Pension Notes

Windsor Actuarial Consultants Ltd

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Issue 3

The Real Value of a Pension

"Winwood Reade is good upon the subject," said Holmes. "He remarks that, while the individual man is an insoluble puzzle, in the aggregate he becomes a mathematical certainty. You can, for example, never foretell what any one man will do, but you can say with (greater) precision what an average number will be up to. Individuals vary, but percentages remain constant. So says the statistician. "
(My parentheses)

When a pension scheme actuary values a pension for CETV purposes, he does so taking account of the "averaging out" that is possible by considering a significant number of members. Due to this averaging out, he or she can be more optimistic regarding the assumptions for future experience that are used. The investment return is a key element of these assumptions. The actuary will take into account the returns on assets he expects the fund to invest in (and is already holding). If the fund can take advantage of the averaging, that means that the risk of having to pay out unexpectedly is much reduced. This gives greater investment freedom, and the ability to invest in 'riskier' asset types, for example shares and property, where the capital values are relatively uncertain at any future point in time, but greater growth over the long term is expected.

An actuary calculating a CETV to value a deferred benefit in this way would derive a relatively low-

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"...then I went to old Daddy Gobseck, and sold a year's interest in my annuity for four hundred francs down…."

Honoré de Balzac

Old Goriot

Martin-Dye—Getting the Balance Right

The main thrust of the Martin-Dye judgement is that pension entitlements and other assets should be assessed separately, and an asset share percentage should apply across both of these asset classes, rather than classing the pension and other asset types as equivalent.

This is undeniably true. Pension sharing requires a degree of care and informed consideration that is not necessary for other asset types. For example, we know that an equal sharing based on the CETV may lead to wide disparities in expected future income for each party. In addition, once each party's liquidity needs are satisfied, there

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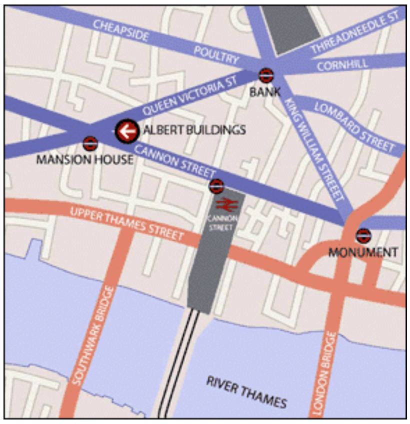
Windsor Actuarial Consultants provide consultancy services for solicitors and other professionals. We have a particular expertise in advising on fair divisions of pensions assets, and clear communication of the issues involved.

We have over 25 years of experience in pension scheme, life assurance and related areas involving complex financial matters.

We offer a service where we will express an initial view on your clients pension issues totally free of charge, so you can decide whether additional work and expense are justified for any particular case.

WE MOVED ON 1ST AUGUST. OUR NEW ADDRESS AND TELEPHONE NUMBER ARE SHOWN ON THE LEFT.

(Sorry for the repetition, but we are still getting mail at our old address).



From Sacred Cow to Cash Cow

Prior to 1995, pensions were accorded a respect by the Courts that was not totally deserved. The Pensions Act 1995 was the first step in bringing this troublesome asset into line, by allowing attachment orders, or 'earmarking', introduced from 1996. Once the pension came into payment, a portion could be paid to the ex-spouse. This route had a major drawback, however—on the death or remarriage of either party, income might cease, or the courts be called upon to reassess the position had either party's circumstances changed. The final piece of the jigsaw (to date!) was the implementing of pension sharing in 2000—allowing a 'clean break', and separation of funds.

Representing, as it often does, one of the two largest assets of the marriage, it is appropriate that the Courts are given as much power as possible in order to deal with the pension assets. However, there are two changed that I would like to see:

1) The availability of an 'irrevocable' attachment order, which pays the income in question directly to the spouse, not ceasing until death, and

2) In respect of sharing order information, Form P should include the question 'What is the estimated market cost of securing this pension?'

There would be strong resistance from more than one quarter to implementing these proposals, but as such relatively simple adjustments would provide disproportionate additional support to arriving at a fair solution, I very much hope this would be overcome!

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- For those who have left a scheme, the ‘deferred pension’ still to come

into payment.

(The guarantees are offered by either an insurance company or occupational pension scheme)

In contrast, ‘money purchase’ type funds are represented by a separately identified portfolio of assets, where although the current value of the fund is easy to determine, there is no guarantee of the level of future pension the fund will provide.

Let me talk around some of the commentary that formed part of the judgement:

A pension (in payment) is no more than a whole life income stream akin to an annuity. An annuity is an immensely valuable asset – an annual salary is a type of annuity, albeit dependent on work! However, a pension entitlement is independent of health*, performance, or office politics – it will never run out, however long you live. It is of particular value to anyone whose future earning potential is limited, and for whom it also provides an automatic budgeting system.

* I exclude here the extreme case.

It could not be sold, commuted for cash or offered as security for borrowings. It had no capacity for capital appreciation.

The inability to sell a pension does not mean it should be treated as an inferior asset. All of the above comments could be applied, for example, to a professional education. To produce it requires an individual with aptitude, commitment, effort, and training resources of some kind. The result will (usually!) generate a significantly higher level of earnings would otherwise be the case. But an education cannot be sold!

Regarding security for borrowings – this refers to the fact that a pension may not be formally assigned to a third party. However, by its very nature it provides practical security for borrowing in that the income can be used directly to meet interest and capital repayments! (It may also be possible, in extremis, for the lender to threaten a court order to indirectly secure part of the income!)

The benefit did not survive the death of the scheme member and thus could not form part of his estate.

Is the glass half empty, or half full? The advantage is that a pension IS ‘for life’ – employment may vanish overnight, state benefits can be reduced at the whim of the chancellor, but the pension contract endures precisely long enough to do its job. This precision is the essence of its value. Fred Bloggs’ pension will provide Mr Bloggs with income to support his living expenses – while he has them.)

So how should we ensure that a settlement is ‘Martin-Dye compliant’?

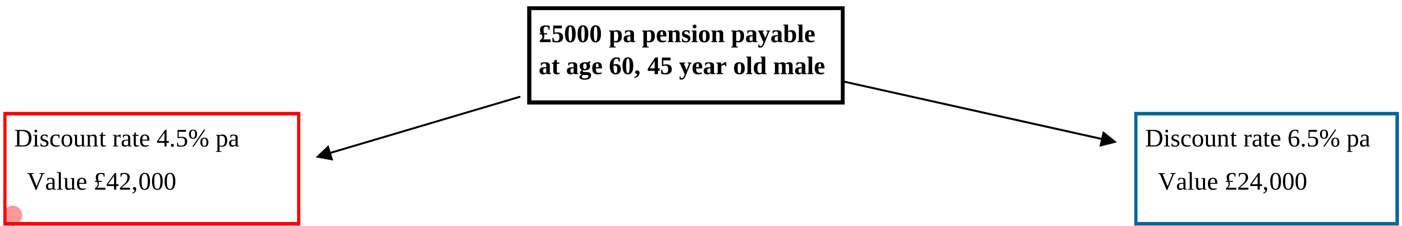
1 Check that any proposed settlement leaves each party with enough ***liquidity.*** The ‘pari passu’ position cited above is a good starting point, as long as the pension is split fairly.

2 Ensure that the conversion rate between pension and more liquid assets is appropriate before considering any exchange

3 A final check of the post negotiation result for both parties’ liquidity.

Useful Tips

- When obtaining a quotation for an internal transfer from the NHS Pension Scheme, it may be sensible to ask for a range of values, for example, “What is the amount of pension granted to the spouse if the pension share is 30%/40%/50%/60%/70% of the CETV? The scheme administrators charge for quotations by the hour, and getting the information ‘up front’ will probably save time and charges, as several calculations are always quicker to do ‘together’. Unfortunately, the benefits from a share are not proportionate (ie, the benefits from a 60% share are not double those for a 30% share), but after looking at figures from the range, reasonably accurate estimates of the intermediate figures should be possible.
- Does one party have more than one pension? If so, by choosing the correct pension to share, it may be possible to obtain a better deal. This would benefit at least one of the parties, and probably both!
- Don’t judge a pension by its CETV!



Martin-Dye—Getting the Balance Right—Continued from Page 1

may be a desire for one party to take a larger share of pension, and a smaller share of the other assets. How should these requests be fairly met?

Some of the comments in the judgement may give the impression that pensions are, in some ways, 'inferior', due to their lack of liquidity. I would suggest it is important not to underestimate the value of a pension.

When Mark Twain was asked what to invest in, his reply was 'Land – they've stopped making it'. Today, the answer might be 'Guaranteed Pensions'.

Twenty years ago, any suitably qualified job candidate would expect a good final salary pension automatically as part of their package. Now, unless they are at director level, or joining the Civil Service, a new employee will be very lucky to be able to join such a scheme. However, many employees who joined a company some years ago will still be entitled to final salary scheme benefits.

By 'Guaranteed Pensions', I mean any one of the following:

- Pensions in payment (where the amount paid each month is guaranteed by either an occupational scheme or by an annuity provided by an insurer – as opposed to a fund subject to 'drawdown')

- For those still in employment, final salary entitlements which are based on future salary, or

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value. As he (or she) is being optimistic about investment returns, he is in effect saying 'money invested now will earn a high rate of return. You therefore only need a small CETV now, which will grow quickly to meet the cost of paying the pension.

HOWEVER, once the same pension is considered from the point of view of the individual, the position changes. An individual is unable to take advantage of this sharing principle, and would be best advised to base his or her view on investments which guarantee the level of income, and return of capital at a fixed future date.

The cost of this guarantee is reflected in the lower investment returns on these assets. What we are in fact saying is, 'money invested now will earn a low rate of return. You therefore would need a large CETV now, as it will grow more slowly to meet the cost of paying the pension.' This is the main reason that an independent pension valuation is often significantly greater than the CETV offered by the scheme. It allows for the positions of the individuals involved, rather than of a large group .

" an independent valuation is often significantly greater than the CETV"

Share Option Schemes and Share Saving Schemes

Following on from the article in issue 2, we have developed some software that can simulate future stock market values on a statistical basis.

This assumes that prices are a combination of generally increasing average values, but the value on an individual day is uncertain.

This works by looking at possible 'average' future scenarios, then allowing for some random fluctuation. Running the model once gives a possible future outcome. We actually run it 10,000 or 100,000 times. This gives us more confidence in the outcomes of our valuations. For further details, contact Windsor Actuarial on 020 7653 1908