Briefing Note – The "£95k Cap" and reform of local government exit payments

The Authority's Chair has asked that members be provided with a briefing note on the proposals by the Government to implement the so-called "£95k Cap" on public sector exit payments and the wider reform of local government exit terms.

The Cap was legislated for some years ago but the lack of capacity and legislative time due to Brexit has meant that implementation has been delayed.

Back in 2016 the Government also indicated it would be looking to review public sector exit payments more widely to provide greater consistency between schemes and to strike a balance between fairness to the individual and to the taxpayer. The Government has finally come forward with these proposals (which will apply more widely across the whole public sector) and further details on these are set out later in this briefing.

Conceptually the Cap itself is simple – no public servant should receive an exit payment of greater than £95k. The intention was to avoid "rewards for failure" by highly paid "fat cats" who then proceeded to secure further employment elsewhere in the public sector.

However, difficulties arise when the scope of what to include in the cost of an exit package is defined. Some elements such as a redundancy payment, any pay in lieu of notice, or other forms of compensation for loss of office are uncontroversial. The difficulty comes when the interaction between an employee exit and the Local Government Pension Scheme comes into play.

The LGPS rules currently require any member aged 55 or over being made redundant to take their unreduced benefits at the point of departure. In these circumstances the employer is required to make a payment (a strain payment) to compensate the Pension Fund for the contributions lost by paying unreduced benefits early. Depending on salary, length of service and age these payments can amount to several hundred thousand pounds. These payments are made to the Fund and not the individual.

LGPS stakeholders strongly expressed the view that strain payments should be excluded from the cap as they resulted in individuals being drawn into the cap who were far from the groups targeted in the initial proposals. For example a long serving social worker or environmental health officer could conceivably be caught. The point was also made that there is no provision to review the cap to take account of inflation, for example the cap would be well over £100k now if adjusted for inflation since it was first legislated for.

The Government in applying these rules for England is proposing following consultation to include strain payments within the definition of an exit payment. There was significant opposition to this during earlier consultation exercises but the position has not changed. The position in other parts of the UK will be slightly different depending on how the devolution settlement operates in each nation.

Following the Treasury's publication of their overarching proposals before the summer MHCLG have now published proposals about how these arrangements will work in local government.

Summary of the Proposals

The consultation sets out the following as the proposed approach for public sector employers within the LGPS (note not all LGPS employers are defined as being within the public sector the most obvious examples who are not being contractors and charities, though there is currently a lack of clarity on exactly which bodies will be affected):

- A general reform of redundancy payments, to involve a maximum of three weeks' pay per year of service, an overall ceiling of 15 months' pay and a maximum salary of £80,000 p.a. which can be used in the calculation.
- As widely publicised, an overall cap on the total value of the exit package of £95,000, including any pension strain cost.
- A waiver process to allow for relaxation of the £95,000 cap in exceptional circumstances. For English councils it seems that this will need ratification of the full council and approval of the MHCLG and in some cases potentially the Treasury.
- Strain costs (and the related pension enhancements) will in all cases be reduced by the value of any statutory redundancy payment, which the employee will receive in cash
- The making of discretionary redundancy payments over and above the statutory redundancy payment will not be allowed in cases where a strain cost is paid (there is an exception to this if the discretionary redundancy payment would be more than the strain cost, in which case the excess is paid to the member as cash).
- A worker can make good from their own resources any reduction in the strain cost arising from the new restrictions.
- A worker can also choose to forgo the entitlement to an unreduced pension and receive the full discretionary exit payment available under the employer's redundancy arrangements

The above will apply to different employers in different ways. In particular:

- The reform of redundancy payments will apply to local authority employers in England and Wales.
- The £95,000 cap will apply to those employers which are the responsibility of the UK government and designated as "public sector" (the Scottish government, Welsh government and Northern Ireland Executive have some flexibility to determine policy for devolved employers).

Practical Effects

Whist the restrictions for workers breaching the £95K cap have been well-publicised, as mentioned above there is a more wide-ranging effect which applies to all redundancies over age 55. For example, consider a member (age 56 say) with a Statutory Redundancy Payment of £5,000, a Discretionary Redundancy Payment of £10,000 and a total potential strain cost of £35,000, and ignore for the time being any effect of the change in redundancy terms. Currently such a member would have an exit package worth £50,000 including the strain cost. Following the proposed changes the member would have the following options:

- The member takes his Statutory Redundancy Payment of £5,000 in cash, leaving a strain cost of £30,000 (the £5,000 Statutory Redundancy Payment is netted off against the potential strain cost of £35,000). Total value of exit package: £35,000.

- The member opts to have his Statutory Redundancy Payment used to meet the reduction in the strain cost. Strain cost is then £35,000. Total value of exit package: £35,000.

- The member takes a Statutory Redundancy Payment of £5,000 plus Discretionary Redundancy Payment of £10,000. No pension enhancement, so the member takes either a reduced early retirement pension or deferred benefits payable from NPA. Total value of exit package: £15,000.

In line with the exit cap, one can see from the above example that the proposals can materially affect any member e.g. a 30%-70% reduction depending on the option taken. As most employers do offer severance over the Statutory Redundancy Payment this will be a substantial change.

Whilst the above would mean less of a cliff-edge in terms of the increase in redundancy provisions which currently happens at age 55, this is clearly being achieved by a reduction in the redundancy package for the over 55's. Whether there is a rush to the exit door before the changes come into effect remains to be seen.

Issues for Funds and Employers

The issues for funds and employers will be wide-ranging. They will affect governance arrangements, retirement processes, calculations, and communications with both employees and employers. We have included below a selection of the main areas which will need to be considered.

- Employers will need to be categorised into those affected by the £95,000 cap and those unaffected, and policies will need to be updated to ensure that severance packages are being dealt with in the correct manner.

- Processes and flows of information for carrying out retirement estimates and final quotations will need to be updated. Employers will need to provide details of statutory and discretionary redundancy payments to the funds in order to enable the retirement calculations to be performed so information can be provided to the member on the resultant costs and benefits.

- It will be some time before administration systems can be updated to accommodate the new arrangements. In the meantime, increased reliance may have to be placed on manual processes, which causes further stress on resources as well as the cost of setting up the relevant processes. This will need careful planning as it is quite possible that employers need to reduce workforces further as the impact of COVID-19 on the economy is felt.

- The number of options available to employees will increase substantially, which will all need to be carefully communicated. Employees are also much more likely to want to seek more detailed guidance/advice around their various retirement options, and in many cases there will be an inevitable tension between the attraction of the up-front redundancy cash and the longer-term pension enhancement (the latter likely to be the more valuable over time in most cases). The availability of suitable independent financial advice as part of the process will become increasingly important in order to protect the interests of scheme members, employers and the Fund.
- Some employers will inevitably struggle in implementing and administering the new arrangements from a payroll/HR point of view, and may look to funds for specialist assistance in this area.
- Some employers may seek advice on ways to mitigate the new arrangements, and may look to the fund for assistance in the first instance.
- Whilst the approach to calculating pension strain costs looks set to be standardised, and guidance is awaited guidance from GAD in this area, funds may need to consider whether the standardised approach is appropriate in every case (e.g. it may be possible to apply different costing factors for employers not affected by the £95,000 cap or with a weaker covenant).

The new arrangements are currently planned to come into effect on 1 January 2021 so careful thought is needed in terms of any quotes or illustrations for cases on or after this date.

Conclusion

Essentially this is an employer issue in terms of policy and individual decision making. However, the administrative impact will fall on the Authority and this will be another issue which further complicates the administration of an already extremely complex scheme.

George Graham

Director

September 2020.