CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 15 February 2023
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

The estimated funding position at 31 December 2022 of 105% is around 12% ahead of the expected position based on the 2019 valuation plan. The objectives and update on the various parts of the Risk Management Framework are included in the Appendix, showing 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 31 December 2022 is c. £60.9m. The currency hedging positions have made a loss of £19.6m in total since inception to 31 December 2022 due to weakening of sterling over that period versus the dollar. 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 environment. The Fund has benefitted from having the Flightpath in place, as the hedging and financing legs of the equity protection strategy have increased in value as equity markets have fallen. The inflation protection has also reduced the funding strain from the increase in inflation expectations over the year.

Following the extreme volatility in the UK gilt market, Fund 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 Officers to re-instate the trigger framework in December 2022, with levels raised to capture more attractive gilt prices. Fund Officers have also developed a plan for sourcing further liquidity at short notice to withstand future gilt market volatility, which has stabilised significantly since the date of the last Committee report.

The report also includes proposed changes to the Scheme of Delegation to clarify actions that can be taken by Officers when managing the Cash and Risk Management framework. These are set out in Appendix 2.

RECOMMENDATIONS	
1	That the Committee note and consider the contents of the report.
2	That the Committee approve the proposed updates to the Fund's Scheme of Delegations.

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 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 105% at 31 December 2022, which is 12% ahead of the expected position when measured relative to the 2019 valuation expected funding plan. The investment environment has continued to be bearish over 2022 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	Fund Officers paused the trigger framework prior to 30 September 2022 to prevent additional collateral strain being put on the risk management framework. The trigger framework has now been reinstated, with levels raised with respect to nominal yields by 0.5% p.a. to capture opportunities from yields being elevated relative to normal levels. The level of hedging was approximately 50% for interest rates and 40% for inflation at 31 December 2022. The liability hedging portfolio performed negatively over the quarter to 31 December 2022 as real yields rose, although this was partially offset by the fall in the value of the liabilities. 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.
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 Q3 2022, meaning it is operating in line within the tolerances monitored by Mercer. The Cash Plus Fund is rated "green" as the Fund had sufficient collateral to withstand the stresses as at 30 September 2022, although additional collateral was required to bolster the position and enable the Fund to take

	advantage of opportunities. The Cash Plus Fund has underperformed since inception and over Q3 2022. The collateral waterfall has returned £4.0m at 30 September 2022 since implementation at 31 January 2019. The collateral waterfall structure will be reviewed on an ongoing basis and 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) Synthetic equity and 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 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. The Fund implemented c. £215m of exposure in long-only synthetic equity positions in October and November 2022 to replicate the exposure lost through equity sales to support the collateral position within the Flightpath. Both positions consist of broad developed market exposure and are implemented through equity total return swap. As at 31 December 2022, the total performance since inception of the bespoke TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £60.9m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £88m 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.

1.06	(ii) <u>Collateral update</u> Officers took a number of actions to support the collateral position in Q3 2022. This included instructing sales from the Fund's equity portfolio (totalling c.£215m) to support the collateral position. The equity exposure (c.£215m) was replaced synthetically with Insight so as to maintain the overall strategic allocation of the portfolio. Actions taken by Fund 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. Officers continue to monitor the collateral position and at the date of this report no further action has been needed by Officers.
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 £19.6m since inception on 8 March 2019 to 31 December 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. £17.4m since inception of the strategy due to the material weakening of sterling versus the US dollar over that period. Overall the action to hedge the Fund's developed equity currency risk has resulted in a loss of £36.9m 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	**Decisions made since previous report** 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. Insight have now reinstated the trigger framework at the new levels.
1.09	**Update to Scheme of Delegation** The Pension Fund Committee has previously delegated a number of responsibilities to Fund Officers. The intention behind this is to ensure that decisions and actions are taken at the right level and in a timely manner. These are listed in the Scheme of Delegation shown in Appendix 2. Fund Officers recently identified that the delegations relating to the Fund's Risk Management Framework could do with further clarification including ensuring it is clear that the reference to deciding actions relating to the inflation and interest rate triggers, which has been delegated to the Head of Clwyd Pension Fund, does include changing the trigger levels. The Scheme of Delegation in Appendix 2 includes suggested updates (highlighted in yellow, bold and italics) to clarify what elements of the Risk

	Management Framework are delegated to the Head of Clwyd Pension Fund.

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 – 31 December 2022 Appendix 2 – Updated Scheme of Delegation

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 (h) **Total Return Swap** – An agreement between two parties constituting the exchange of the return from a financial asset. One party makes payments based on a set rate, either fixed or variable. Further terms are defined in the Glossary in the report in Appendix 1