FLINTSHIRE COUNTY COUNCIL

REPORT TO: **CLWYD PENSION FUND COMMITTEE**

DATE: **4TH FEBRUARY 2015**

REPORT BY: **CHIEF OFFICER (PEOPLE AND RESOURCES)**

SUBJECT: **FUNDING AND FLIGHT-PATH UPDATE**

1.00 PURPOSE OF REPORT

1.01 To update Committee Members on the funding position and liability hedging undertaken as part of the Flight-path strategy for managing liability risks.

2.00 BACKGROUND

2.01 A role of the Committee is to monitor the funding position of the Fund and the management of the liabilities.

2.02 Mercer provides advice to the Fund on liability hedging and flight-paths. Insight Investments were appointed to manage the assets on behalf of the Fund.

2.03 The flight-path strategy commenced from 1st April 2014 with the following aims:

- Achieve a 'base level' of interest rate and inflation hedging (10% hedge ratio) at the outset.
- Aim for a target interest rate and inflation hedge of 40% by April 2019.
- Achieve a target interest rate and inflation hedge ratio of 80% in the long term.

To this end, Insight will construct and manage a portfolio of assets that aims to hedge a proportion of the Fund's liability cash flows.

2.04 By replacing the Fund's passive equity exposure with an Equity Total Return Swap (synthetic equity exposure) the Fund freed up capital to be used as collateral for a liability hedging portfolio. This enables the Fund to maintain its exposure to return seeking assets, while reducing the interest and inflation risks.

2.05 From the 'base level' further hedging will be achieved through an incremental build up over time overlaid with triggers according to prevailing market conditions. In addition there are funding level triggers which will result in the disinvestment of growth assets as the funding level improves. All the above is fully documented and understood by Mercer and Insight.

2.06 The triggers have been formulated on the understanding that the Fund's overall objective is to be fully funded within 10 to 12 years which is ahead of the average recovery plan based on deficit contributions of 18 years.

3.00 CONSIDERATIONS

3.01 The monthly summary report from Mercer on the funding position and an overview liability hedging mandate is attached as at 31st December 2014. It includes a "traffic light" of the key components of the Flightpath and hedging mandate with Insight. This will be presented at the Committee meeting including a verbal update on how things have moved. Based on the preliminary data from Insight, the analysis shows that all traffic lights are "green" at 31st December meaning the mandate is operating in line within the tolerances set by the our advisors. However, there is continuing volatility in markets so the current funding position is closer to an amber rating. This is because the funding position is behind the expected recovery plan given the recent change in market conditions. If this persists then we would possibly need to move to an amber rating and consider if any actions are needed.

3.02 With regards to specific actions since the commencement of the strategy a number of interest rate triggers have been met and the Fund had an interest rate hedge of approx. 24.0% and an inflation hedge of approx. 26.0% at 31st December. No funding triggers had been reached. Since 31 December further inflation triggers were hit on the 2nd, 5th and 6th January meaning the inflation hedge increased to approximately 40%. This means we have already reached our aim the planned target level at April 2019 for inflation hedging. The Advisory Panel will consider if inflation hedging should continue and this will be reported at the next committee meeting in March 2015.

3.03 The estimated funding position as at 31st December is 66% and an estimated deficit of £700m which is behind expectations. The hedges in 3.02 have protected the funding position against the recent changes in interest and inflation rates to the extent the deficit would have been approx. £70m higher if the hedges since inception had not been implemented via the triggers and the original strategy had remained in place.

3.04 The risk framework is structured so that the interest rate and inflation hedge ratio will be increased every quarter by 1.5% until the hedge ratios reach 40%. Given the inflation hedge ratio is now at 40% the time based inflation trigger has been suspended. In addition, a decision was taken to suspend the interest rate time based increase in the hedge ratio given the recent falls in gilt yields (this will be kept under review) as it was consider not to be cost efficient to increase the hedge automatically in the current market conditions.

3.05 The Actuary will verbally update the Committee on developments since 31st December and a further more detailed report will be presented at the March meeting.

4.00 RECOMMENDATIONS

4.01 That Committee Members note and discuss the estimated funding level and the liability hedging undertaken to 31st December 2014 and the further hedging after 31st December resulting in a significant change in the inflation hedge ratio.

5.00 FINANCIAL IMPLICATIONS

5.01 None directly as a result of this report.

6.00 ANTIPOVERTY IMPACT

6.01 None directly as a result of this report.

7.00 ENVIRONMENTAL IMPACT

7.01 None directly as a result of this report.

8.00 EQUALITIES IMPACT

8.01 None directly as a result of this report.

9.00 PERSONNEL IMPLICATIONS

9.01 None directly as a result of this report

10.00 CONSULTATION REQUIRED

10.01 None directly as a result of this report

11.00 CONSULTATION UNDERTAKEN

11.01 None directly as a result of this report

12.00 APPENDICES

12.01 Overview of risk management framework – Q4 2014

LOCAL GOVERNMENT (ACCESS TO INFORMATION) ACT 1985

Background Papers: None

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