Project the pension to date of retirement using the pension revaluation method appropriate to the scheme type chosen.
3. Calculate the annuity value of the projected pension at date of retirement, allowing for guaranteed pension

periods and the spouse's death after retirement pension paid if the spouse outlives the member.

4. Add any compulsory lump sum at retirement benefits determined by the scheme design chosen, to the annuity value of the projected pension at retirement. This gives the projected value of the accrued pension at retirement.
5. Discount the projected value of the accrued pension at retirement to a value at the valuation date, allowing for the present value of money now compared to its value in the future.

These steps can be summarised graphically.



Pensions for current service

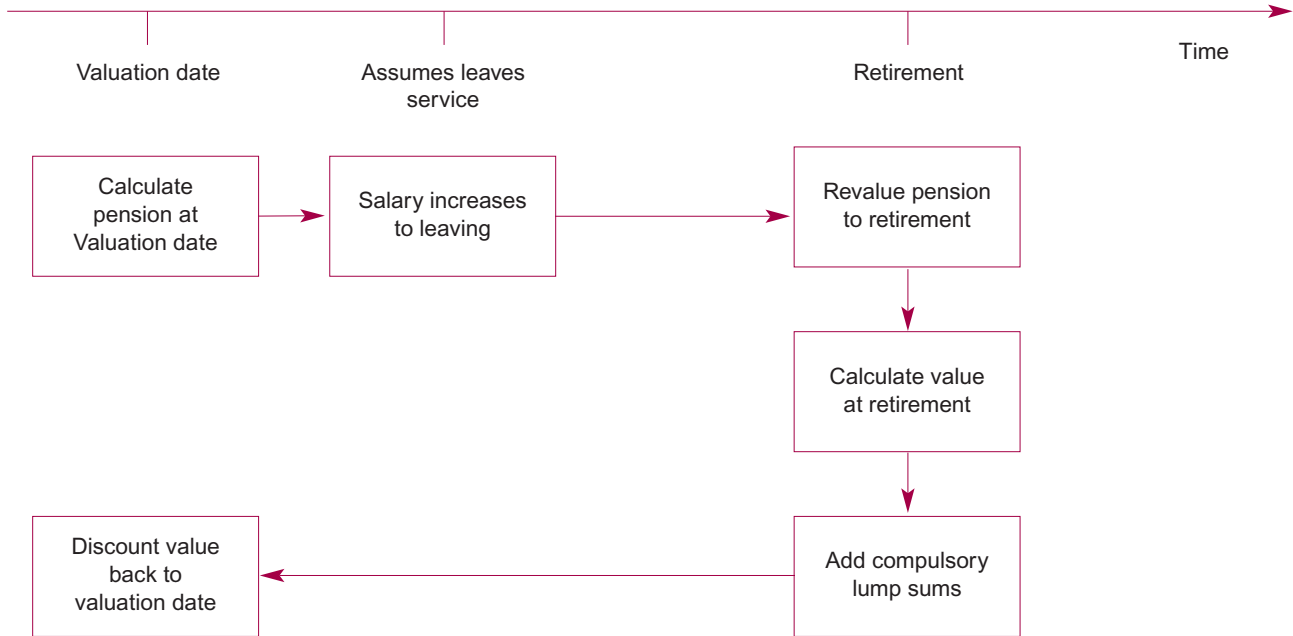
Replace steps 1. and 2. above by:

1. Calculate the pension accrued at the valuation date, using the term of pensionable employment, pensionable salary and scheme benefits for the scheme type chosen.
2. Project the pension to an assumed date of leaving the

scheme using an assumed future rate of salary increases, and then project from there to the date of retirement using the pension revaluation method appropriate to the scheme type chosen.

Steps 3. to 5. are as above.

Again shown graphically.



1.3.13.3 Valuation assumptions

Assumptions are what actuaries use to fill in the gaps of our knowledge. The gaps could be because we cannot practically or economically find out everything about a person and their pensions. We call these our “past assumptions”. However, the significance of these is dwarfed by what we do not know about what is yet to come. We call these our “future assumptions.”

Assumption bias

Each assumption is just a value to be used in a calculation. By the nature of it being an assumption, it is an unknown. There will be a range of possible values which each assumption may actually take, some more likely than others. Therefore, for each assumption there is a range of likely values that someone doing the valuation could reasonably take.

The effect of taking one set of such reasonable assumptions could produce a valuation of the pension rights more in favour of one party or the other in a divorce.

Bradshaw, Dixon & Moore only produce valuations with the intention that they are neutral between the two parties. That

is without bias to either side. This normally means using the most likely value for any assumption.

It should be recognised that this is a judgement call and someone else also looking to be neutral may produce a different result for the value of the pension rights. Therefore, in Full Actuarial Reports from Bradshaw, Dixon & Moore we always quote a reasonable range within which we would expect most other valuations to lie.

“Past” assumptions

In order to reduce the data required to be collected a number of assumptions have been made to provide the complete information on the pension owner’s current entitlement. The main set of assumptions in this category are the detailed benefit definitions behind the generic scheme types.

“Future” assumptions

Future assumptions are made of economic factors, such as rate of inflation, population factors, such as rate of death, and social factors, such as rate of remarriage. For factors such as dying, the calculation allows for a percentage of deaths each year based on the percentage of deaths expected in a population.

In setting assumptions, the value of assumptions relative to each other can be more important than the actual values of the assumptions, for example the rate of salary increases assumed relative to inflation.

An important assumption is the discount rate, which is used to equate the value of monies being received at different times in the future, with the value of money now.

1.3.14 The six reasons why CETV's are an inappropriate valuation method

This analysis is also available separately on www.BradshawDixonMoore.com for inclusion in submissions or briefing packs for barristers.

There are six general reasons why a CETV for defined benefit (final salary) schemes may not be appropriate for divorce cases.

1.3.14.1 CETVs can ignore discretionary benefits

A scheme can ignore discretionary benefits in calculating CETVs, even if the scheme intends to provide such benefits whenever possible. Examples of discretionary benefits include pension increases when in payment, generous early retirement terms or ill-health benefits.

1.3.14.2 Schemes can offer different benefits for active members and leavers

Some schemes offer worse benefits for leavers than active members. The assumption of leaving the scheme used by the CETV triggers a step-down to the worse benefits. For example, most uniformed service schemes offer immediate pensions subject to minimum length of service requirements. However earlier leavers only get their deferred pension at a later age between 55 and 65 depending on the scheme.

1.3.14.3 Active members lose the loyalty benefit of future salary increases

Active members are assumed to leave at the date of the CETV. This loses them the loyalty benefit of future salary increases.

The pension accrued to date is based on a multiple of the years of service times the final pensionable salary of the member. The CETV assumes the member leaves service at the valuation date and calculates the final pensionable salary at retirement based on the current salary increased at the statutory valuation rate.

However, the reality is that for as long as the member remains in service his salary will increase at a rate expected to be higher than the statutory valuation rate. Therefore, the final pensionable salary is lower for the CETV than that actually expected and so the pension accrued is lower.

1.3.14.4 Under-funded schemes

The CETV can allow for the funding state of the scheme and can depress the value payable on transfer by the proportion of the scheme's full value that is not funded. As the CETV is for calculating assets to be taken from a scheme this is reasonable. However, schemes now need to have plans to eliminate under-funding and a divorcee need not reduce their pension by taking a transfer and so it is inappropriate to adjust for scheme underfunding in a valuation for a divorce.

1.3.14.5 CETV assumptions need only be reasonable, not best-estimate.

Currently the assumptions of future experience used in CETV calculations need only be reasonable and consistent with those for setting benefits on transfers in. It is not unreasonable within this range for schemes to veer towards lower valuations for CETVs, which are for members leaving the scheme.

For example, we have found that scheme CETVs tend to ignore the improvement in mortality in retirement that has been allowed for in even the best rates available in the market (for example, from the FSA website).

Regulations have been laid before Parliament such that from 1st October 2008 transfers must be on a "best estimate" basis. The practical interpretation of these regulations remains to be seen.

1.3.14.6 CETVs normally ignore the health of the individuals

CETVs are normally calculated assuming the member and their partner are in good health. However, the pension value should be reduced if either of the partners is in ill-health and their life expectancies are reduced, as the length of time pensions will be paid will be reduced.

If the member is in such ill-health that an ill-health early retirement pension is likely to be triggered then this will increase the value again as the pension might be paid earlier and on more generous terms.

1.4 Defined Contribution Pensions

These are often called money purchase pensions.

In arrangements of this sort, there is no pension promise as such. Instead, each member of the scheme accumulates a fund within the scheme. The investment risk is entirely borne by the individual members. On retirement, the value of the individual's fund is used to purchase retirement benefits, typically by purchasing an annuity, although income drawdown (or unsecured pension) is an increasingly common alternative.

These pensions can be either employer sponsored schemes or individual private arrangements with an insurance company or pension provider.



In most employer-sponsored schemes, but not all, the employer will contribute to the scheme. The contribution that an employer will make is often defined as a percentage of the member's pensionable pay.

Some defined contribution pensions include scheme sponsored or guaranteed annuity rates, which depending on their nature, can increase the value of the pension.

1.4.1 Funding

As there is no pension promise to provide for, the funding is the contributions made by the sponsoring employer, the employee, or in the case of individual private pensions, the member. For employer-sponsored schemes, the contributions are made regularly, typically monthly. If the employee is also making contributions they are also typically paid monthly as deductions from the employee's pay. Most employer-sponsored schemes also allow for irregular additional employee contributions from time to time.

Contributions to individual private pensions are usually made at regular intervals, although for planning reasons single contributions on an annual basis are common.

Under-funding does not apply to defined contribution pensions.

1.4.2 Members additional contributions

Most employer-sponsored schemes provide the option for the employee to increase their level of contribution. In some schemes, the employer will match the employee contribution up to certain limits.

1.4.2.1 Additional contributions – personal pensions

Under current pensions legislation it is permissible for an individual to be a member of an employer-sponsored scheme and to have a personal pension. An individual can therefore be a member of their employers-sponsored pension scheme (defined benefit or defined contribution) and contribute to a private pension.

1.4.3 Common defined contribution pension arrangements

The following are the most common types of defined contribution pension arrangements.

- Employer sponsored occupational pension schemes
- Stakeholder, Group and Personal pensions
- Small Self Administered Schemes (SSASs)
- Self Invested Personal Pensions (SIPPS)

1.4.3.1 Employer sponsored occupational pensions

As described above, the contributions are typically linked to the employee's salary. Investment is usually through some form of collective investment vehicle such as a unit trust or insurance investment fund.

1.4.3.2 Stakeholder, Group and Personal pensions

Stakeholder pensions are a category of personal pensions that meet certain strict government regulations about contribution levels, investment types and charges. They may be purchased individually from an insurance firm or arranged through the employer. Employers, employees or both can contribute. Unlike an occupational pension scheme, the individual owns the pension outright. Beyond the possible collection of contributions through payroll, there is no direct link between the employment and the pension.

Group pensions are individual pensions. The employer is responsible for paying the contributions to the provider and these are often collected from the employee through the payroll system. Employers, employees or both can contribute. Contributions are typically regular and of fixed amounts, although these can usually be varied from time to time. Unlike an occupational pension scheme, the individual owns the pension outright.

Personal pensions that do not meet the Stakeholder regulations usually offer a wider choice of investments although these are always investment funds offered by the insurance firm. The individual owns the pension outright.

1.4.3.3 SSASs

Small Self Administered Schemes are personal pensions with wide investment and funding options. These schemes can both borrow money and make loans. For example, they can make loans to the business owned and run by the members. Similarly, loans can be arranged to buy property. For example, a SSAS could arrange a loan to purchase the premises occupied by the business run by its members. For tax reasons, contributions are typically made by a business rather than individuals. Each member of the scheme has a specified interest in the scheme and the levels can vary from member to member. Members do not have personal ownership of the assets within the scheme.

1.4.3.4 SIPPs

Self Invested Personal Pensions are individual arrangements that have a range of investment options that are not available under other forms of personal pensions. Permitted investments include direct investment in stocks and shares of listed companies, futures and commercial property. The individual personally owns the pension. Individuals and or their employers can contribute. There is no direct link between the employer and the pension.

1.4.4 Membership categories

For occupational pension schemes, an individual is an active member whilst they remain employed by the scheme's sponsor. They continue to accrue benefits as further contributions are made.

Scheme membership is never compulsory and individual employees may opt-out of scheme membership if they wish. If a member opts-out or leaves the service of the sponsoring employer, they cease to be an active member of the scheme.

A member opting-out or leaving service becomes a deferred member of a defined contribution employer-sponsored scheme. They retain the scheme benefits already accrued but no additional benefits are accrued. However, the value of the pension will change depending on the investment performance of the underlying assets.

Subject to the rules set out by the provider, contributions to a personal pension can be stopped and restarted. As there is no direct link between the employer and the pension, contributions can be made during any number of different employments.

1.4.5 Retirement from a defined contribution scheme

On retirement from a defined contribution scheme, the member's funds are used to purchase the pension income. Traditionally this is in the form of an annuity. Current pension legislation allows a tax-free cash sum to be taken at retirement and this option is available to those in defined contribution schemes. The effect of taking the tax-free cash sum is to reduce the member's total pension fund and therefore the pension income it will produce.

Some defined contribution schemes include annuity options and guarantees that may be better than those generally available in the open market. Most defined benefit pensions give the member the option of taking an annuity with the pension provider or from the open market. If the member takes the Open Market Option (OMO), he is able to purchase an annuity from whichever provider is quoting the most advantageous annuity rates at the time.

1.4.5.1 Impaired Life Annuities

Some annuity providers provide higher annuity pension rates for those who are expected to experience worse than average mortality, typically due to ill-health. They are referred to as impaired life annuities, although the term is slightly misleading as it is now common for improved annuity rates to be offered to smokers, even if they are in good health.

1.4.5.2 Income Drawdown (also known as Unsecured Pension)

It is possible to take a pension income from a fund without purchasing an annuity. Instead, the individual gradually draws the income as capital and interest from their retirement fund. There are restrictions on the maximum level of income that can be taken, which are dependant on the age of the individual and based on the value of the fund.

1.4.6 Transfer restrictions and penalties

Some investment funds, particularly those investing in property, have the option to restrict transfers out of the fund if the market is particularly volatile or depressed. This is done to avoid the risk of the fund being forced to sell physical properties to meet transfer requests. Restrictions of this type usually require a period of notice (six months or so) for any transfers. These restrictions do not usually apply if the transfer arises due to the member reaching a pre-determined retirement age. It is usual for pension providers to quote transfer values on these funds even if a restriction would apply. The value of such funds can be used for offsetting purposes but care is required if a sharing order is likely.

Defined contribution pensions can invest in an insurance firm's with-profits-fund. Most of these funds are now unitised and the value is therefore the bid value of the units. With-profits-funds are investment-smoothing arrangements that aim to give investors some protection from investment volatility. From time to time, these funds apply adjustments called Market Value Adjustments (MVAs) as an extra smoothing mechanism. MVAs are effectively temporary early surrender penalties and they vary between funds. A transfer value may include an MVA, which will reduce its value.

1.4.7 Guaranteed Annuity Rates

Some defined contribution pensions, particularly private pensions provide guaranteed annuity rates. Guaranteed annuity rates are usually better than those currently available on the open market are. The existence of such guarantees makes the pension more valuable than will be reflected in its transfer value.

1.4.8 SIPPs & SSASs

The special investment options available under these types of arrangements make valuation difficult and potentially expensive. SIPPs are regularly valued but it is often difficult to obtain the equivalent of a transfer value, unless all the investments are in assets, which are relatively easy to value, such as stocks and shares in stock market listed businesses. Valuation requirements for SSASs are less onerous and it may prove difficult and expensive to obtain valuations. A few SSASs are structured as defined benefit pensions.

1.4.9 Hybrid Pensions

These employer-sponsored schemes have both defined benefit and defined contribution elements. The BAE scheme is an example of this type of scheme; it provides a defined benefit pension of 1% of the final salary for each year of reckonable service. The defined contribution element of the scheme consists of an employer contribution equal to of 2% basic salary, plus and additional contributions that the employee makes.

From the BAE example it is clear that the pension promise element is lower than in most defined benefit schemes and therefore the cost to the sponsoring employer is correspondingly lower.

The BAE example should not be considered as the norm, there are numerous variations of the mix of defined benefit and defined contribution elements. Some hybrid pension schemes are little more than defined contribution schemes with minimal defined benefit underpinning, designed to ensure that a minimum level of pension is provided if the investment performance of the defined contribution element is poor.

1.4.10 Valuation

With the exception of SIPPs and SSASs, most defined contribution schemes invest through collective investment schemes where the contributions purchase investment units that are notionally allocated to the member. These units usually have a two-tiered basis, the higher (offer) price is what the member pays for the units and the lower (bid) price is what the member receives when the units are sold. The difference between the two unit prices, referred to as the bid-to-offer-spread is usually around five percent. Effectively, this means that an immediate deduction of five percent is made on all investments into the investment fund.

A member may have units in several different investment funds under one pension arrangement and there may even be different classes of units within particular funds. In many cases, the value of a member's total fund at any time will be the bid or selling value of the all the units.

Administrators of defined contribution pensions are often not familiar with terms such as CETV and CEB. However, they will understand a request for a transfer value and this should be both quick and easy to obtain.

Many collective investments have some form of equity investment component. This often means that the value of a defined contribution pension can vary considerably from day to day and month to month, depending on the economic climate at the time. A valuation obtained on any particular day can give an unrealistic indication of value and should be used with care.

1.5 Overseas Pensions

Pensions built up outside the UK are not subject to UK pension legislation. They can take various forms from simple savings accounts to arrangements resembling UK defined benefit schemes.

2. Sharing and attachment

2.1 Pension sharing for defined benefit schemes

Although pension sharing is obligation on all UK pension schemes, various aspects of the implementation are discretionary.

2.1.1 Internal and external credits

A pension sharing order will result in a debit for the existing member and a corresponding credit for the ex spouse or partner. Whether the scheme provides the credit within the same arrangement or not is at the scheme's discretion.

2.1.2 Internal credits

Additional State pensions and most public sector schemes only provide internal credits. Internal credits have been referred to as shadow membership but this term is potentially misleading. The benefits provided for pension credit members are not necessarily identical to those enjoyed by the debit member, for example, some schemes do not provide widow(er)s pensions to pension credit members. The pension credit member may receive a different class of benefits, particularly if the scheme that the debit member belongs to is closed to new members.

Pension credit members of a scheme are deferred members, whereas the debit member may remain an active member of the scheme. One of the more obvious implications is that the retirement age for deferred members is often different to that for those who remain active members until their retirement. This can lead to dramatic retirement age disparities, particularly where the scheme gives early retirement options such as the uniformed services schemes. There can also be differences in lump sum retirement benefits.

Some schemes grant different (inflation) increases for active and deferred members, in which case increases for deferred members can be at a lower rate.

For an active member of a defined benefit pension scheme, each year of accrued pension is linked in some way to subsequent accruals. This has the effect of increasing the value of each preceding year of pension accrual. It is a form of loyalty reward applying to the pension. In essence, the first year of pension accrual is linked to the last year of service. Depending upon how the scheme implements pension debits concerning linking of pension accrual, a pension sharing order can break this link for the debit member and cause a loss, without a corresponding gain for the credit member.

2.1.3 External credits

External credits force the credit member to transfer the value to another pension arrangement, typically a defined contribution pension. The amount transferred is set by the CETV, therefore if the CETV undervalued the pension, the resulting theoretical "loss" is crystallised for the pension credit member but not the debit member. If the scheme is underfunded and this is reflected in the CETV, it is probable that the transfer value granted to the credit member will be proportionately reduced, thereby crystallising that theoretical loss.

Where the pension credit is by external transfer, it is likely that the transfer is made into a defined contribution pension. The credit member is therefore exposed to an investment risk on their pension fund, whereas the debit member is not. At retirement, the pension credit member's income will be produced by purchasing an annuity or using income drawdown, whereas the debit member has the pension promise from the scheme. An external pension credit member therefore has a different and usually inferior class of pension asset.

2.1.4 Sharing pensions in payment

It is possible to make a pension sharing order on a pension in payment. A debit is made and the debit member will experience an immediate pension reduction when the order is implemented. If an internal credit is made, unless the credit member has already reached the scheme retirement age, they will become a deferred member of the scheme and unable to draw their pension until they reach the scheme retirement age. A consequence of a pension sharing order can therefore be an immediate reduction in the joint incomes.

2.2 Pension sharing for defined contribution schemes

The concepts of internal and external credits are irrelevant for most defined contribution pensions. A sharing order results in a transfer-out of the debit member's pension and a corresponding transfer-in for the credit member.

Care must be exercised when transferring-out or advising on the pension sharing order that brings it about; so that transfer restrictions and penalties are avoided. Similarly, if a sharing order would result in a transfer-out of a pension arrangement that has guaranteed annuity rates. Both could result in financial harm being caused.

A pension credit created by a pension sharing order must be invested in a suitable pension arrangement. It is unlikely that creating a transfer into the same pension arrangement and with the same investment choices as the debit member will be either suitable or acceptable; in many cases, it may not even be possible. This creates a need for authorised financial advice.

2.2.1 SSIP and SSAS specific issues

A sharing order made on these types of pensions is complicated by the possible nature of the relevant investment assets. These could be extremely difficult to liquidate, for example if they are invested in the business premises of the member.

In the case of a SSAS, the theoretical option of a credit within the scheme arises though this is far from straightforward.

2.3 Pension attachment

Attachment orders on pension payments have well-recognised disadvantages.

- The pension holder retains the right to determine their retirement date and therefore when the attached pension becomes payable
- The attached pension ceases on the death of the pension holder unless a minimum pension payment period applies
- If the ex-spouse of the pension holder remarries, the attachment order ceases.

The availability of sharing orders has made attachment orders less common unless they meet specific needs. Attachment orders can be made against commutation sums and lump sum benefits, such as the death-in-service provision under a pension scheme.

The expenses incurred in setting up a pension attachment order against death-in-service benefits could be outweighed by the cost of obtaining commercially available life insurance cover, particularly as an attachment order is scheme specific and would therefore become irrelevant if the member changes employer.

2.3.1 Attaching defined contributions

For defined contribution pensions, attachment may be beneficial to retain the full benefit of guaranteed annuity rate or similar options, or where early surrender penalties make sharing unattractive.

2.3.2 Attaching pensions in payment

Where the pension is in payment, attachment may be a practical alternative to a sharing order, particularly if the recipient would be unable to draw retirement benefits if a sharing order were made.

3. Ill-health in detail

This section explores the effect of less than perfect health on both the valuation of pension assets, and how they might be distributed to maximise the overall value of assets shared out in the final settlement.

3.1 Extreme ill-health

The extreme ill-health of one party in a divorce or dissolution has many implications, which are generally recognised. In addition to the greater emotional issues, the needs of the ill person might be very high, albeit for possibly a limited time. This may impact on the shape of the final settlement.

Where the person cannot carry on working an ill-health, early-retirement pension may have been, or imminently will be, paid. This may be for an enhanced income compared to the normal pension accrued to date. This pension may be payable for a shorter period, for example in the event of cancer, or for nearer to a normal life expectancy, for example on leaving work due to a mental problem.

Careful actuarial consideration of the value of the pension assets is needed in this situation. Such advice could also cover insurance policies, which are more likely to be paid out due to the ill-health.

3.2 Less than perfect health

Less well understood is the implication of one or both parties being in less than perfect health. Obesity, smoking and an adverse family history are potential issues, as are other illnesses and injuries.

A certain amount of wear and tear is to be expected as we get older, as is an inevitable tendency to fill-out a little. Therefore, there is no need to worry about every ache and pain of clients, nor feel the need to quiz them on intimate medical details.

In the rest of this section, the proportion of those people in less than perfect health who meets the above conditions will be termed as being in ill-health.

3.3 The impact of ill-health on pensions

Ill-health often lowers life expectancy and hence the time over which a pension will be paid. Therefore, the value of a pension of someone in ill-health may be less than an equivalent pension for someone in average or better health.

For example, someone in ill-health as defined above might be expected to experience twice the rate of mortality of the average. The value of a pension of £20,000 per annum to them at retirement to them might only be £375,000, compared to a value of £450,000 for someone in good health.

If all pensions are valued by all parties allowing for the state of health of the individuals then this has a neutral impact on the decision of whether and how to share pensions.

However if a pension scheme is valuing pensions ignoring ill-health, then it will have an artificially high value that can be captured by transferring the pension to the partner in better health through pension sharing.

3.4 The treatment of ill-health in practice

3.4.1 Ill-health and defined benefit pensions

Overlaying the real impact of ill-health is an artificial one due to simplifying assumptions used in some pension valuations. A pension scheme often ignores the actual health of a member or their spouse in calculating CETVs and in pension sharing calculations. This will over-value the pension asset if either is in ill-health. The effect will be greater if it is the member in ill-health rather than the spouse or partner.

If to calculate a CETV the pension scheme does not ask for information on the health of the member or their spouse, then it is making simplifying assumptions and ignoring their actual health.

More appropriate valuations of pensions for use in divorces and dissolutions should provide the option to allow for the health of an individual in calculating the value of the pension asset.

A rule of thumb to judge if a client's health may be an issue

Two or more of the following apply:

- obese
- smoker
- adverse family history
- very physical work or extensive travelling abroad
- major illness in their past; or
- if they say they think that they are in poor health compared to the average of their age

An adverse family history can be taken as a natural parent or sibling having had a life-threatening illness before the age of 60, ignore less than 3 months travelling abroad a year, and judge obesity by eye.

3.4.1.1 Ill-health pension values

If a client is in ill-health, the value of their assets will be lowered by allowing for their state of health. Usually a CETV will not be making this allowance. If allowing for the state of health of the client is carried through to the value of the spouse's pensions then these will also be reduced in value, though usually by a lesser amount.

If the spouse is in ill-health then the value of their assets will be lowered by allowing for their state of health. A CETV not making this allowance will produce a higher value for the spouse's pension assets. An appropriate valuation that does not take the option to allow for the spouse's state of health will normally produce an even higher value.

3.4.1.2 Pension sharing

For example if Mr. and Mrs. A have total assets quoted in Form E of £1,200,000, including a pension for Mr. A valued by his scheme for £480,000. However because he is overweight and smokes then his life expectancy is 7 years shorter than the average assumed and allowing for this his pension is only worth £380,000. So, the real value of their assets is only £1,100,000 in total.

However if Mr. A shares his pension with Mrs. A so she gets all of it then the pension scheme will set up for Mrs. A a pension worth £480,000, an increase of £100,000. The total real value of the couple's assets to be divided therefore increases from £1,100,000 to £1,200,000 less expenses.

The converse is also true and sharing the pension of someone in good or average health, with someone in ill-health, will normally reduce the actual joint assets.

3.4.2 Ill-health and defined contribution pensions

As in most cases, there is no pension promise for defined contribution pensions, the ill-health of a scheme member has no direct affect on the value of the pension. The exception is where there is a guaranteed annuity rate under the pension, the value of which will be reduced. However, if the pension is in payment the health of the pensioner or annuitant is in ill-health, this must be taken into account when arriving at a fair value of the pension. It is unlikely that the pension provider will make this adjustment when providing a Cash Equivalent Benefit quotation.

A sharing order against a defined contribution pension will almost invariably result in an external credit for the pension credit member. If the objective is to equalise on capital value then there are no issues specific to those in ill-health. Where equality of income is the objective it is important to take account of the annuity rates that are likely to be available to the individuals and this includes any enhanced annuity rates that may be obtainable.

Where one party is in poor health and the other in average health, it may be possible to achieve an efficient reallocation of the assets by giving a substantial share of the pensions to the person who is in average health.

3.5 Other approaches

For clients approaching retirement there may be other ways to capitalise artificially high pension valuations, for example through requesting a transfer to a private scheme and then buying an enhanced annuity from an insurer.

3.5.1 Ill-health and pensions in payment

If one individual is in poor health it may be appropriate to achieve an efficient reallocation of the assets by making a sharing order that gives a substantial share of the asset to someone who is in average health.

However, it is likely that the pension provider will insist on making an individual assessment of the pensioner's health when implementing a sharing order on a pension in payment. This may result in a valuation that is much lower than anticipated as the provider seeks to avoid the pensioner selecting against the financial interests of the pension provider.

An attachment order makes little sense if the donor is in poor health. Conversely, it may be an efficient solution if the recipient is in extreme ill-health and expected to have a correspondingly poor life expectancy.

3.5.2 Impaired life annuities

Individuals purchasing annuities are able to obtain enhanced rates if they are in poor health, or they are expected to experience poor health, as is the case for smokers. Impaired life annuities are widely available in the pensions market. The rates a provider will offer a prospective annuitant vary from provider to provider dependant upon both the competitiveness of their basic annuity rates at any given time, and their assessment of an applicant's medical history and how this is expected to translate into a lower than average life expectancy.

Most pension schemes provide what is referred to as an Open Market Option (OMO). This gives the member the opportunity to seek the best available annuity rates in the market, which is particularly important if the member is in ill-health and could benefit from impaired life annuity rates.

3.5.3 Ill-health & lump-sum benefits

Attachment of any lump sum benefits can be particularly desirable if the member is in ill-health and the settlement involves any on-going maintenance payments.

4. Scottish Law

Under Scottish Law, only pension rights accrued during the marriage are included in the value of assets to be divided. The formula to be used in the calculation is specified in the Divorce etc. (Pension) (Scotland) Regulations 2000 [SSI 2000/112] and is:

$(A \times B)$ divided by C

where

- A is the benefit accrued up to the relevant date;
- B is the period of marriage whilst a member of the scheme which falls before the relevant date; and
- C is the period of membership of the scheme before the relevant date.

The relevant date is defined in section 10(3) of the Family Law (Scotland) Act 1985 as being the earlier of:

- a) the date on which the parties finally ceased to cohabit²; or
- b) the date of service of the summons in the action for divorce.

Although seemingly well defined the terms used in the Regulations are open to subjective interpretation, though in general the common sense interpretation that the benefit accrued is proportioned by the time accruing pension whilst married to total time accruing pension is applied.

² Section 10(7) of the Family Law (Scotland) Act 1985 states that in determining the date on which the parties to the divorce ceased to cohabit “no account shall be taken of any cessation of cohabitation where the parties thereafter resumed cohabitation, except where the parties ceased to cohabit for a continuous period of 90 days or before resuming cohabitation for a period or periods of less than 90 days in all”.



Reports from Bradshaw, Dixon & Moore

During Information gathering

- **Pension in Payment EPV** on own client's pensions

Alternative to CEB from scheme for disclosing in Form E	Complete and return BDM instruction form	£100+VAT
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- **Longevity report** on client or spouse

Quantifies effect of poor health on mortality and hence possible shape of financial settlement	Complete and return BDM instruction form	£100+VAT (exclusive of any medical fees)
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On exchange of information (Form E's)

- **Uniformed Services EPV** on spouse's defined benefit pensions

Correct CETV from scheme which is likely to underestimate true value by between 50% and 300%	Complete and return BDM instruction form	£50+VAT with reconciliation
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- **EPV** on spouse's other defined benefit pensions

Correct CETV from scheme which is likely to underestimate true value by 30% or more	Produce on-line	£25+VAT
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- **Pension in Payment EPV** on spouse's pensions in payment

Alternative to CEB from scheme which may underestimate true value by 30% or more	Complete and return BDM instruction form	£100+VAT
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Structuring the financial settlement

- **Full Actuarial Valuation**

Correct pension values for use in offsetting. Suitable for single or joint instructions.	Complete BDM quotation form.	From £475+VAT
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- **Full Pension Reconciliation Report**

Correct pension sharing or attachment percentages to meet income or value-based objectives. Suitable for single or joint instructions.	Complete BDM quotation form.	From £600+VAT
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All forms can be downloaded from www.bradshawdixonmoore.com/downloads.html or phone 0845 838 2551.

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