CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 9th February 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 December 2021 of 102% is around 9% 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 Head of Pensions and FRMG have developed a proposed governance process for the monitoring and implementation of the proposed 110% funding level de-risking trigger for agreement by the Committee.

The objectives and update on the various parts of the Risk Management Framework are included in the Appendix and shows the management of:

- Interest rate and inflation risk
- Equity market risk
- Currency risk
- Liquidity and collateral risk

The Head of Clwyd Pension Fund, under delegated powers, decided that the synthetic equity and equity protection strategy should be continued beyond 23 May 2021, and at that point a gain of c. £129m was crystalised, and the total gain since inception of the equity protection strategy to 31 December 2021 is c. £176m. The currency hedging positions have made a gain of £11.4m in total since inception to 31 December 2021 due to strengthening of sterling over that period. The strong performance of the flightpath has meant excess collateral can potentially be released and consideration is being given to how that will be utilised as part of future Private Market investments. It will continue to be held with Insight until a decision is made on how it is deployed

RECOMMENDATIONS	
1	That the Committee note and consider the contents of the report.
2	That the Committee agree to the 110% funding level trigger and agree the funding level de-risking trigger process.

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 December 2021 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 principal objectives of the framework.
1.02	The estimated funding level is 102% at 31 December 2021, which is 9% ahead of the expected position when measured relative to the 2019 actuarial valuation expected funding plan. Uncertainty continues to be prevalent in the investment environment due to the potential economic impact of the COVID-19 pandemic and other issues. 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 actuarial 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.98% with a corresponding decrease in surplus of £103m to a deficit of £47m.
1.03	*Funding Level Trigger* As discussed at previous Committee meetings, it is proposed that a funding level trigger of 110% should be put in place to prompt future FRMG de-risking discussions. The Committee is asked to approve this trigger. This funding level trigger been incorporated into the amended Investment Strategy Statement which is part of a separate agenda item. The funding level in the attached monitoring report 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 the 2022 actuarial valuation. This trigger will also be considered at the next FRMG in light of the outcome of the interim funding review.
1.04	Following discussions at the previous committee, it was agreed by the FRMG that a formal process should be formulated for the actions to be taken following a breach of the 110% funding level trigger. Currently the "Delegation of Functions to Officers by the Pension Fund Committee" provides that: *"implementation of the agreed market Flightpath triggers and deciding action(s) to be taken when Flightpath funding triggers are reached within the existing constraints of the Investment Strategy."* is delegated to: *"The Head of Clwyd Pension Fund (having regard to ongoing advice of the Investment consultant and Pension Advisory Panel)."* subject to high level monitoring by the Pension Fund Committee.

1.05	The Head of Pensions and FRMG have proposed a process for the de-risking actions which allows engagement with the Pension Fund Committee whilst ensuring that action can be taken in a timely manner having regard to professional advice: The suggested process is as follows: • The funding level be monitored daily using projected asset and liability values from the PFaroe platform. On breaching the 110% funding level, a notification will be sent to the FRMG via email on that or the following Business Day; • Mercer will then independently verify the asset and liability values over the following 10 Business Days (the length of this period reflects the timeframe to receive updated data from the Fund's investment managers) to confirm that the 110% trigger has indeed been breached; • Mercer will conduct analysis of the funding position assuming that the trigger has been breached, and will circulate an advice note to the FRMG no later than 20 Business Days from the initial trigger notification; • The FRMG will hold a call within 25 Business Days of the trigger notification to discuss the advice note and any recommendation made by the Fund's advisers to the FRMG. • The Head of Clwyd Pension Fund will then consider the advice received relating to de-risking, and will report via email their intended decision on this matter to the Pension Fund Committee; • The Committee will be invited to provide feedback over the following 5 Business Days and: o If, after receiving any comments, there are no outstanding issues for discussion (including where no comments have been received from the Committee) regarding the Head of Clwyd Pension Fund's proposed decision, if the decision is to de-risk, the FRMG will liaise with investment managers to agree documentation and instructions in line with the agreed actions within 35 Business Days from the initial trigger notification. o However, if there are any issues highlighted by PFC members that require discussion, a special Committee meeting will be called to consider the issues and at that meeting the Committee will be asked whether or not to endorse the Head of Clwyd Pension Fund's intended way forward (noting that this meeting will need to be scheduled as a matter of urgency). o Following a decision to go ahead with the de-risking actions, the FRMG will work with investment managers to implement the agreed de-risking activity, which will then be reported to Committee at the next regular meeting.
1.06	The Committee is asked to review the process and confirm it is happy with the process being put in place. This process will then be added to the "Delegation of Functions to Officers by the Pension Fund Committee".

1.07	*Hedging* The level of hedging was approximately 20% for interest rates and 40% for inflation at 30 September 2021. 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.
1.08	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 this also means that the higher interest rate triggers have not 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.
1.09	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 outperformed over Q3 2021. 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 £9.6m return from inception at 31 January 2019 to 30 September 2021. No further action is therefore recommended at this point, although given the healthy collateral position, some of the excess has been earmarked to fund Private Market drawdowns as and when required (see 1.11 below) which is being considered further.
1.10	**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 December 2021, the total performance since inception of the synthetic equity and equity protection strategy in May 2018 was an increase of c. £176m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £63m 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.
1.11	(ii) Collateral update As at 30 September 2021 we estimate the collateral headroom (i.e the amount over and above the minimum immediate collateral of £140m) of c. £198m. The QIAIF has available immediate collateral (Tier 1 assets) of £338m. Insight would take action if Tier 1 collateral fell below £140m, and have discretion to take action if Tier 1 collateral falls below £170m. 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. £155m as at 30 September 2021. Given the strong collateral position and the increase in exposures within the QIAIF since the minimum level of collateral was set, the FRMG agreed to increase the minimum level of collateral by £10m from £140m to £150m. This would reduce the collateral headroom slightly. Further, the FRMG has extended the level at which Insight can take discretionary action to top up the Tier 1 assets by £20m, from £170m to £190m. The QIAIF would still have a very healthy collateral position following these changes. The main reason for the healthy collateral position is the positive performance of the flightpath, with £100m of collateral earmarked for Private Market drawdowns. Mercer is conducting further analysis to determine whether a portion of the available collateral within the QIAIF could be transferred to the High Grade ABS Fund (a Tier 2 fund) to generate a higher return whilst awaiting the Private Market drawdowns. Once the collateral analysis has been

	completed, this will be discussed at the FRMG meeting in February and implemented alongside the agreed revisions to the collateral structure.
1.12	(iv) Currency hedging gain The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £1.1m since inception on 8 March 2019 to 31 December 2021 due to the weakening of sterling over that period. The Fund's overseas developed market physical equity holdings are currency hedged and has made an offsetting gain of c. £11.4m 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 gain of £10.3m since inception of the strategies.

2.00	**RESOURCE IMPLICATIONS**
2.01	None directly as a result of this report

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	None

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 – December 2021

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.