HYMANS ROBERTSON

briefing note

Public Sector Exit Payment Cap Proposed

August 2015

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Unintended consequences?

Her Majesty's Treasury (HMT) has published proposals for the introduction of a £95,000 limit on the total value of payments made in connection with the termination of a public sector worker's employment[1]. The proposed cap would cover a broad range of circumstances, including both voluntary and compulsory termination of employment, and affect most of the possible components of severance packages, including the cost of providing enhanced (unreduced) early retirement benefits.

It is this last item, and its application in the LGPS in particular, which has the potential to lead to a number of unintended consequences:

1. The cap will hit many who are not high earners.
2. This may result in sub-optimal Council reorganisations.
3. LGPS Regulations will need to be changed, but how?
4. What is the early retirement "cost" for this purpose?
5. Things get potentially messy when considering contractors.

Affected LGPS employers (mainly Councils, ALMOs, academies, contractors) may wish to consider responding to the consultation within the short (**27 August 2015**) deadline.

> "Some of the Government's thoughts on this may be at a preliminary stage."

Consultation Proposal

What is being proposed?

The Government proposes to cap the total value of exit payments to employees in the public sector at £95,000, before tax. There are no timescales given, but with the short consultation period it seems that this may apply from April 2016.

What benefits does this cover?

As well as cash sums such as redundancy payments that are paid to the employee, it would take account of the additional cost to the employer of early payment of retirement benefits. It would not apply to compensation for wrongful or unfair dismissal or for death or injury in the course of employment, or to benefits paid on ill-health early retirement or in circumstances of serious ill health.

[1] *Consultation on a Public Sector Exit Payment Cap* <www.gov.uk/government/consultations/consultation-on-a-public-sector-exit-payment-cap/consultation-on-a-public-sector-exit-payment-cap>.

In pension terms this would cover all public service schemes, including NHS, Teachers and Civil Service. However, for the purpose of this note we focus on the Local Government Pension Scheme (LGPS). It is worth noting that current practice varies across the public service schemes for early retirements such as on redundancy, e.g. in many cases in the unfunded schemes part or all of the early retirement strain is met from the member's own (non-statutory) redundancy payment.

Which employers would this apply to?

The intention is to apply the cap to central and local government bodies under the control of the UK government, and most non-financial public corporations, as well as Ministers and their Special Advisers. In LGPS terms this means it will apply to Councils, "arms-length" Council operations (ALMOs), academy schools in England, fire & rescue authorities, and possibly contractors (but see below).

It would not appear to apply to other types of body, e.g. colleges, universities, charities, community admission bodies, unless they are deemed to be under Westminster control. The Scottish and Welsh governments and the Northern Ireland Executive will have to decide whether to apply similar measures. However, bear in mind that there could be employers under Westminster control which are in the LGPS outside England, and which therefore would be affected by these proposals.

Would it be mandatory?

The bodies affected would be required to maintain records and publish details of exit payments, annually. The cap could be waived 'in exceptional circumstances' with the consent of the relevant Government Minister, Full Council in local authority cases, or a meeting of members if a fire and rescue authority is involved. Authorities would have to publicise their policies on waivers, and disclose any that are made in their annual Statements of Accounts.

However, the government has a 'strong expectation' that bodies proposed to be outside the scope of the cap on exit payments will set out their own exit cap mechanisms, equivalent to the arrangements proposed here and introduced no later. It is not clear how far this 'expectation' extends.

Unintended consequence 1 – Who would be affected?

This policy was trailed in the Conservative Party's election manifesto earlier this year, with the implication that the cap would prevent unduly generous severance packages for the best paid public sector workers. However, given the current LGPS early retirement terms, the size of the early retirement cost will depend not only the member's pensionable pay, but also the number of years early they retire, and their length of service in the LGPS.

For instance, suppose we allow for an element of redundancy payment leaving say £80,000 for early retirement strain cost (on typical Hymans Robertson factors). In very broad terms the cap may start to apply for members retiring 5 years early:

- On £180,000 pay and 10 years' service, or
- £90,000 pay and 20 years' service, or
- £45,000 pay and 40 years' service.

For individuals retiring 10 years early, the cap would start to apply at levels of pay and service of broadly half the above (e.g. someone on £45,000 pay and 20 years' service, or £20-25,000 pay with 40 years' service).

All the above figures are purely to give an indication of the order of magnitude. The exact impact will vary significantly depending on individual circumstances, and can vary materially because of:

- the period of service for that member: different tranches of benefit have different pension ages, a higher pension age will give a higher strain cost, and hence a higher likelihood that the cap is breached;
- the impact of the "Rule of 85" and other protections for that member's accrued benefits etc: this will affect the normal pension age and thus the strain cost;
- the basis underlying the actuarial factors (see unintended consequence 4 below).

Please let us know if you would like some analysis carried out on your own Fund membership or sample members.

Unintended consequence: Many members who would not be classed as particularly high earners will be caught by a £95,000 cap. A possible solution would be to apply the cap only to those on earnings above a certain level, or to apply a two-tier cap (one for the non-pension element and another including the early retirement strain cost).

Unintended consequence 2 – Council staff changes

Following from the above, the cap could affect the early retirement prospects for many Council staff, particularly the higher paid and/or longer-serving. This would be counterproductive as it could exclude certain staff from early retirement who might otherwise have been part of a headcount reduction exercise.

Unintended consequence: Strategic re-structuring exercises may be hampered by forcing Councils to keep on their higher-paid staff (instead of allowing them to retire and bringing in lower-cost replacements) and longest-serving staff (who might be most inclined to leave).

Unintended consequence 3 – Early retirement terms under LGPS Regulations

By contrast with other public sector pension schemes, the LGPS **entitles** its members to immediate, unreduced early retirement pensions in various circumstances[2]. The Government acknowledges this difference, but says that it nevertheless intends that the cap would apply to the LGPS (in England, at least).

The consultation appears a little contradictory in that it refers to the fact that "employees would retain the option to take early retirement on unreduced pension, where this is available" but then goes on to declare that "the total employer cost of buying out the reduction in pension and the lump sum redundancy payment should not when taken together exceed the value of the cap". It is unclear how both these objectives can be reconciled.

To allow the cap to apply it is likely that the member will have to bear as much of the additional cost (in the form of reduced benefits) as is necessary to bring the total exit payment within £95,000.

This will mean the LGPS Regulations need to be changed to allow this cap to apply in practice in any meaningful way. But what would they be changed to? Any revised system would need to confirm the way in which members and/or employers determine the interplay between redundancy and retirement benefits, in order to meet the cap where relevant. They could either have the capping interplay prescribed in complex administration regulations, or else leave administering authorities to deal with the complex options.

[2] If they are dismissed by reason of redundancy or business efficiency—or leave by mutual consent on grounds of business efficiency—having attained the age of 55. Different terms may apply in Scotland and Northern Ireland.

And if they were to remove the grandfathered retirement rights, or the requirement to unreduced redundancy benefits altogether, one can imagine the Unions' reaction especially given previous government assurances that there will be no further changes for 25 years.

Unintended consequence: The LGPS Regulations will need to be amended for the proposals to work, but whatever these changes are they will bring difficulties of one sort or another.

Unintended consequence 4 – What is the "cost"?

The consultation refers to the early retirement strain cost as "the financial contribution to the employee's pension", which prompts two questions:

(i) Can the government confirm that the "cost" relates to a physical cash sum (see below) or a notional amount set on a standardised basis which may therefore differ from what the employer actually contributes to the fund?

(ii) If the cost varies from one fund to the next, due to different factors being used, this raises the prospect of two members in identical circumstances in separate LGPS funds, where one is caught by the cap and one isn't. The different factors could be due to different actuarial advice, or to the factors having been set at different times in the past.

The "obvious" answer is to standardise the strain cost factors across all funds, and indeed across the all public service pension schemes. But then each fund has potentially two sets of factors.

Unintended consequences:

- If standardised factors are not introduced, there is scope for discrepancies between funds; there is also the discrepancy between treatment of early retirements in the unfunded schemes and the LGPS – it will be crucial to ensure similar treatment, and that LGPS members are not in a worse position than their NHS/civil servant/teacher counterparts.
- Standardised factors bring their own issues however: does the fund run with two sets of factors (one for exit cost purposes and one for cash contribution purposes) with the added administrative complications that brings? Or does the fund use the standardised factors even where these may not be appropriate for the fund?

Unintended consequence 5 – Contractors

The consultation document (Question 9) asks for respondents' thoughts on whether and how the Government could attempt to achieve consistency when public sector employees are transferred to or from the private sector with terms of employment that are carried across under TUPE legislation[3].

There are a couple of areas of uncertainty which are likely to be of interest to contractors:

- Will the changes apply automatically to the employees of admission bodies (or employers that participate in the other public sector schemes under the 'New Fair Deal'), either under new contracts or under existing contracts that use either of these approaches, or will each contractor have to consult with its staff on the changes?
- How will the Government ensure the cap can apply to staff with legacy redundancy rights? If so, will this require private sector employers to introduce equivalent cost caps where staff transferred to the private sector before the recent reforms?

[3] The *Transfer of Undertakings (Protection of Employment) Regulations 2006* (SI 2006 No. 246).

European case law suggests that it would not be easy for the Government to tamper with any enhanced early retirement terms enjoyed by employees who have transferred in circumstances covered by TUPE.

Unintended consequence: If the Government were to introduce the cap, and also found a way for previous TUPE-protected rights also to fall within scope of the cap, this would affect contractor companies in the private sector, not just the public sector.

Next Steps

Responses to the consultation proposals should be submitted by **27 August 2015**. The changes will be implemented through clauses in an Enterprise Bill, in the 2015/16 parliamentary session.

A future consultation exercise will propose further changes to the calculation of compensation and employer-funded early retirement in redundancy cases.

Summary

The level of detail given and the questions asked suggest that some of the Government's thoughts on this proposal—particularly those related to early retirement costs—are at a preliminary stage.

The principles are rooted in a political manifesto pledge – on which we do not comment either way – but their implementation in practice is more complex. For example, staff who would not normally be considered "high earners" could trigger the cap by being made redundant, and this may have knock-on effects on how a Council implements broader cost reduction strategies.

Furthermore, it should be appreciated that the costs of unreduced early retirement pensions **alone** could exceed £95,000 in some cases:

- The Government says that employees would still retain an option to retire early on unreduced pension, but does not specify what that means for LGPS Regulations;
- The consultation does not indicate an appreciation by Government that "funding" is different from "cost": questions therefore arise on how the figure is calculated for this cap's purpose.

Finally, it is not clear how the new policy would apply to the employees of admission bodies or employers that participate in the other public sector schemes under the 'New Fair Deal'. European case law suggests that it would not be easy for the Government to tamper with any enhanced early retirement terms enjoyed by employees who have transferred in circumstances covered by TUPE.