CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 31st August 2022
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

The estimated funding position at 30 June 2022 of 95% is around 2% ahead of the expected position. The assumptions are being reviewed as part of the 2022 actuarial valuation and the updated position will be recalibrated once completed.

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 June 2022 is c. £75m. The currency hedging positions have made a loss of £23.7m in total since inception to 30 June 2022 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 relatively healthy position in terms of funding level versus the expected position, despite a challenging market environment. The Fund has benefitted from having the Flightpath in place, as both the equity protection strategy has increased in value as equity markets have fallen, and the inflation protection has reduced the funding strain from the significant increase in inflation over the year. As interest rates have risen over the six month period to 30 June 2022, the available collateral held by the Fund to support the Flightpath has been depleted but remains in a very healthy position. The robust collateral monitoring framework in place means we can react accordingly should further collateral be required.

The Funding and Risk Management Group (FRMG) formally assess all parts of the Flightpath on an annual basis and will consider whether any refinements are required. This assessment is currently underway and will be discussed at the FRMG meeting on 2 September and will report back to the Committee on any proposed changes including in relation to any impact on the funding position.

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 30 June 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 95% at 30 June 2022, which is 2% 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 and the actions of central banks which have reacted by hiking interest rates. 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 meeting. 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 meeting 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 30 June 2022. The liability hedging portfolio performed negatively over the quarter to 30 June 2022 due to a combination of a continued rise in gilt yields and falling inflation expectations. 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 to be 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 of 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. Given the continued interest rate rises, the FRMG will be considering whether to lock-in some of these higher yields as part of the annual review of the Flightpath to be discussed on 2 September.
1.04	Based on data from Insight, our analysis shows that the management of the Insight Liability Hedging mandate is rated as “green” as at the end of Q1 2022, meaning it is operating in line within the tolerances monitored by Mercer.

	The Cash Plus Fund is rated “amber” due to underperformance since inception and over Q1 2022. The collateral position of the Fund has worsened over the quarter to June 2022 due to rising gilt yields, however the Fund continues to have a healthy collateral position. Further, Insight are mandated to sell the Cash Plus Funds if collateral is required in the short term as part of the robust collateral waterfall framework in place, which has improved the efficiency of the collateral position. As at 30 June there had been no required asset sales from the Cash Plus Funds. Overall, the collateral waterfall has generated an additional £6.2m return from inception at 31 January 2019 to 30 June 2022. The collateral waterfall structure will be reviewed alongside the wider Risk Management Framework as part of the annual health check that is currently ongoing and the outcome of this will be reported at a future Committee meeting. This will consider the appropriateness of the strategy as well as the operational structure in light of the material shift in interest rates and inflation expectations. No immediate action is 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/buffer in the Actuarial Valuation assumptions; this translated into lower 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 up to 2024. As at 30 June 2022, the total performance since inception of the synthetic equity and equity protection strategy in May 2018 was an increase of c. £75m. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £60m 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. Over the year to date the Fund has benefitted from the protection provided

	by the equity protection strategy due to sustained falls in equity markets. This has resulted in the strategy outperforming an investment in passive equities (with no frictional costs) by £15m over the quarter to 30 June 2022.
1.06	(ii) <u>Collateral update</u> As at 30 June 2022 we estimate the collateral headroom (i.e. the amount over and above the minimum immediate collateral of £150m) of c. £77m. The QIAIF has available immediate collateral (Tier 1 assets) of £227m. 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 (the Cash Plus Funds, High Grade ABS and Global ABS) to top up the level of Tier 1 collateral. These daily dealing Tier 2 funds have in total c. £202m as at 30 June 2022. The QIAIF continues to have a very healthy collateral position despite the recent increases in interest rates and falls in inflation, which have caused the value of Liability Hedging assets to fall. This is despite the recent press coverage which was mainly related to private sector schemes with higher hedge ratios and different objectives in relation to risk management.
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 £16.4m since inception on 8 March 2019 to 30 June 2022 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. £7.3m since inception of the strategy due to the material weakening of sterling over that period. Overall the action to hedge the Fund’s developed equity currency risk has resulted in a loss of £23.7m 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	**Impact of interest rate and inflation changes on the discount rate** As part of the valuation, the discount rate (expected return) and inflation rate assumptions will be set in relation to market conditions at 31 March 2022 and this will be discussed with Committee as part of the valuation and Funding Strategy Statement considerations. However, we will also need to consider the impact of the changes in economic outlook and interest/inflation rates after the valuation date in terms of tracking the funding position as part of the monitoring framework. This will also feed into the separate investment strategy review being undertaken later in 2022. This will be discussed at the FRMG meeting on 2 September and the outcome of those discussions will be reported back to Committee and factored into future monitoring reports.

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 – 30 June 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