CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 20 September 2017
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

Members should note that:

- On a consistent basis the estimated funding position at the end of August is 92% which is around 13% ahead of the expected position from the 2016 actuarial valuation. However, there remains uncertainty in future return expectations.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 30 June 2017.

- The Insight investment guidelines were updated during August 2017 to incorporate the interest rate triggers that were agreed at the November 2016 PFC. No interest rate triggers have been breached since the interest rate triggers were re-introduced.

- The LDI restructure completed in March 2017 is expected to achieve a net long-term gain of £36.5m. A gain could be crystallised earlier in certain market conditions. Since the restructure, the Fund has benefitted by around £6.1m at the end of August. This position will continue to be monitored to highlight an opportunity to crystallise a gain earlier (subject to a minimum of £25m).

- The Equity protection strategy was implemented on 24th April 2017 to protect against losses of more than 15% over a one year period on the equity mandate with Insight but retain full gains in the markets. This incurred an expected "premium" of £7.2m. The value of the equity option will be monitored on a quarterly basis.

RECOMMENDATIONS	
1	Note the updated funding and hedging position for the CPF and 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 August 2017 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 92% with a deficit of £162m at 31 August. In absolute terms the relative funding position is 13% ahead of the expected position at the end of August 2017 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 5% to 87% with a corresponding increase in deficit of £90m to £252m.
1.03	The revised interest rate and inflation triggers agreed at the November 2016 PFC are in place with Insight following updated investment guidelines being signed in August. None of the new triggers have been satisfied.
1.04	The level of hedging was around 20% for interest rates and 40% for inflation at 30 June 2017. 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.
1.06	***Update on Risk Management framework*** (i) Restructuring the Insight Portfolio As reported previously, Insight and Mercer identified an opportunity to restructure Insight’s mandate that will be more efficient for the Fund. This involved buying assets with a higher yield/return and selling an equivalent asset with a lower yield/return. Insight implemented the trade subject to achieving a minimum level of benefit (net of transaction costs) of £25m. The trade was completed over the period 20th February to 3rd March 2017.

	The net long-term gain achieved was £36.5m (made up of a yield gain of £38m and transaction costs of £1.5m) which was a very positive result and lower trading costs than expected. The Fund's hedge ratios remain at 20% for interest rates and 40% for inflation. Going forward the relative value trade will be monitored to see if a gain can be crystallised earlier if market conditions allow. Since inception the Fund has benefitted by around £6.1m. This will continue to be monitored. Cash collateral of £80m was released from the LDI portfolio on 23rd March following advice from Mercer. The ongoing collateral adequacy of the LDI portfolio mandate is monitored on a quarterly basis. As at 30 June 2017 the Fund had an additional collateral buffer which could be released to invest elsewhere, however, this should be taken into context with the wider liquidity constraints of the Fund. The suitability of disinvestment will be discussed further at FRMG.
1.07	(ii) Implementation of Equity protection on the Insight mandate 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 will provide further stability in employer 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 was agreed by the FRMG that the Equity protection should only cover exposure within the Equity mandate managed by Insight. Mercer and JLT were tasked to consider various options and put forward a recommendation to the FRMG for agreement on 12th April 2017. It was agreed to implement a 1 year term contract to cover any losses on the mandate (£325m) of 15% or more. This was subject to the premium being no more than 3% of the total exposure (£10m). The strategy was implemented on 24th April 2017 at a premium of £7.2m (including transaction costs) or 2.2% of exposure. The strategy and the value of the equity option contract will continue to be monitored.

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 in the Insight mandate only.

5.00	APPENDICES
5.01	Appendix 1 - Monthly monitoring report - August 2017

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, Clwyd Pension Fund Manager **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

7.00	GLOSSARY OF TERMS
7.01	(a) **CPF – 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) **PFC – 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) **LPB or PB – Local Pension Board or Pension Board** – each LGPS Fund has an LPB. Their purpose is to assist the administering authority in ensuring compliance with the scheme regulations, TPR requirements and efficient and effective governance and administration of the Fund.

(e) **LGPS – Local Government Pension Scheme** – the national scheme, which Clwyd Pension Fund is part of

(f) **FSS – Funding Strategy Statement** – the main document that outlines how we will manage employers contributions to the Fund

(g) **Actuarial Valuation** - The formal valuation assessment of the Fund detailing the solvency position and determine the contribution rates payable by the employers to fund the cost of benefits and make good any existing shortfalls as set out in the separate Funding Strategy Statement.

(h) **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.

(i) **GAD – Government Actuary's Department -** The Government Actuary's Department is responsible for providing actuarial advice to public sector clients. GAD is a non-ministerial department of HM Treasury.

(j) **Section 13 Actuarial Valuation -** Section 13 of the Public Service Pensions Act 2013 provides for a review of the LGPS valuations and employer contribution rates to check that they are appropriate and requires remedial steps to be taken where it is considered appropriate. The GAD will undertake this review based on the results of the 2016 actuarial valuations.

(k) **ISS – Investment Strategy Statement**
The main document that outlines our strategy in relation to the investment of assets in the Clwyd Pension Fund

(l) **Flightpath**
A framework that defines a de-risking process whereby exposure to growth assets is reduced as and when it is affordable to do so i.e. when "triggers" are hit, whilst still expecting to achieve the overall funding target.

(m) **Deficit**
The extent to which the value of the Fund's liabilities exceeds the value of the Fund's assets.

(n) **Funding level**
The difference between the value of the Fund's assets and the value of the Fund's liabilities expressed as a percentage.

(o) **Hedging**
A strategy that aims to reduce funding volatility. This is achieved by investing in assets that mimic changes in liability values due to changes in market conditions.

(p) **Hedge ratio**
The level of hedging in place in the range from 0% to 100%.

(q) **Insight QIF – Insight Qualified Investor Fund**
An investment fund specifically designed for the Fund to allow Insight to manage the liability hedging and synthetic equity assets.

(r) **Funding & Risk Management Group (FRMG)**
A subgroup of Pension Fund officers and advisers set up to discuss and implement any changes to the Risk Management framework as delegated by the committee. It is made up of the Clwyd Pension Fund Manager, Pension Finance Manager, Fund Actuary, Strategic Risk Adviser and Investment Advisor.

(s) **Equity option**
A financial contract in which the Fund can define the return it receives for movements in equity values.

(t) **Equity TRS (Equity Total Return Swap)**
A financial contract in which the Fund receives the return on an equity index. In return the Fund must pay a regular financing fee to a counterparty bank.

(u) **Collateral**
Liquid assets held by the Fund as security which may be used to offset the potential loss by a counterparty.

(v) **Counterparty**
Commonly an investment bank on the opposite side of a financial transaction (e.g. swaps).

(w) **London Interbank Offer Rate (LIBOR)**
An interest rate at which banks can borrow funds from other banks in the London interbank market.

(x) **Z-spread**
The difference between the yield on gilts and swaps.