

| Bath & North East Somerset Council | | |
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| MEETING: | AVON PENSION FUND INVESTMENT PANEL | |
| MEETING DATE: | 14 November 2016 | AGENDA ITEM NUMBER |
| TITLE: | LIABILITY RISK MANAGEMENT FRAMEWORK - IMPLEMENTATION | |
| WARD: | ALL | |
| AN OPEN PUBLIC ITEM | | |
| List of attachments to this report: | | |
| Exempt Appendix 1 – Mercer Report: Liability Risk Management – Update on Triggers | | |

1 ISSUE

- 1.1 At the June 2016 Committee meeting it was resolved to delegate the implementation of the liability risk management framework to Officers in consultation with the Panel. The setting of yield-based triggers is an important element of the risk management framework. Triggers are designed to increase the Fund's exposure to interest rates and inflation to the target level of liability matching over time, and it is the triggers that ultimately determine the real rates of return that the programme will lock-in.
- 1.2 Market yields have moved significantly since they were discussed as part of agreeing the risk management framework in May. This is an update for Panel on those changes and how they impact the setting of trigger levels. The report from Mercer at Exempt Appendix 1 includes the Fund's target exposure level, assumptions around the future path of interest rates and inflation, information on what reference rates will be used to determine the trigger levels and the most effective types of triggers to allow the Fund to achieve its ultimate aim.
- 1.3 The volatility of market yields mean that setting triggers must be monitored closely as they reflect current market prices. Therefore Mercer recommend the Panel delegate the setting of the precise trigger levels to Officers, in conjunction with the appointed Manager, the Fund Actuary and the Investment Consultant, at the point of implementation and as becomes necessary once in place.

2 RECOMMENDATION

That the Investment Panel:

- 2.1 Note the amendment to the setting of the triggers summarised on page 3 and explained on page 5 of Exempt Appendix 1.
- 2.2 Delegate the setting of the trigger levels to Officers in consultation with the Investment Consultant, Actuary and manager, at the time of implementation.
- 2.3 Delegate ongoing review and revision of trigger levels to Officers in consultation with the Investment Consultant, Actuary and Manager, as necessary.

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 2019.
- 3.2 The costs of developing the risk management framework have been provided for in the budget. The estimated costs of implementing the proposed framework were included in Exempt Appendix 1, to the Liability Risk Management paper at the Committee Meeting on 24 June 2016, 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 TRIGGER FRAMEWORK

- 4.1 The proposed methodology for agreeing trigger levels includes setting of 3 reference rates along the yield curve that best fit the time horizon of the Fund's obligation to pay member benefits when they fall due. Attached to these reference rates will be a series of 'fair value' triggers. Fair value is best defined as Mercer's expectation of future interest rates and inflation.
- 4.2 At each trigger point the Fund will seek to increase the exposure to interest rates/inflation by a predetermined percentage relative to liabilities. Where the Fund receives a high fixed interest rate and pays a low fixed inflation rate the greatest 'real' rate of return will be captured. With each layer added to the strategy the Fund will get closer to its target hedge ratio and be in a position to reflect this in its Funding Strategy or de-risk by reducing its allocation to high-risk assets such as equities.
- 4.3 **How has the approach to setting triggers changed?** Mercer have proposed removing the link to market prices for the short term trigger levels because of the recent fall in yields. This is fully explained in Exempt Appendix 1, which also sets out what the trigger levels would be at current market conditions under the amended approach.
- 4.4 **Why has the approach been amended?** By removing the link to market prices in the short term, the Fund will avoid locking into a real rate of return that is too low within the context of the Funding Strategy.
- 4.5 **What is the justification for the delegation of trigger setting?** As shown, current market conditions impact the appropriate trigger levels. Given the volatility in the market it is therefore necessary to finalise the trigger levels at the point of implementation and in the future as becomes necessary. The delegation enables the setting of triggers to be done at the appropriate time by Officers in consultation with the Investment Consultant, Actuary and the Manager. The approach will be in line with that presented in Exempt Appendix 1 but the trigger levels may vary.

- 4.6 Officers will report on trigger levels to Panel periodically, and at least annually. The Panel will periodically review the risk management framework to ensure it is achieving its aims.

5 UPDATE ON IMPLEMENTATION

- 5.1 Officers will provide a verbal update on the manager selection process.
- 5.2 After further discussion regarding the structure of the vehicle and the relative benefits of a segregated account versus a 'client specific unitised fund' approach, the latter structure was preferred. Whilst there is little in practice to choose between the two structures, the benefits of a 'client specific unitised fund' are:
- (1) simpler documentation, reporting and regulatory position
 - (2) limited recourse to wider pension fund assets
 - (3) quicker speed of implementation
 - (4) increased regulatory oversight

Officers and Mercer were comfortable that the potential advantages of a segregated account (marginally lower ongoing admin cost and improved portability between managers) were marginal and are offset by the above benefits.

6 RISK MANAGEMENT

- 6.1 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.

7 EQUALITIES

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

8 CONSULTATION

- 8.1 N/a

9 ISSUES TO CONSIDER IN REACHING THE DECISION

- 9.1 Are set out in the report.

10 ADVICE SOUGHT

- 10.1 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.

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| Background papers | <p><u>Report to June 2016 Committee meeting:</u> Mercer Report 'Liability Risk Management – Proposed Framework'</p> <p><u>Report to May 2016 Panel meeting:</u> Mercer Report 'Liability Risk Management – Implementation Framework'</p> <p><u>Report to March 2016 Committee workshop:</u> Mercer Report 'Managing Liabilities through the investment Portfolio'</p> <p><u>Report to November 2015 Panel meeting:</u> Managing Liabilities - Scenario analysis, with Mercer Report 'Further training and scenario analysis'</p> <p><u>Report to September 2015 Panel meeting:</u> Managing Liabilities, with Mercer Report 'Risk Management Framework'.</p> <p><u>Report to June 2015 Committee meeting:</u> Liability Risk Management with Mercer Report 'Management of Liability Risks: Developing a Risk Management Framework'</p> |
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