CLWYD PENSION FUND COMMITTEE

Date of Meeting	28 November 2018
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

Members should note that:

- On a consistent basis, the estimated funding position at the end of October is 89% which is around 9% ahead of the expected position from the 2016 actuarial valuation. However, there still remains uncertainty regarding future inflation and investment return expectations, especially given the recent market volatility.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 31 October 2018.

- No triggers have been breached since the interest rate triggers were re-structured in September 2017. Mercer recommended no change to the interest rate trigger levels as part of the flightpath healthcheck.

- As reported at the last Committee, Insight were instructed to close out the relative value position over August 2018. This trading has now been completed and resulted in an overall gain of £26.7m net of costs.

- The new dynamic equity protection strategy was implemented on 24 May 2018. As at 31 October 2018, the dynamic protection strategy had decreased by £11m or 3.0% since inception of the strategy. The Fund is protected from falls in equity markets of 13% or more from current levels. More detail is provided separately in the Mercer report in Appendix 1.

- Mercer indicated that there is an opportunity to release £100m in cash from the collateral holding to potentially invest in other assets without impacting the overall risk management profile of the flightpath strategy. Officers have been working with Mercer and JLT to identify a suitable destination for this additional cash. It has provisionally been agreed that c. £50m will be retained at Insight and a so-called collateral waterfall implemented to efficiently manage collateral in a low governance manner. The remaining c. £50m will be released from the Insight QIAIF to be invested elsewhere in the portfolio.

RECOMMENDATIONS	
1	That the Committee note the updated funding and hedging position for the Fund and the progress being made on the various elements of the Risk Management Framework.
2	That the Committee note the restructuring of the LDI strategy has been completed and a positive mark-to-market gain has been realised.
3	That the Committee note that the Officers are working with their advisors in order to finalise a collateral waterfall process at Insight to better manage collateral requirements. Further, it has been provisionally agreed that c. £50m will be removed from the Insight QIAIF to be invested elsewhere in the portfolio.

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 31 October 2018 from Mercer on the funding position and an overview of the liability hedging mandate 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 89% with a deficit of £221m at 31 October 2018 which is 9% ahead of the expected position when measured relative to the 2016 valuation expected funding plan. Uncertainty continues to be prevalent in the investment environment due to ongoing external political and fiscal factors. To illustrate the impact, a reduction of 0.25% p.a. in the assumed future investment return/real discount rate would reduce the funding level by c. 4% to c. 85% with a corresponding increase in deficit of £94m to £315m.
1.03	None of the interest rate triggers have been satisfied since they were re-structured in September 2017.
1.04	The level of hedging was around 20% for interest rates and 40% for inflation at 31 October 2018. The hedging implemented to date provides access to a lower risk investment strategy but maintaining a sufficiently high real yield expectation to achieve the funding targets.
1.05	Based on data from Insight, our analysis shows that the management of the Insight mandate is rated as "green" meaning it is operating in line within the tolerances set by our strategic risk advisors. The LIBOR Plus Fund is rated "amber" due to the temporary limit on future investments into the fund. This should not affect the operation of the

	mandate but it will be kept under watch. The collateral and counterparty position is rated “green”; collateral is within the agreed constraints and the Officers are taking action with their advisors to improve the efficiency of the collateral position (see section 1.08).
1.06	***Update on Risk Management framework*** (i) Restructuring the Insight Portfolio As reported previously Insight were instructed to exit the relative value trade and completed trading by 31 August 2018. This was because the gains had been realised far more quickly than expected and it was felt appropriate to close off exposure to the future risk of losing this gain, The gain on the relative value element was £16.8m, which, when combined with the long term gain of £10.2m from locking in a lower inflation rate, resulted in a gain of £27m gross of costs. This was above the “soft trigger” test of £25m. The £16.8m gain from the relative value trade was realised immediately, whilst the £10.2m gain from locking in a lower inflation rate will continue to be accrued over a 50 year period. These immediate gains can be used to invest elsewhere in the portfolio along with the further release of collateral as noted in this report. Total transaction costs for the trade were c. £269k, which compares favourably to the estimated range of £0.8-£2.2m. By phasing the trades over a number of days, Insight were able to take advantage of trading opportunities which helped to keep costs down materially. This change has had no impact on the level of hedging or the expected return on the portfolio. Critically, closing out this gain does not impact on the risk profile of the flightpath.
1.07	(ii) Dynamic equity protection implementation and progress It was previously approved by Committee that, subject to fair market pricing, protection against potential falls in the equity markets via the use of Equity Options should be implemented. This was to provide 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 which is currently prevalent given the long period of strong equity returns that we have seen. Importantly over the longer-term the increased security allows the Actuary to include less prudence in the Actuarial Valuation assumptions; this would translate into lower deficit contributions at the 2019 valuation whilst maintaining equity exposure supports a lower cost of accrual that under traditional de-risking methods. This will be quantified in the 2018 interim review. As at 31 October 2018, the dynamic protection strategy had decreased by c. £11m or 3.0% since inception of the strategy. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £0.2m or 0.05% since inception. Should equity

	markets fall by more than 13% then the protection structure will kick in, and the strategy should outperform passive equities. There was a significant market fall over October, but not enough so that the protection "kicked in". The protection will be monitored on an ongoing basis and the Committee papers have been updated as part of the reporting in Appendix 1.
1.08	(iii) Collateral position Due to the positive performance of the framework since its implementation, Mercer indicated that there is an opportunity to release cash collateral from the Insight strategy to invest in higher returning assets. Mercer have calculated, and Insight have confirmed, that £100m (inclusive of the gain of unwinding the relative value trade) can be released from the strategy whilst still supporting the current positions and maintaining the flightpath strategy. This still leaves sufficient collateral in the event of market moves or in the event of any triggers being hit in line with the agreed guidelines. The Officers have provisionally agreed to retain c. £50m of the excess collateral within the Insight QIAIF but to be invested in higher yielding credit assets and making use of a collateral waterfall process. The additional c. £50m of excess collateral will be released from the Insight QIAIF to invest elsewhere in the portfolio as advised by JLT. Mercer has proposed the use of a collateral waterfall structure to increase the efficiency of the collateral position within the Insight QIAIF. The premise is to hold three tiers of assets: - Tier 1 comprises of gilts and cash to be used to support collateral requirements on a day to day basis. - Tier 2 comprises of high quality liquid alternative credit assets that act as a ready source of funds to top up Tier 1 quickly, but offer a higher yield than Tier 1. - Tier 3 comprises of less liquid alternative credit assets used predominantly as a return driver within the collateral portfolio. A collateral waterfall ensures that the Insight QIAIF provides the necessary collateral requirements but makes those assets work harder, increasing yield in a low governance manner. The Officers with the advice of JLT and Mercer are considering these proposals and the Committee will be updated in due course.

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.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – October 2018

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.
6.02	Report to Pension Fund Committee – Overview of risk management framework – Previous monthly reports and more detailed quarterly overview. **Contact Officer:** Philip Latham, Clwyd Pension Fund Manager **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.