

<b>Bath &amp; North East Somerset Council</b>	
MEETING:	<b>AVON PENSION FUND INVESTMENT PANEL</b>
MEETING DATE:	<b>25 FEBRUARY 2022</b>
TITLE:	<b>Risk Management Framework Review for Periods Ending 31 December 2022</b>
WARD:	ALL
<b>AN OPEN PUBLIC ITEM</b>	
List of attachments to this report:	
<b>Exempt Appendix 1 – Mercer Report: Risk Management Framework Review to 31 December 2022</b>	
<b>Exempt Appendix 2 – Mercer Paper: Inflation Hedging Considerations</b>	

## **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 4 February 2022. There are no strategic issues or concerns to raise with the Panel.
- 1.3. Exempt Appendix 1 summarises the risk management strategies at 31 December 2021. No LDI triggers were breached during the period. The Equity Protection Strategy (EPS) is currently 'amber' (under review) as it has underperformed unhedged equities, creating a drag on performance. At the end of the period the Fund had sufficient collateral to support the risk management strategies. A verbal update on the outcome of the change to the protection strategy to reflect the removal of the Fund's strategic allocation to Emerging Market equities will be provided at the meeting.
- 1.4. Mercer will present the paper "Inflation Hedging Considerations" (Exempt Appendix 2) 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

- 2.5. 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 examined the impact an increase in the inflation hedge ratio could have on the Fund in light of the recent material rises in inflation. (see section 5 below).
- 4.2. The **funding level** was estimated to be 102% (net of the impact from the equity protection strategy) at the end of December 2021. This shows that the Fund's position was ahead of the expected funding level by c.7%.
- 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 0.4% 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 11% 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 11.2% over the quarter and the EPS detracted -1.1% to produce a net return of 10.1%. 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 31 December 2021 the Fund's existing pool of collateral was within guidelines and could sustain a 3.4% rise in interest rates, a 0.5% fall in inflation or an 11% decline in the value of the EPS before triggering the 'early warning' test.

### 5. INFLATION HEDGING CONSIDERATIONS

- 5.1. Following its last meeting the Panel asked FRMG to consider the quantitative impacts of rising inflation on the Fund's investment strategy, specifically in relation to the LDI hedge ratio. FRMG examined the impact of different inflation hedge ratios in terms of risk/return, collateral and in the context of the wider investment strategy, noting how the Fund's already well diversified portfolio is

well positioned to mitigate a range of downside risks. FRMG concluded that the Fund should maintain the current inflation hedge ratio while continuing to monitor the inflationary environment based on the fact increasing the hedge ratio at this stage:

(I) Increases Value at Risk, although reduces the negative funding impact under an inflation shock scenario

(II) Reduces expected return, potentially putting upward pressure on contributions

(III) Puts a significant strain on the Fund's collateral position

The hedge ratio and trigger framework are reviewed by Committee on an annual basis. Further work relating to the Fund's 'natural' level of inflation protection at the underlying asset level will form part of the 2022/23 strategic review.

## **6. LOW RISK BUCKET – IMPLEMENTATION CONSIDERATIONS**

6.1. FRMG reviewed the current "low risk" investment strategy in place for the Fund's orphan liabilities and considered options designed to limit the funding level volatility brought on by extreme moves in inflation and/or interest rates for employers whose liability terms differ significantly to the average liability term in the low-risk bucket. Further consideration of the various implementation approaches will form part of the 2022 valuation and FSS review.

## **7. EQUITY PROTECTION STRATEGY RESTRUCTURE – POST TRADE UPDATE**

7.1. The EPS was restructured in December 2021 to take account of the changes to the underlying equity portfolio that were agreed as part of the wider equity allocation review in September i.e. the removal of the dedicated emerging market equity allocation and the subsequent increase to developed market equities.

7.2. FRMG considered the post-trade report prepared by Mercer which showed transaction costs for exiting the emerging market exposure came in higher than expected (0.21% of exposure traded vs. 0.14% estimate) as a result of increased volatility at the time of trading. Transaction entry costs for the new developed market exposure were in line with pre-trade estimates (0.07% of exposure traded).

7.3. There was a net gain (after all entry and exit costs) for holding the emerging market protection strategy of c. £4.5m.

## **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.

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<b>Background papers</b>	FRMG papers
<b>Please contact the report author if you need to access this report in an alternative format</b>	