Croydon Council

REPORT TO:	**Croydon Pension Board** **26 March 2019**
SUBJECT:	**Pension Fund Currency Hedging**
LEAD OFFICER:	**Nigel Cook Head of Pensions and Treasury**

1. RECOMMENDATIONS

1.1 To note the report on currency hedging commissioned from Mercer.

1.2 To note the decision of the Pension Committee which was to delegate the decision to implement a currency hedge to the Chief Finance Officer, in consultation with the Pension Committee Chair and Cabinet Member for Finance and Resources.

2. EXECUTIVE SUMMARY

2.1 This report sets out the case for implementing a currency hedge for the equity investment part of the portfolio, referencing the costs and advantages set out in Mercer's paper, which is appended.

3 DETAIL

3.1 Heightened volatility in currency exchange rates has a direct impact on the Pension Fund. This volatility can be managed by employing various hedging techniques. However, these techniques can be expensive, and movements in exchange rates can be beneficial as well as damaging to the Fund. Past Pension Committees have discussed the merits and demerits of actively managing this issue on a number of previous occasions but have never executed a currency hedging strategy.

3.2 Following on from the most recent discussion of this issue by the Committee on 4th December Mercer were asked to review the Pension Fund's currency exposure and suggest options to manage the risk that goes with that exposure. That report is included here as Appendix A and was considered by the Pension Committee at its meeting of 12 March 2019.

3.3 The LGIM Developed World ex-Tobacco Fund fits the criteria set out in the Mercer report for implementing a currency hedge. There are technical reasons, described in the Mercer report, for not hedging other components of the portfolio, and cost issues.

3.4 The liabilities of the Croydon pension scheme are denominated in sterling, with the result that any exposure to foreign currency through the asset portfolio can lead to an increase in volatility with little or no additional expected excess return.

However, there are valid reasons to have exposure to assets priced in foreign currencies, including:

- A further investment opportunity above and beyond that offered by the asset class;
- Hedging currency exposures in and of itself can be expensive;
- Exposure to “reserve currencies” (e.g. USD, EUR, CHF and JPY) can act as a tail risk hedge; and
- Exposure to reserve currencies can act as a second order liability hedge as a fall in UK interest rates (increasing the value of the liabilities) will likely coincide with a fall in the value of sterling and a relative gain on assets exposed to foreign currencies.

3.5 Since 2016 and the outcome of the Referendum on leaving the EU, sterling has devalued so that UK investors with un-hedged overseas currency exposure have seen material gains from their position. This scenario is likely to continue for some time, dependent on the outcome of the immediate process on March.

3.6 Mercer’s review notes that a satisfactory conclusion to the negotiations would result in these currency gains unwinding. Conversely, continued uncertainty would likely result in a weak sterling for a longer period. Thus the review suggests that the Committee might want to consider locking in some of these gains. Three options are set out, hedging all, none, or half of the exposure.

3.7 There are broadly two options available to the Committee if they want to crystallise some of the recent gains and reduce the Fund’s foreign currency exposure: either to introduce a currency hedging manager to implement an overlay strategy or ask the Fund’s existing managers to hedge their foreign currency exposures. Both options give rise to costs.

3.8 The Pension Committee decided on option B – ‘Ask the Fund’s existing managers to hedge their foreign currency exposures’. In effect this means LGIM and initial discussions have paved the way to enabling this. The next step therefore is to put a proposal to the Chief Finance Officer for her consideration and to allow her to consult with the Pension Committee Chair and Cabinet Member for Finance and Resources. The proposal will set out the costs involved, which will comprise a set-up charge and annual fee, and a recommendation as to what proportion of the equity portfolio should be hedged, including what currencies should be hedged.

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BACKGROUND DOCUMENTS:

None

Appendices

Appendix A: London Borough of Croydon Pension Fund Currency Hedging, Mercer February 2019