Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**10 September 2018**	**AGENDA ITEM NUMBER**
TITLE:	**LDI Trigger Framework Annual Review**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Exempt Appendix 1 – LDI Trigger Framework Annual Review		

1 THE ISSUE

1.1 The Fund currently operates a Liability Risk Management Framework with the objective of capturing real yields to give increased certainty of achieving the return assumed in the funding plan (the discount rate).

1.2 At inception of the strategy, real yields were deemed too low to lock in to and achieve the objective of the CPI discount rate. For this reason the trigger framework was set up to monitor two sets of rates; nominal interest rates and long term inflation rates. This approach allows the Fund to take advantage of increases in interest rates and decreases in inflation rates, which can move independently of one another. Locking in excess returns over CPI increases the certainty of being able to meet pension payments as they fall due.

1.3 Over the past year the interest rate environment has remained relatively benign, however lower inflation rates have presented an opportunity for the fund to increase its exposure in this area.

1.4 To ensure the trigger framework remains appropriate an annual review of the triggers is undertaken. Mercers will present their report and recommendation at the meeting.

1.5 The Panel is asked to consider possible refinements to the current trigger framework since the last review and to recommend any changes to Pensions Committee. A full review of the LRMF including recommendations from the Panel will be considered by the Committee at its September meeting.

2 RECOMMENDATION

That the Panel recommends to the Pensions Committee:

2.1 **To maintain the current trigger framework and monitor the viability of implementing either increasing the interest rate hedge or lowering the interest rate triggers over time and as the funding level improves.**

2.2 **That monitoring of and implementation of any change to the framework should be delegated to Officers in conjunction with the investment consultant.**

3 FINANCIAL IMPLICATIONS

3.1 The Liability Risk Management Framework has been implemented to provide greater certainty that the Funding plan will be achieved and therefore contribution levels will be stable and minimised. Any changes to the framework can affect the level of employer contributions in the future.

4 LIABILITY RISK MANGEMENT FRAMEWORK

4.1 The LRMF seeks to hedge the Fund's exposure to real interest rates that are used to value the pension liabilities. Real interest rates can be split into two component parts, nominal interest rates and inflation.

4.2 The Fund's CPI discount rate methodology formed the basis of what the trigger framework needed to achieve as a minimum. The triggers were set based on the outlook for inflation and nominal yields at the time the strategy was implemented. Theoretically the Fund could have opted to implement a trigger framework to hedge its entire exposure at the discount rate (CPI+2.1%); however, this would severely limit the chances of putting any protection in place and incorrectly implies a zero return from the Fund's growth assets.

4.3 The framework is currently structured to increase hedging in 10% increments (as each trigger is hit) across 5 'maturity buckets' which represent the long-term nature of the Fund's liabilities. In aggregate, should every trigger be hit, the Fund would lock in a real return of CPI +1.3%. The difference between the aggregate real return of CPI+1.3% and the discount rate (CPI +2.1%) is expected to be made up by the Fund's growth assets. Because real yields are still low, any change to the existing framework could result in the Fund locking in a lower real return over CPI, putting greater reliance on the growth assets to bridge the gap.

4.4 The framework allows either inflation or interest rate hedging to outstrip the other so that attractive levels can be captured independently. There are currently constraints on the hedge ratio differential, which is monitored on an ongoing basis by Mercer and the investment manager. This constraint can limit the level of hedging depending on market levels.

4.5 Having greater exposure to one or other of the components of real yields through hedging inherently carries more risk due to higher volatility. The component parts of the real yield counteract the effects of one another and therefore 'dampen' volatility. Allowing a large gap to exist between inflation and interest rate hedging could carry with it implications on collateral requirements should market prices sharply increase or decrease.

4.6 Since inception of the strategy a number of inflation triggers have been hit but movement in gilt yields have been insufficient to activate any of the nominal interest rate triggers. As a result inflation hedging is currently 'ahead' of interest rate hedging.

4.7 The Fund is ahead of its funding plan and therefore has the option of using some of the 'funding gains' to refine the strategy in order to increase the hedging ratio. This would allow hedging a portion of the framework at lower yields than the original trigger levels.

5 TRIGGER FRAMEWORK – POSSIBLE REFINEMENTS

5.1 There are several options available to the Fund to address the current position, where inflation hedging outstrips interest rate hedging. Each proposed change is considered below and detailed in the Mercer report at Exempt Appendix 1;

a) **Increase the interest rate hedge immediately to match the current inflation hedge**. This would allow the Fund to reduce the risk attached to holding one component part of the real yield in isolation, which carries with it a higher degree of volatility and therefore risk. Increasing the extent of interest rate hedging to match the current inflation hedging would impact the assumed real yield and could in turn increase the funding deficit and contributions.

b) **Decrease the interest rate triggers across the whole framework to increase the likelihood of capturing a real yield in excess of CPI**. By reducing the interest rate triggers across the whole framework the probability of putting interest rate hedging in place will increase, however it will act to reduce returns in excess of CPI and therefore put more reliance on the Fund's growth assets to deliver higher returns to meet any resultant increase in the value of the liabilities not being met by the framework.

c) **Maintain current trigger framework and monitor the viability of implementing either points (a) or (b) over time and as the funding level improves.** The Fund might consider taking action sooner should the hedging differential reach its maximum permitted level, with a subsequent increase in volatility. ***In light of the long-term nature of this strategy and the wider view that interest rates will start to rise over the medium-term, this is the recommended course of action.***

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.

8 ISSUES TO CONSIDER IN REACHING THE DECISION

8.1 Are considered in this report.

9 ADVICE SOUGHT

9.1 The Council's Section 151 Officer has had the opportunity to input to this report and have cleared it for publication.

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Background papers	Mercer paper to Officers August 2018
Please contact the report author if you need to access this report in an alternative format	