CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 23rd November 2022
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

The estimated funding position at 30 September 2022 of 102% is around 9% ahead of the expected position.

The objectives and update on the various parts of the Risk Management Framework is included in the Appendix and shows the management of interest rate and inflation risk, equity market risk, currency risk, liquidity and collateral risk.

The total gain since inception of the synthetic equity strategy to 30 September 2022 is c. £43.2m. The currency hedging positions have made a loss of £44.3m in total since inception to 30 September 2022 due to significant weakening of sterling over that period versus the dollar and in particular in the recent months. This is offset against gains on the physical overseas equity holdings.

The Fund remains in a healthy position in terms of funding level versus the expected position, despite a challenging market. The Fund has benefitted from having the Flightpath in place, as both the equity protection strategy has increased in value as equity markets have fallen, and the inflation protection has reduced the funding strain from the increase in inflation expectations over the year.

The UK gilt market experienced extreme volatility as a result of the 'mini-budget' on 23 September. The sharp rise in real yields reduced the collateral held to support the Flightpath. The robust collateral monitoring and governance framework meant the Fund were able to react quickly during the gilt market volatility, and the actions taken has meant that there was no detrimental impact on the funding position or expected returns.

The annual FRMG assessment of the flightpath was carried out in September. It was recommended that a restructure of the interest rate and inflation trigger framework be implemented. At 30 September, the trigger framework was paused due to the potential demand on collateral if interest rates continued to rise sharply.

Following the extreme volatility in the UK gilt market, the Officers instructed sales from the Fund's equity portfolio (totalling £215m) in October and November to support the collateral position, replacing the majority of exposure (£210m) synthetically to maintain the overall strategic exposures of the Fund. This has allowed the Officers to re-instate the trigger framework, with levels raised to with stand greater yield rises. The Officers have also developed a plan for sourcing further liquidity at short notice to withstand future gilt market volatility.

RECOMMENDATIONS	
1	That the Committee note and consider the contents of the report and the increase in the level of hedging and the various actions taken.

REPORT DETAILS

1.00	FUNDING, FLIGHTPATH AND RISK MANAGEMENT STRUCTURE UPDATE
1.01	**Update on funding and the flightpath framework** The monthly summary report as at 30 September 2022 from Mercer on the funding position and an overview of the risk management framework is attached in Appendix 1. It includes a "traffic light" of the key components of the Flightpath and hedging mandate with Insight. The report will be presented at the meeting including a reminder of the principle objectives of the framework.
1.02	The estimated funding level is 102% at 30 September 2022, which is 9% ahead of the expected position when measured relative to the 2019 valuation expected funding plan. The investment environment has continued to be bearish year to date amid rising inflation and interest rates. A trigger of 110% has been put in place to prompt future FRMG de-risking discussions and a formal protocol was proposed and ratified by the Committee. The funding level is below this trigger currently but if breached, this would prompt further analysis on whether the Fund can take de-risking actions to provide more certainty for employers without inadvertently putting upwards pressure on contributions in future. This trigger will be kept under review over time and will take into account the 2022 valuation and emerging contributions in due course.
1.03	The level of hedging was approximately 50% for interest rates and 40% for inflation at 30 September 2022. The liability hedging portfolio performed negatively over the quarter to 30 September 2022 due to a combination of a continued rise in gilt yields and falling inflation expectations although this is offset somewhat by the fall in liabilities due to the increased discount rate versus inflation. The hedging implemented to date provides access to a lower risk investment strategy but maintaining a sufficiently high real yield/return expectation to achieve the funding and contribution targets. At its 2 September meeting, the FRMG agreed to restructure the interest rate and inflation trigger framework to ensure the Fund continues to capture attractive opportunities as interest rates rise or inflation expectations fall. It was agreed to increase the interest rate triggers to target a 4.5% yield, and reduce the inflation triggers to target a 2.3% yield. Triggers are in place to purchase additional interest rate or inflation hedging at an affordable level. The increase in interest rate hedge ratio relative to the previous committee report is a result of interest rate triggers being hit due to sharp increases in gilt yields. The Fund has therefore

	taken opportunities to lock into yields at more attractive levels. However, following the significant rise in gilt yields, the Officers decided to pause the trigger framework ahead of 30 September to take stock of the position and provide more collateral to the risk management framework.
1.04	Based on data from Insight, our analysis shows that the management of the Insight Liability Hedging mandate is rated as "green" as at the end of Q2 2022, meaning it is operating in line within the tolerances monitored by Mercer. The Cash Plus Fund is rated "amber" due to underperformance since inception and over Q2 2022, to reflect the challenging market conditions for the asset classes over recent periods. The collateral position of the Fund worsened over the quarter to September 2022 due to sharp rises in gilt yields. In line with the terms of their mandate, Insight sold the majority of the Cash Plus Funds (including the entirety of the High Grade and Global ABS holdings) to improve the collateral position. Insight also used the £30m held outside of the QIAIF in a liquidity fund to help manage the collateral position. The collateral waterfall structure will be reviewed on an ongoing basis and the Officers have carried out additional work to understand the liquidity of the wider investment strategy to understand where capital could be sourced at short notice, should it be required in future to supplement available collateral within the Flightpath.
1.05	**Update on Risk Management framework** (i) <u>Synthetic equity and equity protection strategy</u> The Fund gains exposure to equity markets via derivatives and protects this exposure against potential falls in the equity markets via the use of an equity protection strategy. This provides further stability (or even a reduction) in employer deficit contributions (all other things equal) in the event of a significant equity market fall although it is recognised it will not protect the Fund in totality. It should be noted that, having an equity protection policy in place will protect from any large changes in equity markets. Importantly over the longer-term the increased security allows the Actuary to include less prudence/buffer in the Actuarial Valuation assumptions; this translated into lower contributions at the 2019 valuation, whilst maintaining the equity exposure supports a lower cost of accrual than under traditional de-risking methods. The Fund has a bespoke synthetic equity and equity protection strategy, which is implemented through a Total Return Swap ("bespoke TRS") contract with JP Morgan, held within the Insight QIAIF (the fund that implements the risk management strategies on the Fund's behalf). The TRS contract is for a fixed term of 3 years up to 2024. As at 30 September 2022, the total performance since inception of the bespoke TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £43.2m. Relative to investing in passive equities

	(and assuming no costs to do so), the strategy has underperformed by c. £74m since inception. The underperformance is largely driven by the rise in equity markets since inception of the strategy meaning the protection has become less valuable. Over the year to date the Fund has benefitted from the protection provided by the equity protection strategy due to sustained falls in equity markets. This has somewhat reversed over the quarter as the strategy underperformed an investment in passive equities (with no frictional costs).
1.06	(ii) <u>Collateral update</u> The Officers took a number of actions to support the collateral position since the date of the last committee report. This included instructing sales from the Fund's equity portfolio (totalling £215m) to support the collateral position. The majority of the equity exposure (£210m) was replaced synthetically with Insight so as to maintain the overall strategic allocation of the portfolio. Actions taken by the Officers have ensured that the QIAIF continues to have a healthy collateral position despite the recent increases in interest rates, which have caused the value of Liability Hedging assets to fall. This is despite the recent press coverage which was mainly related to private sector schemes with higher hedge ratios and different objectives in relation to risk management.
1.07	(ii) <u>Currency hedging gain/loss</u> The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £21.3m since inception on 8 March 2019 to 30 September 2022 due to the material weakening of sterling over that period, particularly versus the US dollar. The Fund's overseas developed market physical equity holdings are currency hedged and have made a loss of c. £23.0m since inception of the strategy due to the material weakening of sterling over that period. Overall the action to hedge the Fund's developed equity currency risk has resulted in a loss of £44.3m since inception of the strategies, although this will have been offset by rises in value of the overseas equity holdings due to these currency movements.
1.08	**Impact of interest rate and inflation changes on the discount rate** As part of the 2022 valuation, the discount rate (expected return) and inflation rate assumptions will be set in relation to market conditions at 31 March 2022 and this will be discussed with Committee as part of the valuation and Funding Strategy Statement considerations. Typically, the discount rate will change broadly in line with the global outlook for inflation and interest rates within the framework plus any material shift in economic outlook. Historically the discount rate versus CPI inflation i.e. the CPI+ discount rate has not changed materially and would only be considered in great detail at each valuation or interim valuation update. However, given the material shift in interest rates, inflation and global economic outlook since the valuation date there has been a material shift which has affected the value of the liabilities. It is important when considering the investment strategy and also the Flightpath (as noted above) that we recognise this material change, as it

	will determine the pathway for contributions and links the investment and funding strategy directly. The FRMG discussed this at the 2 September meeting and agreed the approach to updating the discount rate and how that will feed into the investment strategy review to ensure the funding and investment strategies are fully aligned. This will fully take into account the change in economic outlook on a quarterly basis and interest rate/inflation changes on a monthly basis as normal.
1.09	**Decisions made since quarter end** The Fund implemented c. £210m of exposure in long-only synthetic equity positions in October and November 2022 to replicate the exposure lost through equity sales to provide additional capital to the Flightpath to support the collateral position (long-only TRS). Both positions consist of broad market exposure and are implemented through vanilla equity TRS. Further, following the pausing of the interest rate triggers in late September, the FRMG agreed at the 31 October meeting to reinstate the triggers but increase the interest rate trigger levels by 0.5% to target a 5% interest rate trigger level in light of further uncertainty. The Officers are currently awaiting the documentation from Insight to re-instate the triggers at their new levels. The Officers have also reviewed the liquidity of the wider investment strategy to ensure swift action can be taken in the event of future market volatility. For the purpose of providing more collateral to the RMF at short notice, capital would be sourced in the following priority order: **Stage 1:** Sell down physical equity holdings and synthesise the exposure within the RMF with Insight. **Stage 2:** Reduce synthetic equity exposure to reduce the collateral strain within the Insight portfolio; and **Stage 3:** Sell a portion of the next most liquid asset to increase physical collateral within the Insight portfolio.

2.00	**RESOURCE IMPLICATIONS**
2.01	None directly as a result of this report

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	None required

4.00	**RISK MANAGEMENT**
4.01	This report addresses some of the risks identified in the Fund's Risk Register. Specifically, this covers the following (either in whole or in part): • Governance risk: G2 • Funding and Investment risks: F1 - F6
4.02	The Flightpath Strategy manages/controls the interest rate and inflation rate impact on the liabilities of the Fund to give more stability of funding outcomes and employer contribution rates. The Equity option strategy will

	provide protection against market falls for the synthetic equity exposure via the Insight mandate only. The collateral waterfall framework is intended to increase the efficiency of the Fund's collateral, and generating additional yield in a low governance manner. Hedging the currency risk of the market value of the synthetic equity portfolio will protect the Fund against a strengthening pound which would be detrimental to the Fund's deficit. Hedging the currency risk of the developed market physical equity exposure will mitigate the risk of a strengthening pound.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – 30 September 2022 Appendix 2 – Committee Update

6.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
6.01	• Report to Pension Fund Committee – Flightpath Strategy Proposals – 8 November 2016, Report to Pension Fund Committee – 2016 Actuarial Valuation and Funding/Flightpath Update – 27 September 2016 and Report to Pension Fund Committee – Funding and Flightpath Update – 22 March 2016. • Report to Pension Fund Committee – Overview of risk management framework – Previous monthly reports and more detailed quarterly overview. **Contact Officer:** Philip Latham, Head of Clwyd Pension Fund **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

7.00	**GLOSSARY OF TERMS**
7.01	(a) **The Fund – Clwyd Pension Fund** – The Pension Fund managed by Flintshire County Council for local authority employees in the region and employees of other employers with links to local government in the region. (b) **Administering Authority or Scheme Manager** – Flintshire County Council is the administering authority and scheme manager for the Clwyd Pension Fund, which means it is responsible for the management and stewardship of the Fund. (c) **The Committee – Clwyd Pension Fund Committee -** the Flintshire County Council committee responsible for the majority of decisions relating to the management of the Clwyd Pension Fund. (d) **LGPS – Local Government Pension Scheme** – the national scheme, which Clwyd Pension Fund is part of (e) **FSS – Funding Strategy Statement** – the main document that outlines how we will manage employers contributions to the Fund (f) **Actuary -** A professional advisor, specialising in financial risk, who is appointed by Pension Funds to provide advice on financial related matters. In the LGPS, one of the Actuary's primary responsibilities is

	the setting of contribution rates payable by all participating employers as part of the actuarial valuation exercise. (g) **ISS – Investment Strategy Statement** The main document that outlines our strategy in relation to the investment of assets in the Clwyd Pension Fund Further terms are defined in the Glossary in the report in Appendix 1