CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 30 August 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 June 2023 of 107% is 2% ahead of 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 June 2023 is c. £120.3m. The currency hedging positions have made a loss of £28.7m in total since inception to 30 June 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 return performance shown is mainly as a result of rising interest rates, and this will be offset as the liability value will have fallen helping to stabilise the funding position.

A number of the interest rate triggers were hit over June and July 2023, allowing the Fund to purchase gilts at attractive levels. This has increased the interest rate hedge ratio from c. 58% to c. 67% on the current hedging basis. The inflation hedge ratio remains at c. 40% on this basis.

The current hedging basis is based on market conditions as at the 2019 Actuarial Valuation. The FRMG is currently updating the liability benchmark for the 2022 Actuarial Valuation cashflows and as part of this the hedging basis will be revised. Once the hedging basis is updated, the hedge ratios will be re-expressed on the new basis. There will be no change to the gilt exposure gained through the risk management framework as a result. However, given the large increases in real yields since the last time the hedging basis was updated, we expect that the interest rate and inflation hedge ratios will be lower than Insight are currently reporting once the basis is updated.

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 June 2023 from Mercer on the funding position and an overview of the risk management framework is attached in Appendix 1. This uses the assumptions and liabilities calculated from the Actuarial Valuation 2022. 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 107% at 30 June 2023, which is 2% ahead of the expected position when measured relative to the 2022 valuation expected funding plan. The expected funding level will reduce over time as employers are using part of the valuation surplus in line with the agreed 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	The level of hedging was approximately 60% for interest rates and 40% for inflation at 30 June 2023 based on the current hedging basis. The liability hedging portfolio performed negatively over the quarter to 30 June 2023 as real yields rose significantly across all maturities over the quarter. The hedging implemented to date provides access to a lower risk investment strategy by maintaining a sufficiently high real yield/return expectation to achieve the funding and contribution targets. Following the increase in gilt yields over June and July 2023, a number of the triggers were hit, which prompted Insight to implement the following actions: • 13 June: The 4.5% yield trigger was hit in the shortest maturity band (band 1) meaning all 4.5% yield triggers have been hit; • 19 June: The 4.75% yield trigger was hit in maturity band 1. • 6 July: The 5.0% yield trigger was hit in maturity band 1 and the 4.75% trigger was hit in maturity band 2. • 7 July: The 4.75% yield trigger was hit in maturity band 3. The activity has increased the interest rate hedge ratio to c. 67%, with the inflation hedge ratio unchanged at 40%. Transaction costs for the activity totalled c. £64.4k which was in the expected cost range for trading of this size. Following the triggers being hit, collateral remains in a healthy position,

	with the portfolio currently able to withstand an interest rate rise 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. The current hedging basis is based on market conditions as at the 2019 Actuarial Valuation. The FRMG is currently updating the liability benchmark for the 2022 Actuarial Valuation cashflows and as part of this the hedging basis will be revised. Once the hedging basis is updated, the hedge ratios will be re-expressed on the new basis. There will be no change to the gilt exposure gained through the risk management framework as a result. However, given the large increases in real yields since the last time the hedging basis was updated, we expect that the interest rate and inflation hedge ratios will be lower than Insight are currently reporting once the basis is updated.
1.04	The Fund remains in compliance with the TPR guidance on collateral levels, 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 latest data available from Insight, Mercer's analysis shows that the management of the Insight Liability Hedging mandate is rated as "green" as at 31 March 2023, 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 March 2023, 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 Q1 2023. The collateral waterfall has returned £6.5m at 31 March 2023 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 in line with the agreed strategy. Officers and Mercer are comfortable that following this divestment, the portfolio will continue to comfortably comply with the latest TPR guidance as noted in 1.04 above.
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 certainty 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. 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. Following the initial £65m tranche of funding of the WPP Sustainable Active Equity Fund on 21 June 2023, an equivalent amount of vanilla/unhedged synthetic equity exposure was unwound on 30 June 2023, ensuring the Fund was not overweight its strategic allocation to equities. As at 30 June 2023, the total performance since inception of the bespoke TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £120.3m. 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 £16.5m since inception on 8 March 2019 to 30 June 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. £12.2m 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 £28.7m since inception of the strategies, although this is expected to be fully offset by rises in value of the overseas equity holdings due to these same currency movements.

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 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