

**FLINTSHIRE COUNTY COUNCIL**

**REPORT TO:** **CLWYD PENSION FUND COMMITTEE**

**DATE:** **26<sup>th</sup> NOVEMBER 2015**

**REPORT BY:** **CHIEF OFFICER (PEOPLE AND RESOURCES)**

**SUBJECT:** **FUNDING AND FLIGHT-PATH UPDATE**

**1.00 PURPOSE OF REPORT**

1.01 To update Committee Members on the funding position and liability hedging undertaken as part of the Flight-path strategy for managing liability risks.

**2.00 BACKGROUND**

2.01 A role of the Committee is to monitor the funding position of the Fund and the management of the liabilities.

2.02 Mercer provides advice to the Fund on liability hedging and flight-paths. Insight Investments were appointed to manage the assets on behalf of the Fund.

2.03 The flight-path strategy commenced from 1<sup>st</sup> April 2014 with the following aims:

- Achieve a 'base level' of interest rate and inflation hedging (10% hedge ratio) at the outset.
- Aim for a target interest rate and inflation hedge of 40% by April 2019.
- Achieve a target interest rate and inflation hedge ratio of 80% in the long term.

To this end, Insight will construct and manage a portfolio of assets that aims to hedge a proportion of the Fund's liability cash flows.

2.04 By replacing the Fund's passive equity exposure with an Equity Total Return Swap (synthetic equity exposure) the Fund freed up capital to be used as collateral for a liability hedging portfolio. This enables the Fund to maintain its exposure to return seeking assets, while reducing the interest and inflation risks.

2.05 From the 'base level' further hedging will be achieved through an incremental build up over time overlaid with triggers according to prevailing market conditions. In addition there are funding level triggers which will result in the disinvestment of growth assets as the funding level improves. All the above is fully documented and understood by Mercer and Insight.

- 2.06 The triggers have been formulated on the understanding that the Fund's overall objective is to be fully funded within 10 to 12 years which is ahead of the average recovery plan based on deficit contributions of 18 years.

### **3.00 CONSIDERATIONS**

- 3.01 The monthly summary report from Mercer on the funding position and an overview liability hedging mandate is attached as at 30<sup>th</sup> September 2015. There was no hedging activity in September 2015. It includes a "traffic light" of the key components of the Flightpath and hedging mandate with Insight. This will be presented at the Committee meeting including a verbal update on how things have moved. It is noted in the report that the funding position is now at 62%, which is c.8% behind the "expected funding level". Given this, and the continuing volatility in markets, the current funding position rating has been retained as an "amber" rating (it was also amber at 31 August). Since the end of September, the funding position has improved to c.64%. This will continue to be monitored and any action will be considered within the Actuary's interim funding review in advance of next year's actuarial valuation.
- 3.02 This deterioration was largely driven by falls in equity markets over the month to end September and the volatility in markets is continuing due to the uncertainty over the Chinese economy. As indicated previously the funding assumptions (in particular the expected real return over CPI inflation which determines the valuation discount rate used) and approach will be reviewed in light of the risk management framework and the overall expected return on the growth assets portfolio. The discount rate used can have a material effect on the funding position and deficit. For example an increase in the expected return/discount rate of 0.25% p.a. would increase the estimated funding level to 65% and reduce the deficit to £720m at 30<sup>th</sup> September 2015.
- 3.03 Since the commencement of the strategy a number of interest rate triggers have been met and the Fund had an interest rate hedge of approx. 21.3% and an inflation hedge of approx. 40.0% at 30<sup>th</sup> September. No funding triggers had been reached.
- 3.04 As a result of the hedging noted above we have already reached the planned target level for inflation hedging at April 2019, namely a 40% hedge ratio. Mercer has recently produced a health check for the flightpath which contains a number of options for enhancing the overall framework. These recommendations are to be considered in light of the upcoming funding review and we will report back on any actions at a future committee meeting.
- 3.04 The estimated funding position as at 30<sup>th</sup> September is 62% and an estimated deficit of £821m which is behind expectations. The hedges in 3.03 have protected the funding position against the recent changes in interest and inflation rates to the extent the deficit would have been approx. £75m higher if the hedges since inception had not been implemented via the triggers and the original strategy had remained in place.
- 3.05 The Actuary will verbally update the Committee on developments since the previous Committee meeting.

#### **4.00 RECOMMENDATIONS**

4.01 That Committee Members note the estimated funding level and the liability hedging undertaken to 30<sup>th</sup> September 2015 plus that the overall funding framework is being reviewed in the run up to the full 2016 actuarial valuation, noting the funding level improvement to c.64%.

#### **5.00 FINANCIAL IMPLICATIONS**

5.01 None directly as a result of this report.

#### **6.00 ANTIPOVERTY IMPACT**

6.01 None directly as a result of this report.

#### **7.00 ENVIRONMENTAL IMPACT**

7.01 None directly as a result of this report.

#### **8.00 EQUALITIES IMPACT**

8.01 None directly as a result of this report.

#### **9.00 PERSONNEL IMPLICATIONS**

9.01 None directly as a result of this report

#### **10.00 CONSULTATION REQUIRED**

10.01 None directly as a result of this report

#### **11.00 CONSULTATION UNDERTAKEN**

11.01 None directly as a result of this report

#### **12.00 APPENDICES**

12.01 Risk management framework – monthly monitoring report September 2015

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#### **LOCAL GOVERNMENT (ACCESS TO INFORMATION) ACT 1985**

Background Papers: None

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