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Clwyd Pension Fund

Committee Update

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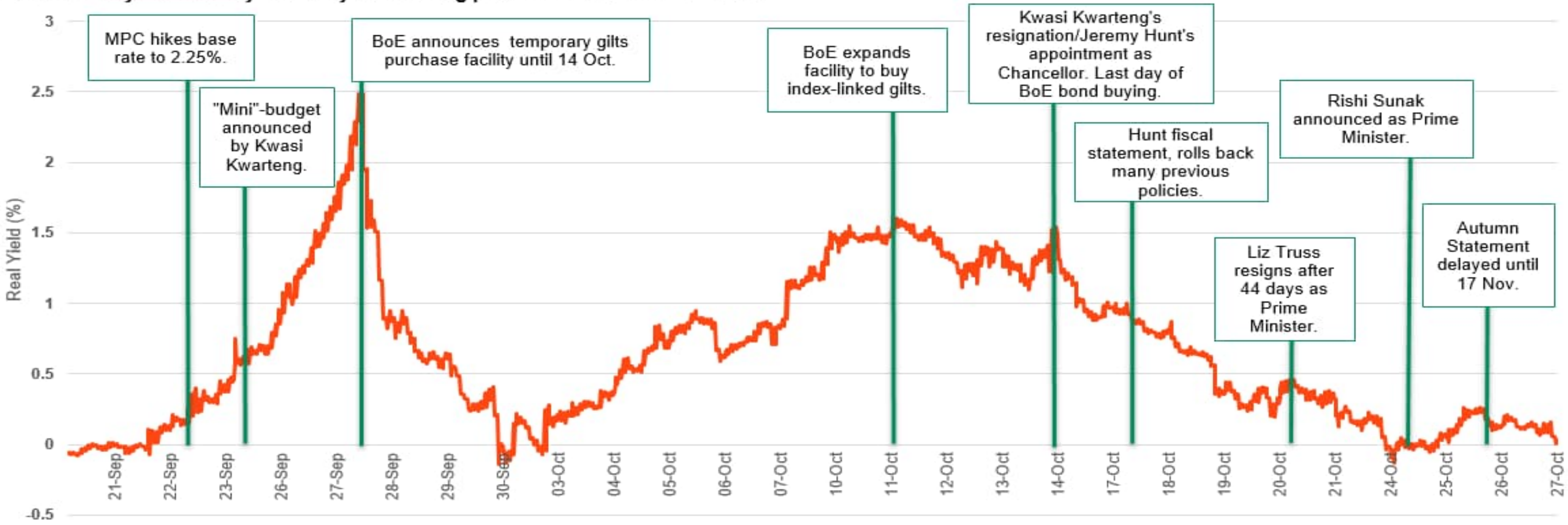
Reminder of Recent Events

Following Kwasi Kwarteng's 'mini-budget' announcement on Friday 23rd September, the UK gilt market has since experienced extreme volatility, with nominal and real yields rising c. 1% over as little as three days, on the expectation of increased gilt supply in the market and a fall in confidence in the strength of the UK economy. The Bank of England ("BoE") subsequently stepped in to stabilise gilt markets, committing to buying up to £5bn of long-dated gilts on a daily basis until 14th October to prevent the continued sell off in markets, after which support fell away.

The appointments of Jeremy Hunt as Chancellor and the resignation of Liz Truss and appointment of Rishi Sunak as Prime Minister have served to stabilise markets thus far. However, it should be noted that yields remain elevated relative to 'normal' levels and there is scope for them to rise further as a result of near-term events across fiscal and monetary policy.

On 3 November 2022 the BoE increased base rates by 0.75% p.a. to 3.00% p.a., which was the biggest single rate rise in interest rates since 1989. Gilt yields rose on the news, however the increase was largely priced in by the market. Market expectations are that base rates may reach 4.75% p.a. by June 2023.

Extreme real yield volatility driven by fast moving political events and BoE actions



Source: Bloomberg, BlackRock. Data as at 27 October 2022. Yield shown is for 2052 Index-linked Gilt.

Summary of Actions Taken

Interest Rate and Inflation Trigger Framework

The interest rate and inflation trigger framework was refreshed in September as a result of the annual healthcheck of the RMF. The margin between interest rate triggers was increased from 0.15% to 0.25% and the margin between inflation triggers was increased from 0.05% to 0.10%, so that the Fund could lock in to more favourable yields following trigger hits.

Further to increase volatility at the end of September, the Officers suspended the Fund’s trigger framework to prevent increases in hedge ratios, which would strain collateral levels if yields were to rise further. There were a number of interest rate triggers hit in the week to the framework being paused on 23rd September. No inflation triggers were hit since the last assessment at 31 August 2022. Three of the four duration bands have breached the third interest rate trigger, with the longest band breaching the second.

Collateral Waterfall

The collateral waterfall framework worked as planned in the immediate aftermath of the Chancellor’s “mini-budget”, providing additional immediate collateral to the liability hedging portfolio as the Fund suffered mark-to-market losses as a result of rising yields.

In early October, the Officers instructed sales of the BlackRock Global ESG Equity Fund (totalling £125m) to support the collateral position within the RMF. The equity exposure was replaced synthetically with Insight so as to maintain the expected return on the portfolio to the extent possible. A further £90m was sold from the WPP Emerging Market Equity holdings to increase collateral, which settled in the QIAIF in early November. This exposure was also replaced synthetically.

Action taken by the Officers as a result of extreme market movements meant that the collateral position remained strong. Swift action to take additional steps needed is facilitated by the strong governance arrangement.

Further Actions Being Taken

Interest Rate and Inflation Trigger Framework

The Officers have agreed to re-instate the interest rate trigger framework, increasing the interest rate triggers by 0.5% in each maturity band, which will allow the Fund to capture higher yields opportunistically without having to re-collateralise the liability hedging portfolio in the immediate term.

Collateral Arrangements

The Officers have reviewed the liquidity of the wider investment strategy to ensure swift action can be taken in the event of future market volatility. This review has given due consideration to the long term strategic targets of the Fund and allows investment strategy to maintain a similar balance of return and risk as the current investment strategy.

In the event of extreme market volatility, for the purpose of re-collateralising the RMF, the priority order for sourcing additional capital will be as follows:

- **Stage 1:** Sell down physical equity holdings and synthesise the exposure within the QIAIF with Insight.
- **Stage 2:** Reduce synthetic equity exposure to reduce the collateral strain within the QIAIF; and
- **Stage 3:** Sell a portion of the next most liquid asset to increase physical collateral within the QIAIF.

There are wider implications to be considered as part of synthesising the Fund’s equity exposure, such as the relationship with the Pool and any knock on impact on the Fund’s ESG commitments, however the Officers note that these are second order compared to the risk of lost exposure or default as a result of running too much leverage within the RMF.

It is worth noting that in a scenario where extreme stress is applied to the QIAIF as a result of rising interest rates, it is likely that the Fund’s financial position would have improved significantly, and therefore it may be appropriate to de-risk from higher-returning assets. Any proceeds from such de-risking activity may be used to increase the collateral within the QIAIF as required.

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