Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**
MEETING DATE:	**25 NOVEMBER 2022**
TITLE:	**Risk Management Framework Review for Periods Ending 30 September 2022**
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: **Exempt Appendix 1 – Mercer Report: Risk Management Framework Review to 30 September 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. Exempt Appendix 1 shows all risk management strategies are rated green and continue to perform in line with expectation. Action taken in response to the extreme market volatility in September meant the collateral position remained strong. At the end of September and based on the existing collateral adequacy framework, the collateral in the QIF remained comfortably above the 'early warning test'. FRMG are reviewing the current collateral adequacy framework with the manager who has indicated a greater level of collateral may be required in future to ensure resilience against market shocks of the same magnitude as those seen in September.

1.3. Exempt Appendix 1 is the Mercer report the FRMG considered at its last meeting on 4 November. 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. **That the FRMG are currently considering the appropriate time to reinstate the trigger framework following the pause it implemented in September and;**

2.3. **Whether the interest rate trigger framework should be adjusted higher to reflect current market conditions so that the Fund continues to hedge at attractive levels.**

3. FINANCIAL IMPLICATIONS

2.4. 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

Strategy/Objective	Commentary	RAG	Trend
LDI	• Trigger framework currently suspended • Interest rate hedge ratio c. 40% • Inflation hedge ratio c. 40% • Mandate performed as expected. Manager in compliance with investment guidelines		⇔
Equity Protection	• Since inception the dynamic EPS has added value (c. £64.2m in net gains at 30 Sept 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 – to update mandate following provision of 2022 actuarial valuation data.		⇔
Collateral Position	• At 30 Sept 2022 the collateral pool could sustain a 2.7% increase in interest rates, a 3.6% fall in inflation or a 35% fall in the value of the equity options. • Collateral adequacy framework currently under review with manager		⇔

5. FRMG CURRENT WORKSTREAMS

5.1. The trigger framework was paused in September due to the collateral implications of increasing hedging levels while the assets held within the QIF were simultaneously falling in value. As gilt market volatility has subsided and yields have returned approximately to the levels they were at prior to the 'mini-budget', FRMG considered reactivating the trigger framework but capping the amount of further hedging that could be implemented to reduce the strain on collateral. Given the uncertain interest rate outlook and the likelihood that any increase in hedging would require additional assets to be sourced and transferred into the QIF, FRMG agreed that it should convene following the 17th November budget statement and reassess before taking further action.

5.2. The FRMG are also considering a 0.5% increase in the current interest rate trigger levels to ensure the Fund achieves the right balance between locking in at attractive levels and not missing opportunities to hedge.

5.3. Forward looking long-term return expectations have increased post the March 2022 valuation date due to a significant increase in real yields. These return expectations are model driven and therefore do not account for the uncertain macro environment. FRMG discussed how much of this increase in expected returns should be allowed for in the post-valuation discount rate used for strategy objective setting and funding measurement purposes. Mercer currently adopt a simplified approach that allows for movements in interest rates and inflation to the extent that the Fund is hedged against these risks via its LDI programme. However, it does not allow for the increase in expected returns from other

(growth) assets that are also correlated with changes to real interest rates. In considering the extent to which the Fund should account for these changes in the discount rate, FRMG considered four different scenarios, including making no allowance for the change in yields since the valuation (i.e. no change and, as a result, a material increase in prudence versus the model return). It was concluded that an approach that allows for the correlation of the other assets (not just hedging assets) with real yields was the most appropriate for the purpose of the 22/23 investment strategy review and reporting the progression of the funding level.

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 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 Head of Pensions has reviewed this paper for publication.

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