CYNGOR Sir y Fflint Flintshire COUNTY COUNCIL

CLWYD PENSION FUND COMMITTEE

Date of Meeting	Thursday, 28 November 2019
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

Members should note that:

- On consistent actuarial assumptions, the estimated funding position at the end of September is 91% which is around 10% ahead of the expected position from the 2016 actuarial valuation. The valuation assumptions are being consulted on with employers and these are expected to be finalised at the February committee meeting after the end of the consultation.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 30 September 2019.

- As at 30 September 2019, the revised equity protection strategy (which increased protection levels by 5%) had made a gain of £13m since inception of the strategy.

- A strategic currency hedging solution on the Fund's synthetic equity portfolio was implemented on 8 March 2019 to protect the Fund against a strengthening pound which would have a detrimental impact on the Fund's deficit. The Fund implemented a further hedge in August on the physical overseas developed equities to lock in currency gains. This results in an overall hedge ratio of 75%.

RECOMMENDATIONS	
1	That the updated funding position (currently 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 is noted.
2	That the impact of the equity protection strategy is noted.
3	That the Committee note that any currency risk associated with the market value of the synthetic equity portfolio with the Flightpath strategy is hedged, and a further hedge has been placed on the Fund's developed market physical equity holdings.

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 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 91% with a deficit of £189m at 30 September 2019 which is 10% 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. 3% to c. 88% with a corresponding increase in deficit of £94m to £283m. 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 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 30 September 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. Overall, the collateral waterfall has generated an additional £2m in returns since implementation at 31 January 2019 to 30 June 2019 versus the previous structure. No action required.
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 30 September 2019, the dynamic protection strategy had increased by c. £13m 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 since inception. On 1 August 2019, the level of protection for the Fund was increased from 12 month average market levels of 15% to 10%, the cost of which will be offset by the Fund's participation in losses beyond 30%. 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.
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 achieved 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 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 as overseas assets would be worth less in sterling terms. The Fund implemented a short term tactical currency hedge of 100% of the physical developed overseas equities in order to lock-in gains from the recent sterling weakness and reduce the risk of a materially strengthening pound following the Brexit outcome. This was implemented in August 2019, and is expected to be in place for the next 6-12months after which the outcome of Brexit will hopefully be clearer. This increases the currency hedge on the overall equity portfolio to approximately 75%. This position was achieved quickly and cheaply via an overlay implemented in the Insight QIAIF. Transaction costs were approximated in advance to be 0.006% p.a. on total exposure, (c. £7.5k p.a.) and 0.03% p.a. management fees (c. £37.5k p.a.) were negotiated.

	Since inception to 30 September, the strategy has increased in value by £1.2m due to the pound strengthening.

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 as a result of Brexit uncertainty.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – September 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, 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