Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**
MEETING DATE:	**9 SEPTEMBER 2022**
TITLE:	**Risk Management Framework Review for Periods Ending 30 June 2022**
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: **Exempt Appendix 1 – Mercer Report: Risk Management Framework Review to 30 June 2022**	

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 (RMF) 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. This quarter Exempt Appendix 1 contains details relating to the Fund's annual health check of the RMF. All strategies are rated green and continue to perform in line with expectation. There has been no material change in the Fund's collateral position, which remains comfortably above the 'early warning test'.

1.3. Further details relating to the annual health check are contained in Exempt Appendix 1 which Mercer will present at the meeting. A summary of the FRMG discussion is included in Section 5 of this report.

2. RECOMMENDATION

The Avon Pension Fund Investment Panel is asked to note:

2.1. **The performance of each of the underlying RMF strategies**

2.2. **The decision by FRMG to adjust the inflation trigger framework to reflect the RPI/CPI difference**

2.3. **The ongoing FRMG consideration regarding the hedge ratio of the LDI portfolio**

2.4. **That the FRMG may consider adjusting the interest rate trigger framework to reflect current market conditions so that the Fund hedges at attractive levels.**

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

Strategy/Objective	**Commentary**	**RAG**	**Trend**
Funding Level	• 92% (£462m deficit) • Behind existing recovery plan by c.3%		⇩
LDI	• Quarterly return of -8.2% due to rise in gilt yields • No inflation or interest rate triggers breached over Q • Interest rate hedge ratio 11% • Inflation hedge ratio 38% • Mandate performed as expected. Manager in compliance with investment guidelines		⇔
Equity Protection	• EPS adds 3.6% over the Q to deliver a net equity return of -11.5% • Since inception the dynamic EPS has added value (c. £60.8m in net gains at 30 June 2022) as markets have broadly fallen over the first half of 2022		⇧
Low Risk Corporate Bonds	• Level of cashflow matching has declined since inception due to the rise in inflation which impacts the liability cashflows but not the corporate bonds cashflows. Ongoing monitoring by FRMG		⇔
Collateral Position	• At 30 June 2022 collateral pool could sustain a 4.8% rise in interest rates, a 0.6% fall in inflation or an 8% decline in the value of the EPS before triggering the 'early warning test'		⇔

5. RMF ANNUAL HEALTH CHECK

5.1. FRMG considered increasing the interest rate hedge ratio outside of the current trigger framework as a result of the increase in yields. The group looked at the implications of increasing the hedge by 10%, 20% and 30% and concluded that an increase beyond 10% was not viable due to the impact on collateral. Whilst interest rates are currently attractive relative to recent history they are still below the current trigger levels and therefore the Fund would be better off if interest rates continued to rise and additional hedging was implemented at cheaper rates. **Given the current market environment, the view was that there was a high probability of further interest rate rises to come (but not guaranteed) and that interest rates could rise faster than the market is expecting. In this scenario, the Fund would be better to wait given the interest triggers in place.**

5.2. FRMG will continue to monitor interest rates to consider whether the current interest rate trigger levels could be widened given the current market conditions. The trigger framework needs to achieve a balance between locking in at attractive levels and not missing opportunities to hedge.

5.3. Under delegated authority the FRMG resolved to change the inflation triggers to account for the reduction in the structural gap between RPI and CPI which will materialise as we progress toward 2030 given the reform of RPI to CPI from that date. This means all inflation triggers will be re-struck at 0.2% lower than current levels, equivalent to a move in the structural gap from 0.5% to 0.3%, which is in line with the 2022 actuarial valuation assumptions. The structural gap will be kept under review and adjusted downwards as necessary as we approach 2030.

Further, FRMG agreed to widen the spread between the inflation trigger levels from 0.05% to 0.1% to compensate for increased volatility in inflation over recent months and to avoid the risk of breaching several triggers at once which could present issues from a collateral perspective. Widening the spread between triggers is an implementation decision and does not alter the target real return over CPI.

5.4. The cashflows attached to the liabilities hedged as part of the low-risk funding strategy have increased since the strategy was incepted due to the rise in inflation. This increase has not been matched by the corporate bond assets held as part of this strategy, resulting in a decline in the overall level of cashflow matching. Currently, the low-risk bond strategy draws on the inflation hedge of the main fund to fully hedge the inflation sensitivity of the liability cashflows. As the low-risk liabilities grow the current approach will lead to a degradation in the inflation hedge of the main fund (at the current size of the LRFS the impact on the inflation hedge of the main fund is immaterial). FRMG considered the cost-benefit of introducing a standalone LDI portfolio for this subset of liabilities and concluded that such an approach did not represent good value at this stage given the size of the strategy but would be kept under review. Meanwhile Officers will work with Mercer and the LDI manager to model a corporate bond portfolio that provides a good cashflow match of the liability profile under the existing approach once data from the 2022 actuarial valuation is available.

5.5. Given the significant upward pressure on interest rates since the valuation date, discussions will be needed about the positive impact this had had on long-term forward-looking return expectations and how much the Fund should allow upfront. Allowing for some of the higher interest rates (and therefore expected return) within the discount rate post-valuation is projected to lead to a c.2-3% improvement in the current reported funding level. Although this market impact will not result in a change to the discount rate used as part of the March 2022 valuation, FRMG will need to consider the impact on the funding plan and the return assumptions given the impact this would have on the 2022/23 investment strategy review. Panel will be notified of any strategic issues or concerns arising from this discussion in due course.

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 Director – One West has had the opportunity to input to this report and has 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	