FACTSHEET No 7:

Pensions & Divorce

a better way to settle

To reach a financial settlement during divorce proceedings it is necessary to calculate the total value of all assets owned by the couple (whether jointly or individually). This total should include any pensions acquired during the marriage. For a pension to be included within this total a "cash equivalent value" needs to be obtained.

This is the value attributed to the pension fund if it was transferred out of one scheme and into another on a given date. It is important to remember that a cash equivalent value is not exactly the same as cash but it is the measure of a pension's value as an asset used by pension providers and the courts.

Pension providers will normally provide the cash equivalent value to the person whose pension it is without charge in response to an enquiry in the context of a divorce settlement.

Types of Pensions

There are two main types of pension arrangements; defined contribution schemes and defined benefit schemes.

In a defined contribution scheme, also known as a money purchase scheme, a fund is built up over time through the contributions (premiums) paid by the individual. At retirement the accumulated fund can then be used to provide a lump sum and/or income. The majority of private pensions are defined contribution schemes.

A defined contribution, or final salary, scheme however is where the benefit payable to the individual at retirement is based on a specific formula (often a % of salary) and the contributions required to fund this amount are made (often by the employer) throughout the period. These schemes are generally associated with company pensions particularly within the public sector such as Civil service, NHS and teachers pensions.

Ways of Dealing with Pensions

Offsetting

Often the only significant assets owned by a couple when they separate are the family home and one pension (often accrued by the husband).

Instead of splitting both assets equally, which would most likely involve the sale of the family home, the value of the assets can be offset against each other and divided accordingly.

Example:

A couple have a family home with equity of £100,000. The husband also has a pension with CE value of £50,000.

By using an offsetting arrangement the wife would retain the house (providing accommodation for her and children) and husband would retain the pension in full as an asset.

Pension Sharing

The existing pension is split by the pension provider so that both the husband and wife have separate, independent pensions. In this way a 'clean break' at least in respect of pensions is achieved. A pension sharing order can only be made on divorce.

There is no requirement that the pension is split equally. The percentage transferred to a separate pension fund, usually for the wife, depends on the couple's individual circumstances. For example if the wife has a modest pension and the husband a large one pension sharing could enable them each to enjoy an equal proportion of the total available CEvalue. In such a case the CEvalue from the larger fund can be transferred into the spouse's existing smaller fund.

The pension is split at a given date based on the valuation of the pension fund to be shared (provided to the court by the pension trustees) at that date.

The benefit of pension sharing is that once the pension sharing order has been made both parties own entirely independent pension provision. A 'clean break', at least in terms of pensions will have been achieved.

Another advantage of pension sharing is that it avoids some of the difficulty inherent in the fact that a pension fund is not an immediately realisable asset; it is easier fairly to compare a pension with another pension, than to compare a pension CEV with equity in house.

Pension sharing can incur significant administration costs from the pension provider (up to £2000).

Example- A divorcing couple have decided to sell the family home and equally divide the proceeds. The husband has a defined contribution pension CEV £200,000, the wife has a defined contribution pension CEV of £50,000. They agree to a pension sharing order whereby £75,000 of CEV is transferred from husband to wife

Earmarking

Earmarking was used, before pension sharing became available, to provide benefits in retirement, typically for a wife who, in the course of a marriage had not built up much or any pension entitlement.

Earmarking enables the courts to set a percentage of the future pension benefits that would be earmarked directly for the wife. This usually takes the form of an order addressed to the trustees of the husband's pension fund directing them to pay a given percentage of his future pension benefits to the wife. Earmarking applies to both lump sum amounts and also any pension payments he would receive.

The wife only receives the benefits when the husband takes his pension entitlement and all benefits would be lost in the event of the husband dying prior to retirement. Earmarking can be varied at anytime in the future.

Further Information & Help:

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It doesn't create a clean break for the couple. These are, for many divorcing couples significant drawbacks. Earmarking is therefore not now widely used.

Difficulties with the Valuation of Pensions

The way in which pensions are taken into account will vary greatly from one divorce case to another.

For example, if both spouses are fairly young and have negligible pension provision it may not be an important part of any settlement. Where both the husband and wife have been working during the marriage they may have fairly comparable pension provision and so they can be dealt with fairly easily.

Problems can arise in the fact that the CE value of a pension does not necessarily accurately take into account the true value of the benefits available.

For example, people working in the public sector often have rights to retire early whilst taking a full pension. A straight CE value of a pension with these benefits may underestimate its true value.

Whilst in the past the value of a pension would be worth more to a person in good health to one in poor health, or provide less of an income for a woman than a man, recent pension changes have significantly widened the choices for individuals on retirement and made valuing pensions more complex. Differences in age and gender may significantly affect the value of pension benefits in any particular case. The CEValue does not take account of these.

In cases where the value of pensions is substantial it may be helpful to consider instructing an actuary. In mediation it will make sense to agree whom you decide to appoint as actuary, and to agree the questions you put. An actuary's report may provide you with a better informed understanding of all the factors that contribute to the value of your pensions in your circumstances and how fairly to deal with them. In circumstances in which the conundrum of how truly to value the pension funds threatens to become a significant obstacle along the way to a settlement an actuary's report may be worth the significant cost involved.

You may or may not feel that the instruction of an actuary is warranted in your case. We do suggest, however that at a time when important financial decisions have to be made you give careful thought to pensions, review the benefits available under any scheme to which you belong, reflect on how you can realistically provide for your retirement and consider seeking the advice of a suitably qualified financial advisor when considering the options available.

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