CYNGOR Sir y Fflint
Flintshire
COUNTY COUNCIL

CLWYD PENSION FUND COMMITTEE

Date of Meeting	Tuesday, 11th February 2020
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

Members should note that:

- On consistent actuarial assumptions with the 2016 valuation, the estimated funding position at the end of December is 94% which is around 14% ahead of the expected position from the 2016 actuarial valuation. The 2019 valuation assumptions will be finalised at this committee meeting. The monitoring report will then be rebased from 1 April 2019 using the 2019 valuation as a starting point.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 31 December 2019. Potential RPI reform poses a risk to the values of the Fund's holdings of inflation-linked assets. The Fund has decided to reduce the inflation exposure by 20% on a temporary basis to partly mitigate this risk but retain inflation hedging at 20% to protect against an unanticipated increase in inflation between now and the finalisation of the RPI reform.

- As at 31 December 2019, the revised equity protection strategy (which increased protection levels by 5%) had made a gain of c. £38m since inception of the strategy.

- The currency risk associated with the market value of the synthetic equity portfolio within the Flightpath is hedged, and a further hedge has been placed on the Fund's developed market physical equity holdings. The level of currency hedging remains at 75% and has made a gain of c. £9m since inception of the strategy due to the strengthening of sterling.

RECOMMENDATIONS	
1	That the information (including the funding position) on the various elements of the Risk Management Framework is noted.
2	That the impact of the equity protection strategy is noted.
3	That the impact of the currency hedging strategy is noted.
4	That the Committee are aware of the risk from potential RPI reform and the balanced action taken to reduce this risk as well as the costs.

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 December 2019 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 94% with a deficit of £139m at 31 December 2019 which is 14% 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. 90% with a corresponding increase in deficit of £91m to £230m. For the purposes of this report the funding position has been measured on consistent actuarial assumptions with the 2016 valuation. The 2019 valuation assumptions will be finalised at this committee meeting. The monitoring report will then be rebased from 1 April 2019 using the 2019 valuation as a starting point.
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 approximately 20% for interest rates and 40% for inflation at 31 December 2019. 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 Cash Plus Fund is rated "green" and is performing as expected. The collateral and counterparty position is rated "green"; collateral is within the agreed constraints and the efficiency of the collateral position has been improved following the implementation a collateral waterfall framework with Insight earlier in the year. Overall, the collateral waterfall has generated an additional £4.6m in returns since implementation at 31 January 2018 to 31 December 2019 versus the previous structure. No action required.
1.06	***Impact of potential RPI reform and proposed mitigating actions*** In September 2019, the Sajid Javid responded to letters written by the House of Lords' Economic Affairs Committee and the UK Statistics Authority calling for RPI to be abolished and replaced with CPIH (similar to CPI but allows for housing costs) given the known errors with the metric.

	The Chancellor was broadly in agreement with their proposals and is launching a consultation from 11 March 2020 for 6 weeks to determine when this change should be brought into force (earliest 2025, and latest 2030). CPIH has historically been c. 1% p.a. lower than RPI. As such, assets linked to RPI could see a structural fall in value due to RPI reform. The likelihood of RPI changing in the future has increased and this is an important issue to be considered for the Fund given that the investment strategy has c. 40% inflation hedge ratio, holding assets that directly reference RPI. The Fund's liabilities are linked to CPI, so RPI reform is not expected to impact the value of liabilities, but if the value of RPI-linked assets falls, then this will negatively impact the Fund's funding position. Mercer estimate that the potential worst case impact could be a c. £100m increase in deficit unless asset holders are compensated in some way. RPI-linked assets are currently the best proxy for the inflation sensitivity of the liabilities, as CPI-linked assets are not available in the market. They provide protection from a scenario where inflation expectations rise. There's lots of uncertainty around RPI reform. The risk is RPI is repriced at a much lower value, causing a one-off structural fall in the value of RPI-linked assets. However, it may be that following the consultation, RPI reform is abandoned, or investors are appropriately compensated for the negative impact moving from RPI to CPIH would have on index-linked gilts and RPI swaps. In this case, we would expect to see markets reprice RPI higher, which would have a positive impact on the Fund of c. £40m. In order to manage this risk, the Clwyd Pension Fund manager, on the advice from Mercer, have decided to reduce the inflation hedge ratio from 40% to 20% to maintain some protection from increasing inflation between now and when the reform to RPI is known. This would be achieved by selling the c. £320m index-linked gilts and buying fixed interest gilts of an equivalent duration, thus maintaining the 20% interest rate hedge ratio. Transaction costs are expected to be in the region of £320k-£640k and the transition will be completed before the consultation opens on 11 March 2020. These costs should be considered in light of the potential impact on the Fund of the RPI reform. This balanced approach would reduce the risk RPI reform could have on the Fund's deficit from £100m to £50m. To completely remove the risk of RPI reform would materially increase the risk of inflation rising in the interim period and therefore retaining an inflation hedge ratio of 20% continues to provide some inflation protection. There would be a process to buy back the inflation protection at more attractive levels following the announcement of the results of the consultation.
1.07	***Update on Risk Management framework*** (i) 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

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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 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.
On 1 August 2019, the level of protection for the Fund was increased from 12 month average market levels of 15% to 10%, the cost of which will be offset by the Fund's participation in losses beyond 30%. Protecting for such extreme unlikely scenarios is proportionately expensive and not necessarily required by the Fund as it has the governance and implementation framework in place in order to act quickly and bank the returns from the protection in the event of an equity market drawdown.
As at 31 December 2019, the dynamic protection strategy had increased by c. £38m since inception of the strategy. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £20m since inception.
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(ii) Implementation of currency hedging
A strategic currency hedging policy was implemented in March 2019. By currency hedging the market value of the synthetic equity portfolio, and leaving the physical equity portfolio unhedged from a currency perspective, this policy achieved a c.50% currency hedged position of the overall equity portfolio. The strategic hedge ratio was based on analysis that indicated such a level minimised risk over the long term.
The uncertainty surrounding Brexit has resulted in a significant depreciation of the pound. Whilst this has resulted in gains for the Fund due to the overseas equity exposure, currency risk remains a major risk to the Fund and a strengthening pound would have a detrimental impact on the Fund's deficit as overseas assets would be worth less in sterling terms.
Whilst Brexit uncertainty extends into the new year, sterling has continued to depreciate resulting in a small loss on the strategy currency hedge of c. £0.4m relative to an unhedged position as at 31 December 2019.
The Fund implemented a short term tactical currency hedge of 100% of the physical developed overseas equities in order to lock-in gains from the recent sterling weakness and reduce the risk of a materially strengthening pound following the Brexit outcome. This was implemented in August 2019, and is expected to be in place for the short term until the outcome of Brexit is clearer. This increases the currency hedge on the overall equity portfolio to approximately 75%.
Since inception to 31 December 2019, the strategy has increased in value by £9.4m due to the pound strengthening.
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2.00	RESOURCE IMPLICATIONS
2.01	None directly as a result of this report

3.00	CONSULTATIONS REQUIRED / CARRIED OUT
3.01	Discussion at the Funding and Risk Management Group but not formal consultation 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 as a result of Brexit uncertainty.

5.00	APPENDICES
5.01	Appendix 1 - Monthly monitoring report – December 2019

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, 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