CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 10th November 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 a recent date and details to enable the monitoring of the Risk Management Framework.

The estimated funding position at the end of September 2021 of 107% is around 14% ahead of the expected position from the 2019 actuarial valuation although uncertainty remains. This is below the 110% threshold that was agreed by the Funding and Risk Management Group ("FRMG") to prompt discussions on potential de-risking actions, analysing the impact these changes would have on employer contributions and risk. The allowance for updated membership data and other experience factors from the interim funding review will be incorporated in the October report (see Investment and Funding report for further details).

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

The synthetic equity and equity protection strategy was rolled on 23 May 2021, crystallising a gain of c. £129m, and the total gain since inception of the equity protection strategy to 30 September 2021 is c. £130m. The currency hedging positions have made a gain of £5.8m in total since inception to 30 September 2021 due to strengthening of sterling over that period.

The strong performance of the flightpath has meant excess collateral can potentially be released and consideration is being given to how that will be utilised as part of future Private Market investments. It will be held with Insight until a decision is made on how it is deployed. Overall the framework is currently operating as expected in the current market conditions and this is regularly reviewed, most recently through an annual strategic healthcheck that was discussed at the 4 September FRMG meeting. Overall, the FRMG were comfortable that no strategic changes were required at this stage.

RECOMMENDATIONS	
1	That the Committee note and consider the contents of the report.

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 30 September 2021 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 107% at 30 September 2021, which is 14% ahead of the expected position when measured relative to the 2019 valuation expected funding plan. Uncertainty continues to be prevalent in the investment environment due to the potential economic impact of the COVID-19 pandemic. This means that the likelihood of achieving the assumed discount rate/returns going forward has fallen. 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.103% with a corresponding decrease in surplus of £90m to £64m. As a reminder, the Funding and Risk Management Group ("FRMG") considered the potential for a change in the investment strategy following the breach of the soft funding level trigger of 100% on 9 July 2021. A new soft trigger of 110% has been put in place to prompt future FRMG de-risking discussions after it was agreed that no de-risking actions should be taken at the current time. The funding level is below this soft 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 ahead of the 2022 actuarial valuation. This trigger will also be considered at the next FRMG in light of the outcome of the interim funding review.
1.03	The level of hedging was approximately 20% for interest rates and 40% for inflation at 30 June 2021. 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. Triggers are in place to purchase additional interest rate or inflation hedging at an affordable level, currently the cost to purchase gilts in order to further increase the hedging is felt too prohibitive at the current time and therefore none of the interest rate triggers have been breached since they were re-structured in September 2017. No inflation triggers have been breached since May 2020. In September 2020, the inflation hedge was rebalanced back to the current strategic target 40% from 20% to reduce the risk that inflation will increase due to central bank and government intervention in managing the COVID-19 pandemic and the related market volatility. Following the annual strategic healthcheck of the risk management strategy, it was decided to maintain the current interest rate and inflation

	hedge ratios as well as the trigger levels. However, the Liability Benchmark Portfolio ("LBP") that provides Insight with a snapshot of the underlying liability characteristics for the Fund as been updated as part of the healthcheck to allow for accrual and changes in market conditions since the previous LBP. Mercer and Insight are in the process of implementing the updated LBP. This ensures that if trigger are hit, for example, Insight will be hedging based on a more accurate representation of the Fund's liabilities. The LBP will continue to be updated on an annual basis as well as following an actuarial valuation.
1.04	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 monitored by Mercer who are also the Fund's strategic risk advisors. The Cash Plus Fund is rated "amber" following underperformance since inception because of increased credit spreads driven by the economic impact of the COVID-19 pandemic. However, the Cash Plus Fund outperformed the benchmark over Q2 2021. 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. Overall, the collateral waterfall has generated an additional £8.8m return from inception at 31 January 2019 to 30 June 2021. No further action is therefore recommended at this point, although given the healthy collateral position, some of the excess has been earmarked to fund Private Market drawdowns as and when required (see 1.08 below) which is being considered further.
1.05	**Update on Risk Management framework** (i) <u>Synthetic equity and equity protection strategy</u> 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 in the Actuarial Valuation assumptions; 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. The Fund's synthetic equity and equity protection strategy is implemented through a Total Return Swap ("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, and was due to expire on 23 May 2021. The Head of Clwyd Pension Fund, advised by the FRMG, decided under delegated powers that it was appropriate to maintain this exposure, and therefore a new TRS contract was put in place for another 3 years. This reset the market value back to zero, crystallising the positive c. £129m gain (as at 23 May 2021) into the Insight QIAIF. Further, Mercer and the Officers were able to negotiate a 50% reduction (c. £1m p.a.) in the ongoing transaction costs with JP Morgan. As at 30 September 2021, the total performance since inception of the synthetic equity and equity protection strategy in May 2018 was an increase of c. £130m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £56m since inception. The underperformance is largely driven by the rise in equity markets since inception of the strategy meaning the meaning the protection has become less valuable.
1.06	(ii) <u>Collateral update</u> By rolling the equity protection strategy, the mark-to-market value of the TRS was reset to zero. As the existing contract had a positive market value of c. £129m (as at 23 May 2021), this amount was released into the wider collateral pool within the Insight QIAIF as part of the rolling of the contract. Mercer's analysis shows that there is sufficient collateral available within the QIAIF to allow a disinvestment of c. £100m upon rolling the equity protection strategy. On the advice of FRMG, the Head of Clwyd Pension Fund agreed to retain this amount within the Insight QIAIF for the time being awaiting further analysis of the Private Market drawdowns before considering how this will be utilised and this is still the position pending further discussion. The excess collateral amount was invested as follows: • £50m invested in the High Grade ABS fund • Remainder held as cash The High Grade ABS a "Tier 2 fund"; a liquid daily dealing fund that provides return above cash on excess collateral that isn't required on a daily basis. This ensures the risk management framework is operating efficiently. Once the timing of the Private Market drawdowns are better understood, some of the proportion of the excess collateral held as cash may be invested into the Tier 2 funds. This will be considered at a future FRMG meeting.
1.07	(iv) <u>Currency hedging gain</u> The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £3.6m since inception on 8

	March 2019 to 30 September 2021 due to the weakening of sterling over that period. The Fund's overseas developed market physical equity holdings are currency hedged and has made an offsetting gain of c. £9.4m since inception of the strategy due to the strengthening of sterling over that period. Overall the action to hedge the Fund's developed equity currency risk has resulted in a gain of £5.8m since inception of the strategies.

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 – September 2021

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 Further terms are defined in the Glossary in the report in Appendix 1