

Bath & North East Somerset Council

MEETING:	AVON PENSION FUND INVESTMENT PANEL
MEETING DATE:	19 NOVEMEBR 2021
TITLE:	Risk Management Framework Review for Periods Ending 30 September 2021
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: Exempt Appendix 1 – Mercer Report: Risk Management Framework Review to 30 September 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 two meetings of the FRMG on the 19 October 2021 and 4 November 2021. There are no strategic issues or concerns to raise with the Panel.
- 1.3. Exempt Appendix 1 summarises the risk management strategies at 30 September 2021. No LDI triggers were breached during the period. The Equity Protection Strategy (EPS) is currently 'amber' (under review) as it needs to be restructured following decision to change the equity allocations. At the end of the period the Fund had sufficient collateral to support the risk management strategies. Mercer will present their paper at the meeting.

2. RECOMMENDATION

The Avon Pension Fund Investment Panel is asked to:

- 2.1. **Note the current funding level and LDI hedging position**
- 2.2. **Note the impact and performance of the equity protection strategy**
- 2.3. **Note the current collateral adequacy position**
- 2.4. **Note the current FRMG workstreams as summarised in sections 5-7 below**

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 level of risk in the investment portfolio following the outcome of the interim funding review. (see section 5 below).
- 4.2. The **funding level** was estimated to be 101% (net of the impact from the equity protection strategy) at the end of September 2021. 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 4.1% over the quarter due to 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 38%, 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 equities returned -0.8% over the quarter and the EPS added marginal gains to produce a net return of -0.6%. On a regional basis, the net return of the hedged DM equity portfolio was 0.4% over the quarter. For EM the net return was -7.2% over the same period. Periodic returns are included on pages 8-9 of Exempt Appendix 1.
- 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 September 2021 the Fund's existing pool of collateral was within guidelines and could sustain a 2.9% rise in interest rates, a 0.4% fall in inflation or an 11% decline in the value of the EPS before triggering the 'early warning' test.

5. INVESTMENT STRATEGY RISK AND CONTRIBUTION ANALYSIS

- 5.1. Following the September 2021 interim funding review, FRMG considered the potential for increasing risk/return in the investment strategy to support the 2019 valuation assumptions, given that longer term inflationary factors meant the expected return outlook - and probability of achieving the 2019 discount rates - had reduced. FRMG resolved to maintain the current investment strategy and revisit as part of the broader investment strategy review next year.

6. REFRESH OF LIABILITY BENCHMARK PORTFOLIO

- 6.1. FRMG are considering an increase to the level of inflation hedging under the LDI mandate following the outcome of the annual recalibration of the liability

benchmark portfolio (LBP) that was presented at the September Panel meeting. It should be noted that any increase to the hedge ratio could impact the level of collateral required to implement the change.

- 6.2. A positioning paper on inflation is included under Agenda Item 9, Appendix 5 which will form the basis of further work by FRMG to assess the suitability of increasing the inflation hedge ratio; the outcome of which will be reported back to Panel.

7. EQUITY PROTECTION STRATEGY RESTRUCTURE

- 7.1. The EPS is currently being restructured to take account of the changes to the underlying equity portfolio that were agreed as part of the wider equity allocation review in September.
- 7.2. FRMG has considered how many counterparties the additional global equity exposure should be split across, which counterparty should be selected and the process for implementation. Mercer will give a verbal update on the EPS restructure at the meeting.

8. RISK MANAGEMENT

- 8.1. 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.

9. EQUALITIES

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

10. CLIMATE CHANGE

- 10.1. 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 Paris Aligned Global Equities, Sustainable Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

11. OTHER OPTIONS CONSIDERED

- 11.1. None

12. CONSULTATION

- 12.1. 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	FRMG papers
Please contact the report author if you need to access this report in an alternative format	