CLWYD PENSION FUND COMMITTEE

Date of Meeting	20 February 2019
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 January is 89% which is around 9% ahead of the expected position from the 2016 actuarial valuation. However, there still remains uncertainty regarding future inflation and investment return expectations, especially given the recent market volatility.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 31 January 2019.

- No triggers have been breached since the interest rate triggers were re-structured in September 2017. Mercer recommended no change to the interest rate trigger levels as part of the flightpath healthcheck.

- The dynamic equity protection strategy was implemented on 24 May 2018. As at 31 January 2019, the strategy had decreased by £20m or 5.6% since inception of the strategy. The Fund is protected from falls in equity markets of 14% or more from current levels. More detail is provided separately in the Mercer report in Appendix 1.

- The Officers, with the advice of JLT and Mercer have decided to implement a collateral waterfall structure to increase the efficiency of the collateral position within the Insight QIAIF in a low governance manner, but without impacting the overall risk management profile of the flightpath strategy. The collateral waterfall will be fully in place by end February 2019 and introduces two new funds at Insight; the Global ABS Fund (c. £45m investment) and the Secured Finance II fund (c. £50m investment). It has also been decided that c. £30m will be released from the Insight QIAIF to be invested in infrastructure as directed by JLT in due course.

RECOMMENDATIONS	
1	That the Committee note the updated funding and hedging position for the Fund and the progress being made on the various elements of the Risk Management Framework.
2	That the Committee note that the Officers have been working with their advisers in order to implement a collateral waterfall process at Insight to better manage collateral requirements. Insight are in the process of implementing the collateral waterfall which will be in place by end February 2019. It has also been agreed that c. £30m will be removed from the Insight QIAIF to be invested in infrastructure as directed by JLT in due course.

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 January 2019 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 89% with a deficit of £225m at 31 January 2019 which is 9% ahead of the expected position 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 c. 4% to c. 85% with a corresponding increase in deficit of £96m to £321m.
1.03	None of the interest rate triggers have been satisfied since they were re-structured in September 2017.
1.04	The level of hedging was around 20% for interest rates and 40% for inflation at 31 January 2019. 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. The LIBOR Plus Fund is rated "amber" due to the temporary limit on future investments into the fund. This should not affect the operation of the mandate but it will be kept under watch.

	The collateral and counterparty position is rated "green"; collateral is within the agreed constraints and the Officers are taking action with their advisors to improve the efficiency of the collateral position (see section 1.07).
1.06	***Update on Risk Management framework*** (i) Dynamic equity protection implementation and progress 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 was to provide 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 which is currently prevalent given the significant volatility of equity returns that we have seen over Q4 2018. Importantly over the longer-term the increased security allows the Actuary to include less prudence in the Actuarial Valuation assumptions; this would translate into lower deficit contributions at the 2019 valuation whilst maintaining equity exposure supports a lower cost of accrual that under traditional de-risking methods. This will be quantified in the 2018 interim review. As at 31 January 2019, the dynamic protection strategy had decreased by c. £20m or 5.6% since inception of the strategy. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £7.8m or 2.1% since inception. It should be noted that the strategy did outperform passive equities by providing protection during the December equity market downturn; the subsequent equity market rally in January, however, has meant that this protection is now less valuable and hence the underperformance. This underperformance is essentially the cost of reducing the risk of contribution increases for employers. The strategy provides protection from equity market falls of 14% or more. If such a downside event occurred then the protection structure should outperform passive equities. The protection will be monitored on an ongoing basis and the Committee papers have been updated as part of the reporting in Appendix 1.
1.07	(ii) Collateral position Due to the positive performance of the flightpath framework since its implementation, Mercer indicated that there was an opportunity to increase the efficiency of the collateral in the QIAIF by implementing a collateral waterfall process at Insight and the Officers, with the advice of JLT and Mercer, have decided to implement this structure. The waterfall will be fully in place by end February 2019, and introduces two new funds, namely the Global ABS Fund (c. £45m investment) and the Secured Finance II fund (c. £50m investment). Mercer calculated, and Insight have confirmed, the minimum level of collateral required whilst still supporting the current positions and

	maintaining the flightpath strategy to be £170m. This would still leave sufficient collateral in the event of market moves or in the event of any triggers being hit in line with the agreed guidelines. The waterfall at outset can be summarised as follows: • Tier 1: c. £215m in cash and gilts to support collateral requirements on a day to day basis • Tier 2: c. £100m of additional collateral that acts as a buffer invested high quality liquid funds (Global ABS fund and Libor Plus fund) • Tier 3: £50m of excess collateral that is invested in high quality but illiquid assets (Secured Finance II fund) Approximately £30m will be released from the QIAIF to be invested in infrastructure assets as directed by JLT in due course. The waterfall requires that Insight hold at least £170m in Tier 1 assets at any time and if the value falls below that amount, they have discretion to sell assets from Tier 2 to top this up. Tier 2 funds are daily traded and can act as a ready source of collateral as required whilst generating a higher expected yield in the meantime. This approach is expected to generate an additional yield of £3m p.a. whilst still providing adequate security that the collateral position is managed effectively. A collateral waterfall ensures that the Insight QIAIF provides the necessary collateral requirements but makes those assets work harder, increasing yield in a low governance manner. The Committee will be updated in due course once Insight have completed the implementation towards end February 2019.

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.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – January 2019

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) **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