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Lack of clarity with public sector exit pay cap law

For public sector employers who are scheme employers of the Local Government Pension Scheme (LGPS) the Exit Pay Regulations raise significant legal issues.

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Against a backdrop of: (1) historic significant, and in some cases unmanageable, financial pressure on the public sector to continue to provide their services; (2) the emerging impact of the Covid-19 pandemic; and (3) a Government reform agenda, the public sector will have to achieve significant efficiency savings.

The Restriction of Public Sector Exit Payments Regulations 2020 (the 'Exit Pay Regulations') came into force on 4 November 2020 with the objective to essentially restrict the financial pressure on the public sector (covered by these regulations) and to address the public perception that public sector employees received too generous exit payments.

The Exit Pay Regulations essentially does what it says in its full-title - the Regulations prevent certain public sector employers from making an 'exit payment' which exceeds the 'exit payment cap'. The exit payment cap is £95,000.

The type of payments caught by the Exit Pay Regulations are broad and cover almost every type of payment you could expect to see on the termination of employment whether statutory or contractual (including under the terms of a settlement agreement).

Under the Exit Pay Regulations, a public sector employer's obligation is clear for those employers who are not scheme employers of the LGPS. HM Treasury has issued useful guidance for these employers.

However, for public sector employers who are scheme employers of the Local Government Pension Scheme (LGPS) the Exit Pay Regulations raise significant legal issues.

Scheme employers of the LGPS

Pension strain is unique to the LGPS as it is funded by members' contributions, rather than the Government. Currently the strain cost for an early payment of pension is calculated by each LGPS fund and met by the employer. For example, under the LGPS, the public sector employer carries the pension strain costs where an employee is aged 55, or over, who qualifies for an unreduced pension where that employee is made redundant or retires due to business efficiency. In this situation their employer is responsible for the shortfall in the pension fund to cover the cost of the employee taking their pension early and receiving an unreduced pension.

So, against the backdrop, as outlined above, we expect to see the reorganisation of the public sector. Consequently, we expect to see job losses on the grounds of redundancy and business efficiency and public sector employers will be forecasting the employee exit costs.

As matters currently stand, the additional employee exit costs of reorganisation, for those employers who are scheme members of the LGPS, will be the pension strain cost. It is anticipated that this will be significant.

What is the issue?

The Exit Pay Regulations' 'exit cap' includes pension strain costs incurred by scheme employers of the LGPS, who are caught by the Exit Pay Regulations. The problem is that it is not currently clear what the legal obligations are of these employers and clarity is needed.

The reason for the lack of clarity is that separate regulations, designed to bring the LGPS in line with the Exit Pay Regulations, remain in draft form and consultation has been further delayed. There have been previous drafts of the current draft regulations. None of these drafts were enacted and each draft differed from earlier drafts. Therefore, it is unfortunate, but a fact, that we cannot say with any certainty that the current draft LGPS regulations will be enacted, in their current form, and if so, when.

The consequence?

The consequence of the delay on the consultation of the draft LGPS regulations leaves the affected public sector employers in the position of having pension scheme rules that are at odds with the Exit Pay Regulations.

Given that the exit payment cap has been set at £95,000 it is not surprising to learn from various commentators that relatively low earning employees, who are members of the LGPS, and whose employers are covered by the Exit Pay Regulations, may be caught by the cap because of the amount of the pension strain cost their employer will have to make on the termination of their employment by reason of redundancy or business efficiency. That leaves these affected public sector employers in an invidious position where an employee is entitled to an unreduced LGPS pension, but the Exit Pay Regulations prevent the pension strain payment to be made because the strain exceeds the cap of £95,000 and/or where a long-serving employee is entitled to statutory redundancy and contractual payments that 'eat up' the cap.

This raises legal issues about the conflict between the employee's contractual and pension rights. Does the employee in this situation take a statutory redundancy payment with an immediate actuarially reduced pension (calculated using the strain cost reduced by the amount of the statutory redundancy payment), and capped at £95,000, but no other contractual payments? Or a statutory redundancy and contractual payments up to £95,000 and a fully reduced early retirement pension or a deferred pension? We understand the Ministry of Housing, Communities & Local Government is consulting on allowing employees to receive a greater redundancy payment but forgo early access to their pension.

What can an employer do if it dismisses an employee and the Exit Pay Regulations are likely to be breached?

If the Exit Pay Regulations were breached, it would be possible for the employer to exercise its discretion to determine that the Exit Pay Regulations should be waived. The employer would need to make a business case to the Treasury in respect of the exercise of its discretion, and the Treasury would have to formally consent. The Treasury Guidance provides a proforma for exercising discretion to relax the cap in this type of situation.

What can an affected employer do if the draft LGPS regulations are implemented in their current form?

There are several matters to consider. For example, the draft LGPS regulations provide that compensation in excess of statutory redundancy pay can only be increased to an amount that the employee would have received (under the statutory regime had their pay been capped at £80,000) and any compensation payment must be reduced by the amount of the pension strain which the employer must pay to secure any unreduced early retirement pension.

As outlined above, there is a system under the Exit Pay Regulations where the employer may exercise a discretion (with the consent of the Treasury) to disapply the cap imposed by the Regulations. The draft LGPS regulations do not provide for a similar mechanism.

Is there an arrangement that would be legal and would not breach the draft LGPS regulations or any contractual terms?

What is clear is that the Exit Pay Regulations and the draft LGPS regulations do not void inconsistent pre-existing contractual terms. This means that contractual terms remain enforceable. We understand that the NHS has applied for judicial review in respect of this point and we will update this note when we are able.

If the draft LGPS regulations come into force the options available to an employer (covered by the Exit Pay Regulations) where they will breach the exit pay cap are limited and they should seek legal advice. One option, now, may be to delay the decision. By that we mean, delay any payments to the employee until it is clear how much the pension strain may be or delay the termination of employment until the draft LGPS regulations come into force.

Immediate next steps

It is for the LGPS administering authority, not the employer, to decide whether to pay an unreduced pension or a reduced pension. Therefore, the employer should contact their LGPS administering authority and obtain confirmation what it intends to do. With this information then seek legal advice on options.

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