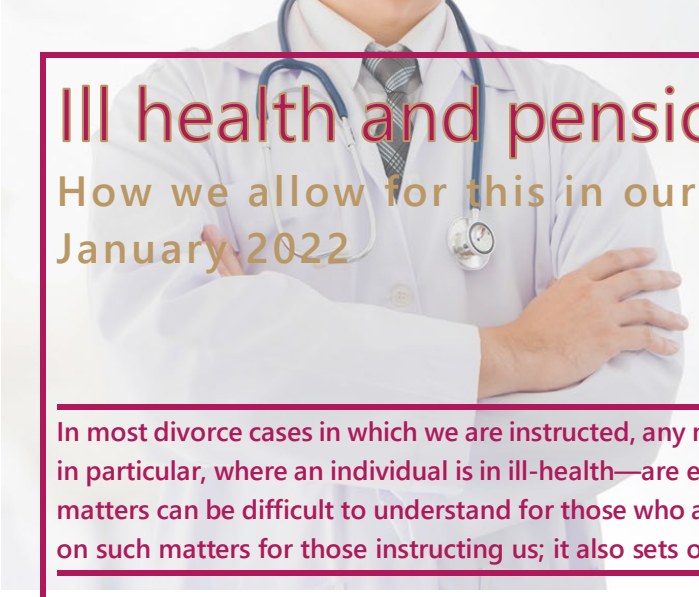

Ill health and pensions on divorce

How we allow for this in our reports

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Mathieson Consulting Ltd
actuarial and expert witness services

In most divorce cases in which we are instructed, any matters pertaining to the health status of one or other of the parties—in particular, where an individual is in ill-health—are extraordinarily difficult to resolve. Moreover, the implications of these matters can be difficult to understand for those who are instructing us. This flyer is intended to provide useful information on such matters for those instructing us; it also sets out this Firm's approach, and the rationale for our approach.

Background

Why does an individual's health status matter?

A pension is an entitlement to a *per annum* income for the rest of one's life, and it follows that the value of any such pension depends upon the recipient's future life expectancy. At a simple level, the value of a pension is *"amount × years over which it will be paid"*, and it follows that if an individual's health gives rise to his/her having a reduced life expectancy, the value of such pension rights may be said to be reduced.

To this end, ill health *can* affect our calculations because the vast majority of these require us to convert pension capital into an income stream—usually at retirement—with this income stream then being sustained for life.

How in general do we allow for life expectancy?

For the calculations in our reports, we need to make an assumption as to the future life expectancy of each individual. Standard annuity rates reflect life expectancy based on historic mortality data, with projections made to allow for future expected improvements in longevity.

However, if an individual has a medical condition which means that his/her life expectancy may be less than "standard", an insurer (i.e. the annuity provider) may provide a bespoke medically-underwritten annuity rate. This rate will reflect the probability that the capital will be required to produce an income for a shorter period than usual and thus it will convert the capital into income on more generous terms. These are often referred to as *Medically Underwritten* or *Impaired Life* annuities.

But what if no annuities are to be purchased?

What is set out above relates primarily where defined contribution (or money purchase) pensions are held i.e. where each individual has a "pot" in his/her own name, and is then assumed—for the purpose of our calculations—to purchase an annuity at retirement.

However, in many cases the parties may instead hold defined benefit (or final salary) pensions. We still may need to make reference to annuity rates when dealing with these defined benefit pensions, at least where we are asked to take account of pension capital values.

In particular, it is noted that the Cash Equivalent Values (CEVs) of such defined benefit pensions are not comparable between different schemes, nor do they typically reflect the fair value of the promised pension benefits. To this end, we calculate "Open Market Values" of such pensions, and determine these with reference to the defined contribution funds required to replicate the benefit promise via annuity purchase in the open market i.e. what would be needed in defined contribution funds today, were we to seek to match the defined benefit pension promise at retirement.

Therefore, we still need to rely upon annuity rates even when dealing with such defined benefit pensions to allow us to value these rights in a consistent form. It follows once again that such defined benefit pension promises are less valuable where the holder of these is in ill-health and has a reduced life expectancy.

Other matters pertaining to the status of the parties' health and the terms upon which they may take any defined benefit pensions are discussed later.

Annuity rates

A simple worked example

In very simple terms—and alas pensions are never this simple—if an individual has £100,000 of pension capital at the point of annuity purchase:

- If the standard mortality assumption is that he will live for 25 years, he may then receive c. **£4,000 pa** of annuity.
- If the individual is assessed as having a life expectancy of only 20 years, he may be able to obtain a medically underwritten annuity of c. **£5,000 pa**.

It therefore follows that—in a case where equality of income is required—if the potential recipient of a Pension Sharing Order (PSO) can obtain a medically underwritten annuity, then that individual will require a smaller such PSO than if he/she could only obtain standard terms.

The converse is also true: if the pre-divorce holder of the pension funds could obtain a medically-underwritten annuity, then that person may have to concede a larger PSO to the ex-spouse than if standard annuity rates were used.

Indeed, we see much confusion on this point, based on its being wrongly assumed that asserting that an individual is in poor health will help him/her obtain a better pension settlement than would otherwise be the case.

How are such medically underwritten annuity rates obtained?

To provide a medically underwritten annuity rate, the insurer requires the completion of a very detailed health questionnaire. This will seek information about the medical condition(s) such as:

- What medication is currently being taken;
- When did the individual last have medical treatment;
- When was the individual last admitted to hospital;
- How many occurrences in the last 5 years; and
- How long ago was the condition first diagnosed.

Other, more general, health information is also gathered e.g. height, weight, waist size, tobacco / alcohol use etc.

Why do we have misgivings about using such questionnaires?

The health questionnaires used by insurers are extremely detailed, and often require the potential annuitant to disclose all sorts of detail as discussed above. The person handling the questionnaire then need input this complex data to an online form, often using drop-down menus, and if incorrect data are input, unsafe outcomes in terms of estimated annuity rates might well be obtained.

We simply do not have the expertise to deal with these questionnaires. In particular, details of medications taken may be provided that do not correspond to the options provided by the online form: the individual might use the trade name of a medicine taken, while the system may rely upon generic names. Only one with some medical or pharmaceutical knowledge will be able to comment upon how one such name maps across to the other.

What about retirement in the future?

While it may be possible to gather such information for an individual who is seeking to retire and buy an annuity immediately, **it is impossible to answer these questions if retirement is assumed to be at some future date**.

The questionnaire that a potential annuitant is asked to complete is designed to enable an insurer to provide a quotation for *immediate retirement*, and *not* some hypothetical retirement in say two, five or ten years' time.

Thus even if the issues discussed above in respect of the interpretation of the questionnaires could be overcome, it remains the case that any such information gathered will tell us nothing about the terms upon which one might purchase an annuity some years hence in the future.

Our stance with reference to health questionnaires

Therefore, it is this Firm's policy that we will not obtain medically underwritten quotations from annuity providers, neither for **immediate retirement** (based on our lack of expertise) nor for **retirement in the future** (based on any such rates being highly spurious).

Our proposed approach

How can we allow for ill health upon immediate retirement?

If we are to assume immediate retirement for the party in ill health, we will accept a medically underwritten annuity quotation *obtained by the party's own financial adviser*. We will include a statement that this has been provided by a third party, and that we are not able to challenge or audit what has been provided. If a financial adviser is to provide an immediate medically underwritten annuity quotation, it should be on a single-life basis, with no guarantee period, payable monthly in advance, on both i) a non-escalating basis, and ii) a fixed 2.50% pa escalating basis.

Alternatively, if the party with poor health has correspondence from his/her GP / Consultant / other medical professional which proffers an opinion as to the impact of such conditions on life expectancy, we will be content to reply upon such data.

What about retirement in the future?

If retirement is in the future, we will provide calculations using standard assumptions, but then provide some sensitivity analysis around this, so that the parties can form their own opinion as to whether the issue of ill health is potentially a material issue, requiring further consideration. We can also use this "sensitivities approach" for assumed immediate retirement if required.

In our experience, however, we often find that **such issues of ill health have no material impact on our calculations**.

What about defined benefit pensions?

It should also be noted that if the party in ill health will only hold defined benefit pensions after pension sharing, then it is very likely that health issues are not relevant.

Some defined benefit schemes will offer early retirement without actuarial reduction where the member is in ill-health, but this will not typically extend to an ex-spouse member. In general, it is not appropriate for us to investigate the terms upon which such ill-health early retirement might be offered.

Conclusions

It is hoped that this flyer helps both divorcing parties and their instructing solicitors understand the issues that arise where health conditions are to be considered in pension on divorce calculations. Moreover, we seek to make clear that slavish adherence to calculations that are based on possibly spurious predictions of medical conditions that might exist if retirement is in the future can be both dangerous and misleading.

If we are to take into account medical conditions for assumed immediate retirement, we will require either the help of the party's own financial adviser, or the input of a medical professional on the possible impact on life expectancy.

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