Croydon Council

REPORT TO:	**Pension Committee** **12 March 2019**
SUBJECT:	**Pension Fund Currency Hedging**
LEAD OFFICER:	**Nigel Cook Head of Pensions and Treasury**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Resources**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: **Sound Financial Management**: This report relates to the question of currency hedging in respect of the Pension Fund.	
FINANCIAL SUMMARY: There are significant financial implications relating to this question, whether a currency hedging strategy is employed or not.	

1. RECOMMENDATIONS

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

1.2 To delegate to the Chief Financial Officer, in consultation with the Committee's Chair and Cabinet Member for Finance and Resources, the decision whether to implement a currency hedge.

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.

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.

4 FINANCIAL CONSIDERATIONS

4.1 There are no further financial considerations flowing from this report. In the long run the impact of currency movements will likely be neutral. This strategy is more about eliminating, or whenever possible, mitigating the effects of volatility of the currency markets.

5. OTHER CONSIDERATIONS

5.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

6. LEGAL CONSIDERATIONS

6.1 The Head of Litigation and Corporate Law comments on behalf of the Director of Law and Governance that the recommendations within this report do not give rise to any legal considerations however, Appendix A provides a number of options for consideration which are not reflected within the recommendations. Specific specialist legal advice will be required regarding the legal implications prior to any decisions being taken if the Committee is minded to progress any of the options suggested within Appendix A or indeed in paragraphs 3.5 and 3.6 above.

Approved by: Sandra Herbert, Head of Litigation and Corporate Law on behalf of the Director of Law and Governance

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BACKGROUND DOCUMENTS:

None

Appendices

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