Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**
MEETING DATE:	**17 September 2021**
TITLE:	**Risk Management Framework Review for Periods Ending 30 June 2021**
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: Exempt Appendix 1 – Mercer Report: Risk Management Framework Review to 30 June 2021	

1. THE ISSUE

1.1. The Funding and Risk Management Group (FRMG) is responsible for agreeing the operational aspects relating to the Fund's risk management framework thereby ensuring that strategic objectives continue to be met. This report informs Panel of issues considered and decisions made by FRMG as well as any recommendations.

1.2. Since the last Panel meeting there has been one meeting of the FRMG on the 26 August 2021. There are no strategic issues or concerns to raise with the Panel.

1.3. This quarter the report at Exempt Appendix 1 contains further detail relating to the dynamic equity protection strategy and an overview of the annual recalibration exercise of the liability benchmark which is used to determine the Fund's inflation and interest rate hedge ratio. Mercer will present their report at the meeting.

2. RECOMMENDATION

The Avon Pension Fund Investment Panel is asked to:

2.1. **Note the updated funding level and LDI hedging position**

2.2. **Note the impact and performance of the equity protection strategy**

2.3. **Note the performance of the Buy & Maintain Corporate Bond strategy**

2.4. **Note FRMG considerations regarding the hedge ratio of the liability benchmark portfolio**

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. UPDATE ON RISK MANAGEMENT STRATEGIES AND FUNDING LEVEL

4.1. FRMG reviews the performance of each strategy each quarter ahead of the Panel meeting. At the last meeting it also considered the change in the Liability benchmark portfolio (see section 5 below) and the trade outcome report for moving from static to dynamic equity hedging (see section 6).

4.2. The **funding level** was estimated to be 101% (net of the impact from the equity protection strategy) at the end of June 2021, a rise of c.4% over the quarter as a result of strong returns from the Fund's growth assets over the period. This shows that the Fund's position was ahead of the expected funding level by c.6%.

4.3. **The Liability Driven Investment (LDI)** strategy seeks to hedge the impact of inflation and interest rates on the value of the Fund's liabilities. The liability hedging component of the risk management framework delivered a return of 1.2% over the period versus a benchmark return of 1.1% due to falling yields and changes in inflation expectations. No interest rate or inflation triggers were breached over the quarter and based on the current liability benchmark the hedge ratios are estimated to be 10% and 39%, respectively. The mandate has performed as expected and the manager is in compliance with investment guidelines.

4.4. **The Equity Protection Strategy (EPS)** protects the fund's equity assets from a material fall in value whilst allowing the Fund to participate in equity gains sufficient to support the actuarial valuation assumptions. The underlying Developed Market (DM) equities returned 4.8% over the quarter; as a result, the value of the EPS detracted (return -2.1%) as markets rose further from the protection levels. The net return of the hedged DM equity portfolio was 2.8% over the quarter. The underlying EM equities returned 5.1% over the same period, net of protection. Note that these returns reflect the combined performance of the static and the dynamic strategies over the relevant periods.

4.5. **The Corporate Bond Buy-and-Maintain Strategy** seeks to reduce the funding risk in respect of the 'low risk' bucket of liabilities, which are valued on a corporate bond discount basis. There has been minimal change in the cashflow matching within the portfolio over the period and credit spreads have returned to pre-pandemic levels. No further action is required in respect of this portfolio at this stage.

4.6. **Collateral and Counterparty Position.** When interest rates rise, inflation falls or the EPS declines in value the investment manager is required to post collateral to maintain the strategies. An 'early warning' and 'top up' trigger allow the Fund time to source collateral from elsewhere in the portfolio. As a secondary line of defence, the investment manager has access to a pooled fund of listed equities that they can sell to generate cash collateral should the need arise. At 30 June 2021 the Fund's existing pool of collateral was within guidelines and could sustain a 3.1% rise in interest rates, a 0.4% fall in inflation or a 7% decline in the value of the EPS before triggering the 'early warning' test.

5. REFRESH OF THE LIABILITY BENCHMARK PORTFOLIO

5.1. The Liability Benchmark Portfolio (LBP) represents the liabilities the investment manager uses to hedge against. The LBP is reviewed on an annual basis taking account of market movements and the accrual of benefits.

5.2. FRMG considered the impact the most recent refresh of the LBP has had on the Fund's hedge ratios. Further details are provided on p9 of Exempt Appendix 1.

6. DYNAMIC EPS AND POST TRADE OUTCOME

6.1. The static equity protection was unwound in May 2021. The dynamic strategy was incepted at the same time the legacy strategy was rolled off to ensure the Fund hedged the correct equity notional amount at each stage

6.2. Total transaction costs of c. £1.3m (equivalent to 0.06% of total exposure traded) were in line with the pre-trade estimate of 0.05%-0.1%. There was some variation in costs between regions with the US incurring the lowest transaction costs and emerging markets incurring the highest.

6.3. Mercer have provided assurance that the dynamic strategy has been implemented in line with expectations.

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 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 Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

Contact person	Nathan Rollinson, Investments Manager (Tel. 01225 395357)
Background papers	None

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