CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday 10 February 2021
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

This report provides the Committee with the estimated funding position at the end of the last quarter and details to enable the monitoring of the Risk Management Framework.

The estimated funding position at the end of December 2020 of 96% is 4% ahead of the expected position from the 2019 actuarial valuation. However, uncertainty in the outlook for returns is still high in light of the pandemic and economic factors.

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

Overall the framework is currently operating as expected in the current market conditions but this is regularly reviewed. There have been no changes to the level of interest rate, inflation or currency hedging. During the quarter the method of providing equity protection was refined to be more efficient, an approach which was previously too cost prohibitive to implement.

The funding position is monitored daily and officers with advisors will consider whether any further action is required if the funding level moves over 100%.

RECOMMENDATIONS	
1	That the estimated funding position for the Fund is noted along with the progress being made on the various elements of the Risk Management Framework.

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 2020 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 96% with a deficit of £91m at 31 December 2019 which is 4% ahead of the expected position when measured relative to the 2019 valuation expected funding plan. Uncertainty continues to be prevalent in the investment return environment due to ongoing external factors in relation to the pandemic. To illustrate the risk 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. 92% with a corresponding increase in deficit of £93m to £184m. For the purposes of this report the funding position has been measured on consistent actuarial assumptions with the 2019 valuation adjusted to reflect the hedging assets held.
1.03	No interest rate or inflation triggers were breached since the last update.
1.04	The level of hedging was approximately 20% for interest rates and 40% for inflation at 31 December 2020. 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 advisor, Mercer. The Cash Plus Fund is rated "amber" following underperformance since inception, primarily as a result of increasing credit spreads driven by the economic fallout of the Covid-19 pandemic. Collateral is within the agreed constraints and the efficiency of the collateral position has been improved following the implementation of a collateral waterfall framework with Insight last year. Overall, the collateral waterfall has generated an additional £2.6m return since implementation at 31 January 2019 to 30 September 2020 versus the previous structure. No action is required.
1.06	***Update on Risk Management framework*** **(i) Synthetic equity protection strategy** 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 being 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 as a contingency against material market falls; this translated into lower deficit contributions at the 2019 valuation, whilst maintaining the equity exposure supports a lower cost of accrual than under traditional de-risking methods. On 20 November 2020, the strategy was refined by increasing the level of upside achievable from 5% each month to 5% every two weeks. This will allow the strategy to participate in more upside in a rising market and reduce the chances of being capped out if we see a fall in markets and then a swift rebound, as we experienced in 2020. Until recently, the costs for increasing the upside frequency has been prohibitively expensive, however, the refined strategy is expected to have broadly the same costs as the previous strategy but with increased upside potential and therefore should improve the efficiency of the strategy. As at 31 December 2020, the synthetic equity strategy had increased by c. £57.3m since inception of the strategy in May 2018. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £54m since inception. The underperformance is largely driven by the sharp rally in equity markets causing the value of the protection to fall and a subsequent financing drag for paying for protection that is not required.
1.07	**(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 continues, sterling has remained weak resulting in a loss on the strategy's currency hedge of c. £1.8m relative to an unhedged position as at 31 December 2020. In addition, the Fund implemented a 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. This was implemented in August 2019, and relative to currency rates at this point, sterling has strengthened. Since inception to 31 December 2020, the strategy has increased in value by £10.4m. The currency hedge ratio on the overall equity portfolio is approximately 75%.

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 as a result of Brexit uncertainty.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – December 2020

6.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
6.01	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