

## Bath & North East Somerset Council

MEETING:	<b>AVON PENSION FUND INVESTMENT PANEL</b>
MEETING DATE:	<b>27 MAY 2022</b>
TITLE:	<b>Risk Management Framework Review for Periods Ending 31 March 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 March 2022</b> <b>Exempt Appendix 2 – Mercer Paper: Collateral Management Plan</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 two meetings of the FRMG; most recently on the 6 May 2022 where the group considered the current collateral position, risks that would result in depletion of collateral and what steps should be taken to guard against this scenario. At its meeting in March, FRMG agreed to consider the impact of different higher risk investment strategies on the actuarial valuation outcome in the context of risk and contributions, as well as giving further thought to future inflation as part of the valuation. Panel will be notified of any strategic issues or concerns arising from this discussion in due course.
- 1.3. Exempt Appendix 1 summarises the risk management strategies at 31 March 2022. 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.
- 1.4. Mercer will present the paper "Collateral Management Plan" (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. Approves the proposed collateral plan as set out in Exempt Appendix 2 and further delegates the implementation of the plan to FRMG**

**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. FRMG will continue to monitor the risk of persistent high inflation on the Fund's asset portfolio, along with the potential impact on the funding position and expected returns in the run up to the 2022 valuation.

4.2. The **funding level** was estimated to be 100% (net of the impact from the equity protection strategy) at the end of March 2022. This shows that the Fund's position was ahead of the expected funding level by c.5%.

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 3.7% 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 10.2% and 39.0%, 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 -5.78% over the quarter and the EPS detracted -0.04% to produce a net return of -5.82%. 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 March 2022 the Fund's existing pool of collateral was within guidelines and could sustain a 2.5% rise in interest rates, a 0.4% fall in inflation or a 16% decline in the value of the EPS before triggering the 'early warning' test.

## 5. COLLATERAL MANAGEMENT PLAN

- 5.1. The paper at Exempt Appendix 2 seeks to formalise how the Fund would source additional collateral in order to maintain its risk management strategies and avoid the risk of counterparties closing out the hedging positions. FRMG has reviewed the proposal and recommend it to Panel.
- 5.2. The analysis makes no allowance for increasing the interest rate or inflation hedge ratios if triggers were met through rising interest rates or falling inflation, both of which would impact the collateral position.
- 5.3. The point at which the Fund would need to source additional collateral is unknown and therefore Panel are asked to delegate the implementation of the collateral plan to FRMG, who will report to Panel following any activity to source additional collateral.

## 6. RISK MANAGEMENT

- 6.1. 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.

## 7. EQUALITIES

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

## 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 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.

## 9. OTHER OPTIONS CONSIDERED

- 9.1. None

## 10. CONSULTATION

- 10.1. The Section 151 Officer has had the opportunity to input to this report and has 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>	