

# **The Devil is in the Detail: Calculating Pension Loss**

*Andrew Post*

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# **The devil is in the detail: calculating pension loss**

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We all work not just to pay our mortgage and our bills but also to build up a surplus for retirement. An injury that affects our ability to earn will therefore lead not just to reduced earnings but also to a reduced pension. We all know that a Claimant is therefore entitled to claim damages not merely in respect of the earnings he or she will lose over the rest of a working life, but also for the reduction in pension that will follow. The measure of the damages will be the difference between the pension that would have been received and the pension that will now be received, less adjustment for accelerated receipt.

The difficulty is not with this principle, which is uncontroversial, but with the practice; this talk will attempt to offer some guidance as to the way in which a pension loss should be valued.

## **Types of Pension**

The first question is what sort of pension the Claimant has or would have had:

- Final salary (also known as defined benefit)
- Money purchase (also known as defined contribution)
- State pension

## Final Salary Pensions

### The Basic Scheme

Final salary schemes remain common in the public sector, but they are rapidly disappearing from the private sector. The pension an employee receives is based on the final year's salary (or less often the average of final three years' salary) multiplied by a factor dependent on the number of years service. A typical formula would be

$$\text{Pension} = \text{Final salary} \times \frac{\text{years of service}}{60}$$

Thus an employee who worked for an employer for 20 years and retired with a salary of £30,000 would receive a pension of £30,000 x 20/60 = £10,000.

It is easy to see from that formula that if either the final salary or the years of service are reduced, the annual pension will be reduced. The reduction is the multiplicand. The total pension loss for life from the appropriate retirement age can then be simply calculated using the appropriate Ogden table; thus if the Claimant is a man who would have retired at 65, use Ogden Table 15. If the Claimant is 50 at the time of trial or settlement the multiplier, taking account of life expectancy and accelerated receipt is 6.70.

An alternative to the multiplier/multiplicand approach is to obtain a quotation from a pension company for an annuity in the sum of the shortfall commencing at the Claimant's retirement age. The price of the annuity would then be a measure of the loss.

### Complication 1: early retirement

What, however, of the situation where the injury does not merely reduce the earnings or the length of service with a particular employer, but causes the Claimant to take early

retirement on medical grounds? How do you take account of the pension he will receive in the years up to his normal retirement age?

The answer is that you do not take any account of those early retirement pension payments. The House of Lords in Longden v British Coal [1997] 3 WLR 1336 rejected an attempt to argue for deduction of early retirement pension payments. These payments are treated like insurance monies and no deduction is therefore made. Note that this applies whatever the early retirement pension payments are called.

### Complication 2: commutation

Most people take a large part of their pension in the form of a tax free lump sum; this reduces the annual pension that would otherwise be payable. Just as the annual pension will be reduced by reduced earnings or a shortened working life, the same applies to the lump sum. If the Claimant retires at the normal retirement age but receives a reduced lump sum, the recoverable loss is the reduction in the level of lump sum. Note however that for the lump sum, specific allowance has to be made for accelerated receipt by discounting by 2.5% per annum.

If, however, the Claimant retires before his normal retirement age, the position is more complicated. The Court of Appeal in Longden also decided that since a commuted lump sum paid to an employee who has taken early retirement relates to the whole period of the pension entitlement, credit need only be given for part of that lump sum, namely the part referable to the period after normal retirement age.

Thus the Longden calculation involves calculating, using the Ogden tables, to establish the multipliers for the period of early retirement and for the period of receipt of pension. If the multiplier for the period of early retirement is 6 and the multiplier for the full life from the date of early retirement is 18, then one third of the lump sum is referable to the early retirement pension and no credit is therefore to be given for one third of the commuted lump sum.

### Complication 3: spouses

Many pension schemes provide for a surviving spouse to continue to receive part of the pension (often 50%) after the death of the pensioner. If a claim is made on this basis it is essential to obtain disclosure of the policy in order to establish the spouse's entitlement. If the spouse is entitled then the claim will be increased accordingly: in the case of a spouse entitled to 50% of the pension, by 50% of the loss x the additional multiplier referable to the spouse's longer life expectancy, duly reduced for accelerated receipt.

### Complication 4: employment contingencies

All the calculations set out above assume that if not for this medical accident the Claimant would have worked through to his normal retirement age. But many employees do not work to age 65: they may be made redundant, they may take early retirement to move to Spain, they may suffer some independent injury or contract some disease that prevents them working to retirement. The Ogden tables make allowance for mortality. They make no allowance for deduction for other contingencies.

These contingencies can be reflected in one or both of the following ways:

- Contend that the Claimant would in any event have retired at, say 60 rather than 65; this will reduce the loss of earnings claim and may also reduce the loss of pension claim (although this will not necessarily be so - you must check the terms of the particular policy).
- The award should be reduced to reflect the level of risk that the employee would not have worked through to 65. The appropriate discount will depend on the age of the Claimant, the nature of the employment and his or her state of health.

### Complication 5: pension fund contingencies

It is known that many occupational pension funds have been in deficit at times over recent years. The Mirror pensioners have ended up penniless; the same may happen to the Rover pensioners. On the other side of the coin, directors whose company is in financial trouble may consider altering the terms of the pension scheme as a convenient way to increase the assets and/or reduce the liabilities.

All this means that workers now face two further contingencies that might, arguably be taken into account in appropriate cases:

- There is a risk that the pension fund will prove insolvent (although note that there is now a limited government guarantee fund for these unfortunates)
- There is a risk that the fund will be converted from a final salary to a less lucrative money purchase scheme.

This argument is not going to be immediately attractive to a court, and the appropriate test case would have to be carefully chosen, but it may be worth considering if faced by a huge claim for a loss from the loss of a final salary pension that the Claimant had been due to receive many years into the future.

## **Money purchase schemes**

### The basic scheme

Under a money purchase scheme the pensioner has no guaranteed level of pension. He invests in a scheme, and usually his employer also invests. The money invested goes to purchase investments which create a fund from which an annuity must be purchased on retirement. The employee receives tax relief on contributions and the pension fund receives favourable tax treatment. The theory is that the wise investment policies of the fund managers will produce returns in excess of inflation and therefore create a large pension pot. The reality is often that large charges and patchy stock market performance mean that the pensioner would have been better off keeping the money in a Building Society.

### The valid basis of a claim

You will often have seen very substantial claims for loss of a money purchase pension in Schedules. These will, most likely, have been based on the projections produced by pension companies. These are, whatever the pensions industry may say, essentially marketing documents. They represent the triumph of hope over experience and blithely continue to claim that pensions funds will achieve average returns of 7.5% net per annum, notwithstanding the clear evidence of the last 10 years that they will not achieve anything of the sort.

Happily, we can largely ignore claims on this basis. These schemes are money purchase schemes: if the employee has put in less money than he would have done over the last five years, then he can be put back into the position he would have been in by the simple expedient of putting in the money now. Thus if an employee earns £20,000 per annum and pays into the fund 10% of his salary and the employer matches that sum, then at the end of 5 years unemployment the pension fund will have received contributions of £20,000 less than it should.

Schedules will sometimes seek to argue that a £20,000 shortfall now means that the Claimant will suffer a loss of several thousand pounds per annum throughout retirement (because the £20,000 would have grown at 7.5% per annum for ever). This argument is fallacious: he has lost £20,000. He should receive damages of £20,000, and he will then be able to invest that sum in the fund and thus be put into the same position as he would have been in.

Indeed the loss may be even smaller than that. The employee was paying £2,000 per annum out of his salary into the pension. If that figure was not deducted from the loss of earnings claim, then it should be ignored - the Claimant cannot recover twice for that £2,000 per annum - it cannot be both part of his loss of earnings and part of his pension

loss. If he has claimed his loss of earnings in full, then the loss to the fund is just the employer's £2,000 per annum.

#### Complication 1: tax relief

The employee would, however, have lost the benefit of the tax relief he would have received on those pension contributions. Thus on the basis of the £2,000 contribution, the employee would be able in principle to claim the tax overpaid at 22%. The annual additional loss would be  $£2,000 \times 22\% = £440$ , producing £2,200 over the five years.

That may not, however, be the accurate statement of the loss. Just as the employee would have received tax relief on the contributions he made over the last five years, he will now receive some tax relief on the contributions he is going to make in order to make up the shortfall. The level of relief will depend on his earnings, but even if he is unemployed he is still able to get tax relief on contributions of £3,600 per annum.

Thus in the case of our example of a shortfall of £10,000, then if the Claimant is unemployed, he will get tax relief on the first £3,600 and lose the tax relief on £6,400. His loss will be just £1,408, not £2,200.

#### Complication 2: growth to the date of trial

It may be argued that this approach fails to take account of the growth that would have occurred over the previous 5 years, and once again large figures may be brandished based on the fictitious 7.5% growth rates.

The actual growth rate is easily established. The Claimant was presumably paying into this fund up to the accident. He may have accrued, let us say, £35,000 in the fund by 2000 when he ceased work owing to the surgery. His annual pension statements should record

the actual growth achieved on that money over the period. It will not be 7.5% per annum. It may indeed be negative, meaning that the damages for loss of pension can be reduced.

If it is positive, then if the overall growth rate was, say, 20% over five year, then the damages need to be increased to take account of that lost growth. As the payments were made over the five year period, we can halve the rate, and therefore apply a 10% factor to reflect the loss of that growth.

#### A sample calculation of past loss allowing for the complications

If we take the same employee contributing £2,000 per annum, and assume that he has claimed his net earnings in full, the claim for loss of pension will therefore be:

Employer's contributions:	
£2,000 x 5	£10,000
Reduced tax relief on employee's contributions	
£6,400 x 22%	£1,408
Lost growth on both contributions	
£20,000 x 10%	£2,000
	—————
	£13,408

#### Future pension contributions

For the future, the loss simply consists of the employer's contributions plus the tax relief lost. Note, however that the Claimant will have to give credit for the tax relief he will receive on the contributions he now makes out of his damages.

Thus the annual loss is  $£2,000 + (22\% \times £2,000) = £2,440$ .

The Claimant will however, assuming he is not working, be entitled to tax relief on the first £3,600 of the £4,000 per annum he will be paying into the pension fund. (If he is working he will probably be entitled to tax relief on the whole sum).

$£3,600 \times 22\% = £792.$

The ongoing claim for pension contributions is therefore  $£2,440 - £792 = £1,648.$

The award of damages will then consist of that contribution for the rest of the Claimant's working life, and no award in respect of the period after retirement.

### **State Pensions**

If the Claimant was merely going to receive a state pension he is unlikely to have suffered any loss unless the pension was within the State Earnings Related Pension Scheme. In that event the Claimant will need to disclose details of the expected and actual pension; the calculations are broadly similar to those for a final salary scheme.

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