PENSION ON DIVORCE

METHODOLOGY

The effect of a Pension Sharing Order is to “cash in” part of the pension benefits of one party to a marriage and allocate that cash to pension benefits for the other party (either to add to existing pension benefits or to start a new pension arrangement). This is one of the means available to the parties to adjust their respective financial assets, or for the Court to do so – thus it may be an element of an arrangement affecting other financial assets such as ownership of a house. Sometimes not all the existing pension benefits of the parties are taken into account (for example, sometimes it might be decided to exclude pension benefits accrued before the marriage).

A Pension Sharing Order is applied against one pension benefit, owned by the party who is going to give up some pension benefits, in favour of additional pension benefits for the other party. Sometimes two (or more) Pension Sharing Orders, against different pension benefits of one of the parties, is required to make up the required total adjustment in financial assets. Generally speaking, one should keep to the fewest number of Pension Sharing Orders because of administrative complexity and costs but this is not a universal rule.

Generally speaking, a Pension Sharing Order is preferably against a defined contribution pension and not against a defined benefit pension – but this is not always achievable. The reason to avoid a pension sharing order against a defined benefit pension – if it is possible to avoid it – is that the amount of cash provided by defined benefit pension scheme administrators is sometimes a poor exchange for the pension benefits given up – effectively some of the value of the applicable pension benefit is “destroyed” rather than being allocated to the other party.

As we have indicated above, the purpose of a Pension Sharing Order is to adjust the respective financial assets of the two parties. The purpose is usually to equalise pension income in retirement for the two parties. However, sometimes, because there are other financial assets or an imbalance in the assessed needs of the two parties, the pension income planned for each of the parties is in some ratio other than 50 / 50, for example 60 / 40.

In order to compare the pension income of the two parties we define a “standard pension” of £1,000 per annum. The standard pension starts at defined ages for each of the parties

(usually the same age but this is not necessary); by default, we choose age 67 years. We allow for inflation – thus the £1,000 per annum standard pension for a party currently age 52 years means a pension starting in 15 years' time (assuming age 67 years) at an amount of £1,000 per annum plus 15 years' future inflation. If the other party is currently age 47 years a £1,000 per annum standard pension means a pension starting in 20 years' time (again assuming age 67 years) at an amount of £1,000 per annum plus 20 years' future inflation.

From the next paragraph we will dismiss from further consideration the point that a defined pension benefit is usually worth more than the cash-in value. Either of the parties who will retain some or all of a defined benefit pension will benefit, as a "windfall", excluded from the determination of a Pension Sharing Order to the extent that the economic value is greater than the cash-in value, but it requires a secondary adjustment in the calculations and we are concerned in this note with the primary calculation. Some commentators say that because there is certainly an element of uncertainty in whether the expected defined benefit pensions will in fact eventually be paid, and in view of the "clean -break principle" applying when a Pension Sharing Order is applied, it is reasonable in any event to ignore the secondary effect.

Next, we determine two figures. The first is the sum of the values of the standard pensions of £1,000 per annum for each of the two parties – purely for illustrative purposes please assume this sum is £20,000. The pensions of the two parties all have a cash-in value (unless, very exceptionally, there is an exception to this in which event the process described here cannot be used without modification). The second of the two figures that we require at this stage is the sum of these cash-in values for the two parties. Again, purely for illustrative purposes please assume this sum is £200,000. Note that £200,000 is ten times the sum required to provide standard pensions of £1,000 per annum and therefore in this illustration the standard pensions will each be £10,000 per annum.

The final step is to determine the size of the Pension Sharing Order. This is determined so that each party has total pension benefits with a value exactly equal to the amount required to provide for the standard pensions – in the case of the illustration this would mean £100,000 each. The Pension Sharing Oder then has the effect, for the party with the higher total cash-in value, of reducing that total and, for the party with the lower total cash-in value, increasing that by means of the transfer that the Pensions Sharing Order provides.

Please note that we do not take into account the specific retirement age or other details of any of the pension benefits – except for its cash-in value. This is because we need to compare the result of the Pension Sharing Order on a common basis for the two parties.

The "Congruent Pension Sharing Order – Calculation Tool" makes the calculation described above. We allow for discount rates, inflation rates, and gender-specific mortality rates including future mortality improvement. Discount rates are used to compare aggregate future standard pension payments with the total cash-in value allowing for the time-value of

money. All these forecasting elements are based on research published daily by the Bank of England or the yearly Continuous Mortality Investigation of the Institute and Faculty of Actuaries.

Congruent has kept the options made available to users of the portal simple but behind-the-scenes Congruent has the facilities to adjust the pension starting age and a pension ratio between the two parties other than 50/50 – that is an optional additional, chargeable, service.

It is important to realise that the amount of the standard pension determined is unlikely to be achieved, even approximately, in practice. When the applicable age is reached the amount of pension may be very different (even if one then excludes the pension earned subsequently). This situation is a consequence of the “clean break” principle and the fact that discount rates and inflation rates are volatile – when the time is reached for the pensions to be payable the history of discount rates and inflation rates can be very different. Especially if either of the parties is many years from the age assumed for the pension to be payable the fact that mortality has been assumed is also a factor (but explaining that is too detailed to be set down here).