Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**24 JUNE 2016**
TITLE:	**LIABILITY RISK MANAGEMENT – PROPOSED FRAMEWORK**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Exempt Appendix 1 – Mercer Report: Risk Management – Implementation Framework Appendix 2 - Committee Workshop: Managing Liabilities Through The Investment Portfolio, Mercer, March 2016	

1 THE ISSUE

1.1 The Committee requested that the Investment Panel review the way in which the risks arising from the liabilities are managed within the asset portfolio.

1.2 Liability risks arise because the value placed on the Fund's liabilities can change significantly over time due to changes in the assumptions used to value the liabilities. Some of these assumptions are derived from financial markets so they vary as market conditions change. This causes volatility in the funding level and contribution rates.

1.3 The Fund manages the liability risk by investing in Stabilising Assets (currently bonds) within the investment portfolio. These assets help moderate the volatility in the funding level as their value changes in a similar way over time to the value of the liabilities. The review evaluated options to manage these liability risks more effectively within the asset portfolio.

1.4 The liabilities can only be funded over time through contributions and the returns generated on the investment portfolio. Given the funding environment facing scheme employers, affordability of contribution levels is a critical consideration when agreeing the funding strategy. As a result, the investment portfolio will become ever more important in managing the liability risk in the future.

1.5 Exempt Appendix 1 provides and explains the proposed Liability Risk Management Framework for agreement. Appendix 2 contains the slides from the Committee Workshop session on Managing Liabilities from March 2016.

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

2.1 **Agree the Liability Risk Management Framework recommended by the Investment Panel summarised on pages 13 and 14 of Exempt Appendix 1**

2.2 **Delegate the implementation to Officers in consultation with Investment Panel**

3 FINANCIAL IMPLICATIONS

3.1 The triennial valuation of the Fund's liabilities and assets determines the contribution levels. The extent to which changes in the value of the Fund's liabilities can be managed and the cost of doing so will affect the next triennial valuation in 2016.

3.2 The costs of a review have been provided for in the budget. The estimated costs of implementing the proposed framework are included in Exempt Appendix 1, they comprise transaction costs, manager fees and advisory costs.

3.3 Regular cash flows arising once the framework is implemented will be managed on a daily basis by the investment manager. These cash flows will be both positive and negative and the portfolio will be structured to withstand large movements in interest rates and inflation to assist in managing cash calls/refunds. Where required the asset portfolio will be used to realise cash if needed to meet the requirements of the hedging activity.

4 LIABILITY RISK MANAGEMENT

4.1 Pension liabilities are the accrued benefits that will be paid out in the future. The monetary values of these future cashflows are known. The funding strategy calculates how much must be paid into the Fund to fully fund these cashflows as they fall due. 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".

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. The volatility in contributions and affordability of contributions are posing an ever greater financial risk to employers and the Fund. However the Fund has few tools with which to manage the risks. A Liability Risk Management framework will provide additional options for managing this risk: as the mismatch is reduced, the Fund would be able to reduce the investment risk by reducing the allocation to growth assets or increase affordability for employers by increasing the discount rate used to value liabilities or a combination of the two.

4.3 **Why manage these risks now?** The investment strategy has two distinct drivers of value, the growth portfolio and the stabilising portfolio. The majority of assets are invested in "growth assets" that generate higher returns. These "excess" returns help reduce the deficit contributions and employer contribution rates within the funding strategy. The stabilising portfolio seeks to reduce volatility in the valuation outcome by investing in assets that behave more like the liabilities. Although the investment strategy has delivered excess returns to those assumed in the funding strategy over recent years, it has not been sufficient to offset the rise in liabilities over the same period. Therefore the investment strategy needs to focus more on its "stabilising assets" to improve the "hedging" of the liabilities within the investment portfolio.

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

(1) 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)

(2) Changes in inflation rate – higher rates of inflation lead to larger benefits payments to members

(3) Changes in longevity – a rise in life expectation increases the future liabilities as it is assumed on average they have to be paid for longer (and vice versa).

4.5 **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' within the stabilising portfolio to the liabilities).

4.6 **What extra risks will this investment approach entail?** Each investment strategy adopted by the Fund brings its own set of risks. However, utilising a framework as proposed by the investment advisor is not unusual for defined benefit pension funds. A number of LGPS funds already have similar strategies in place.

Implementation of the strategy will be delegated to a manager and the mandate will be monitored in line with the other investment mandates. The manager will be appointed following due diligence of its capabilities to manage all the risks associated with this strategy. In particular, emphasis will be on collateral management, leverage and cash management, all of which are critical elements of the strategy. The Fund already has a currency overlay mandate that is exposed to these risks so officers have experience of implementing and monitoring such mandates and in managing cash flows with the manager.

The triggers to increase the level of hedging within the portfolio will be set by the investment advisor consistent with the market outlook to ensure the triggers are appropriate and aligned to the Fund's strategic objective. The portfolio will be structured to withstand large movements in interest rates and inflation to assist in managing cash calls/refunds.

4.7 **What are the costs of the strategy?** Compared to other strategies the costs are low as it is a passive, buy and hold type strategy. There will be initial implementation costs as advice will be needed to structure the cashflows that need to be matched.

4.8 **Framework Objective: To increase the certainty of achieving the real return objective by increasing the level of liability matching within the investments portfolio.**

5 REVIEW – SCOPE, PROCESS AND OUTCOME

5.1 **Scope** - Following an analysis of the investment portfolio's matching properties, the review considered the range of investment options available to more effectively manage these liability risks, how they may be implemented and the cost.

5.2 **Process** – The Committee delegated the task of undertaking the review to the Panel. The Panel then considered the following reports before coming to their recommendations:

(1) Report to September 2015 Panel meeting: Managing Liabilities, with Mercer Report 'Risk Management Framework'.

(2) Report to November 2015 Panel meeting: Managing Liabilities - Scenario analysis, with Mercer Report 'Further training and scenario analysis'

(3) Report to May 2016 Panel meeting: Liability Risk Management Framework, with Mercer Report ‘Liability Risk Management – Implementation Framework.

5.3 **Outcome** – The Panel concluded that more effective liability matching will be beneficial, and agreed a framework for the implementation of interest rate and inflation rate hedging to be proposed to Committee. The liability risk management framework establishes a target level of hedging and a plan for how that target level can be reached over time by setting a yield trigger framework which requires action as each trigger is reached. The Panel have proposed the types of trigger, reference rates, how triggers are set and how it will work in practice.

6 RECOMMENDATIONS FOR AGREEMENT BY COMMITTEE

6.1 **The Panel recommend the Liability Risk Management Framework summarised on pages 13 and 14 of Exempt Appendix 1.**

<u>Rationale</u> – *The proposed framework delivers greater certainty of achieving a real return above inflation. This greater certainty allows the Fund to either improve affordability (by increasing the asset outperformance assumption in the funding strategy to reduce the cost of providing the benefits), or increase stability (by reducing the variability associated with growth asset exposure i.e. de-risking by reducing the allocation to growth assets). In practice a balance of both benefits can be realised subject to the degree of certainty achieved.*

The minutes of the previous Panel meeting (to be found in another appendix item) detail much of the discussion by the Panel in arriving at this recommendation.

6.2 **The Panel recommend that the implementation of the framework be delegated to Officers in consultation with the Investment Panel.**

7 RISK MANAGEMENT

7.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund’s future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

8 EQUALITIES

8.1 An Equality Impact Assessment has not been completed as this report is for information only.

9 CONSULTATION

9.1 This report is for information and therefore consultation is not necessary.

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 The issues to consider are contained in the report.

11 ADVICE SOUGHT

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

Contact person	Liz Woodyard, Investments Manager (Tel: 01225 395306)
Background papers	Committee Papers and Investment Panel minutes
Please contact the report author if you need to access this report in an alternative format	