

Bath & North East Somerset Council	
MEETING:	AVON PENSION FUND COMMITTEE
MEETING DATE:	21 SEPTEMBER 2018
TITLE:	ANNUAL REVIEW OF RISK MANAGEMENT FRAMEWORK
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: Exempt Appendix 1 – Mercer Report:	

1 THE ISSUE

- 1.1 The Risk Management Framework encompasses two strategies, the Liability Driven Investment Strategy (LDI) and Equity Protection Strategy (EPS). These strategies are linked to the funding strategy and are designed to de-risk the Fund by placing less reliance on growth assets to fund future pension benefits and to simultaneously protect the Funds current funding position.
- 1.2 Committee reviews the strategies annually to assess whether there has been a material change in market conditions which requires an adjustment to either strategy to ensure they meet the strategic objectives. The annual review also considers any financial implications on the portfolio, specifically an increase in the collateral requirements. To support this paper, a Committee workshop was held prior to the meeting explaining the principles of the two strategies.
- 1.3 The Committee has delegated the monitoring of both strategies to the Investment Panel. The Panel monitors the collateral adequacy of the pooled vehicle that contains the LDI and EPS, the performance of the strategies and of the manager, Blackrock.
- 1.4 At its meeting on 10 September 2018, the Panel reviewed whether the current trigger levels for hedging in the LDI strategy remain appropriate given market conditions and the funding level. Their recommendations are in paragraph 4.4.
- 1.5 Mercer will present their report at the meeting.

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

- 2.1 **Agree the Panel recommendation that the existing trigger framework for the LDI strategy should be maintained.**
- 2.2 **Delegate the decision whether to use dynamic hedging in the equity protection strategy to the Investment Panel.**
- 2.3 **Delegate to Officers in consultation with the Chair of the Panel, restructuring of the Equity Protection Strategy, as advised by the investment consultant.**
- 2.4 **Note Mercer's report reviewing the strategies and collateral position.**

3 FINANCIAL IMPLICATIONS

- 3.1 The LDI and EPS have 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 ANNUAL REVIEW OF LDI STRATEGY

- 4.1 The LDI strategy seeks to hedge the Fund's exposure to real interest rates as these are used to value the pension liabilities. This increases the certainty that the real returns assumed in the funding plan will be achieved.
- 4.2 The aim is to lock in attractive real yields ('trigger points'). As the real yield is determined by nominal interest rates and inflation expectations - which move independently of one another - it is important to keep these under review for appropriateness as each can be hedged independently. The current objective is to hedge up to 70% of the assets as market conditions allow and there is a trigger framework in place, reflecting the market conditions when set, to achieve this hedge ratio.
- 4.3 This strategy utilises unfunded hedging instruments meaning there is limited or no initial outlay of capital to put the hedging in place. However, these instruments fluctuate in value (mark to market) through their life to maturity and must be supported by collateral, in the form of assets that can be sold to meet mark to market requirements. The collateral held by the Fund must be monitored to ensure there is enough to support the strategy.
- 4.4 **Review of the Trigger Framework:**

The Panel reviewed the trigger framework at its meeting on 10 September. **The recommendation of the Panel is to maintain the current trigger framework** in light of the long term nature of the strategy and the view that interest rates should start to rise over time.

In the meantime the strategy will be monitored closely so that options to increase the interest rate hedge or lower the interest rate trigger levels are reviewed when the funding level improves or if the hedge ratio differential between interest rates and inflation reaches the maximum currently permitted.

- 4.5 Exempt Appendix 1 explains how the strategy has evolved over the last 12 months.

5 ANNUAL REVIEW OF EQUITY PROTECTION STRATEGY

- 5.1 The EPS is structured to protect the Fund from a sharp draw down in equity valuations over the 2019 triennial valuation as equities, although c. 40% of assets contribute c. 75% of risk. The EPS will pay out a cash amount to compensate for any significant falls in the equity market and simultaneously allow the Fund to participate in upside gains to a predetermined level or 'cap'.
- 5.2 The strategy sits within the pooled vehicle (QIF or Qualified Investment Fund) established for the LDI strategy. To reduce the risk of the Fund having to sell assets at short notice to meet its obligations under the collateral agreements, units of a passively managed pooled equity fund are held within the QIF which will be sold to meet collateral calls as they arise. However, derivatives will then be used to replicate the equity assets sold in order that the strategic allocation to equities is maintained.

5.3 Future Planning:

Officers have already discussed with the investment consultant the options for how this strategy could be restructured prior to maturity (due to changes in market levels) and if the decision is made to retain a protection strategy longer term when the current strategy expires, how it could be implemented. This will be considered as part of the next Strategic Review. Issues to consider in the future are:

- a) Whether to restructure the strategy as markets move e.g. if markets rise then the Fund may reduce its equity allocation if the funding position has improved and no longer needs the same return from equities. If markets fall then the Fund may want to close out the strategy and invest gains in equities.
- b) Renew static hedge – by re-striking the contracts to protect the Fund at the market level at implementation
- c) Implement dynamic hedge – The strategy is currently structured using a static hedge which creates timing risk as the value is determined by the market level at inception and expiry. A static hedge is less costly and quicker to implement compared to a dynamic hedge. A dynamic hedge averages in protection at different market levels and therefore reduces timing risk.

5.4 Implementation of the Equity Protection Strategy is delegated to the Investment Panel. **Therefore it is recommended that the Panel are asked to decide whether dynamic hedging should be implemented.**

5.5 Mercer and Officers monitor the strategy and report quarterly to Panel. However, decisions to restructure due to changes in market levels may have to be taken between Panel meetings as they will be market timing driven. **Therefore it is recommended that the decision to restructure is delegated to Officers in consultation with the Chair of the Panel, acting on advice from Mercer.**

5.6 Exempt Appendix 1 explains how the strategy has evolved since inception in 4Q17.

6 RISK MANAGEMENT

6.1 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.

7 EQUALITIES

7.1 An Equality Impact Assessment has not been completed.

8 CONSULTATION

8.1 Consultation is not necessary.

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 The issues to consider are contained in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer and Section 151 Officer 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	