CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 21 June 2023
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

The estimated funding position at 30 April 2023 of 105% is broadly the same as the expected position. This is now calculated using the updated assumptions and liabilities in the Actuarial Valuation 2022.

The objectives and update on the various parts of the Risk Management Framework is included in the Appendix and shows the management of interest rate and inflation risk, equity market risk, currency risk, liquidity and collateral risk.

The total gain since inception of the synthetic equity strategy to 30 April 2023 is c. £96.0m. The currency hedging positions have made a loss of £31.2m in total since inception to 30 April 2023 due to weakening of sterling over that period versus the dollar. This is offset against gains on the physical overseas equity holdings.

The Fund remains in a healthy financial position, despite a challenging market environment. The Fund has benefitted from having the Flightpath in place, as it has served to reduce risk in the investment strategy relative to the Fund's liabilities. Whilst the relative performance of the components has varied, overall the Flightpath framework has performed as expected over recent periods. The recent negative performance shown is mainly as a result of rising interest rates, and the liability value will have fallen by at least this amount, serving to stabilise the funding level and employer contributions.

In April 2023, the Pensions Regulator issued guidance to pension schemes to ensure that they had minimum levels of collateral resiliency and a robust framework in place for monitoring and replenishing collateral. The Fund is in compliance with the guidance, with comfortable levels of collateral to support the current hedges in place and to take advantage of opportunities through the market based interest rate and inflation trigger framework should they arise. There is also a robust framework to take action quickly, and further liquidity can be sourced from liquid assets held outside the Insight Mandate at short notice if required.

A number of the reinstated triggers were hit over May 2023, allowing the Fund to purchase gilts at attractive levels. This has increased the interest rate hedge ratio from c. 51% to c. 58%. The inflation hedge ratio remains at 40%.

RECOMMENDATIONS	
1	That the Committee note and consider the contents of the report and the various actions taken.

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 April 2023 from Mercer on the funding position and an overview of the risk management framework is attached in Appendix 1. This is the first update report where the funding position has been restated to use the assumptions and liabilities calculated from the Actuarial Valuation 2022. Previous updates continued to use the 2019 assumptions when considering the expected funding level until the Funding Strategy Statement was approved and employers agreed revised employer contribution plans in March 2023. 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 principal objectives of the framework.
1.02	The estimated funding level is 105% at 30 April 2023, which is broadly in line with the expected position when measured relative to the 2022 valuation expected funding plan. We have restated the expected funding level to commence from 1 April 2022 based on the final position signed off in the Actuary's valuation report. The expected funding level will reduce over time as employers are using part of the valuation surplus in line with the agreed funding plans. New employer contributions commenced from 1 April 2023. The investment environment has continued to be bearish over 2023-to-date amid rising inflation and interest rates. A trigger of 110% is in place to prompt future Funding & Risk Management Group (FRMG) de-risking discussions and based on the formal protocol agreed by the Committee. The funding level is below this trigger currently but if breached, this would prompt further analysis on whether the Fund can take de-risking actions to provide more certainty for employers without inadvertently putting upwards pressure on contributions in future. This trigger will be kept under review over time.
1.03	As previously reported the trigger framework was paused prior to 30 September 2022 to prevent additional collateral strain being put on the risk management framework. The trigger framework was reinstated in December 2022, with interest rate trigger levels raised by 0.5% p.a. to capture value opportunities from yields being elevated relative to normal levels. The level of hedging was approximately 50% for interest rates and 40% for inflation at 31 March 2023. The liability hedging portfolio performed positively over the quarter to 31 March 2023 as real yields fell, although this has reversed over April and May as real yields increased by around 1% since quarter end. The hedging implemented to date provides access to a lower risk investment strategy but maintaining a sufficiently high real yield/return expectation to achieve the funding and contribution targets. Following the increase in gilt yields over 2023 to date, a number of the reinstated higher triggers were hit in May 2023, which prompted Insight to implement the following actions:

	• 18 May: The 4.25% yield trigger was hit in the longest maturity band (band 4) meaning all 4.25% yield triggers have been hit; • 22 May: the 4.50% yield trigger was hit in maturity band 3; and • 25 May: the 4.50% yield triggers were hit in maturity bands 2 and 4. (NB: This activity is not captured in appended April 2023 report but will be captured in future reports). The activity has increased the interest rate hedge ratio to c. 58%, with the inflation hedge ratio unchanged at 40%. Transaction costs for the activity totalled c. £54k and were at the lower end of the expected cost range. Following the triggers being hit, collateral remains in a healthy position, with the portfolio currently able to withstand an interest rate rise of in excess of 5% (i.e. to over 9%) whilst supporting suitable stresses on the other hedging exposures (equity and FX), without drawing on the existing collateral waterfall. With regard to this, the portfolio is in line with guidance issued by the Pensions Regulator in April 2023 as per paragraph 1.04 below.
1.04	In April 2023 the Pensions Regulator issued guidance to pension schemes to ensure that they had minimum levels of collateral resiliency and a robust framework in place for monitoring and replenishing collateral. Specifically the Pensions Regulator recommended that: • LDI mandates should have available collateral (typically cash and gilts) within the mandate that comprises 2 elements: a market stress buffer and an operational buffer. • The market stress buffer should be sufficient to cover at least a 250bps upward movement in interest rates. • The operational buffer should be in addition to the market stress buffer, and should be such that under day-to-day volatility the market stress buffer can be maintained in normal market conditions. • A larger operational buffer is appropriate where non-LDI assets are less liquid or additional collateral might take time to source from the wider scheme assets. • In the event of market stress, it is acceptable for the market stress buffer to be drawn down (i.e. the total buffer level can fall below 250bps but it should be replenished quickly). • Trustees should regularly monitor the resilience of their LDI strategy to adverse interest rate, inflation and other market stresses. The Fund is in compliance with the guidance, with comfortable levels of collateral to support the current hedges in place and to take advantage of opportunities through the market based interest rate and inflation trigger framework should they arise. The Fund has a robust governance framework to monitor collateral levels and take action quickly as needed, and further liquidity can be sourced from liquid assets held outside the Insight Mandate at short notice if required.
1.05	Based on data from Insight, Mercer's analysis shows that the management of the Insight Liability Hedging mandate is rated as "green" as at the end of Q4 2022, meaning it is operating in line within the tolerances monitored by Mercer.

	The Cash Plus Fund is rated “green” as the Fund had sufficient collateral to withstand the stresses as at 31 December 2022, although additional collateral was required to bolster the position and enable the Fund to take advantage of opportunities. The Cash Plus Fund has underperformed since inception and over Q4 2022. The collateral waterfall has returned £4.9m at 31 December 2022 since implementation at 31 January 2019. The collateral waterfall structure is reviewed on an ongoing basis and further work has been carried out to understand the liquidity of the wider investment strategy and where capital could be sourced at short notice, should it be required in future to supplement available collateral within the Flightpath. Following completion of this work and the investment strategy review, the remaining assets within the collateral waterfall are to be divested to fund the allocation to WPP Sustainable Equity. Officers and Mercer are comfortable that following this divestment, the portfolio will continue to comply with the latest guidance issued by the Pensions Regulator.
1.06	**Update on Risk Management framework** (i) <u>Synthetic equity and equity protection strategy</u> The Fund gains exposure to equity markets via derivatives and protects the majority of this exposure against potential falls in the equity markets via the use of an equity protection strategy. This provides further stability (or even a reduction) 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 should be noted that, having an equity protection policy in place will protect from any large falls in equity markets. Importantly over the longer-term the increased security allows the Actuary to include less prudence/buffer in the Actuarial Valuation assumptions; this translates into lower contributions at each valuation (all other things equal), whilst maintaining the equity exposure supports a lower cost of accrual than under traditional de-risking methods. The Fund has a bespoke synthetic equity and equity protection strategy, which is implemented through a Total Return Swap (“bespoke TRS”) contract with JP Morgan, held within the Insight QIAIF (the fund that implements the risk management strategies on the Fund’s behalf). The TRS contract is for a fixed term of 3 years up to 2024. The Fund implemented c. £215m of exposure in long-only synthetic equity positions in October and November 2022 to replicate the exposure lost through equity sales to support the collateral position within the Flightpath on a temporary basis. These will be unwound as the WPP Sustainable Equity allocation is funded. Both positions consist of broad developed market exposure and are implemented through vanilla equity total return swap. Unlike the custom TRS, these vanilla swaps have no protection in place and rise and fall with equity markets. As at 31 March 2023, these swaps had experienced a gain of c. £13m since inception.

	As at 30 April 2023, the total performance since inception of the bespoke TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £96.0m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £88m since inception. The underperformance is largely driven by the rise in equity markets since inception of the strategy meaning the protection has become less valuable.
1.07	(ii) Currency hedging gain/loss The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £17.5m since inception on 8 March 2019 to 30 April 2023 due to the material weakening of sterling over that period, particularly versus the US dollar. The Fund's overseas developed market physical equity holdings are currency hedged and have made a loss of c. £13.7m since inception of the strategy due to the material weakening of sterling versus the US dollar over that period. Overall, the action to hedge the Fund's developed equity currency risk has resulted in a loss of £31.2m since inception of the strategies, although this will have been offset by rises in value of the overseas equity holdings due to these currency movements.
1.08	**Delegated decisions made since previous report** The FRMG agreed at the 3 April meeting to implement a refinement to the synthetic equity protection strategy which serves to reduce market timing risk and improve efficiency with no additional cost. This has since been implemented by JP Morgan.
1.09	**Overview of Flightpath strategy** The Flightpath was first implemented in 2014 as a risk management strategy in order to stabilise the funding position and thereby manage employer contributions. The value of the Flightpath increased materially over the period to the start of 2022 due to falling interest rates and rising equity markets. Whilst the performance of the components of the Flightpath have varied, overall the Fund has benefitted from having the Flightpath framework in place to date and it has served to reduce risk in the investment strategy relative to the Fund's liabilities. This has allowed the Fund and the Actuary to stabilise employer contributions and in fact reduce average employer contributions at the 2022 valuation. Over recent periods, performance of the framework has been negative as gilt yields have risen and equity market volatility has increased. Though inflation protection has reduced the funding strain from the increase in inflation since early 2022, the rise in gilt yields to date has resulted in a fall in value for the framework. This performance is in line with expectations and will have served to reduce volatility in the funding level since the Fund's liabilities also decreased over the period. As a result of the increase in gilt yields, the Flightpath has enabled the Fund to lock-in to attractive levels of return due to the interest rate trigger framework as discussed in paragraph 1.03.

	The framework's equity protection mandate has also served to reduce funding level volatility relative to holding unprotected equities. As equity exposure is achieved synthetically, the addition of this mandate has increased risk-adjusted returns for the Fund (noting that absolute returns added are less than would have been achieved if investing in more volatile unhedged synthetic equity). Reducing volatility is a primary objective of the Flightpath strategy.

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 generate 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.

5.00	**APPENDICES**
5.01	Appendix 1 – Monthly monitoring report – 30 April 2023

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. • 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. (h) **Vanilla/Unhedged Synthetic Equity** – Derivative contracts that enable the Fund to gain exposure to broad equity markets with no embedded equity protection. The change in value of vanilla contracts is perfectly correlated to the change in the value of broad equity market indices. (i) **TPR LDI Guidance** – Guidance issued by the Pensions Regulator in April 2023 covering the use of leveraged liability-driven investment by pension schemes (https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/liability-driven-investment) Further terms are defined in the Glossary in the report in Appendix 1