AVON PENSION FUND COMMITTEE – JUNE 2015 COMMITTEE MEETING

MANAGEMENT OF LIABILITY RISKS: DEVELOPING A RISK MANAGEMENT FRAMEWORK

1. INTRODUCTION

The Committee reviewed the Fund's strategic asset allocation (the mix of assets which the Fund invests in) in 2013. The Fund currently has a 20% allocation to Stabilising Assets (comprising UK and overseas government bonds and UK corporate bonds). The broad purpose of the Stabilising Assets is to help control investment risk relative to the Fund's liabilities and thereby help to "stabilise" the funding level and the Fund's contribution requirements. The purpose of this note is to outline a proposal for reviewing the investment risk that the Fund is exposed to relative to the Fund's liabilities, and how this is mitigated by the Stabilising Assets. This proposal involves the Committee delegating power to the Panel to undertake the review with the Officers and the Fund's Advisor, Mercer Ltd and report back its findings in 2016.

2. RECOMMENDATION

That the Committee agrees to delegate power to the Panel to undertake this review and notes:

- **The key issues behind the review (Section 3)**
- **The scope of the review of the Fund's asset allocation in the context of liability risk management (Section 4)**
- **The provisional timetable for the review (Section 5).**

3. THE ISSUE: BETTER RISK MANAGEMENT

Risk can ultimately be defined as the possibility of being unable to pay benefits as and when they fall due. However, these benefit payments are due over many decades in the future. Given this, measuring the current funding position is a way of assessing the risk of this happening now.

The value of the asset portfolio varies but the present value of the Fund's liabilities also varies over time, just as much if not more. To illustrate, over the fourth quarter of 2014 alone, the value of the Fund's liabilities increased by c. £370m as a result of market implied changes to the discount rate and inflation assumptions (which are used to value the liabilities), while the Fund's total assets increased only increased by c. £100m over the same period.

Such changes clearly lead to volatility in the funding level and therefore volatility in contribution requirements. There has been a lot of work in recent years to better structure the Growth assets within the Fund's asset portfolio and diversify away risk. As such, the purpose of this exercise will be to focus solely on the Stabilising Assets and to make these assets "work harder" to better mitigate against the liability risks whilst ensuring the arrangements in place remain affordable.

In order to illustrate the liability risks, taking a step back, when carrying out an Actuarial Valuation or indeed any funding update, the Actuary determines a present value of the Fund's liabilities by using a discount rate to calculate the value of the liabilities in today's terms. However, this discount rate varies over time, as conditions change in financial markets. In particular, since the discount rate is based on gilt prices (which can be very volatile) it can change markedly over time, which leads to material changes in the present value of the liabilities and therefore changes to the funding level and

potentially, contribution rates. This risk is often called “interest rate” risk. Volatility in the funding level and contribution requirements have been clearly evident in recent years and interest rate risk is one key reason why this has been the case.

HOW CAN THESE RISKS BE MITIGATED?

The aim of the portfolio of Stabilising Assets is to invest in bonds and bond-like assets to mitigate liability risks like interest rate risk as described above in an affordable manner. Whilst the Fund’s Stabilising Assets are currently invested in a diversified range of “generic” bond funds and will broadly move in line with the value of the liabilities, considerable volatility remains as these funds are not a close match to the actual Fund-specific liabilities. **By improving the matching characteristics of the Fund’s assets** (implemented through the Stabilising Asset portfolio), the assets could be used more effectively to reduce the “mismatch” with the liabilities and help to better stabilise the funding level. In addition, improving the design of the Stabilising Assets will ensure that there are sufficient assets available over the long term to invest in the Growth portfolio and target the excess returns needed to close the funding deficit and therefore help to manage the cost of future contributions.

Aside from interest rate risk, the other main liability risk to consider is “inflation risk”. The amount the Fund pays out in benefit payments each year is directly impacted by inflation given the uncapped CPI linked nature of the benefit payments (i.e. higher inflation leads to larger pension payments out of the Fund’s assets to members). There are ways to improve the effectiveness of the Fund’s assets to better hedge against these inflation risks (by investing in assets whose values have a better linkage to CPI inflation).

It is proposed that the Panel review the Fund’s asset allocation and make pragmatic recommendations to the Committee as to how this can be enhanced (through the Stabilising Assets portfolio) to better focus on reducing liability risks and the volatility of contributions.

It should be noted that this can be a complex area of investment which will require training over the coming months. In particular, changes to the Stabilising Assets may involve some use of leveraged funds for the purposes of reducing risk and ensuring the Fund’s assets better cover the liabilities. A key part of this exercise will be the Panel investigating these approaches (which are already commonplace with private sector defined benefit pension schemes and are increasingly being used within LGPS) before deciding on a suitable recommendation to Committee.

This report sets out the scope of the review and the provisional timetable for completion.

4. SCOPE OF REVIEW

It is proposed that the Committee delegate to the Panel the undertaking of this exercise to review the liability matching characteristics of the Fund’s assets and develop a risk management framework to cover:

1. The current level of liability matching provided by the Stabilising Assets and all other bond assets, both at a total level and also split into the level of interest rate and inflation matching
2. Potential impact on risk and return of improving this level of liability matching and increasing contribution stability whilst ensuring the arrangements remain affordable

3. The range of funds and techniques available to better control these liability risks
4. Current "costs" of improving matching characteristics, relative to long-run interest rate and inflation expectations, and tools / asset classes for gaining this improved matching
5. The potential to use market-based triggers to improve matching characteristics of Stabilising Assets when affordable and attractively priced (i.e. when bond yields are high enough to justify locking in to them).
6. The suitability of the corporate bond assets held in respect of those employers and former employers where the liabilities are valued with a discount rate based on corporate bonds yields

The 2016 triennial actuarial valuation will commence in earnest after 31 March 2016, and the Actuary will provide input into this review as required. Panel will report their recommendations to Committee alongside the discussions on the 2016 valuation.

5. PROVISIONAL TIMETABLE

Following suitable training of Officers and Panel members, and the analysis detailed above, the Panel will report their recommendations to Committee in 2016 alongside the availability of results from the Actuarial Valuation.