

| <b>Bath &amp; North East Somerset Council</b>  |   |                           |
|--|---|---------------------------|
| MEETING:   | <b>AVON PENSION FUND INVESTMENT PANEL</b>         |                           |
| MEETING DATE:  | <b>18 November 2015</b>                           | <b>AGENDA ITEM NUMBER</b> |
| TITLE:   | <b>MANAGING LIABILITIES – ADDITIONAL ANALYSIS</b> |                           |
| WARD:  | ALL   |                           |
| <b>AN OPEN PUBLIC ITEM</b>   |   |                           |
| List of attachments to this report:  |   |                           |
| Appendix 1 – Mercer Report: Risk Management Framework – Further training and scenario analysis   |   |                           |
| Appendix 2 – <u>Copy of Mercer report to September Panel Meeting</u> - Risk Management Framework |   |                           |

## **1 THE ISSUE**

- 1.1 At the September meeting, the Panel considered recommendations from Mercer on how the liability risks could be managed more effectively. At the meeting the Panel requested further analysis before making full recommendations to Committee.
- 1.2 The report from Mercer providing the additional analysis is at Appendix 1.
- 1.3 Insight Investment (an investment manager with experience of managing liability matching mandates) will give a presentation to the Panel on how an investment mandate of this nature can be implemented.

## **2 RECOMMENDATION**

- 2.1 **The Panel having considered the additional information provided by Mercer and agrees:**
  - (1) That, in principle, the Fund should put a framework in place to more effectively use the investment assets to match the liabilities.
  - (2) To prepare the proposed framework to be considered by the Panel for recommendation to the Committee. The proposal will bring together the work done to date and the proposed framework including a 3 year plan to increase the level of matching and a longer term plan to reach a target level of matching when affordable.

### 3 FINANCIAL IMPLICATIONS

3.1 There is provision in the 2015/16 budget for investment advice relating to the review of the Fund's management of liability risks. Any future implementation of a liability risk management framework may incur additional costs for future budgets.

### 4 BACKGROUND

4.1 Pension liabilities are the accrued benefits that will be paid out in the future. The monetary values of these cashflows are known. However, the "net present value" of these liabilities changes over time and the investment strategy only partially matches these cashflows, i.e. there is a "mismatch". The funding strategy calculates the contributions required to be paid into the Fund to fully fund pension cashflows as they fall due.

4.2 **Why manage these risks?** By managing the mismatch between the change in value of assets and liabilities over time, the Fund can minimise funding level volatility and stabilise employer contribution rates more effectively.

4.3 **What are the causes of such risks?** The 2 largest factors affecting changes in the value of liabilities are as follows:

- Changes in interest rate – higher interest rates increase the discount rate used to value liabilities, thereby reducing the current value put on future liabilities (and vice versa)
- Changes in inflation rate – higher rates of inflation lead to larger benefits payments to members

4.4 **How can we manage these risks?** The impact of these risks on the funding level and contributions can be reduced by investing in assets whose value responds to changes in interest rates, inflation rates or longevity, in a similar way as the value of liabilities responds to such changes (i.e. by improving the 'matching characteristics' of the stabilising portfolio to the liabilities).

4.5 The stabilising portfolio seeks to reduce volatility in the valuation outcome; the majority of the investment portfolio remains invested in growth assets that generate higher returns. These "excess" returns help reduce the deficit contributions and employer contribution rates within the funding strategy.

4.6 **Progress to date:** In September, the Panel considered recommendations from Mercer and requested additional information before making full recommendations to Committee. Mercer's original recommendations to the September Panel are outlined in Appendix 2 which is a copy of the September paper in which they explain the rationale, the impacts and the risks of the proposed framework. Specifically the report included:

- (1) How interest rates and inflation rates impact the liabilities and investments portfolio and how the 'mismatch' in changes to liabilities and assets arises.
- (2) How by using current bond assets more efficiently the Fund can significantly improve the matching characteristics of the investments portfolio.

- (3) How by setting a target level of matching and putting an appropriate framework in place to reach that target the Fund can ensure the programme is implemented in an efficient manner.
- (4) How by managing this mismatch, the increased certainty of outcome allows the actuary to reassess the level of prudence assumed when valuing the liabilities and thereby manage consistent contribution levels.
- (5) An explanation of the nature of the investments to be made to achieve the desired outcome.

## **5 MERCER REPORT WITH ADDITIONAL ANALYSIS**

5.1 Having considered Mercer's report at the September meeting, the Panel requested further work covering the following:

- (1) How interest rates and inflation rates impact the liabilities and investments
- (2) Explanation of leverage, how it is used and the risks
- (3) Scenario analysis outlining the impact of moves in yields
- (4) Explanation of gilt repo's as a hedging instrument and the inherent risks

5.2 The new report produced by Mercer with the additional information requested is included at Appendix 1.

## **6 RECOMMENDATIONS**

6.1 Mercer's original recommendations to the September Panel are outlined in Appendix 2. The recommendations were:

- (1) An immediate change to the UK government bond portfolio to improve matching.
- (2) Developing a three year plan to increase the level of matching.
- (3) Establish a longer term plan to reach a target level of matching when affordable.

6.2 At the September meeting the Panel agreed recommendation 1, to change the government bond portfolio to improve the matching of liabilities.

6.3 Having considered the information on liability driven investing provided to date, the Panel is asked to agree the following:

- (1) Whether in principle they believe the Fund should put a framework in place to more effectively use the investment assets to match the liabilities.
- (2) To prepare the proposed framework to be considered by the Panel for recommendation to the Committee. The proposal will bring together the work done to date and the proposed framework including a 3 year plan to increase the level of matching and a longer term plan to reach a target level of matching when affordable.

6.4 The final proposal to be put forward to the Committee will be considered at the next Panel meeting in February.

## **7 RISK MANAGEMENT**

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in

place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

## **8 EQUALITIES**

8.1 An equalities impact assessment is not necessary as the report contains only recommendations to note.

## **9 CONSULTATION**

9.1 N/a

## **10 ISSUES TO CONSIDER IN REACHING THE DECISION**

10.1 Are set out in the report.

## **11 ADVICE SOUGHT**

11.1 The Council's Section 151 Officer (Divisional Director – Business Support) has had the opportunity to input to this report and has cleared it for publication.

|  |  |
|--|--|
| <b>Contact person</b>  | Liz Woodyard, Investments Manager 01225 395306 |
| <b>Background papers</b>   |  |
| <b>Please contact the report author if you need to access this report in an alternative format</b> |  |