CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 15th June 2022
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

This report provides the Committee with the estimated funding position at a recent date and details to enable the monitoring of the Risk Management Framework.

The estimated funding position at the end of March 2022 of 101% is around 8% ahead of the expected position from the 2019 actuarial valuation although uncertainty remains. The allowance for updated membership data and other experience factors from the interim funding review have been incorporated in the report. The assumptions will be reviewed as part of the 2022 actuarial valuation. This is below the 110% threshold that was proposed by the Funding and Risk Management Group ("FRMG") to prompt discussions on potential de-risking actions, analysing the impact these changes would have on employer contributions and risk. The Head of Pensions and FRMG have outlined a governance protocol for the monitoring and implementation of the 110% funding level de-risking trigger that was ratified by the Committee at the last meeting.

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 31 March 2022 is c. £137m. The currency hedging positions have made a loss of £0.2m in total since inception to 31 March 2022 mainly due to weakening of sterling over that period versus the dollar.

At the meeting on 29 April 2022, the FRMG discussed the current inflationary environment in relation to setting the inflation assumption for the 31 March 2022 actuarial valuation. It was noted that supply/demand dynamics particularly at longer maturities was having a bigger impact at this valuation and therefore a larger inflation risk premium could be reasonable. The Fund's Actuary will discuss setting the valuation assumptions in more detail with the Committee.

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

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 March 2022 from Mercer on the funding position and an overview of the risk management framework 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 101% at 31 March 2022, which is 8% ahead of the expected position when measured relative to the 2019 valuation expected funding plan. The investment environment has been bearish year to date amid rising inflation, partly driven by supply chain issues caused as a result of Russia’s invasion of Ukraine, and the actions of central banks which have reacted by hiking interest rates. This means that the likelihood of achieving the assumed discount rate/returns going forward may be reduced and need to be reflected in the assumptions at the 2022 valuation. 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.97%, with a corresponding decrease in surplus of £100m to a deficit of £71m. A trigger of 110% has been put in place to prompt future FRMG de-risking discussions and a formal protocol was proposed and ratified at the previous 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 ahead of finalising the 2022 actuarial valuation. This trigger will be considered at a future FRMG in light of the outcome of the actuarial valuation.
1.03	The level of hedging was approximately 20% for interest rates and 40% for inflation at 31 March 2022. The liability hedging portfolio performed negatively over the quarter to 31 March 2022 due to a sharp rise in gilt yields. This negative performance was partially offset by an increase in the value of inflation protection as inflation continued to climb. 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. Triggers are in place to purchase additional interest rate or inflation hedging at an affordable level, currently the cost to purchase gilts in order to further increase the hedging is felt too prohibitive at the current time and therefore none of the interest rate triggers have been breached since they were re-structured in September 2017. No inflation triggers have been breached since May 2020. In September 2020, the inflation hedge was rebalanced back to the current strategic target 40% from 20% to reduce the risk that inflation will increase due to central bank and government intervention in managing the COVID-19 pandemic and the related market volatility.

1.04	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 monitored by Mercer who are also the Fund's strategic risk advisors. The Cash Plus Fund is rated “green” although underperforming since inception, the collateral waterfall underperformed the benchmark over Q4 2021 and since inception. Collateral is within the agreed constraints, and the efficiency of the collateral position has been improved following the implementation of a collateral waterfall framework with Insight. Overall, the collateral waterfall has generated an additional £7.2m return from inception at 31 January 2019 to 31 March 2022. No further action is therefore recommended at this point.
1.05	**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 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 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 translated into lower deficit contributions at the 2019 valuation, whilst maintaining the equity exposure supports a lower cost of accrual than under traditional de-risking methods. The Fund’s synthetic equity and equity protection strategy is implemented through a Total Return Swap (“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, and was due to expire on 23 May 2021. The Head of Clwyd Pension Fund, advised by the FRMG, decided under delegated powers that it was appropriate to maintain this exposure, and therefore a new TRS contract was put in place for another 3 years. This reset the market value back to zero, crystallising the positive c. £129m gain (as at 23 May 2021) into the Insight QIAIF. Further, Mercer and the Officers were able to negotiate a 50% reduction (c. £1m p.a.) in the ongoing transaction costs with JP Morgan. As at 31 March 2022, the total performance since inception of the synthetic equity and equity protection strategy in May 2018 was an increase of c.

	£137m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £75m 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.
1.06	(ii) <u>Collateral update</u> As at 31 December 2021 we estimate the collateral headroom (i.e the amount over and above the minimum immediate collateral of £140m) of c. £217m. The QIAIF has available immediate collateral (Tier 1 assets) of £357m. Insight would take action if Tier 1 collateral fell below £150m, and have discretion to take action if Tier 1 collateral falls below £190m. The action they would take would be to sell some of the Tier 2 assets (High Grade ABS and Global ABS) to top up the level Tier 1 collateral. These daily dealing Tier 2 funds have in total c. £156m as at 31 December 2021. Since the last Committee meeting £50m of Tier 1 assets have been transferred to the High Grade ABS Fund (a Tier 2 fund), transacting in five £10m tranches between 10 March and 21 March 2022, to generate a higher return whilst awaiting the Private Market drawdowns. The QIAIF still has a very healthy collateral position following this change.
1.07	(ii) <u>Currency hedging gain/loss</u> The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £7.2m since inception on 8 March 2019 to 31 March 2022 due to the weakening of sterling over that period. The Fund's overseas developed market physical equity holdings are currency hedged and have made a gain of c. £7.0m since inception of the strategy due to the strengthening of sterling over that period. Overall the action to hedge the Fund's developed equity currency risk has resulted in a loss of £0.2m 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	Setting the inflation assumption for the 31 March 2022 valuation At the meeting on 29 April 2022, the FRMG discussed the current inflationary environment in relation to setting the inflation assumption for the 31 March 2022 actuarial valuation. The FRMG discussed how the market may be overshooting inflation due to current market dynamics (e.g. demand for index-linked gilts from private sector pension schemes outweighing supply). The FRMG therefore looked at a range of inflation risk premia that might more accurately reflect expectations for future inflation and considered the impact on funding and contributions under different assumptions. It was noted that supply/demand dynamics particularly at longer maturities was having a bigger impact at this valuation and therefore a larger inflation risk premium could be reasonable. However a balance is needed to be struck, as should realised inflation exceed the Fund's inflation assumption, then this would lead to a funding strain. The Fund's Actuary will discuss setting the valuation assumptions in more detail with the Committee.

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.

5.00	APPENDICES
5.01	Appendix 1 - Monthly monitoring report – 31 March 2022

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 Further terms are defined in the Glossary in the report in Appendix 1