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# PENSIONS AND DIVORCE
## AN ACTUARIAL NOTE ON THE
## FAMILY LAW (SCOTLAND) ACT 1985

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## LEGISLATIVE BACKGROUND

The Family Law (Scotland) Act 1985 (the Act) received the Royal Assent on 16 July 1985. The Act followed two reports by the Scottish Law Commission: Aliment and Financial Provision[1] and Matrimonial Property[2]. The Act, except S25, came into operation on 1st September 1986[3]. Section 25 (the presumption of equal sharing of household goods) came into operation on 26 October 1988[4].

Before the 1985 Act financial provision on divorce was discretionary under S5(2) of the Divorce (Scotland) Act 1976. The 1976 legislation enabled the court, on application, to make:

> "Such (an) order, if any, as it thinks fit, having regard to the respective means of the parties to the marriage and to all circumstances of the case, including any settlement or other arrangements made for financial provision for any child of the marriage".

The 1976 Act did not provide guidance as to how discretion was to be exercised. Following the Scottish Law Commission Reports the 1985 Act was introduced to correct and clarify matters. The post 1985 situation is covered in Thomson's book[6].

Matrimonial Property is the assets of the marriage acquired during the period of marriage. The 1985 Act introduced a specific element of such property:-

> "Any rights or interests of either party under a life policy or occupational pension scheme or similar arrangement".

All matrimonial property is valued at the Relevant Date, the date of separation or the date of serving a summons in the action for divorce. As actuaries will appreciate the capital value of pensions (in particular) may be substantial. In practice the value of a pension entitlement is often greater than the value of the matrimonial home.

## ACTUARIAL INVOLVEMENT

Consulting actuaries have been involved with the Act since the first cases were considered in 1986. Consideration of the value of pension rights, etc., was however initially slow, with many in the legal profession unaware of the financial significance of the above new explicit element of matrimonial property.

It should also be appreciated that divorce is not a quick process. For example the Muir case[8], with actuaries instructed in July 1986, came to court in May 1987. The decision was given in September 1987. The case was formally reported in the Legal Journals in

1988. The result (from the position of the aggrieved pension owner) was front news in a Sunday newspaper in March 1989.

The first element of publicity of the actuarial side of such matrimonial property arose from an article in the Journal of the Law Society of Scotland in November 1987[5]. The article briefly outlined the legislative background, practical difficulties of information gathering, alternative valuation approaches as well as various practical matters.

Information about and understanding of individual pension arrangements is perhaps the most troublesome areas for practitioners. An element of sympathy is necessary for solicitors receiving replies from life offices to the effect that "this policy has no value until age 60". Legal practitioners may also experience difficulties in correctly interpreting and processing the illustrated "values" of policies where "initial units" or a "capital units" disguise the extent of the front end expenses of the contract. Although surrender values (or transfer values to personal pension contracts) may reveal a more realistic (cash) value the understanding of such matters may be a more difficult process.

## PENSIONS – VALUATION APPROACH

Two approaches were initially considered. For practical purposes the easiest value to consider was the transfer value (cash equivalent) available in lieu of leaving service benefits. For legal practitioners this was particularly attractive as being available (free of charge) direct from the pension administrator. The practice of providing such transfer values on benefit statements also increased attention. Actuaries will of course be aware of the potential difficulties for legal practitioners associated with using cash equivalents – apportionment to period of marriage, level of scheme funding, treatment of pension increases, etc. The availability of an "expert witness" is also a particular problem.

The second main approach was to consider the actuarial reserve or continuing service value of entitlements. Such an approach would take account of future salary increases, the incidence of death, withdrawal, ill health retirement, early retirement as appropriate. Depending on the age of the pension scheme member, withdrawal will be a potentially significant factor. In practice, the majority of cases have concentrated on this "continuing service" approach, not least because few individuals actually left service at the Relevant Date, or indeed in the period prior to settlement.

A Sheriff commented in one case[9] (where both cash equivalent and continuing service approaches were considered) that a range of values for different dates of withdrawal from the scheme could be sought. The cash equivalent was (deemed) zero (presumably a non-contributory contracted in scheme; separation in 1985 with less than 5 years service) and continuing service value £2,652. Pragmatism however applied in the end due to fears regarding potential additional valuation costs!

Differences between consulting actuaries have also arisen in connection with the approach to taxation. Actuaries will of course be aware that approved pension schemes exist in a very favourable taxation environment – tax relief for employee and employer on the contribution input, tax free build up of funds retirement with pensions taxed as earned income. This tax free build up and tax charge on payment is reflected in one approach. (This reflects underlying principles of Scots Law, that is, a £10,000 [cash] money purchase fund is worth £10,000 – before consideration of tax deduction [if any] on payment). Other actuaries take the view that the pension asset should be considered on the basis of what personal saving would be required for replacement. Valuating a £10,000 contribution via net roll up at say £11,000 may lead to ridicule.

The judiciary have commented on the appropriateness of the "share of funds" implicit in the "gross" approach. However a definitive Court of Session consideration of this difference is still awaited. A December 1989 case involving actuaries on both sides (with differing taxation approaches) was unfortunately settled out of court (after 6 days!).

## LIFE ASSURANCE – VALUATION APPROACH

The valuation of life assurance arrangements (by legal practitioners) almost universally rely on the life office surrender value quotation. The discounted value of projected maturity values (with or without terminal bonus) has however been considered on occasions by (instructed) actuaries. However the availability of surrender values (free and independently calculated) generally means the only additional consideration is the possible auction of the policies. The availability of borrowing on the basis of the surrender values is also an important factor.

## CONSIDERATIONS

For convenience the various actuarial considerations are outlined below and briefly discussed. Actuaries will undoubtedly be able to add to the list.

**Earnings** – not all earnings will necessarily be pensionable. Fixed deductions e.g. basic state pension may apply in determining the ultimate benefit. Establishing pensionable earnings with (lay) individuals may be difficult.

It is widely recognised that earnings generally outpace prices, etc. Utilisation of an additional salary scale may be difficult to justify as it could be argued as an event after the Relevant Date.

**Retirement Age** – many schemes provide benefits at a range of retirement ages or after a set period of service. Benefit at the earliest time will (generally) be the most valuable whilst a (valuation) assumption of uplift at the latest time may arguably depress the emerging value for divorce purposes. A definitive statement of this valuation assumption will be appropriate. For example in the Police Scheme a ⅔ index-linked pension can be available from age 50-60.

**Mortality** – may be considered in two stages, pre- and post-retirement. Before retirement any mortality allowance must be considered along with the scheme death benefits. In many cases a lump sum payment and spouse's/dependant's pension benefit will apply reducing the significance of the underlying assumption. Often aggrieved pension scheme members will say that they (personally) will get nothing if they die tomorrow. That is of course true but they similarly personally receive no benefit from their £100,000 house, but it's still valued at £100,000.

Post-retirement mortality is usually applied from standard tables. It would take special circumstances (and probably medical evidence) for anything else to be accepted. Few schemes are large enough for meaningful scheme mortality experience to be applied although theoretically there is no reason why such statistics should not be used.

**Real returns** – assumptions regarding investment returns, earnings inflation and price increases generally follow familiar pension fund valuation rates. Adjustments to reflect market conditions at the Relevant Date are also made (as appropriate given the valuation approach and method).

**Taxation** – as mentioned above the approach of consulting actuaries differs on this subject. Irrespective of the approach it is appropriate to ensure the court and the legal practitioners are fully aware of the assumptions and also the effect of those assumptions.

**Withdrawal** – as previously mentioned withdrawal assumptions may crucially affect the valuation figure. Incorporation of the underlying average scheme decrement is one (theoretically sound) way to make allowance for withdrawal. Courts and legal practitioners are increasingly aware of the two approaches – leaving service transfer value and continuing service reserve. Getting to an appropriate figure in between and justifying it is the actuarial practitioner's problem.

**Pension increases** – with many schemes still leaving pension increases to the trustees' discretion, difficulties may arise in valuing prospective but unguaranteed benefits. Leaving service transfer values may or may not make full allowance for such increases. The Social Security Act 1990 of course adds a new dimension to this problem. Is the certainty of pension increases heightened by a scheme in surplus?

**Early retirement** – schemes may provide early retirement benefits from, for example, age 50 with the employer's consent. Allowance for such benefits on an individual basis is very difficult to explain in practice (although theoretically similar to a mortality decrement). Again a clear statement of any assumptions would seem appropriate. Given availability of early retirement at age 50, much greater significance is placed on benefits of individuals of 50 or over due to the potential immediacy of benefits.

**Ill Health** – as with early retirement, this is a difficult assumption for non actuaries to accept on an individual basis. Without medical evidence it is generally ignored as benefits at least equal to past service reserve are payable making the exact assumption/ rate less "geared" than applicable to decrements in a tontine!

**Pension mortgages** – although pension benefits cannot be assigned, numerous pension mortgages are taken out each year. Individual policies are more popular than scheme entitlements, although this probably has more to do with commercial realities than anything else. The prospective tax free lump sum gives "ability to pay" and lenders are generally happy with interest only payments pre-retirement, life cover and physical security. The use of, indeed existence of, pension mortgages is seen by legal practitioners as tangible evidence of the pension value and frequently arguments of "liquidity" centre on it. Interest payments may however be equated with what one party may be able to afford from income by way of capital settlement by instalments. Physical security is crucial and imposing unmanageable debt on one party is not something courts do!

**Spouse's benefit** – legal practitioners say divorce is a very stressful and traumatic time. Giving half your pension to your spouse is generally viewed unfavourably (understatement of the year). Allowance for the scheme benefit of a (new?) spouse's benefit and or dependants' pension is therefore an equally delicate subject. Actuarial practitioners generally take solace in the general proportions married. It is however quite valid but usually futile to debate the chances of re-marriage at various ages given various periods of marriage, given current "habitation" and background details (previous education, age of children, social life history, etc). Ultimately some assumption is necessary which the actuarial practitioner is willing to justify as reasonable.

**AVCs** – free standing or main pension scheme AVCs may add a new tranche of benefit to a valuation. Money purchase or added year benefits may apply. A devious mind may wonder whether a salary scale or withdrawal assumption should be varied where added years have been consciously accepted or rejected.

## CASE LAW

The majority of cases now concentrate on service (rather than leaving service) values. Very limited case law is available on the subject however Muir[8], Little[11] and Carpenter[12] indicate 37.5%-50% as the "going rate" (the share given to the spouse). Few cases have involved actuaries on both sides but at least some progress has been made since 1986[7], where the Sheriff personally completed the valuation of the pension rights when neither side submitted actuarial evidence (good idea for one side only!). The actuary will rarely be aware of all the circumstances of a case and the full details should be considered by expert counsel.

In all cases matrimonial property values must be compared with the individual's "ability to pay". The courts will not force the one party into (unserviceable) debt because for example a significant pension asset exists. Immediate settlement from house (or other matrimonial property) proceeds is generally the first preference. A capital settlement by instalment is often the next best thing followed by deferred payment from retirement (or death) benefits. The latter alternative risks falling foul of the "clean break" principle underlying the legislation.

Developments in England and Wales, additional case law and comments of the actuarial profession will be welcomed by all practitioners.

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