SLAUGHTER AND MAY/

PENSIONS ESSENTIALS

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One Bunhill Row
London EC1Y 8YY
United Kingdom
T: +44 (0)20 7600 1200

REFUNDING SURPLUSES

The Government has announced that it intends to legislate to provide DB schemes with more flexibility around the use of surplus where both trustees and employers agree.

In July 2023, the previous government asked for evidence on whether allowing extraction of surplus in ongoing schemes (as opposed to those winding-up) might encourage more risk to be taken in DB investment strategies and what the risks of such a change might be. Despite mixed views from the industry, it went on to consult on proposals to make accessing surplus easier on the basis that it would facilitate investment in UK industry.

Until now, it had not been clear whether the current government would take these proposals forward and, if so, in what form. However, the Government has announced that it does intend to make changes which would allow surplus to be refunded to employers with trustee consent.

Under current legislation, a resolution had to be passed by existing schemes before 6 April 2016 to retain any power to distribute ongoing surplus. Where no resolution was passed, no refunds can be made in any circumstances. Even where a resolution was passed, the conditions around refunds have made them very difficult in practice. In particular, trustees must be satisfied that any refund is in the interests of members.

The Government has said that it "*will give businesses more flexibility, allowing trapped surplus funds to be invested into the wider UK economy, or given to scheme members as additional benefits*". In terms of how this could be done, it notes that: "*Legislative changes could enable all DB schemes to change their rules to permit surplus extraction where there is trustee-employer agreement. This allows trustees to assess the suite of options available in striking a deal with employers on how best scheme members can also benefit – linked to improving member outcomes.*"

So far, the Government has yet to publish any details of its proposals. This means that it is currently unclear which schemes will be in scope, what conditions will need to be met and how far member benefits will need to be protected. It seems likely that more detail will emerge over the next few months but in the meantime, what is clear is that any process will require the engagement of both trustees and employers so where this is a possible option for the future, parties will need to work together.

Practical points:

- *Watch out for final proposals.*
- *Consider if they might be relevant to your scheme.*

COVENANT GUIDANCE

For valuations from 22 September 2024, trustees will need to comply with new legislation that requires them to have a funding and investment strategy. Covenant assessment is required to form part of the funding strategy and the Pensions Regulator has issued updated guidance on its expectations.

For the first time regulations define employer "covenant". It is the financial ability of the employer to support the scheme together with any legally enforceable contingent assets. When assessing covenant, trustees are required to consider "*the cash flow, and expected future cash flow, of the employer*" as well as "*other matters which are likely to affect the employer's future ability to support the scheme including but not limited to the performance, future development and resilience of the employer's business, and the likelihood of an insolvency event occurring in relation to that employer*". The trustees will also need to consider how long they can be reasonably certain that they can rely on this assessment and how long they can be reasonably certain that the employer will be able to continue to support the scheme.

The level of risk that can be taken in relation to the calculation of liabilities along the scheme's journey plan is dependent on covenant strength and the new strategy statement which must be submitted after each valuation must contain the assessment of covenant and how long it is reasonable to rely on the assessment.

TPR's covenant guidance sets out its expectations in relation to this covenant assessment. The guidance is intended to help trustees "*review whether their existing covenant analysis is focused in the right areas and remains proportionate, especially if they have experienced a significant change in their scheme funding position in recent years*". In addition, it expects "*all trustees to read applicable sections… in full and make sure their members are protected*".

The guidance is broken down into 9 parts:

- **General:** The DB Funding Code says that TPR expects DB scheme trustees to "*assess covenant support at each valuation. However, the required depth, and frequency thereafter, of an assessment should be proportionate to the circumstances of the scheme and employer*." The guidance considers the factors to take into account when determining the frequency and detail of covenant assessments, including size of scheme, funding level, maturity and size of employer. It also considers when a professional covenant assessment is likely to be required.
- **Identifying the employers:** The covenant review should focus on entities with a legal obligation to support the scheme. Where there are multiple employers, the guidance considers whether trustees need to assess the covenant of each employer, some of them or carry out an aggregate assessment. As part of the decision-making process, trustees will need to determine whether the scheme is a last man standing scheme or has partial winding-up provisions which will require legal advice. In a last man standing scheme, it may be appropriate to focus on the employers with the largest liability share. Where a scheme has partial wind-up provisions, reviewing covenant on an aggregated basis may risk overstating it.
- **Assessing cashflow:** The covenant assessment should consider the employer's cash flow available to meet any deficit repair contributions and support any investment risk. Cashflow for these purposes is the free cash after taking account of reasonable operational and committed finance costs (e.g., utility costs, maintenance and staff costs), but before deficit repair contributions or other reasonable alternative uses of cash (e.g. investment in sustainable growth; covenant leakage such as dividends; and discretionary payments to other creditors). Trustees need to understand management's forecasting assumptions and be able to understand and challenge the forecasts.
- **Employer prospects:** Assessing the employer's prospects and insolvency risk will help trustees to understand the extent and duration of reliance that can be placed on covenant. The assessment should also highlight the risks of that support deteriorating. This involves looking at things like market outlook, market position, ESG issues and changing consumer demand. Where the employer has operational or financial links to the wider group, it may be necessary to extend the assessment of prospects beyond the employer. Trustees should also understand how an employer fits within its corporate group and how contagion from elsewhere in the group could affect it as well as the potential outcome for the scheme on insolvency.
- **Covenant reliability and longevity periods:** Trustees should assess the reliability period, which reflects how long they have reasonable certainty of the employer's cash flow to support the funding needs and investment risk of the scheme. The assessment of reliability should be proportionate. TPR expects that most employers will only have reliability in relation to cash flow for 3 to 6 years. They should also determine how long they expect the employer

to continue to support the scheme. For most employers, reasonable certainty over covenant longevity will not exceed 10 years.

- **Contingent assets**: To factor contingent asset support into the covenant assessment, trustees must reasonably expect a contingent asset to be legally enforceable and provide the specified level of support when required. Legal enforceability is determined by the terms of the relevant agreement and the applicable law.

  The guidance considers how trustees should assess various forms of contingent asset. It differentiates between "look through" and other guarantees. A "look through" guarantee has a number of specific characteristics including a mechanism for trustees to look through to the guarantor's cashflows when setting contributions and allows the trustees to assess the guarantor as if it was a statutory employer. If the conditions for a look through guarantee are not satisfied, the trustees will need to assess the level of risk that the guarantee can support.

- **Recovery plan:** Where a scheme is in deficit on a technical provisions basis, a recovery plan must be put in place to recover the deficit as soon as the employer "*can reasonably afford*". When determining reasonable affordability, trustees should consider the employer's available cash (cash flows and liquid assets) and the reasonableness of other alternative uses of cash (e.g. investment in sustainable growth, covenant leakage such as dividends and discretionary payments to other creditors). The guidance considers when using cash for these alternatives is likely to be reasonable. Covenant leakage and discretionary payments are less likely to be reasonable the closer the scheme is to reaching significant maturity and once a scheme has reached significant maturity, deficit repair contributions should generally be prioritised except in relation to investment in sustainable growth.

- **Supportable risk:** The funding and investment strategy should set out the scheme's journey plan towards not being reliant on employer covenant. Funding and notional investment risk should be "supportable" and take into account available covenant support and the maturity of the scheme. When assessing supportable risk, trustees should consider maximum affordable contributions over the reliability period and the guidance provides factors to consider when assessing this.

- **Monitoring:** Trustees are expected to monitor the covenant throughout the lifetime of a scheme. The frequency and depth of monitoring should be proportionate to the circumstances of the employer and the scheme, but TPR expects updates to be at least annual.

There is a lot in the covenant guidance and trustees should test existing processes against TPR's expectations and identify where additional information and assessment may be required. They should also consider the degree of reliance that can be put on any contingent assets and the extent to which they can support additional risk taking. The concept of a "look through" guarantee is a new one and both trustees and guarantors will want to assess existing guarantees to determine if they satisfy the criteria and whether trustees are able to assess the availability of guarantor funds when determining scheme contribution rates.

Practical points:

- *Assess existing covenant assessment processes against guidance.*
- *Take legal advice in relation to existing contingent assets.*

PPF LEVY

The PPF did not publish its final levy determination in December as usual on the basis that it was reviewing whether there was scope for further reduction in the overall amount of the levy. It has now confirmed that the total levy for 2025/26 will be reduced to £45 million (from £100 million last year) which will be the lowest levy it has ever collected. The final levy determination for 2025/26 has also been issued.

The PPF's latest annual report and accounts shows that in 2023/24 its reserves grew by over £1bn (although its total assets under management fell slightly from £32.2bn to £32.1bn). At the same time, the latest edition of the PPF's purple book which looks at the position of PPF eligible DB schemes shows that their net funding position improved from a surplus (on a PPF basis) of £206.9bn to £219.2bn and that the total number of PPF eligible schemes fell from 5,063 to 4,974.

This means that whilst the PPF is increasingly well funded, there is, for the moment, a falling demand for PPF compensation. In Autumn 2024 the PPF consulted on the 2025/26 levy and proposed to maintain it at £100m which it has previously said is the lowest level it can reduce it to whilst still being able to increase it as necessary to respond to future funding challenges. However, in December 2024, the PPF announced that it was delaying publication of its final levy determination for 2025/26 to allow more time to consider options for the future of the levy, including engagement with DWP.

The PPF has now confirmed that its levy estimate for the 2025/26 levy year has halved to £45m. This is a significant reduction on the £100m estimate initially proposed and is its lowest ever levy. The PPF says that 99.7 per cent of schemes are expected to see a reduction in their levy.

In addition, the PPF has included a new provision in its 2025/26 levy rules that would enable it to calculate a zero levy if appropriate changes that would give the PPF greater flexibility in setting the levy are brought forward, and sufficiently progressed, in the course of 2025/26. The necessary changes refer to legislation that restricts annual increases in the levy to 25% of the previous year's levy. This was intended to protect levy payers from sharp increases, but it clearly restricts the way that the PPF could react to future developments if it reduced the levy significantly or to zero. It seems clear the Government has indicated that changes may be made to this cap in the up-coming Pension Schemes Bill.

Deadlines for submitting the documents required as part of the 2025/26 levy process are set out on the PPF's website.

Practical points:

- *Be aware that levy amounts are likely to reduce for 2025/26.*
- *Note submission deadlines as they are inflexible.*

IDENTITY VERIFICATION FOR TRUSTEE DIRECTORS

The Economic Crime and Corporate Transparency Act 2023 includes a number of measures to improve corporate transparency which will apply to sponsors and corporate trustees. These include new requirements to verify the identity of all directors and "People with Significant Control" in both new and existing companies. Regulations have now been issued setting out more detail in relation to these requirements.

As we reported in our November 2023 edition, the Economic Crime and Corporate Transparency Act 2023 contains a number of provisions which are designed to stop the use of complex corporate structures to conceal economic crime and to improve corporate transparency. Once in force, this will include a requirement for all new and existing company directors and individuals who are "persons with significant control" to verify their identity. If this requirement is breached, both the individual and the company will have committed an offence. Identify verification can be carried out either directly by the registrar of companies, or an authorised corporate service provider.

More details of identity verification are set out in new regulations which set out the procedure that must be followed for identity verification. An application will need to contain an individual's name and date of birth as well as additional information required in rules to be issued by the registrar. These rules have been issued in draft and envisage that individuals needing to register will provide documentation such as either a UK passport or driving licence - although alternatives are specified where an individual does not have such documentation. Once the registrar has verified an individual's identity, they will be issued with a unique identifier.

The key provisions of the regulations are not yet in force but the Government has said that from 25 March 2025, individuals can voluntarily verify their identity and that there will be a range of support and services to help them.

This process will apply to directors of pension scheme trustee companies and "persons with significant control" ("**PSCs**"). Details of who the PSCs are for a company will have been set out in the annual confirmation statement filed at Companies' House. However, if you are unclear about who PSCs are, there is detailed Government guidance which can help.

As there are potential criminal sanctions for non-compliance with required deadlines, companies, individual directors and PSCs need to keep an eye out for final deadlines or consider voluntary identification verification from March 2025.

Practical points:

- *Watch out for deadlines and consider early voluntary verification.*
- *Ensure that someone is responsible for compliance.*

AUTOMATIC ENROLMENT

Each year the Government is required to review the thresholds for auto-enrolment and it has confirmed that they will remain unchanged for the 2025/26 year. The previous Government introduced legislation which would allow for age and income thresholds in relation to contributions to be removed, but relevant regulations have yet to be laid.

Under the requirements of the Pensions Act 2008, employers must make arrangements to automatically enrol employees into an appropriate pension scheme where they are between 22 and state pension age and earn over a specified amount (currently £10,000). Once enrolled, contributions must be paid on earnings between a lower and upper threshold.

The Government has concluded that the earnings trigger of £10,000 for eligibility for auto-enrolment should be maintained for 2025/2026. This represents a real term reduction in the value of the trigger given increases in average earnings. As a result, it is anticipated that the number of people in private pension schemes will rise to 15.7 million in total.

In relation to the earnings thresholds for contributions, the conclusion was that these should also remain unchanged at £6,240 and £50,270. The Government says that maintaining the lower threshold is "*consistent with [its] ambitions to improve financial resilience for retirement, in particular among low and moderate earners [and]... helps ensure that pension savings... will be broadly maintained*". Leaving the upper limit unchanged is appropriate because "*higher earners might reasonably be expected to have access to a pension scheme that offers more than the minimum and are more likely to make personal arrangements for additional saving*".

An Act issued by the previous government contained provisions for regulations to change the existing age condition (to reduce it to 18) and the definition of qualifying earnings on which contributions are paid (to reduce the threshold to £0 so contributions are paid from the first pound earned). No regulations have so far been issued and it is not clear whether the current Government proposes to do so.

Practical points:

- *Note the thresholds for 2025/26.*
- *Watch out for future developments.*

CONTRACTING-OUT

Although we are now nearly 9 years from the cessation of all contracting-out, it continues to be something that schemes have to grapple with. There has recently been an industry statement on the Virgin Media case and a further case is due to be heard by the High Court in February which might provide more answers to some of the outstanding practical issues. The Ombudsman has also issued an interesting recent determination on GMP equalisation.

Virgin Media update: By way of reminder, between 6 April 1997 and 6 April 2016, schemes could contract members out of the second tier of the state pension on a "reference scheme test" basis which meant that the scheme had to provide benefits at least broadly equivalent to a "reference scheme". The actuary needed to certify that a scheme continued to meet the reference scheme test every three years and provide confirmation (in accordance with section 37 Pension Schemes Act 1993) when an amendment was made that it continued to be satisfied (although the nature of the confirmation changed over time).

In July 2024, the Court of Appeal confirmed that where actuarial confirmation was not obtained in relation to pre 6 April 2013 amendments, amendments in relation to both past and future service would be void, irrespective of whether they might have been in the members' interests.

This has resulted in schemes doing audits of historic amendments and, across the industry, it is clear that actuarial confirmations cannot now be found in all cases for such amendments.

On 17 December 2024, the Association of Pension Lawyers, Association of Consulting Actuaries and Society of Pension Professionals published a joint statement saying they were continuing to work with and provide information to DWP in relation to the potential impact of the decision. In their view, the Government should make regulations that would "*enable the validation retrospectively of any amendment that is held to be void solely because either a written actuarial confirmation was not received before the amendment was made, or where such a confirmation cannot now be located*" and the statement indicated that the form of such regulations continues to be discussed with the DWP. There is however no indication as to what DWP's views are or whether any regulations are likely to be forth coming or in what time frame.

In addition, a case (*Verity Trustees v Wood)* is due to be heard in February which may shed light on practical questions in relation to missing actuarial confirmations and the evidence that might demonstrate the existence of confirmation.

GMPs: In a recent Ombudsman determination, a member who had transferred out of the scheme in 1991 asked the trustees on a number of occasions since 2020 to confirm the amount of his equalised GMP. The trustees replied that they were dealing with the matter but had limited data in relation to benefits that were transferred out 30 years ago. The member complained about delays in confirming whether his transfer payment would be uplifted and the lack of data.

The Ombudsman concluded that "*This is a difficult and complicated project, and it is important to ensure it is carried out correctly. Therefore, although it should not be unnecessarily delayed, it is understandable that it will take a reasonable period of time to implement. I do not find that the project has, at this point, been unreasonably delayed.*"

In relation to the lack of data about a 1991 transfer, the Ombudsman said: "*While I acknowledge [the] concern that the Trustee records appear to be incomplete, on the other side of the coin I also acknowledge that [the member] transferred out of the Scheme some considerable time ago and that, in any event, the amount of data kept in respect of past transfers is limited*". In addition, the member could not show that he had suffered any loss as a result of the missing data.

The trustee had agreed to keep the member updated about the equalisation project and had failed to do so, so the Ombudsman award him £500 for distress and inconvenience.

This decision will come as a relief to the many schemes that are still in the midst of their GMP equalisation projects.

Practical points:

- *Watch out for further developments in relation to Virgin Media.*
- *Ensure that GMP equalisation projects are being progressed appropriately.*

TAX UPDATE

HMRC has issued two recent newsletters providing updates around the Government's proposals to introduce inheritance tax on death benefits and inherited pension pots as well as well as the lump sum allowance for members who took lump sums in anticipation of tax changes being announced in the Autumn 2024 Budget.

It was announced in the Autumn 2024 Budget, that from 6 April 2027 most unused pension funds and death benefits will be included within the value of a person's estate for Inheritance Tax ("**IHT**") and pension scheme administrators (in the tax sense - meaning those responsible for complying with the Finance Act 2004) will become liable for reporting and paying any Inheritance Tax due on pensions to HMRC. A consultation was issued on the processes for reporting and paying IHT which closed on 22 January 2025. No further details have so far been provided on how this will work in practice but in Newsletter 166 HMRC said that it will issue a formal response to consultation and draft legislation later this year.

HMRC also used the newsletter to remind schemes that from April 2025, they will need to submit any pension scheme returns for the tax year 2024/25 onwards on its new online "managing pension schemes" service. There is also a reminder that the deadline for applying for fixed protection 2016 and individual protection 2016 is 5 April 2025.

In addition, in Newsletter 165, HMRC confirmed that where members took pension commencement lump sums or uncrystallised lump sums because of speculation about changes that might have been included in the Autumn 2024 Budget, their lump sum allowance will not be restored to the level it would have been had they not taken the lump sum. HMRC says that in general, the payment of a tax-free lump sum cannot be undone and reminds schemes that unauthorised payments charges may apply if the conditions for "recycling" a pensions commencement lump sum are met. Recycling will apply where various conditions are satisfied, including a requirement that because of the lump sum, the amount of contributions paid into a registered pension scheme in respect of the individual is significantly greater than it otherwise would have been.

Practical points:

- *Watch out for further developments in relation to inheritance tax on death benefits.*
- *Make sure administrators are on top of any HMRC updates.*

PENSIONS REGULATOR UPDATE

The Pensions Regulator has made some changes to the DB and hybrid scheme returns that schemes should be prepared for. It has also released its annual report which gives some insight into its overall approach to regulation as well as its annual statistical review of the DB landscape.

Scheme return for DB and hybrid schemes: TPR has added new questions to the scheme return, which for most schemes will need to be submitted by 31 March 2025. The new questions are on:

- Data quality: Whether the scheme has measured common or scheme-specific data in the last 12 months, considered reviewing data quality, how often trustees review data and what their data score is. This additional data will help schemes ensure that they are dashboard ready and comply with TPR's expectations in the General Code.

  It might be helpful to note that the Pensions Administration Standards Association (PASA) has released new guidance on Data Scoring. The guidance is designed to support trustees and providers "*in achieving higher data standards while aligning with broader industry expectation*". It recommends annual testing of member data.

- Scheme membership: Details of the number of members with DC, DB and both DB and DC benefits to enable TPR to calculate the general levy for the year from 1 April 2025.
- Investment consultancy providers: Whether trustees have set strategic objectives for investment consultants, when performance was last reviewed against these objectives and when the objectives were last reviewed or if there has been no review, why not.

TPR annual report and accounts: TPR's annual report and accounts for 2023/24 show that 70% of members are now in schemes covered by relationship supervision and TPR has targeted a quarter of schemes for intervention (although the nature of that intervention is not specified). TPR suggests that this demonstrates its "*dynamic market oversight to respond to a pensions landscape of fewer, larger schemes [which]… enabled it to address emerging risks, while supporting innovations in savers' interests*". The more collaborative ongoing engagement with schemes also seems to have resulted in a fall in the total amount of "frontline" penalties issued (other than for auto-enrolment non-compliance) from £107,600 to £70,800 and a fall in the use of its information powers.

TPR on DB landscape in 2024: TPR has released its annual overview of the DB landscape in UK for 2024. Key findings reveal that the DB and hybrid landscape continues to shrink at a yearly rate of 3% on average. Schemes are still closing, with the percentage closed to future accrual (excluding those in wind-up) increasing from 72% to 73%. Total membership in private DB and hybrid schemes has decreased by 2% since 2023 to 9,424,000, with only 12% of members in open schemes. However, the funding level has remained fairly constant, increasing to 118% in 2024 from 117% in 2023.

Practical points:

- *Be aware of TPR's ongoing approach to supervision.*
- *Ensure appropriate information is available to complete the scheme return.*

WATCH LIST

For upcoming developments see our pensions: what's coming webpage.

No	Topic	Effective date or expected effective date	Further information/action
1	Changes to DC scheme governance and disclosure	2024/25	Anticipated that wording for new value for money framework in occupational pension schemes will be included in a new Pension Schemes Bill. The FCA has consulted on the requirements for personal pension schemes. Draft legislation on consolidating small DC deferred pots also expected in the Bill, along with new obligations in relation to decumulation options.
2	DB consolidation	2024/25 Public consolidator to be established by 2026, consultation on features closed on 19 April 2024.	TPR further updated interim superfund guidance -issued July 2024. Draft legislation on superfunds expected in Pension Schemes Bill.
3	Pensions tax	Changes are anticipated from 6 April 2027 in relation to inheritance tax (IHT) on lump sum death benefits and inherited benefits. Changes to be made from 6 April 2026 in relation to need for UK scheme administrators. Changes to be made to overseas transfer regime from 6 April 2025 to bring transfers to schemes in EU or EEA in line with transfers to schemes elsewhere in the world.	Draft legislation awaited in relation to IHT changes.
4	Repayment of surplus	The reduction in the tax charge took effect on 6 April 2024. Further changes to legislation in relation to refunding surpluses have no clear date.	Tax charge on repaying surplus reduced from 35% to 25%. The Government has announced that changes will be made to surplus legislation but has yet to publish details. Provisions may be included in the upcoming Pension Schemes Bill.
5	Funding and investment strategy requirements for DB schemes	Legislation came into force 6 April 2024. Funding and investment strategy in place 15 months from date of the first valuation obtained on or after 22 September 2024. Revised Code of Practice from TPR came into force on 12 November 2024.	The first strategy statements will need to be submitted electronically in spring 2025.

No	Topic	Effective date or expected effective date	Further information/action
6	Notifiable events for DB schemes on corporate and financing activity	Significant uncertainty about publication of government response to consultation on draft Notifiable Events (Amendment) Regulations. No dates are known as to when any progress will be made.	TPR will consult on an update to Code of Practice 2 (Notifiable Events) and accompanying guidance once DWP have published their finalised regulations and consultation response.
7	Pensions dashboards	Compulsory connection deadline of 31 October 2026 for schemes with 100 or more active and/or deferred members at year end between 1 April 2023 and 31 March 2024. Staging timetable set out in DWP guidance.	All registrable UK-based schemes with active and/or deferred members.
8	Collective defined contribution schemes	Legislation allowing unconnected multi-employer schemes may be issued in 2025.	The Government has consulted on the possibility of extending the legislation allowed collective defined contribution schemes to schemes for unconnected-employers, paving the way for commercial providers to offer such schemes.
9	DC consolidation	Proposals on default funds may come into force in 2030.	The Government has consulted on requiring multi-employer DC schemes to have a maximum number of default funds of a minimum size.

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650