BREWIN DOLPHIN

Pensions – A "condensed" Baker's Dozen of Pitfalls to Avoid with Pensions in Divorce Plus McCloud

Mathieson Consulting Ltd
actuarial and expert witness services

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Lifecycle of a Report

1 March 2021	Instructed
8 March 2021	Acknowledgement Docs & Letters Of Authority (L o A) issued to solicitors.
15 March 2021	L o A Returned, and issued, with questionnaires to pension providers.
15 June 2021	Responses from schemes received, but incomplete on one scheme. Further questions asked
15 July 2021	Further information received
25 July 2021	Report written and full peer review /check
1 August 2021	Report issued.

5 months start to finish, of which 4 months waiting for schemes to respond.

15 instructions received in April 2021, report already issued.

Lifecycle of a Report

Q: Biggest cause of delay?

A: Dealing with pre marital pension accrual.

We wait 12 weeks for a scheme to send us details of the pension history, for this then to reveal that early on in life of pension, there was a transfer in from another pension. Was this pre marital?

- Go back to solicitors for new L o A;
- Wait for client to return L o A
- Send of questionnaire with L o A to newly discovered scheme.
- Longer wait than usual as they have to delve through archives.
- Another 3 months added to process.

1. Asking too many permutations

Becomes expensive, report becomes impenetrable, clients will be bamboozled

I was only trying to help…..

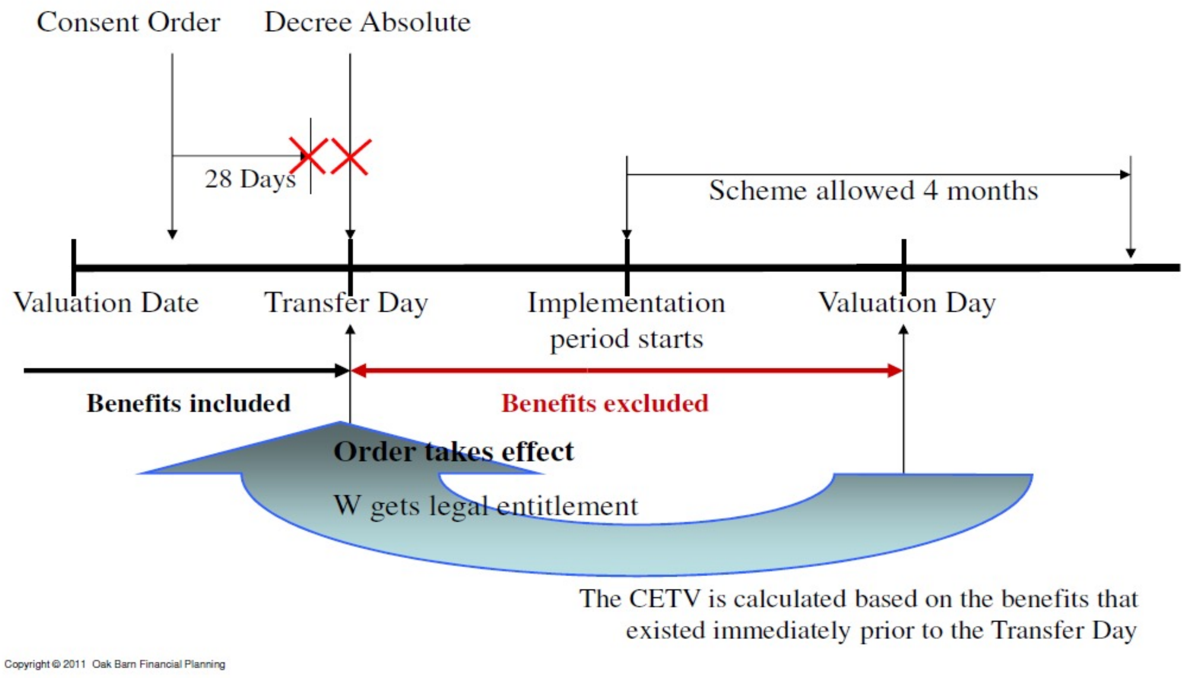
"Fortunately, the court process has yet to evolve to the point at which it is run by lay-experts, rather than fully trained lawyers, with many years of experience of due legal process. I am sure that if at any stage legal proceedings are run by experts, you will be the first to know and to put your hat in the ring. In the meantime, your role is to do as instructed by your instructing solicitors, and I would be grateful were you to confine yourself to that."

2. Automatically wanting calcs which exclude contributions outside marriage

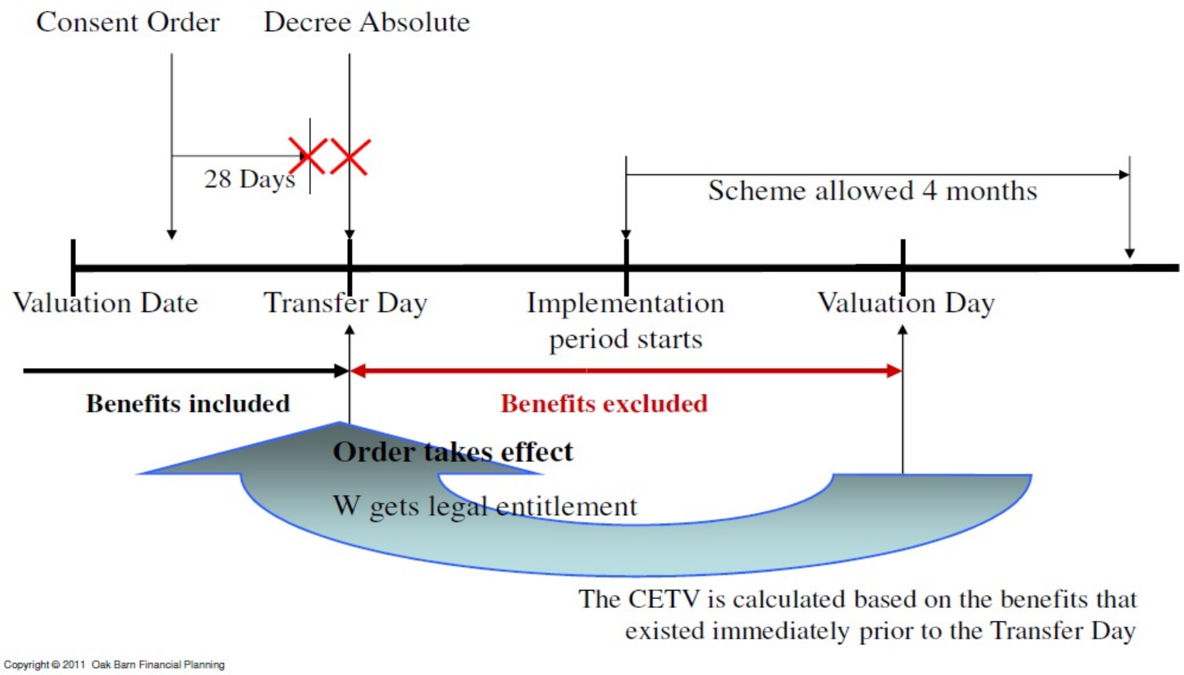
From the PAG report:

“In a ‘needs’ case, the court can have resort to any assets to meet the parties’ needs; in such cases it is rarely appropriate to apportion the pension based on the length of the marriage and existence of the pension.”

3. Sharing a Pension in Payment – Clawback and no lump sum



4. Applying for Decree Absolute too soon



5. Offsetting against DB scheme without knowing true comparative value

- H and W both aged 40.
- H active member of Armed Forces Pension Scheme.
- Only assets are equity in FMH worth £150,000, and AFPS CEV £144,650.
- W desperate to keep the house to house herself and children.
- H keen to retain pension.

5. Offsetting against DB scheme without knowing true comparative value

- Risk of negligence.

- What was done:

  - Straightforward offset, with assets seemingly of the same value. H keeps pension, W keeps house.
  - W's lawyers suggest they have actuarial report.
  - W resists on grounds of (i) costs and (ii) H putting pressure on W to settle.

5. Offsetting against DB scheme without knowing true comparative value

Look beyond H's CEV at the actual benefits:

- Has a preserved pension of £10,000 pa, plus lump sum of £30,000, payable at age 60.
- Cost to W of buying an equivalent pension on open market is £223,000.
  This is also the open market value of H's pension.
- Is accepting equity in FMH to meet basic housing need now a good trade off?

5. Offsetting against DB scheme without knowing true comparative value

- But H currently has 21 years of service, next year he will have 22 years of service, at which point his pension would be paid immediately on leaving service, not at age 60.

- CE in 12 months' time will be £281,400 (not because his pension is any greater, still £10,000 pa plus lump sum of £30,000, but because it is now payable immediately not at age 60).

5. Offsetting against DB scheme without knowing true comparative value

- How does offset against equity in FMH look now?
- Open market value of H’s pension in 12 months’ time is over £500,000.
- Negligence claim against the solicitors.

6. Accepting pension scheme data from administrators at face value.

XYZ Co Ltd Pension scheme:

- CEV, £600,000
- AVC fund £100,000

Does the CEV of £600,000 include the AVC fund or not?

Statement ambiguous but because of subtle wording we assume AVC in addition to £600,000, but we ask.

No, we are told, the AVC fund is included in £600,000, not in addition.

Are you sure we ask, because that doesn't quite make sense, given certain wording?

Ah, yes you are right, it is in addition.

7. LTA Issues

Too complex to cover.

- Very complicated.
- Co-operation of both parties can on occasions save enormous amounts of tax.
- Sometimes a window of allowances with which we can bring both sides' pensions, but does not achieve equality , W still has less pension than H, but increasing PSO takes W over limit, and tax will become payable.
- Get pension incomes as close as possible, avoiding tax, then offset remaining difference.
- Many many other scenarios.

McCloud - Background

A potted history of public sector pensions

- There are many public sector pension schemes, including Police, NHS, Teachers', Armed Forces, Civil Service, Judicial and Local Government
- Local Government operates via county-wide funds; all other schemes are unfunded
- Most public sector pensions were final salary in nature, NRA 60 and three-times lump sum
- Labour's 2005 reforms moved to NRA 65 and dropped automatic lump sum, **but only applied to new entrants**
- It was recognised that these schemes were becoming increasingly expensive to operate (ageing population etc)
- Further, final salary schemes had closed across the private sector during the 2000s
- Coalition Government sought to revisit the issue via Independent Public Service Pensions Commission (chaired by Lord Hutton)
- The Commission reported in March 2011 and set out proposals for HM Government to consider
- Discussions then proceeded between HMG, public sector employers and the trade unions

Background

The relative merits of the schemes

- It is not axiomatic that "old scheme = good, new scheme = bad" as is often believed
- Whether the old or new scheme provisions leads to higher pension benefits for an individual depends on many factors
- For example:
    - Final salary rewards high earners who have advanced through the pay grades, while CPI plus x% might actually deliver a better outcome while salaries are broadly level
    - The higher accrual rates may well provide fair compensation for the loss of the lump sum accrual, and may lead to more generous pension provision overall
    - Benefits payable at age 60 are more generous than those payable at a later age BUT many of the new schemes still allowed active members to retire early on enhanced terms
    - Old 80ths schemes did not offer any enhancement for taking benefits after age 60
    - Spouses' pensions arguably anachronistic anyway in days of equality in the workplace

Background

Transitional arrangements for transfer to the new schemes

- Crucially, these changes were to be applied across the board i.e. not just to new entrants as per 2005 reforms
- The new schemes generally opened on 1 April 2015 with service commencing as at this date; legacy benefits remained in the old schemes and remained linked to salaries as applicable
- However, transitional arrangements were to be applied such that **those nearer retirement would not be made subject to the change and would remain in the old scheme**
- For example, in the NHS scheme, NRA 60 section:
  - Those aged 50+ as at 1 April 2012 would have full protection and would remain in the old scheme
  - Those aged below c. 46½ at 1 April 2012 would automatically move to the new scheme in 2015
  - Those in between would be subject to a tapered transfer date from 2015 to February 2022
- LGPS was slightly different; the change came in 2014 and all members were moved across, but an underpin was applied to legacy final salary members, again subject to age-related transitional terms

What could possibly go wrong?

McCloud (and Sargeant)

The reforms were deemed to breach age discrimination legislation

- It was noted that pension scheme members were being treated differently, depending on age, and some individuals pursued this via Employment Tribunals
- These related to the pensions of Judges (McCloud) and Firefighters (Sargeant) respectively, but “McCloud” seems to have become the accepted shorthand
- The Court of Appeal ruled that in these two cases the Government failed to demonstrate that the transitional protection arrangements were based upon a legitimate aim. The key content of the judgment said:

  “We have found that in both the judges’ and firefighters’ cases the manner in which the transitional provisions have been implemented has given rise to unlawful direct age discrimination.”
- In the Firefighters case, the Court of Appeal noted that:

  “the Government’s rationale for the protective provisions did need to be supported by evidence”.
- The original ruling was made by the Court of Appeal in December 2018 Neutral reference [2018] EWCA Civ 2844

The practicalities of the ruling

What this means for affected members

- At this stage, **no legislation has been passed and thinking at this point reflects mere speculation**
- However, all members will be treated consistently from 1 April 2022 onwards, and the DCU approach means that there is then clarity over the benefits that would be accrued under the two different schemes
- The schemes are to have until 1 October 2023 to introduce the retrospective changes, but **this looks very optimistic given the size of the task ahead**
- The response to the consultation suggests that other issues are to be dealt with as follows:
  - Annual allowance charges that have been incurred will be dealt with in a manner that does not give rise to additional costs to the individual
  - Differences in contributions payable between the schemes are to be allowed for (either by means of members having to pay more or receive a refund)
  - Some thought is being given to such matters as abatement, added years, those who have died since 2015 etc…
  - …and indeed divorce

What McCloud means with reference to divorce issues

What we know at present

- The response to the consultation (February 2021) states that:

  "The CETV will be calculated as though the pension debit member had become a deferred member and had elected to transfer their pension rights at the relevant date, so the transfer value will be based on whichever scheme, legacy or reformed, produces the higher amount in relation to any period of service during the period between 1 April 2015 and 31 March 2022. Where the CETV provided to the court would have been higher as a result of the implementation of the DCU, the pension credit member's benefits will be increased in proportion with the increase in CETV to reflect that additional amount. The changes will come into effect when the DCU is implemented in scheme regulations."

- To this end, once the schemes are ready (2023 at the earliest), the scheme will seek to determine which outcome is better and will base the CETV upon these higher benefits

- We understand that for PSOs already implemented to date, both the pension credit and pension debit members may receive an uplift to pension benefits, therefore both might end up slightly better off than before

- **But what to do in the meantime?**

What McCloud means with reference to divorce issues

The interim period

- At least until 2023, the public sector schemes will not produce CETVs that make any allowance for McCloud
- This ruling complicates matters significantly as there will be many individuals who may receive a retrospective uplift to their accrued pension benefits
- Both pension sharing and offsetting rely on there being some certainty over the accrued pension benefits as at the point of the divorce
- PODEs will naturally wish to avoid "second guessing" what an individual might do when making a choice between the schemes. For instance:
    - Retirement age may drive which outcome is better
    - How each individual will value pension per annum *vs.* cash
    - The dangers of "getting it wrong" are all too obvious
- However, we accept that divorcing parties and their solicitors are unlikely to be prepared to wait until at least 2023 before the divorce can proceed simply due to some pensions complications

What McCloud means with reference to divorce issues

Current thinking

- GAD (the Government Actuary's Department) have admitted that there is no thinking on this beyond what is stated in the consultation response
- We have no "inside track" on this matter either, and there is no definitive answer to all of the outstanding questions
- Once again, the legislation has to be passed by Parliament and proposals remain subject to scrutiny and change
- Some PODEs refuse to allow for the implications of McCloud, and insist that solicitors will have to choose between:
    - Having calculations performed as things stand at present, with no allowance for possible McCloud implications; **or**
    - Postponing the resolution of pension issues until such time as CETVs are produced that do take account of McCloud (October 2023 at the very earliest)
- While we note the complexities that are presented here, we pride ourselves on being as helpful as possible, and we are keen to bring a degree of pragmatism to our work where we can
- Further, we intend to keep close to scheme contacts for updates on how they are with dealing with these issues

Mathieson Consulting's proposed approach

Our intentions on how to proceed

- In the first instance, there are many individuals whose pension benefits remain unchanged as a consequence of McCloud, and therefore it is "business as usual" (for example, where both members left before 2015)
- Once again, the affected individuals are those who joined before April 2012 and were still in service after April 2015

What we will do	What we won't do
• Judge each case on its merits and seek to identify where there is an issue • Where possible and proportionate, ring-fence affected pensions and equalise these separately • Provide details of where we think pension amounts may be uplifted • Set out the issues and pitfalls in a clear and logical manner	• Provide certainty upon matters where none yet exists • Construct expected benefits under the different scheme definitions • Provide advice upon which scheme is "better" in respect of each member's benefits • Indemnify solicitors against further changes in legislation or approach

Putting McCloud in Context

A worked example

Scheme:	NHS 1995 (NRA 60, 80ths pension, 3× lump sum)			
Born:	1965			
Joined scheme:	1987			
	Member A	**Member B**	**Member C**	**Member D**
Salary 2015 (pa)	£100,000	£100,000	£30,000	£30,000
Salary increases 2015 to 2021	5% pa	5% pa	1% pa	1% pa
Promotional increase	No	£20k pa in 2020	No	£10k pa in 2020
Combined 1995 & CARE CEV pre impact of McCloud	£1,222,390	£1,402,306	£306,948	£393,585
CEV of 1995 scheme if CARE reversed into 1995	£1,245,124	£1,449,998	£307,606	£406,140
Benefit (in CEV terms) of McCloud	**£22,734**	**£47,691**	**£658**	**£12,555**
As a percentage	1.9%	3.4%	0.2%	3.2%

Putting McCloud in Context

But…..

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Just come across 1st suspected very big McCloud case in divorce. Police pension 19 years service in 2015. Since then accrual 55ths @ age 67. Had he stayed in old scheme accrual mainly 30ths @ 50. Increase in CEV >£100k in case where combined legacy & CARE CEV previously £350k
3:48 PM · Apr 27, 2021·Twitter Web App

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