

Bath & North East Somerset Council	
MEETING:	AVON PENSION FUND COMMITTEE
MEETING DATE:	27 SEPTEMBER 2019
TITLE:	ANNUAL REVIEW OF RISK MANAGEMENT FRAMEWORK
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: Exempt Appendix 1 – Mercer Report: Annual Review of Risk Management Framework	

1 THE ISSUE

- 1.1 The Risk Management Framework encompasses three strategies, the Liability Driven Investment Strategy (LDI), Equity Protection Strategy (EPS) and the Buy-and-Maintain Corporate Bond (CB) portfolio as well as a passively managed equity fund for collateral management purposes. These strategies are linked to the funding strategy, designed to de-risk the Fund by placing less reliance on growth assets and to simultaneously protect the Fund's funding position.
- 1.2 The 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.
- 1.3 Monitoring of the framework has been delegated to the Investment Panel. The Panel monitors the collateral adequacy of the pooled vehicle that contains the strategies, the performance of the strategies and of the manager, Blackrock.
- 1.4 At its meeting on 2 September 2019, the Panel reviewed whether the current trigger levels for hedging in the LDI strategy remain appropriate given market conditions and the funding level. In addition they considered how the EPS should be implemented in the event it is rolled over at expiry.
- 1.5 Mercer will present their report at the meeting (Exempt Appendix 1).

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

- 2.1 **Agree the following delegations given the government's announcement regarding RPI:**
 - i. **That the Panel reconsider the LDI trigger framework at the next Investment Panel meeting**
 - ii. **If market conditions dictate, that Officers take appropriate action to protect the Fund's position in the meantime.**

- 2.2 Agree the Panel's recommendation, subject to full consideration at the November Strategy review workshop, to put in place another static EPS for 12-18 months when the current strategy rolls off.**
- 2.3 Delegate implementation of a new static hedge to Officers and the Investment Panel.**
- 2.4 Delegate the decision whether to use dynamic hedging in the equity protection strategy to the Investment Panel.**
- 2.5 Note Mercer's report reviewing the strategies and collateral position.**

3 FINANCIAL IMPLICATIONS

- 3.1 These strategies 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, in order to increase 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 2 September. The recommendation of the Panel was 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.

- 4.5 However on 4 September 2019 the Treasury announced its intention to phase out RPI as measure of inflation by 2030, in preference to CPI measures. As inflation instruments all reference RPI rather the CPI, this has altered the pricing of inflation in the market. As this development was expected at some point (the government has adopted CPI as its preferred inflation measure in recent years) it is not clear how much of this adjustment is already priced into inflation expectations in the long-term.
- 4.6 Following advice from Mercers, the trigger framework was suspended by the Fund to ensure the current inflation triggers are not breached which could result in inflation being hedged at unfavourable levels. The risk is that the levels do not have

to be adjusted and the Fund misses out on hedging more of the liabilities. However, this risk is less significant than the risk of hedging at an unfavourable level.

- 4.7 Mercers will advise the Fund in due course as to the revised trigger levels and the impact on the Fund of the inflation hedging already in place. As this is a market driven issue, it is proposed that Committee delegate the resetting of the trigger framework to the Panel at its next meeting in November, as advised by Mercers. However, in the meantime it is recommended Officers are delegated power to protect the Fund's position should market conditions dictate.
- 4.8 Between annual reviews, the strategy is 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.

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. 60% 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. Should this happen, derivatives will be used to replicate the equity assets sold in order that the strategic allocation to equities is maintained.
- 5.3 The current structure is a static hedge, whereby the level of protection is fixed at the market level on implementation. With this approach timing risk arises as the value is determined by the market level at inception and expiry. An alternate approach is a dynamic hedge which averages in protection at different market levels and therefore reduces timing risk. The static hedge is less costly and quicker to implement compared to a dynamic hedge.
- 5.4 The Panel considered how a new strategy should be implemented if the decision is taken to roll over the current strategy on expiry in early 2020, and **recommend that a new static strategy should be implemented over a 12-18 time frame.** During this time, the Panel will then consider whether a dynamic hedging strategy should be implemented. Mercer advises that the EPS should become a long-term component of the overall investment strategy and a dynamic open-ended structure will give better protection to equity market risk. However, a dynamic structure is more complex to implement and monitor so time is needed to do the necessary Panel training and implementation work.
- 5.5 The decision whether to retain the EPS within the wider investment strategy will need to be taken by Committee during the Investment Strategy Review (following the November review workshop), when the allocation to equities will be considered. Subject to the Committee agreeing to continue with an EPS, **implementation of the new static EPS should be delegated to the Investment Panel and Officers.**
- 5.6 Subject to a hedge being retained **it is recommended that the Panel are asked to decide whether dynamic hedging should be implemented.**

- 5.7 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. As a result Committee has previously delegated **the decision to restructure due to market conditions to Officers in consultation with the Chair of the Panel, acting on advice from Mercer.**

6 ANNUAL REVIEW OF CORPORATE BOND BUY-AND-MAINTAIN STRATEGY

- 6.1 Historically the liabilities that are funded on a corporate bond basis were invested in a passively managed corporate bond fund by Blackrock. With the asset pot at a large enough size to merit a bespoke strategy, Blackrock were instructed to implement a buy-and-maintain corporate bond portfolio as part of a bespoke cash flow matching strategy for the Fund's low-risk liability bucket.
- 6.2 This strategy was implemented in early 2019 and sits within the QIF so that it is hedged against inflation.
- 6.3 An annual review along with an in-depth review will be undertaken after each valuation or when a large liability falls into scope for the low-risk bucket upon termination. There were no recommendations about this strategy from 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 CLIMATE CHANGE

- 8.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and is in the process of addressing this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

9 OTHER OPTIONS CONSIDERED

- 9.1 None.

10 CONSULTATION

- 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.

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Background papers	Investment Panel Papers and minutes
Please contact the report author if you need to access this report in an alternative format	

