Briefing Note for Lawyers involved in Ancillary Relief

A warning if excluding Pension Benefits accrued outside the marriage

The subject of this Briefing Note is a contentious issue.

It is outside my area of expertise as to whether pension benefits accrued outside of the marriage (whether pre-marriage or post-separation) should be excluded, especially in a long marriage - that is for lawyers to argue about. However, in instructions I receive, I am becoming increasingly asked to calculate what proportion of the CETV was built up (accrued) either before the parties were married, or after they separated, so that the lawyer can then try and get the Court to set aside, from the overall settlement, the amount of the pension accrued outside the marriage.

This is, I understand, common practice in Scotland. Indeed, there is specific provision for this in the guidance notes issued to some public sector pension scheme administrators in Scotland. For example, Section 9 of the pension scheme manual for administrators of the Principle Civil Service Pension Scheme (PCSPS) states:

In Scotland, employing departments may be asked to calculate the CETV as at the date of separation and to determine that part of the CETV which relates to the period of the marriage or civil partnership. This is equal to: $\frac{A \times B}{C}$

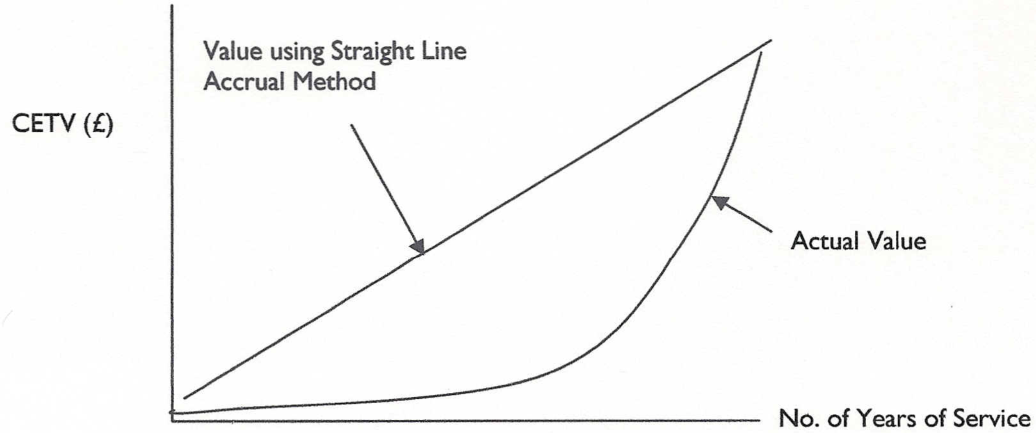
where: A = the CETV as at the date of separation; B = is the period of C during which time the member was married to, or in a civil partnership with, the partner from whom he or she has separated and C = the reckonable service to which the CETV relates.

So, using this formula, if husband had a full CETV of £400,000, and had been a member of the scheme for 40 years, but it was only during the last 35 years that he was married, then the CETV for divorce purposes would be (£400,000 x 35) ÷ 40 = £350,000, i.e. £50,000 of the CETV would be excluded, which *in theory* represents the proportion of the CETV accrued before he was married.

Now, although scheme administrators in England and Wales do not do these calculations, I have seen a number of reports by pensions experts use this basis of calculation, where they have been asked by their instructing lawyer, to calculate the amount of the pension CETV accrued before marriage. Indeed, on occasions I have done so myself.

<u>But just how realistic is this formula?</u>

The problem with this formula is that it assumes a <u>straight-line accrual</u> of pension benefits of, in this example, 1/40th of the CETV for each year of service – i.e. £10,000 per annum. However, in a final salary scheme, pension accrual, and thus the rate at which the CETV increases year by year, is far from a straight-line. In the early years of service when the member is young and on a comparatively low salary compared with what he/she will earn when he/she is older, the CETV will increase very little each year, and certainly at a rate significantly less than the average rate of increase assumed by the straight-line methodology. However, when the scheme member gets older, earns more, has more years of service under his/her belt, and is closer to retirement, the CETV will increase each year at a rate significantly greater than the average, assumed by the straight-line method. The following graph illustrates this point.



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To understand *why* this is the case we need to have some understanding as to how final salary schemes work, and how CETVs are calculated.

Final salary schemes promise a pension of say 1/60th of the member's final salary for each year of service. So, if in a 60ths scheme the member completes 40 years of service, and just before he retires he is on a salary of £30,000, then his pension will be 40/60ths of £30,000 — i.e. £20,000 p.a. Now if this member were to get divorced just before he retired, and the pension administrators were asked to produce a CETV, the question they would be asking themselves, in order to calculate the CETV, would be "How much money would we, as administrators, have to put on one side to meet this future, but imminent liability of £20,000 per annum?" The answer may be £400,000.

Now if we applied the straight line accrual method to this pension fund, as suggested by the precedent in the PCSPS manual, then the assumption would be that for each year of service, £10,000 of CETV had accrued (£400,000 ÷ 40). But would the CETV have really been £10,000 after just 1 year's service, or £50,000 after 5 years service, because this would be the amount excluded if the straight line method were used? The answer is no.

After say 5 years service, this member's salary may have been say £7,000 pa, and thus he would have accrued a pension entitlement of 5/60ths of £7,000, which equals a pension entitlement of £583 p.a. Now bearing in mind the administrators would not need to pay out this pension of £583 p.a. for a further 35 years, the CETV may have been £5,000 - if generous!

So using this scenario, if you are acting for W, would you be happy with having £50,000 of H's CETV set aside (assuming H and W were married after he had been a member for 5 years) when in reality he had only accrued a small fraction of this amount at the time of marriage? The reverse is also worth considering, if looking to set aside pension accrual *post separation*, when H would have set aside only £50,000 (using the straight line method) but in the last 5 years he may well have accrued significantly more than £50,000 of the CETV.

Using a more realistic method for calculating pre-marital or post separation pension accrual is far more complicated and time consuming for the expert, but in large money cases, this is probably cost effective (dependent upon which side you are on). Even with what I would call a middle of the road case with a CETV of £200,000 (typical for say a teacher with 25 years' service), the difference between excluding say £50,000 and£10,000 is substantial and probably worth extra investigation.

This Briefing Note has only dealt with extra-marital pension accrual for *final salary* schemes. The methodology for excluding pension benefits accrued pre-marriage or post separation for *money purchase* type pensions is totally different, and beyond the scope of this ***particular*** Briefing Note - *the sound of anticipation is almost deafening!*

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