

<b>Bath &amp; North East Somerset Council</b>	
MEETING:	<b>AVON PENSION FUND INVESTMENT PANEL</b>
MEETING DATE:	<b>11 September 2020</b>
TITLE:	<b>Risk Management Annual Review</b>
WARD:	ALL
<b>AN OPEN PUBLIC ITEM</b>	
List of attachments to this report:  Exempt Appendix 1 – Mercer Report: Risk Management Framework Review & Report on the Quarter to 30 June 2020	

## **1. THE ISSUE**

- 1.1. The Risk Management Framework encompasses three dedicated risk management strategies and a passive equity fund for collateral management purposes. The Liability Driven Investment (LDI) Strategy and the Buy-and-Maintain Corporate Bond (CB) Portfolio are designed to hedge interest rate and inflation risks arising from the Fund's liabilities, whereas the Equity Protection Strategy (EPS) is designed to shield the Fund from a large drawdown in the value of its underlying equity holdings. These strategies are linked to the funding strategy and de-risk the Fund by placing less reliance on growth assets to fund future pension benefits and to simultaneously protect the Fund's current funding position.
- 1.2. The Investment Panel reviews the strategies annually to assess whether there has been a material change in market conditions which requires an adjustment to any of the strategies 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. Any recommendation from the Panel to change a strategy requires approval by the Committee.
- 1.3. The Committee has delegated monitoring to the Investment Panel. The Panel monitors the collateral adequacy, the performance of the strategies and the performance of the manager, Blackrock.
- 1.4. Mercer will present their report at the meeting.

## **2. RECOMMENDATION**

**The Avon Pension Fund Investment Panel is asked to:**

- 2.1. **Note Mercer's report reviewing the strategies and collateral position**
- 2.2. **Recommend to the Committee that the existing trigger framework for the LDI strategy should be maintained**
- 2.3. **Recommend to Committee that the inflation hedge be reinstated outside of the trigger framework to the level it was prior to the restructure that took place in March, and to further increase the inflation hedge to the maximum**

**allowable under the mandate guidelines following the conclusion of the RPI reform consultation in late 2020.**

### **3. FINANCIAL IMPLICATIONS**

- 3.1. The risk management 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 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. The 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 (mark-to-market) value 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. During the year Panel agreed to switch the index-linked gilts with maturities post 2030 into conventional gilts in order to mitigate the risk of falling inflation following an announcement around the RPI reform consultation. Further, Panel agreed to downwardly revise the trigger framework to account for this potential change. The changes to the trigger framework took place in June and remain appropriate.
- 4.5. The Liability Benchmark Portfolio (LBP), which is used by BlackRock to hedge against movements in the value of the Fund's liabilities arising from changes in interest rates and inflation, has been updated based on the assumptions and member data underlying the 2019 actuarial valuation. Further information on the construction of the LBP can be found at Exempt Appendix 1.
- 4.6. Due to significant event risk the future path of inflation is uncertain. However, the market expectation is for inflation to rise in the short to medium term which presents an opportunity for the Fund to increase its inflation hedge outside of the existing trigger framework in anticipation of a rise in inflation. In order to mitigate timing risk the recommendation is to reinstate the hedge ratio to the level it was at prior to the restructure in March with immediate effect and then once the outcome of RPI reform is known to further increase the hedge ratio to the maximum allowable under the mandate guidelines. This would involve capturing inflation at less attractive levels than what is currently built into the trigger framework. There is also an opportunity cost if inflation falls following RPI reform as the Fund would have already locked in higher inflation levels. On balance the risks point to inflation increasing and the phasing in of the inflation hedge acts to reduce this opportunity cost. Further, if the existing triggers were hit in the interim these would be actioned as normal.

## **5. ANNUAL REVIEW OF EQUITY PROTECTION STRATEGY**

- 5.1. The Fund currently employs a static equity protection strategy (EPS), encompassing both developed and emerging market exposure. The level of the upside cap is set to allow the Fund to participate in equity gains sufficient to support the actuarial valuation assumptions. Further, the parameters of the structure are set so as to incur little or no upfront cost, otherwise known as a 'nil-premium structure'.
- 5.2. During the 1Q20 the EPS expired and was rolled over in three tranches for an interim period allowing the Panel time to consider dynamic equity protection in further detail. The third tranche expired in March and due the unprecedented volatility the decision was made to roll this portion of the hedge for a shorter duration to limit the risk of not being able to participate in equity gains in a sustained market recovery. Post period-end, Panel resolved to further extend tranche 3 to align with tranches 1 and 2, delegating implementation to Officers and Mercer. The underlying regional exposures to rollover are currently under discussion in line with the upcoming restructure of the equity portfolio with the allocation to global sustainable equities.
- 5.3. Over the year the EPS performed as expected, adding significant value as equity markets fell in March. During 2Q20 as markets recovered from the lows seen in the previous quarter the positive value attached to the EPS decreased as equity markets approached the upside cap(s). Tranche 3 exhibited negative market value at quarter end as all underlying equity markets, except for the UK, had recovered to a point beyond the upside cap struck when the tranche was rolled over in March. Since inception (November 2017) the overall return of the proxy equity portfolio, net of the protection, was c. 8.8% for developed market equities. If the protection had not been in place the return would have been c. ~11.5%. The net return, since inception (January 2020), for the emerging market portion was -4.1%. If the protection had not been in place the Fund would have incurred losses of c. -7.0%
- 5.4. At its last meeting in August, Panel assessed the governance, cost and risk implications of switching to a dynamic strategy. Having looked at two implementation options Panel resolved to implement a dynamic EPS using a total return swap on a custom index when the current static strategy expires next year. A formal proposal detailing the design and structure of the new dynamic EPS will be presented to Panel at its November meeting.

## **6. ANNUAL REVIEW OF CORPORATE BOND BUY-AND-MAINTAIN STRATEGY**

- 6.1. The primary objective of this strategy is to reduce the funding risk in respect of the 'low risk' bucket of liabilities, which are valued on a corporate bond discount basis. The low-risk bucket includes orphan employers and those employers looking to terminate. The strategy was structured so that the liabilities are fully funded at outset and residual interest rate and inflation risk is covered by the broader LDI mandate.
- 6.2. Over the year the average credit rating of securities held in the portfolio has not changed, despite an increase in downgrades in 2Q20 as a result of the pandemic. Turnover within the portfolio has remained below 1% and there has been minimal change to the level of cashflow matching within the portfolio since inception.

6.3. The expectation is for the strategy to grow over time as either more employers can afford to move to a lower risk strategy or if more employers look to exist the fund. There are no recommendations to rebalance this portfolio at present.

## **7. RISK MANAGEMENT**

7.1. 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.

## **8. EQUALITIES**

8.1. A proportionate equalities impact assessment has been carried out using corporate guidelines and no significant issues have been identified.

## **9. CLIMATE CHANGE**

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

## **10. OTHER OPTIONS CONSIDERED**

10.1. NONE

## **11. CONSULTATION**

11.1. 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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<b>Background papers</b>	None
<b>Please contact the report author if you need to access this report in an alternative format</b>	