Cyngor Sir y Fflint
Flintshire County Council

CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 4 September 2019
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

This paper provides an update of the Funding and Risk Management framework and any actions taken during the quarter.

Members should note that:

- On consistent actuarial assumptions, the estimated funding position at the end of July is 94% which is around 13% ahead of the expected position from the 2016 actuarial valuation.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 31 July 2019. No triggers have been breached since the interest rate triggers were re-structured in September 2017.

The following actions have been implemented since the last Committee.

- The equity protection levels of assets covered (c£350m) have been increased in order to reduce the likelihood of contribution increases in the future.

- The previously implemented currency hedging policy is being increased to revise the overall currency hedge to 75% (from the current 50%) until the outcome of Brexit is clearer.

RECOMMENDATIONS	
1	That the Committee note the updated funding position (on assumptions consistent with the 2016 valuation) and hedging position for the Fund and the progress being made on the various elements of the Risk Management Framework.
2	The committee note that the equity protection structure has now been revised to increase the level of protection.
3	That the Committee note that any currency risk associated with the market value of the synthetic equity portfolio and the developed equity markets which have now been fully hedged.

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 July 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 94% with a deficit of £127m at 31 July 2019 which is 13% 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. 90% with a corresponding increase in deficit of £93m to £220m. For the purposes of this report the funding position has been measured on consistent actuarial assumptions with the 2016 valuation. The actuarial assumptions are being reviewed as part of the 2019 valuation.
1.03	None of the interest rate triggers have been breached 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 July 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 Cash Plus Fund is rated "green" and is performing as expected following the investment into Insight's Global ABS fund and the Secured Finance II fund. The collateral and counterparty position is rated "green"; collateral is within the agreed constraints and the efficiency of the collateral position has been improved following the implementation a collateral waterfall framework with Insight earlier in the year.
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. 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. As at 31 July 2019, the equity protection strategy had increased by c. £14m or 3.9% since inception of the strategy. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £14m or 4.4% since inception. The strategy provides protection from equity market falls of 21% or more from current market levels. If such a downside event occurred, then the protection structure should outperform passive equities. The protection was recently reviewed, and on 1 August 2019, the level of protection for the Fund was increased by 5%, the cost of which will be offset by the Fund's participation in losses beyond a fall of 35% from current market levels. Protecting for such extreme unlikely scenarios is proportionately expensive and not necessarily required by the Fund as it has the governance and implementation framework in place in order to act quickly and bank the returns from the protection in the event of an equity market drawdown. The committee papers have been updated as part of the reporting in Appendix 1. JP Morgan originally quoted a one off 0.03% of exposure to make the transition (c. £100k), however Mercer negotiated a reduction to this cost of £70k to £30k. There are no additional ongoing costs for implementing this refined structure and it was considered that the reduction in risk outweighed the costs.
1.07	(ii) Implementation of currency hedging A strategic currency hedging policy was implemented in March 2019. By currency hedging the market value of the synthetic equity portfolio, and leaving the physical equity portfolio unhedged from a currency perspective, this policy achieves a c.50% currency hedged position of the overall equity portfolio. The strategic hedge ratio was based on analysis that indicated such a level minimised risk over the long term. The uncertainty surrounding Brexit has resulted in a significant depreciation of the pound. Whilst this has resulted in gains for the Fund due to the unhedged physical overseas equity exposure, currency risk remains a major risk to the Fund and a strengthening pound would have a detrimental impact on the Fund's deficit. The implementation of a currency hedging policy on the Fund's physical equity holdings would lock-in gains from the recent sterling weakness and reduce the risk of a materially strengthening pound following the Brexit outcome on 31 October 2019.

	The Fund holds c. £270m in physical equities, of which c. £125m is developed overseas exposure and practical to hedge at low cost. As at 30 June 2019, if sterling appreciated by 15% say (back to pre EU referendum levels), the Fund would lose c. £16m on these developed equity holdings (ignoring any changes on the underlying equity valuations). Conversely, if sterling continued to depreciate following a no-deal Brexit for example, and fell to 10 year lows, this would only represent a further c. 5% fall in sterling, increasing the value of these developed overseas equities by a c. £5m. Mercer highlighted that there was more to be lost if sterling appreciates to pre EU referendum levels and, on balance, it was more likely for sterling to appreciate than depreciate following the outcome of Brexit. It was therefore decided to currency hedge 100% of the physical developed overseas equities until the outcome of Brexit was clearer, banking recent gains and removing currency volatility. This will result in the physical equity mandate being c.50% currency hedged, and the overall equity portfolio c. 75% currency hedged. This position can be achieved quickly and cheaply via an overlay implemented in the Insight QIAIF. Insight have estimated transaction costs of 0.006% p.a. on total exposure, (c. £7.5k p.a.) and 0.03% p.a. management fees (c. £37.5k p.a.). It was considered that the reduction in risk more than outweighed the costs to hedge. The Officers, working closely with Mercer and Insight, are aiming for the currency hedge to be in place before the end of August 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. 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 point as a result of Brexit uncertainty.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – July 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