SACCO SOCIETIES REGULATORY AUTHORITY

GUIDELINE

ON

RISK MANAGEMENT PRACTICES

FOR

DEPOSIT-TAKING SACCO SOCIETIES

June, 2015

ABREVIATIONS AND ACRONYMS

ALCO	Asset and Liability Management Committee
ALM	Asset and Liability Management
ICT	Information and Communications Technology
IFRS	International Financial Reporting Standards
KPI	Key Performance Indicators
KRI	Key Risk Indicators
MIS	Management Information System
NII	Net Interest Income
RMC	Risk Management Committee
RMG	Risk Management Guidelines
RMP	Risk Management Program
SASRA	Sacco Societies Regulatory Authority

FORWARD

To

All deposit-taking Sacco Societies

RE: GUIDELINE ON RISK MANAGEMENT FOR DEPOSIT-TAKING SACCO SOCIETIES

The Sacco Societies Act and Regulations thereunder require Sacco societies to develop and implement risk management and internal control systems as a precondition for licensing. This Guideline supplements the legal and regulatory requirements by outlining the minimum standards expected of Sacco Societies in the prudent management of the deposit taking business risks. The primary objective for this guideline is to contribute towards maintaining and improving financial safety and soundness through better risk management policies and practices in all deposit taking Saccos. The purpose therefore is to equip the Board of Directors and Senior Management Staff of the Sacco societies with minimum standards in terms of policies, procedures and structures for effective risk management practices in the Sacco societies.

Besides detailing the basic elements of a sound risk management framework, the guideline identifies key major risks affecting the Deposit taking Sacco Societies and details ways of mitigating these risks. The risks covered include:

a) Strategic Risk
b) Credit Risk
c) Operational Risk
d) Liquidity Risk
e) Interest Rate Risk
f) Compliance Risk

A standard approach has been adopted in discussing each of these risks to cover the responsibilities of the Board of directors and senior management, policies and procedures and finally monitoring.

This Guideline is issued under Section 50 of the Sacco Societies Act, 2008 which empowers Authority to exercise such incidental powers as may be necessary to enable it to effectively carry out its functions under the Act including ensuring a stable and efficient deposit-taking Sacco subsector. This is in line with the Authority's principal mandate of ensuring the safety of members' deposits in Sacco Societies, including the issuance of directions, guidelines, and advisory to Sacco Societies generally for purposes of ensuring a stable and efficient Sacco industry and financial system as provided in Section 50 of the Sacco Societies Act. It is thus expected that the observance of this ***Guideline*** will greatly enhance risk management, internal control systems and regulatory compliance by Sacco Societies in deposit-taking business. These will subsequently ensure the overall stability of the Sacco Society thereby substantially improving their competitiveness as financial services providers.

Kindly be guided but contact the Authority in case of any clarification, questions or comments.

John Mwaka
AG: CHIEF EXECUTIVE OFFICE

1. OVERVIEW OF RISK MANAGEMENT FRAMEWORK REQUIREMENTS

1.1 Introduction

Saccos, like any other business enterprises, face a variety of risks that pose negative threats to their business. Risk-taking is an inherent and unavoidable aspect of financial service provision against which reward in the form of profits is sought. However, excessive and poorly managed risks can lead to losses and endanger the investments and savings of a Sacco's members and depositors. Risks taken are justified when they are understandable, measurable, controllable and within a Sacco's capacity to withstand for adequate financial returns. Sound risk management systems enable managers of Saccos to take risks knowingly, reduce risks where appropriate and strive to prepare for an uncertain future.

The Sacco Societies Regulatory Authority (SASRA) issues these guidelines on the risk management systems that are expected of all deposit taking Saccos.

These guidelines outline the minimum standards for Saccos towards the prudent management of risks. The major objective of these guidelines is to contribute towards maintaining and improving financial safety and soundness through better risk management practices in all Saccos.

These guidelines do not replace, but rather supplement, the applicable laws enacted in Kenya, and the regulations and guidelines issued by the Government of Kenya and SASRA.

These guidelines are in line with internationally accepted best practice risk management principles.

1.2 The Essence of Risk Management

For the purpose of these guidelines, risk refers to the possibility that the outcome of an action or event could bring adverse impacts on a Sacco's capital, earnings or its viability. Such outcomes could either result in direct loss of earnings and erosion of capital or may result in imposition of operational or financial constraints on the Sacco's ability to meet its business objectives. These constraints can hinder the Sacco's capability to conduct its business or to take advantage of available opportunities to enhance its business. As such, the board and senior management of a Sacco are expected to ensure that the risks the Sacco is taking are appropriate in nature and level.

Proactive risk management should be at the core of every Sacco's strategy and activities. It involves identification, measurement, monitoring and controlling risks to ensure that:

a) The individuals who take or manage risks clearly understand it.
b) The Sacco's risk exposure is within the limits established by the board of directors.
c) Risk taking decisions are in line with the business strategy and objectives set by the board.
d) The expected payoffs compensate for the risks taken.
e) Risk taking decisions are explicit and clear.
f) Sufficient capital as a buffer is available to take risk.

Each situation is unique, in terms of roles and capabilities of individuals and the structure, activities and objectives of the Sacco. Risk management practices considered suitable for one Sacco may be unsatisfactory for another. Because of the vast diversity in risk that Saccos take, there is no single prescribed risk management system that works for all. Moreover, in the context of a particular Sacco, the definition of a sound or adequate risk management system is ever changing, as new technology accommodates innovation and better information and as market efficiency grows. Each Sacco should tailor its risk management program to its needs and circumstances and regularly adapt and improve it.

1.3 Risk Management Process

Risk management processes are those policies and procedures that the Sacco Board has developed and implemented to supervise and therefore control the risks in various business activities. Regardless of the size of a Sacco, a risk management programme should include:

a) Risk Tolerance: This is the level of risk that the board and management are willing to undertake to achieve their business goals and objectives. Risk tolerance is usually defined in the Sacco's policy limits –often limits also established in regulation- and criteria and in its planning. Policies provide the framework under which operating officers can act, and generally establish the risk parameters for transactions in a particular area of activity. The regulator is typically concerned with the adequacy of policies governing each significant activity to determine whether the risk underwriting is reasonable, including plans for expansion and entry into new products, services or markets.

b) Risk Identification: This is the process by which the particular risks in individual transactions, portfolios and activities are recognized and understood by management. The regulator is interested with whether and how management identifies risks in their activities, and whether this identification process is adequate.

c) Risk Measurement: This is the estimation of potential impact of the risk in transactions, portfolios or activities. Basic ratios, compared over time, are useful tools to estimate the level and direction of risk. The Sacco's MIS should provide management and the board with appropriate reports on significant activities/events to enable them measure the direction of the risks inherent in each activity and whether the Sacco is exceedingly exposed.

d) Risk Control: This is the integrated system of limits, policies, standards, internal control procedures, internal audit, organization and staffing put in place by management and the board for the purpose of keeping risk levels within tolerable levels. Changes in this system are made based upon the risk identification and risk measurement results. A regulator assesses the various controls in each significant area of activity, whether they sufficiently control existing risk and whether they enable management to respond to changes.

e) Risk Monitoring: This is the ongoing process used to identify changes in risk levels and to ensure adherence to established controls. Risk monitoring is most often achieved with a good MIS and internal audit. A regulator is concerned on whether the processes used to monitor risk are, independent, timely, accurate and informative, and that reports are provided to appropriate levels within the organization.

1.4 The Basic Elements of a Sound Risk Management Framework

A sound risk management system should have the following elements:

1.4.1 Active Board and Senior Management Oversight

The Board of directors has the ultimate responsibility for the level of risk taken by the Sacco. Accordingly, the Board should:

a) Approve the overall business strategies and significant policies of their organizations, including those related to taking and managing risks; and
b) Ensure that senior management implements the procedures and controls necessary to comply with adopted policies on risk management.
c) Ensure that senior management is fully capable of managing the business activities that the Sacco conducts.

Consequently, all members of the board are responsible for understanding the nature of the risks significant to their Sacco and for ensuring that the management is taking the steps necessary to identify measure, monitor and control these risks. The Board should in this regard receive regular reports from the management that identify the nature, size and *significance of the risks the Sacco is exposed is to and in turn provide policy guidance on acceptable levels of risks.*

Senior management is responsible for:

a) Implementing strategies in a manner that limits risks associated with each strategy. Management should therefore be fully involved in the activities of their Sacco and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated.

b) Establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards.

Meeting these responsibilities requires senior managers of Saccos to demonstrate a thorough understanding of developments in the financial sector and knowledge of the activities the Sacco conducts, including the nature of the internal controls necessary to limit the related risks.

1.4.2 Risk Management Coordination

A coordinating risk management department or if the Sacco is yet to establish the department, a designated personnel should provide an oversight on the management of risks inherent in the Sacco's activities. The functions of the department or personnel should include;

a) Identifying current and emerging risks;
b) Developing risk assessment and measurement systems;
c) Establishing policies, practices and other control mechanisms to manage risks;
d) Developing risk tolerance limits for senior management and board approval;
e) Monitoring positions against approved risk tolerance limits; and
f) Reporting results of risk monitoring to senior management and the board.

2 Adequate Policies, Procedures and Limits

The board of directors and senior management should tailor their risk management policies and procedures to the types of risks that arise from the activities the Sacco conducts. Once the risks are properly identified, the institution's policies and procedures should provide detailed guidance for the day-to-day implementation of broad business strategies and should include limits designed to shield the Sacco from excessive and imprudent risks.

A Sacco's policies, procedures and limits should:

a) Provide for adequate and timely identification, measurement, monitoring, control and mitigation of the risks posed by its lending, investing, trading and other significant activities at the business line and institution-wide levels;
b) Ensure that the economic substance of a Sacco's risk exposures are fully recognised and incorporated into the Sacco's risk management systems;
c) Be consistent with the Sacco's stated goals and objectives, as well as its overall financial strength;
d) Clearly delineate accountability and lines of authority across the Sacco's various business activities, and ensure there is a clear separation between business lines and the risk function;
e) Escalate and address breaches of internal position limits;
f) Provide for the review of new businesses and products by bringing together all relevant risk management, control and business lines to ensure that the Sacco is able to manage and control the activity prior to it being initiated; and
g) Include a schedule and process for reviewing the policies, procedures and limits and for updating them as appropriate.

3 Adequate Risk Measurement, Monitoring and Management Information System

Unless risks are identified, assessed and measured, it is not possible to manage them. Further, a true assessment of risk gives management a clear view of the Sacco's standing and helps in deciding future action plan. To adequately capture the Saccos' risk exposure, risk measurement should represent aggregate exposure of Sacco to both risk type and business line and encompass short run as well as long run impact on Sacco. To the maximum possible extent Saccos should establish systems/models that quantify their risk profile; however, in some risk categories such as operational risk, quantification is quite difficult and complex. Where it is not possible to quantify risks, qualitative measures should be adopted to capture those risks.

4 Comprehensive Internal Controls.

A Sacco's internal control structure is critical to the safe and sound functioning of the organization, in general and to its risk management, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties is one of management's important responsibilities.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting, safeguards assets and helps to ensure compliance with relevant laws, regulations and institutional policies. Internal controls should be tested by an independent and suitably qualified internal auditor who reports directly to the board's Audit Committee. Given the importance of appropriate internal controls to Saccos, the results of audits or reviews, conducted by an internal auditor or other persons, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allows negative or sensitive findings to be reported directly to the board's audit committee.

In order to ensure the adequacy of its internal controls and audit procedures, a Sacco should observe the following:-

a) The system of internal controls should be appropriate to the type and level of risks posed by the nature and scope of the Sacco's activities.
b) The Sacco's organisational structure should establish clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
c) The Sacco's organisational reporting lines should provide sufficient independence of the control areas from the business lines and appropriate segregation of duties throughout the institution such as those relating to front and back office activities.
d) Financial, operational, and regulatory reports should be reliable, accurate and timely; exceptions should be noted and promptly investigated.
e) Adequate procedures for ensuring compliance with applicable laws and regulations should be in place.
f) Internal audit should provide for independence and objectivity.
g) Internal controls and information systems should be adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests should be adequately documented. Identified material weaknesses should be given appropriate and timely high level attention, and management's actions to address material weaknesses should be objectively verified and reviewed.
h) The Sacco's board audit committee should review the effectiveness of internal audits and other control review activities on a regular basis

5 Independent Review

Risk assessments should be validated by independent review functions with resources, authority and expertise sufficient to assess the risks, test the effectiveness of risk management activities, and make recommendations for remedial action. An independent review mechanism is intended to ensure that those who take or accept risk on the behalf of the Sacco are not the only ones who measure, monitor and evaluate the risks they take.

1.5 Risk Management Program

A risk management program (or framework) framework encompasses the scope of risks to be managed, the process/systems and procedures to manage risk and the roles and responsibilities of individuals involved in risk management. The framework should be comprehensive enough to capture all risks a Sacco is exposed to and have flexibility to accommodate any change in business activities. An effective risk management framework includes

1.6 Risk Categories

Each Sacco is required to develop its own comprehensive Risk Management Program (RMP) tailored to its operational circumstances and needs. At a minimum the RMP should cover:-

g) Strategic Risk
h) Credit Risk
i) Operational Risk, including fraud, errors, client and products, employment practices, workplace safety, business processes, damage to physical assets, and business disruption and system (including IT) failures.
j) Liquidity Risk
k) Market Risk
l) Compliance Risk

2. STRATEGIC RISK MANAGEMENT

2.1 Introduction

Strategic risk is the current and prospective impact on earnings and/or capital and arises from a Sacco's inability to implement appropriate business plans, strategies, decision-making, resource allocation and its inability to adapt to changes in its business environment. This risk is therefore a function of:

a) The compatibility of a Sacco's strategic goals
b) the business strategies developed to achieve the goals
c) the resources needed to carry out business strategies both tangible and intangible
d) the resources deployed in pursuit of these goals, and;
e) the quality of implementation

They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. In strategic management, the Sacco's internal characteristics must be evaluated against the influence of economic, technological, competitive, regulatory, and other environmental changes.

2.2 Common Sources of Strategic Risk

Strategic risk can arise through many ways. However, the common sources of the risk within Sacco's stem from the following:

a) Competition – through emerging industry rivals
b) Technology – shift in technology
c) Over-reliance on a few Customers and priority shift in member priorities.
d) Economic factors
e) Regulations
f) Adequacy of work processes and procedures and
g) Adequacy of information for decision-making.
h) Uncontrolled investment in non-core business lines i.e land and building

2.3 Board and Senior Management Oversight

The board of directors and senior management oversight is an integral part of an effective strategic risk management program. The board bears the overall responsibility for strategic risk management. It is chiefly responsible for setting corporate strategy and reviewing management performance in implementing the Sacco's strategic plan. In turn, senior management have a duty to ensure that there is an effective strategic risk management process by transforming the strategic direction given by the board through policy. To do this, senior management should have an understanding of the nature and level of the various risks associated with the Sacco's strategic plan and how such risks fit within the overall business strategies.

2.3.1 Board Oversight

The specific responsibilities of the board of directors with regard to strategic risk management are to:

a) Establish corporate objectives and values, strategic goals, and a mission statement describing the purpose of the Sacco; and ensure that these are effectively communicated and consistently applied throughout the Sacco;
b) Ensure that risk management practices are an intrinsic part of strategic planning; and
c) Ensure that the Sacco's overall strategic risk exposure is maintained at prudent levels, and is compatible with developed business strategies.

2.3.2 Senior Management Responsibilities

Senior management's responsibilities with regard to a Sacco's strategic risk management entail:

a) Establishing and implement the institution's strategic risk management framework based on criteria and standards set by the board;
b) Assisting the board in developing strategies to meet the institution's strategic goals and objectives;
c) Formulating the institution's strategic implementation plans (such as business, development and operating plans)
d) Ensuring adequate implementation of the Sacco's strategic plan, as approved by the board.
e) Implementing an effective institutional performance evaluation system;
f) Ensuring that any strategic issues and material risks arising from environmental changes or implementation of the Sacco's strategies are reported to the board on a timely basis.

2.4 Policies Procedures and Limits

2.4.1 Strategic Planning Process

A poor strategic planning process and inadequate strategic plan exposes a licensed Sacco to elevated strategic risk.

Every Sacco should have in place a comprehensive strategic plan supported by realistic financial budget and financial projections. A strategic plan clarifies a Sacco's overall purpose, defines goals and priorities and determines practical approaches for achieving targeted priorities.

In this regard, a Sacco is expected to adopt a participatory and effective strategic planning process characterised by:

a) Support or participation of the board, board committees, and senior management;
b) Participation of staff from various departments;
c) Adequacy of information in developing assumptions in relation to economic factors, position of the institution compared to competitors, current competitive position, future market trends and customer needs, amongst others;
d) Consistency of operational plans with the overall institutional strategic objectives, and
e) Assessment of actual performance against previous strategic plans.

2.5 Strategic Planning Considerations

The board of directors of the Sacco should ensure the following are considered, at a minimum, when the strategic plan is being prepared and proposed strategies are being identified:

a) The goals and objectives of the Sacco;
b) Analysis of the Sacco's economic, social, technological and competitive environment
c) The current and anticipated member product and service needs;
d) A comprehensive and realistic appraisal of the existing business model including
    - ⇨ analysis of the Sacco's income and expenditure and financial position,
    - ⇨ membership and common bond, competitive capabilities, governance arrangements
    - ⇨ risk management and operational capabilities;
e) Independent evaluations and reports made by the external auditor, operational reviews, internal audit reports, SASRA's inspection reports and any other third party report.
f) The regulatory framework including developments in legal and regulatory requirements and guidance;
g) The risk tolerance of the Sacco and the risks that the Sacco is, or might reasonably be, exposed to
h) Assessment of key financial and non-financial resources needed to support the activities undertaken or to be undertaken in the strategic plan. This assessment should have regard to the nature, scale, complexity and risk profile of the Sacco.

2.6 Minimum components of the Strategic Plan

A Sacco's strategic plan approved by its board of directors shall at a minimum include:

a) The objectives of the Sacco's activities for a specified period of at least 3 years
b) The nature and scope of the activities to be undertaken,
c) The strategies and policies for achieving those objectives,
d) The targets and criteria for assessing the performance of the Sacco,
e) The financial projections for the Sacco for a specified period of at least 3 financial years from, and including, the current financial year together with the supporting financial analysis and assumptions made, and
f) The funding strategy proposed to support the projected balance sheet structure.
g) The sustainable advantage relative to competition.

A sample outline of at strategic plan format is presented in Annex 1 of these risk management guidelines.

2.7 Alignment and Change Management

Before implementing its strategies, a Sacco should ensure that they have made proper alignment of internal resources and processes and, if necessary, managed all change issues (such as those arising from institutional or cultural changes) to facilitate the achievement of desired outcomes. Interdependencies between processes across departments (e.g. reconciliation of transaction information between front and back offices using a more advanced IT system) should also have been addressed so that they can be properly understood and accounted for during the implementation.

Ensuring proper alignment of internal resources and processes means, for example, checking to see whether: –

⇨ Sufficient resources (financial and non-financial) have been allocated to undertake the necessary tasks;
⇨ The right people are or can put in the right place; and
⇨ The organisational and risk management structure, systems, infrastructure and technology are or can be adapted support the new initiatives.

2.8 Other Supporting Processes

2.8.1 Planning and Management Funding Needs

A Sacco shall maintain adequate resources, both financial and non-financial, in relation to the nature, scale, complexity and risk profile of the activities being undertaken in accordance with the strategic plan.

2.8.2 Management Information System

In a competitive financial services environment, the ability to effectively manage information is crucial to a Sacco's ability to remain competitive, introduce new products and services, and achieve desired goals. Saccos should therefore ensure that they have sufficient and robust MIS to support their strategic planning and decision making processes.

2.8.3 Human Resources Management and Development

Human resources management has a strategic focus in that it is involved in gaining commitments to a Sacco's goals and shaping its corporate culture. By developing policies to meet future needs, human resources management enables the adoption of a forward-looking approach to deal with change and growth and to anticipate future problems.

2.8.4 Succession Planning

A Sacco's management should develop management succession plans to cater for staff turnover and retirement. This is particularly essential to cater for major turnover in senior and middle management, whether due to transfer, resignation or retirement.

A Sacco's board of directors should also maintain succession plans for critical positions such as Chairman of the board and the Chief Executive Officer (CEO).

2.9 Measuring and Monitoring

The failure or success of a Sacco' strategy depends on whether it has adequate resources and capability to implement the strategy and its ability to effectively monitor and control the progress of implementation. As such, in addition to strategic planning, a Sacco should have a process to facilitate the monitoring and control of strategies being implemented.

Active board and senior management oversight with the support of the strategic risk management function will help ensure effective implementation and control of strategies.

In addition, there should be adequate management guidelines and written procedures for implementing strategies and monitoring and reporting the progress of implementation.

Where institutions have identified strategic issues arising from anticipated operational or market changes which may result in a significant adverse impact on their business or financial conditions, such issues should be reported to the board and senior management in a timely manner, with an assessment of the strategic risk implications and the need for taking remedial actions (such as modifying existing strategies and implementing risk mitigating or contingency measures).

In order to ensure an effective strategic risk management process, every Sacco should deploy a management information system that will enable management to monitor:

a) Current and forecasted economic conditions, e.g. economic growth, inflation, interest rates, trends, etc.
b) Current and forecasted industry and market conditions, such as:
   - ⇨ Increasing competition by new market entrants
   - ⇨ Number and size of mergers and acquisitions
   - ⇨ Changing customer behaviour
   - ⇨ New products/substitutes
c) Exposure to different sectors (e.g. agriculture, employed clientele), and associated sector risks.

Comparison of actual performance to desired outcomes serves as an important check on the success of implementing approved strategies, and allows management to take timely remedial actions to address significant deviations from set targets. Therefore, institutions are expected to develop a performance evaluation system that tracks progress towards achieving both financial and non-financial targets.

In order to ensure efficient and continuous performance evaluation, at the setting of strategic goals and targets stage, long term goals and targets should be broken down in short term (preferably yearly) measurable goals and targets.

2.10 Internal Controls and Audit

A Sacco's board and senior management should have in place a strong internal control system to ensure that it is not unduly exposed to strategic risks. Internal controls are required to ensure that:

a) The Sacco's organisational structure establishes clear lines of authority.
b) The Sacco's systems and structures provide for business continuity planning.
c) The process of setting up and reviewing strategic plans is comprehensive and is adhered to.

The results of such audit reviews, including any issues and weaknesses identified should be reported to the board and senior management directly. Both the board and senior management should be sufficiently engaged in the process to determine whether such reviews and audits are effectively performed (e.g. whether the performing staff are independent and have sufficient authority to perform their duties) and identified issues are addressed.

3. CREDIT RISK MANAGEMENT

3.1 Introduction

Credit risk is the likelihood that a borrower is unwilling or unable to pay interest and /or repay the principal of a loan according to the terms specified in the loan agreement, resulting in financial loss for the lender.

This section presents the minimum fundamental credit risk management policies and practices that every Sacco is required to have in place. The guideline outlines the general principles around which more detailed lending procedures and practices should be developed and implemented.

3.2 Board and Senior Management Oversight

3.2.1 The Board of Directors

The board of directors carries the ultimate responsibility of approving and reviewing the credit risk strategy and credit risk policies of the Sacco. This role is part of the board's ultimate responsibility to offer overall strategic direction. The credit risk strategy should clearly set the acceptable risk appetite and tolerance the institution is willing to engage, and the level of profitability it expects to achieve for incurring credit risks. The credit policies should be adequate and must cover all the activities in which credit exposure is a significant risk.

The specific responsibilities of the board with regard to credit risk management include:

a) Defining the institutional overall risk tolerance in relation to credit;
b) Ensuring that appropriate plans, policies and procedures for credit risk management have been developed and implemented
c) Ensuring that top management as well as other staff responsible for credit extension and risk management possess sound expertise and knowledge to accomplish the functions;
d) Ensuring that significant credit risk exposure is maintained at prudent levels and consistent with the available capital.
e) Reviewing exposures to insiders and their related parties, including policies related thereto;
f) Ratifying exposures exceeding the level of the management authority delegated to management and be aware of exposures; and
g) Reviewing trends in portfolio quality and the adequacy of provisions for credit losses;

h) Specifying the content and frequency of management reports on credit risk management to the board.
i) Ensuring that internal audit reviews the credit operations to assess whether or not the Sacco's policies and procedures are adequate and implemented

3.2.2 The Board Credit Committee

Each Sacco is required under section 60 of the Sacco Societies (Deposit Taking Sacco Business) Regulations to have a Board Credit Committee. This committee should be empowered to oversee credit risk taking activities and overall credit risk management function. The committee should be mainly responsible for;

a) The implementation of the credit risk policy/strategy approved by the board.
b) Monitor credit risk and ensure compliance with limits approved by the board.
c) Recommend to the board, for its approval, clear policies on standards for presentation of credit proposals
d) Recommend delegation of credit approving powers, prudential limits on large credit exposures, standards for loan collateral, portfolio management, loan review mechanism, risk concentrations, risk monitoring and evaluation, pricing of loans, provisioning, and legal and regulatory compliance.

3.2.3 Role of Senior Management

The overall responsibility of risk management rests on the Sacco's board of directors. The responsibility of senior management is to transform strategic direction set by board in the shape of policies and procedures. The formulation of policies relating to risk management itself may not be adequate until and unless these are clearly communicated down the line. Senior management has to ensure that these policies are embedded in the culture of an organization.

Senior management is responsible for implementing the approved (by the board) credit risk management strategies and policies and ensuring that procedures are put in place to manage and control credit risk and the quality of credit portfolio in accordance with these policies.

The specific responsibilities of senior management with regard to credit risk management should include:

a) Developing credit policies and credit administration procedures for Board approval;
b) Implementing credit risk management policies to ensure effective credit risk management process;
c) Ensuring the development and implementation of an appropriate reporting system;

d) Monitoring and controlling the nature and composition of the Sacco's credit portfolio in compliance with exposure and prudential limits and regulatory requirements;
e) Monitoring the quality of credit portfolio and ensuring that the portfolio is soundly and conservatively valued and probable losses are adequately provided for;
f) Ensuring adequate research is undertaken for any new products or activities to ensure the risks are appropriately identified and managed. Examples of most high risk products include microcredit and small and medium enterprise (SME) credit. These products must receive prior board and subsequent SASRA approval.
g) Establishing internal controls and setting clear lines of accountability and authority
h) Timely dissemination of credit risk management policies, procedures and other credit risk management information to all the credit staff.
i) Ensure internal audit reviews of the credit risk management system and the credit portfolio are undertaken regularly

3.3 Product Strategy and Development

3.3.1 Systematic Product Development Process

A Sacco seeking to introduce a new product should determine whether and how the new product idea helps promote its mission, its competitive strategy, its financial goals, and its social impact.

Once the Sacco decides that the product idea would not detract from these goals and objectives, it must then assess its capacity to handle the additional product. Major factors that should be considered in this evaluation include staff capacity and skill levels, delivery channels, management information systems, and training. In addition, the Sacco should assess how the introduction of the new product will impact its overall portfolio and liquidity risk. Such risk management considerations should be viewed in relation to the added customer benefit and profit gain from portfolio diversification.

New product introduction should follow a systematic process outlined below:

i) *Institution Evaluation and Preparation:*
   - ⇨ Analyse the Sacco's capacity and "readiness" to undertake the development of the product
   - ⇨ Assemble the multi-departmental product development team to oversee various aspects of the product being developed e.g. pricing, procedures, internal controls and risk management, and marketing.

ii) *Market Research:*

- ⇨ Obtain and analyse secondary market data relevant to the proposed product, e.g. demand for the product, and performance of similar products offered by competitors
- ⇨ Undertake primary market research and intelligence amongst the Sacco's current and target clients

iii) *Product Features and Delivery Design:*

- ⇨ Define initial product concept
- ⇨ Develop the product delivery structures, procedures, and MIS configuration.
- ⇨ Undertake cost analysis and revenue projections
- ⇨ Verify legal and regulatory compliance

iv) *Pilot Testing:*

- ⇨ Define objectives to be measured and monitored during pilot test, primarily based on operational targets and financial projections
- ⇨ Establish parameters of pilot test including location(s), duration, periodic evaluation dates
- ⇨ Monitor and evaluate pilot test results
- ⇨ Complete recommendation letter documenting the results of the pilot test, comparison with projections, lessons learned, finalised systems/procedures manuals, etc. and the initial plans for the roll out

v) *Product Rollout:*

- ⇨ Manage transfer of piloted product into mainstream operations
- ⇨ Establish product rollout budget, schedule and tracking system
- ⇨ Install and test delivery systems and channels, finalise procedures manuals, develop marketing materials, train staff.
- ⇨ Monitor and evaluate rollout process and results, and refine product based on monitoring findings

3.3.2 Regulatory Review and Approval of New Credit Products

As provided for in the section 34 of the Sacco Societies (Deposit Taking Sacco Business), 2010, a Sacco intending to introduce a new loan product shall seek prior approval from SASRA before introducing the product. Key information to be included in the application for approval that will be considered by the Authority will include the market segment that the proposed product targets, the projected demand for the product, and the capacity including availability of qualified or experienced staff, to disburse loans

3.4 Policies, Procedures and Limits

3.4.1 Credit Policy Document

A properly documented credit policy is an essential element of the credit risk management process and provides the basis for effective portfolio management. It should set out the criteria and guidelines for the granting, maintenance, monitoring and management of credit at the individual and portfolio levels. In addressing all significant credit matters, the policy should include:

a) The types of credit facilities to be offered, with pricing policies, profitability targets, maximum maturities and maximum debt-servicing ratios for each type of lending;
b) Ceilings for the total loan portfolio in terms of, for example, loans-to-deposit ratio, or percentage of capital base;
c) Limits on exposures by sector, category of borrower/counterparty, product type, groups of related borrowers and single borrowers etc.
d) Procedures for identifying when it is appropriate to classify a group of borrowers as connected counterparties and for aggregating exposures to individual customers across business activities:
e) Types of acceptable collateral, loan-to-value of collateral ratios and the criteria for accepting guarantees;
f) Authorization levels/limits
g) Delegation of credit authority to management and staff, including authority to approve exceptions;
h) Procedures for the review of loans including a grading/rating system;
i) Problem credit identification and administration and associated provisioning and
j) The minimum information required from loan applicants bearing in mind anti-money laundering best practice and legal requirements.
k) Collection processes.

Saccos should ensure that their own internal exposure limits comply with requirements made by SASRA under the prudential regulations. In order to be effective, credit policies must be communicated throughout the organization, implemented through appropriate procedures, and periodically revised to take into account changing internal and external circumstances.

3.4.2 Segregation of Duties

Credit policy formulation, credit limit setting, monitoring of credit exposures and review and monitoring of documentation are functions that should be performed independent of the loan origination function. For small institutions, where it might not be feasible to establish such structural hierarchy, there should be adequate compensating measures to maintain credit discipline, introduce adequate checks and balances and standards to address potential conflicts of interest.

3.4.3 Policies Relating to Credit Products

The various types of loan products and credit instruments the Sacco intends to offer should be documented. Management must have a good understanding of all the products on offer and a careful review of the existing and potential risks must be undertaken. The products should also have a maturity profile and the pricing of these products should be included and periodically reviewed. Any new products should be fully researched and prior board approval obtained before introduction to the customers.

3.4.4 Policies Relating to Credit Assessment and Granting Process

A Sacco must operate under sound, well-defined credit-granting criteria. These criteria should include a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

The Sacco must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty.

At a minimum, the factors to be considered and documented in approving credits must include:

a) The purpose of the credit and source of repayment;
b) The integrity and reputation of the borrower or counterparty;
c) The current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and its sensitivity to economic and market developments;
d) The borrower's repayment history and current capacity to repay, based on historical financial trends and cash flow projections;
e) The borrower credit rating/report from licensed Credit Reference Bureau;
f) A forward-looking analysis of the capacity to repay based on various scenarios;
g) The legal capacity of the borrower or counterparty to assume the liability;
h) For commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
i) The proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and
j) Where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

Also lending authority delegated to staff with clearly established limits should be documented. It is important to include the functions and reporting procedures of the various committees and individual lending officers.

In addition, it is important to have checks and balances in places that ensure credit is granted on arms-length basis. Extensions of credit to directors, senior management and other influential parties, for example shareholders, should not override the established credit granting and monitoring processes of the Sacco.

3.4.5 Individual Borrower Monitoring

A Sacco should have in place a system for monitoring the condition of individual credits. Key indicators of credit condition should be specified and monitored to identify and report potential problem credits. These would include indicators from the following areas:-

a) Financial Position and Business Conditions:

Key financial performance indicators on profitability, equity, leverage and liquidity should be analysed as well as the operating environment of the obligor.

When monitoring companies dependent on key management personnel or shareholders, such as small and medium enterprises, a Sacco should pay particular attention to assessing the status of these parties.

b) Conduct of Accounts

A Sacco should monitor the borrower's principal and interest repayments, account activity, as well as instances of excesses over credit limits.

c) Loan Covenants:

The borrower's ability to adhere to pledges and financial covenants stated in the loan agreement should be assessed and breaches detected should trigger prompt action.

d) Status and Valuation of Collateral

The value of collateral should be updated periodically to account for changes in market conditions. For example, where the collateral is property or shares, a Sacco should undertake more frequent valuations in adverse market conditions. If the facility is backed by an inventory or goods purportedly on the obligor's premises, appropriate inspections should be conducted to verify the existence and valuation of the collateral.

e) External Rating:

Adverse changes in a borrower's external credit rating or profile, for example by a credit reference bureau could indicate potential credit concerns

f) Force Majeure Situation

A Sacco should consider any unforeseen circumstances that have come into play which might affect the borrower's ability to repay a facility.

In addition to monitoring the above risk indicators, a Sacco should also monitor the use of funds to determine whether credit facilities are drawn down for their intended purposes. Where a borrower has utilised funds for purposes not shown in the original loan application, the Sacco should determine the implications on the borrower creditworthiness. Exceptions noted during the monitoring process should be promptly acted upon and reported to management

3.4.6 Credit Collateral

Institutions use various techniques of mitigating credit risk. The most common are collateral, guarantees and netting off of loans against deposits of the same counter-party.

A collateralized transaction is one in which institutions have a credit exposure or potential credit exposure and the exposure is reduced in whole or in part by collateral.

The following is essential:

a) The Sacco should primarily assess the borrower's capacity to repay and should not use collateral to compensate for insufficient information.
b) There must be legal certainty. All documentation used for collateralized transactions must be binding to all parties and also be legally enforceable.
c) Guidance on the various acceptable forms of collateral should be documented.
d) Perfection of collateral, it is the type of collateral that can be legally perfected.
e) Steps to be taken for obtaining and maintaining an enforceable security, for example registration, right of set-off or transfer of title must meet all the legal requirements.
f) Procedures for timely liquidation of collateral
g) Annual assessment of the value of collateral should be undertaken to confirm that it remains realisable.

3.4.7 Internal Risk Rating Systems

An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a Sacco. This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits and the adequacy of loan loss reserves. In determining loan loss reserves, a Sacco should ensure that SASRA's classification criteria are the minimum.

Typically, an internal risk rating system categorises credits into various classes designed to take into account the gradations in risk. Simpler systems might be based on several categories ranging from satisfactory to unsatisfactory; however, more meaningful systems will have numerous ratings for credits considered satisfactory in order to truly differentiate the relative credit risk they pose.

While developing their systems, Saccos must rate the riskiness of the borrower or counterparty as well as the risks associated with the specific credit facility.

Internal risk ratings are an important tool in monitoring and controlling credit risk. In order to facilitate early identification, a Sacco's internal risk rating system should be responsive to indicators of potential or actual deterioration in credit risk e.g. financial position and business condition of the borrower, conduct of the borrower's accounts, adherence to loan covenants and value of collateral.

Credits with deteriorating ratings should be subject to additional oversight and monitoring, for example, through more frequent visits from credit officers and inclusion on a watch list that is regularly reviewed by senior management. Line management in different departments can use the internal ratings to track the current characteristics of the credit portfolio and help determine necessary changes to the credit strategy or operational focus. Consequently, it is important that the board of directors and senior management also receive periodic reports on the condition of the credit portfolios based on such ratings.

The ratings assigned to individual borrowers or counterparties at the time the credit is granted must be reviewed on a periodic basis and individual credits should be assigned a new rating when conditions either improve or deteriorate. Because of the importance of ensuring that internal ratings are consistent and accurately reflect the quality of individual credits, responsibility for setting or confirming such ratings should rest with a credit review function independent of that which originated the credit concerned. It is also important that the consistency and accuracy of ratings is examined periodically by a function such as an independent credit review group.

3.4.8 Policies on Management of Problem Credits

The credit policy should establish the procedures for dealing with deteriorating and managing problem credits. Early recognition of weaknesses in the credit portfolio is important and allows alternative action and for an effective determination of loan loss potential.

A Sacco must have clearly articulated and documented policies in respect of the counting of days past due. In particular, policies should cover granting extensions, deferrals, renewals and additional credits to existing accounts. At a minimum, it must have approval levels and reporting requirements in respect of the above.

The policy should define a follow-up procedure for all loans and the various reports to be submitted both to management and board of directors. It should also include the internal rating for loan classification and provisioning.

3.4.9 Policies on Transactions with Other Financial Institutions

Transactions between a Sacco and another financial institution also portend significant credit risk. A Sacco's policy for such transaction should discuss at least the following:

a) The establishment and observation of counter party limits.
b) The method and accuracy of reconciliation of the accounts with other financial institutions.
c) The concentration of exposure to other financial institutions with a detailed listing of the institutions and amounts outstanding as well as lending limits.

3.4.10 Provisioning and Write-off Policy

The credit policy must clearly outline the provisioning procedures for all credits. This should comply at a minimum to the International Financial Reporting Standards (IFRS), regulatory requirements and provisioning guidelines already issued by SASRA.

3.5 Measuring and Monitoring Credit Risk

3.5.1 Measuring Credit Risk

A Sacco should have procedures for measuring its overall exposure to credit risk as well as exposure to connected groups, products, customers, market segments and industries for appropriate risk management decisions to be made.

The measurement of the risk should take into account the nature of the credit, maturity, exposure, profile, existence of collateral or guarantees and potential for default. The Sacco should also undertake an analysis of the whole economy or in particular sectors to ensure contingency plans are developed for higher than expected levels of delinquencies and defaults.

An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a Sacco. This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of loan loss reserves.

Typically, an internal risk rating system categorizes credits into various classes designed to take into account the graduations in risk. Simpler systems might be based on five categories which include Normal, Watch, Substandard, Doubtful and Loss; however, more detailed systems with numerous ratings for credits may be considered.

3.5.2 Credit Administration

Credit administration is critical in ensuring the soundness of the credit portfolio. It is the responsibility of management to set up a credit administration team to ensure that once a credit is granted it is properly maintained and administered. This will include record keeping, preparation of the terms and conditions as well as perfection and safe custody of the securities. Credit files of Saccos should contain the following information:

- ⇨ Credit application.
- ⇨ Evidence of approval.
- ⇨ Latest financial information.
- ⇨ Record and date of all credit reviews.
- ⇨ Record of all guarantees and securities.
- ⇨ Record of terms and conditions of facility.
- ⇨ Evidence of securities validation function that should include legal validity, existence, valuation, registration of charge and safekeeping.
- ⇨ Internal rating.

While developing the credit administration processes, a Sacco should develop controls to ensure compliance with the applicable laws, regulations and internal policy.

Adequate segregation of duties between credit approval and administration processes should be maintained.

On-going administration of the credit portfolio is an essential part of the credit process.

The credit administration function is basically a back office activity that supports and control extension and maintenance of credit. A typical credit administration unit performs the following functions:-

a) *Documentation* - It is the responsibility of credit administration to ensure completeness of documentation (loan agreements, guarantees, transfer of title of collaterals etc.) in accordance with approved terms and conditions. Outstanding documents should be tracked and followed up to ensure execution and receipt.

b) *Credit Disbursement* - The credit administration function should ensure that the loan application has proper approval before entering facility limits into computer systems. Disbursement should be effected only after completion of covenants, and receipt of collateral holdings. In case of exceptions necessary approval should be obtained from competent authorities.

c) *Credit monitoring* - After the loan is approved and draw down allowed, the loan should be continuously monitored. These include keeping track of borrowers' compliance with credit terms, identifying early signs of irregularity, conducting periodic valuation of collateral and monitoring timely repayments.

d) *Loan Repayment* - The borrowers should be communicated to ahead of time as and when the principal/mark-up instalment becomes due. Any exceptions such as non-payment or late payment should be tagged and communicated to the management. Proper records and updates should also be made after receipt.

e) *Maintenance of Credit Files* - Saccos should devise procedural guidelines and standards for maintenance of credit files. The credit files should not only include all correspondence with the borrower but should also contain sufficient information necessary to assess the financial health of the borrower and its repayment performance.

f) *Collateral and Security Documents* - Saccos should ensure that all security documents are kept in a fireproof safe under dual control. Registers for documents should be maintained to keep track of their movement.

Procedures should also be established to track and review relevant insurance coverage for certain facilities/collateral. Physical checks on security documents should be conducted on a regular basis.

While in small Saccos, it may not be cost effective to institute a separate credit administrative set-up, it is important that in such Saccos individuals performing sensitive functions such as custody of key documents, wiring out funds, entering limits into system, should report to managers who are independent of the credit origination and approval process.

3.5.3 Credit Exposure and Risk Reporting

Credit risk information should be provided to the board and management with sufficient frequency, timelines and should be reliable. Reports should be generated on the credit activities, for example:

a) Credit exposures by business line, product, sector

b) Credit exposures relating to major types of counterparties, including individual consumers, companies, and other financial institutions.
c) Significant credit exposure in relation to individual borrowers, related borrowers or groups of borrowers.
d) Credit exposures by major asset category showing impaired and past due amounts relating to each category.
e) Credit exposures restructured during a certain period and credits for which special conditions have been granted.

3.5.4 Management Information System

A Sacco should have in place information systems and analytical techniques that enable management to obtain reliable and timely information for the adequate measurement of credit risk. The system should:

a) Allow for detailed analysis of individual credits and the portfolio as a whole. For example, it should provide a breakdown of the loan portfolio such as by loan type, maturity, sector/industry, geographic location, counterparty, collateral type, or any other breakdown applicable to the nature of the Sacco's business activity;
b) Detail the terms of the loan (interest rates, repayment schedule), type of security, collateral or guarantee assigned as well as provide a report of the payment history of a given loan facility;
c) Permit aggregation of individual loan facilities for instance by client group, sector/industry, geographic location, or maturity to allow for analysis on concentrations;
d) Allow for a determination of large exposures both on an individual loan and aggregated basis;
e) Facilitate the use of a classification system to classify loans and assist in the determination of the level of provisioning of the loan portfolio;
f) Be able to provide a breakdown of the loan portfolio based on the classification assigned;
g) Provide suspension of interest accruals for non-performing loans in accordance with SASRA's prudential regulations; and
h) Facilitate exception reporting for incomplete loan accounts

3.6 Internal Controls and Audit

A Sacco should have in place an independent internal system for assessment of the credit risk management process. This function is necessary in order to independently enable the board determine whether the risk management process is working effectively.

The results of these audits should be communicated promptly to the directors and senior management. The review should provide sufficient information to the board and management to enable them evaluate accurately performance and condition of the portfolio. The credit review function should report directly to the board of directors or a board audit committee.

A review of the lending process should include analysis of the credit manuals and other written guidelines applied by various departments of a Sacco, and the capacity and actual performance of all departments involved in the credit function. It should also cover origination, appraisal, approval, disbursement, monitoring, collection and handling procedures for the various credit functions provided by the Sacco.

The internal audit review team should ensure the following:-

a) The credit granting function is carried out effectively.
b) The credit exposures are within the prudential and internal limits set by the board.
c) Validation of significant change in the risk management process.
d) Verification of the consistency, timeliness and reliability of data used for internal risk rating system.
e) Compliance with the Sacco's credit policies and procedures.
f) Adherence to internal risk rating system.
g) Identification of areas of weaknesses in the credit risk management process.
h) Exceptions to the policies, procedures and limits.

The internal audit should be conducted on a periodic basis and ideally not less than once a year. The audits should also identify weaknesses in the credit risk management process and any deficiencies in the policies and procedures.

4. OPERATIONAL RISK MANAGEMENT

4.1 Introduction

The operational risk in these guidelines refers to the risk of loss resulting from inadequate or failed internal processes, people and IT system, or from external events. It includes legal risk but excludes strategic and reputational risk.

Saccos should, in line with these guidelines, set up an operational risk management system suitable to the nature, scale and complexity of their operations to effectively identify, assess, monitor and control/mitigate operational risk. This system should comprise at least the following basic elements:

a) Oversight and control by the board of directors;
b) Roles and responsibilities of senior management;
c) Appropriate organizational structure;
d) Operational risk management policies, methods, and procedures; and
e) Independent review

4.2 Board and Senior Management Oversight

4.2.1 Board Responsibilities

The board of directors in a Sacco bears the ultimate responsibility for monitoring the effectiveness of operational risk management.

The board's specific responsibilities include:

a) Establishing a governance and management culture, and supporting processes, that are conducive to understanding the nature and scope of the operational risk inherent in the Sacco's strategies and activities and diligently mitigating them.
b) Developing in conjunction with senior management, strategies and policies for institution-wide operational risk management that are aligned with the Sacco's strategic goals;
c) Reviewing and approving senior management's functions, authorisation and reporting arrangements with regard to operational risk management. This should be directed at ensuring the effectiveness of the Sacco's decision-making system in operational risk management and ensuring that the operational risk is controlled appropriately.
d) Ensuring that senior management takes necessary measures to effectively identify, assess, monitor and control/mitigate operational risk;

e) Reviewing regularly the operational risk reports submitted by senior management; fully understanding the Sacco's overall operational risk management and the effectiveness of the senior management in handling material operational risk events; and monitoring and evaluating the effectiveness of daily operational risk management;
f) Ensuring that management are availing themselves of advances in line with best practices; and
g) Having in place an appropriate reward-sanctions framework to effectively promote the development and implementation of the Sacco's operational risk management system.
h) Ensuring that the Sacco's operational risk management system is effectively audited and overseen by internal audit department and preferably a suitable external and independent reviewer.

4.2.2 Role of Senior Management

The Sacco's senior management is responsible for implementing the operational risk management strategies, general policies and running the system approved by the board, specifically:

a) Being ultimately responsible to the board regarding daily operational risk management;
b) Implementing and regularly reviewing the operational risk management policies, procedures and detailed processes in accordance with the strategies and general policies approved by the board;
c) Adequately assessing and understanding the overall situation of the Sacco's operational risk management, particularly the events or programs with material operational risk;
d) Clearly defining each functional department's responsibilities with respect to operational risk management as well as the reporting line, frequency and contents;
e) Equipping operational risk management with appropriate resources, including but not limited to providing necessary funds, setting up necessary structures with appropriate staff, availing appropriate training courses to operational risk management personnel, delegating authorisation to the said personnel to fulfil their duties, etc.; and
f) Making prompt checks and revision of the operational risk management system so as to effectively respond to operational risk events brought about by changes in internal procedures, products, business activities, IT system, staff, external events or other factors; and

g) Submitting to the board regular reports on overall operational risk management ;

4.3 Operational Risk Management Policies and Procedures

A Sacco's operational risk exposure may increase when it engages in new activities or develops new products, enters new or unfamiliar markets, implements new business processes or technology system. The level of risk may also increase when new products activities, processes or systems become a material source of revenue or is a critical business operation. A Sacco should ensure that its risk management control infrastructure is appropriate at inception and that it keeps pace with the rate of growth of, or changes to, products activities, processes and systems. Saccos should have policies and procedures that address the process for review and approval of new products, activities, processes and systems, which consider the following:

a) Inherent risks in the new product, service or activity;
b) Changes to the operational risk profile and appetite and tolerance, including the risk of existing products or activities;
c) The necessary controls, risk management processes and risk mitigation strategies;
d) The residual risk;
e) Changes to relevant risk thresholds or limits; and
f) New procedures and metrics to measure, monitor and manage the risk of the new product of activity.

4.4 Measuring, Monitoring and Control

4.4.1 Measuring Operational Risk

Examples of some tools that may be used for identifying and assessing operational risk include, but are not limited to: -

a) Internal/External Audit Findings: While audit findings primarily focus on control of weaknesses and vulnerabilities, they can also provide insight into inherent risk due to internal or external factors;
b) Internal Loss Data Collection and Analysis: Internal operational loss data provides meaningful information for assessing a Sacco's exposure to operational risk and the effectiveness of internal controls. Analysis of loss events can provide insight into the causes of large losses and information on whether control failures are isolated or systematic. Saccos may also find it useful to capture and monitor operational risk contributions to credit and interest rate risk related losses in order to obtain a more complete view of their operational risk exposure
c) External Data Collection and Analysis: External data elements consist of general trend of operational loss events occurring within the Sacco sub-sector. External loss

data can be compared with internal loss data, or used to explore possible weaknesses in the control environment or consider previously unidentified risk exposure;

d) Risk Assessments: In a risk assessment, a financial institution assesses the processes underlying its operations against a library of potential threats and vulnerabilities and considers their potential impact. In a well-developed risk function the institution can then evaluate inherent risk (the risk before controls are considered), the effectiveness of the control environment, and residual risk (the risk exposure after controls are considered). Scorecards can be built on this assessment by weighting residual risks to provide a means of translating the scorecard output into metrics that give a relative ranking of the control environment;

e) Business Process Mapping: Business process mappings identify the key steps in business processes, activities and departmental functions. They also identify the key risk points in the overall business process. Process maps can reveal individual risks, risk interdependencies, and areas of control or risk management weakness. They also can help prioritise subsequent management action;

f) Risk and Performance Indicators: Risk and performance indicators are risk metrics and/or statistics that provide insight into a financial institution's risk exposure. Risk indicators, often referred to as Key Risk Indicators (KRIs), are used to monitor the main drivers of exposure associated with key risks. Performance indicators, often referred to as Key Performance Indicators (KPIs), provide insight into the status of operational processes, which may in turn provide insight into operational weaknesses, failures, and potential loss. Risk and performance indicators are often paired with escalation triggers to warn when risk levels approach or exceed thresholds or limits and prompt mitigation plans;

g) Scenario Analysis: Scenario analysis is a process of obtaining expert opinion of business line and risk managers to identify potential operational risk events and assess their potential outcome. Scenario analysis is an effective tool to consider potential sources of significant operational risk and the need for additional risk management controls or mitigation solutions. Given the subjectivity of the scenario process, a robust governance framework is essential to ensure the integrity and consistency of the process;

h) Measurement: Larger Saccos may find it useful to quantify their exposure to operational risk by using the output of the risk assessment tools as inputs into a model that estimates operational risk exposure.

4.4.2 Monitoring

Saccos should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk.

An effective monitoring process is essential for adequately managing operational risk. Regular monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the policies, processes and procedures for managing operational risk. Promptly detecting and addressing these deficiencies can substantially reduce the potential frequency and/or severity of a loss event.

In addition to monitoring operational loss events, Saccos should identify appropriate indicators that provide early warning of an increased risk of future losses. Such indicators (often referred to as key risk indicators or early warning indicators) should be forward-looking and should reflect potential sources of operational risk such as rapid growth, the introduction of new products, employee turnover, transaction breaks, system downtime, and so on. When thresholds are directly linked to these indicators, an effective monitoring process can help identify key material risks in a transparent manner and enable the Sacco to act upon these risks appropriately.

The frequency of monitoring should reflect the risks involved and the frequency and nature of changes in the operating environment. Monitoring should be an integrated part of a Sacco's activities. The results of these monitoring activities should be included in regular management and board reports, as should compliance reviews performed by the internal audit and risk management functions.

Senior management should receive regular reports from appropriate areas such as business units, group functions, the operational risk management office and internal audit. The operational risk reports should contain internal financial, operational, and compliance data, as well as external market information about events and conditions that are relevant to decision making. Reports should be distributed to appropriate levels of management and to areas of the Sacco on which areas of concern may have an impact. Reports should fully reflect any identified problem areas and should motivate timely corrective action on outstanding issues. To ensure the usefulness and reliability of this risk and audit reports, management should regularly verify the timeliness, accuracy, and relevance of reporting systems and internal controls in general. Management may also use reports prepared by external sources (auditors, supervisors) to assess the usefulness and reliability of internal reports. Reports should be analysed with a view to improving existing risk management performance as well as developing new risk management policies, procedures and practices.

In general, the board of directors should receive sufficient higher-level information to enable them to understand the overall operational risk profile and focus on the material and strategic implications for the business.

4.4.3 Control and Mitigation

The board and senior management should establish policies, processes and procedures to control and/or mitigate operational risks that the Sacco has identified. A Sacco should also have a system in place for ensuring compliance with a documented set of internal policies concerning the Sacco's risk management system.

The risk management control infrastructure should keep pace with growth or changes in business activities (e.g. new products and operations and entry into new markets).

A critical element to the control of operational risk is the existence of a sound internal control system. When properly designed and consistently enforced, a sound internal control system will help management safeguard the Sacco's resources, produce reliable financial reports, and comply with laws and regulations. Sound internal controls will also reduce the possibility of significant human errors and irregularities in internal processes and systems, and will assist in their timely detection when they do occur.

a) A Sacco should have an effective internal control system which ensures:
   - ⇨ Appropriate segregation of duties and that personnel are not assigned responsibilities which may create a conflict of interest.
   - ⇨ Close monitoring of adherence to assigned risk limits or thresholds and investigation of breaches;
   - ⇨ Maintaining safeguards for access to and use of Sacco assets and records;
   - ⇨ Staff has appropriate expertise and training;
   - ⇨ Identifying of business lines or products where returns appear to be significantly out of line with reasonable expectations; and
   - ⇨ Regular verification and reconciliation of transactions and accounts.

b) A Sacco should utilise risk mitigation tools to reduce the exposure to, or frequency and/or severity of significant operational risks with low probabilities and potentially very large financial impact, and uncontrolled risk events.

c) The Sacco should use risk mitigation tools as complementary to, rather than a replacement for, thorough internal operational risk control. Careful consideration should also be given to the extent to which risk mitigation tools such as insurance truly reduce risk, or transfer the risk to another business sector or area, or even create a new risk (e.g. legal or counterparty risk).

d) A Sacco should have relevant policies and procedures to control/mitigate their exposures arising from the following operational risk drivers, among others:

- new products and activities;
- change of IT systems, facilities and equipment;
- Mobile and electronic banking services;
- outsourcing arrangements;
- money laundering;
- suitability of customers, and
- External documentation e.g. contracts and transaction statements.

4.5 Internal Controls and Audit

The internal audit department in a Sacco should not directly take charge of or participate in other departments' operational risk management, but it should regularly check and evaluate how well the Sacco's operational risk management system operates, supervise the implementation of operational risk management policies, independently evaluate the Sacco's new operational risk management policies, processes and specific procedures, and report to the board of directors the evaluation results of operational risk management system.

5. INFORMATION AND COMMUNICATION TECHNOLOGY (ICT) RISK MANAGEMENT

5.1 Introduction

As Saccos increasingly depend on technology to deliver services to their members, inappropriate use of technology may have significant risk implications including:

- ⇨ The strategic risk resulting from poor decision on technology related investments
- ⇨ Operational risk caused by unauthorised access or disruptions to technology systems that support service delivery to members
- ⇨ Reputation and legal risks due to security breaches

5.2 Board and Senior Management Oversight

5.2.1 Board Oversight

The roles and responsibilities of the Board for ICT strategy and risk management include:

a) Approving the Sacco's ICT strategy and policy
b) Ensuring that the Sacco's business strategy is indeed aligned with its ICT strategy
c) Ensuring that the ICT organizational structure complements the Sacco's business model and its direction
d) Assessing Senior Management's performance in implementing ICT strategies, processes and practices that ensure that the ICT delivers value to the business
e) Ensuring that the Sacco's investments in ICT represent a balance of risks and benefits and that ICT budgets are acceptable
f) Monitoring the method that management uses to determine the ICT resources needed to achieve strategic goals and provide high-level direction for sourcing and use of ICT resources
g) Maintaining adequate awareness about the Sacco's exposure towards ICT risks and evaluating the effectiveness of management's monitoring and control of the risks

5.2.2 Senior Management Responsibilities

The roles of the senior management with respect to ICT risk are:

a) Ensuring that all employees of the institution fully understand and adhere to the ICT risk management policies and procedures approved by the board of directors and the senior management, and are provided with pertinent training.
b) Ensuring customer information, financial information, product information and core banking system of the legal entity are held in a secure environment.

c) Reporting in a timely manner to SASRA any significant adverse incidents of information and communication systems or unexpected events, and how they have been handled;
d) Cooperating with SASRA in the surveillance of the risk management of information systems, and ensure that supervisory opinions are followed up; and
e) Performing other related ICT risk management tasks.

5.2.3 Head of Information and Communication Technology

The following are the responsibilities of the Head of ICT:

a) Play a direct role in key decisions for the business development involving the use of ICT in the institution;
b) Ensure that information systems meet the needs of the institution, and the ICT strategies, in particular information system development strategies, comply with the overall business strategies and ICT risk management policies of the institution;
c) Be responsible for the establishment of an effective and efficient ICT organization to carry out the ICT functions of the institution. These include the IT budget, IT risk management, ICT policies, standards and procedures, ICT internal controls, professional development, ICT project initiatives, ICT project management, information system maintenance and upgrade, ICT operations, ICT infrastructure, Information security, disaster recovery plan (DRP), ICT outsourcing, and information system retirement;
d) Ensure the effectiveness of ICT risk management throughout the organization including all branches.
e) Organize professional trainings to improve technical proficiency of staff.

5.2.4 People Selection Process

A Sacco should ensure that a careful selection of staff, vendors and contractors is undertaken to minimise ICT risks due to system failure, internal sabotage or fraud. As people play an important role in managing systems and processes in an IT environment, the Sacco should implement a screening process that is well designed, comprehensive and effective.

Staff, vendors and contractors, who are authorised to access the Sacco’s ICT systems should be required to protect sensitive or confidential information.

5.3 ICT Strategy

A Sacco should formulate an ICT strategy that aligns with the overall business plan of the Sacco, ICT risk assessment plan and an ICT operational plan. The ICT strategy should ensure that adequate financial resources and human resources are allocated to maintain a stable and secure ICT environment.

5.4 ICT Infrastructure

In considering, acquiring and installing ICT infrastructure, a Sacco should take due note of and comply with SASRA's ***Guidelines on Management Information Systems (MIS) for Deposit Taking Saccos***. These guidelines cover the following areas:

- ⇨ Establishment of Board and senior management roles in setting and implementing ICT policy and procedures
- ⇨ IT function/departments staffing and organisations
- ⇨ Onsite and offsite storage of information
- ⇨ Development and implementation of disaster recovery plan
- ⇨ Functional capabilities to handle products and client data
- ⇨ Statutory returns and reports that the MIS should be capable of generating
- ⇨ Use of industry standard relational database
- ⇨ Compatibility with standards operating systems
- ⇨ Accessibility of MIS transacting outlets and channels
- ⇨ Operational reporting requirements
- ⇨ Internal control requirements
- ⇨ Physical security
- ⇨ Data backup and recovery
- ⇨ Infrastructure access, control and accountability
- ⇨ Outsourcing

5.5 ICT Management Policies and Procedures

A Sacco should put in place a comprehensive set of ICT management policies that include the following areas:

- ⇨ Information security classification policy,
- ⇨ System development, testing and maintenance policy,
- ⇨ ICT operation and maintenance policy,
- ⇨ Access control policy,
- ⇨ Physical security policy,
- ⇨ Change controls policy,
- ⇨ Personnel security policy, and

- Business Continuity Planning and Crisis and Emergency Management procedure.

5.6 Risk Identification

Risk identification entails the determination of all kinds of threats, vulnerabilities and exposures present in the ICT system configuration which is made up of components such as internal and external networks, hardware, software, applications, systems interfaces, operations and human elements.

Security threats such as those manifested in denial of service attacks, internal sabotage and malware infestation could cause severe disruption to the operations of a Sacco with consequential losses for all parties affected. Vigilant monitoring of these mutating, growing risks is a crucial step in the risk containment exercise.

Both threat-sources and threats must be identified. Threats should include the threat source to ensure accurate assessment. Some common threat-sources include:

- Natural Threats—floods, earthquakes, hurricanes.
- Human Threats—threats caused by human beings, including both deliberate actions (network based attacks, virus infection, unauthorized access), and unintentional (Inadvertent data entry errors).
- Environmental Threats—power failure, pollution, chemicals, water damage
- The risk management function in the institution should compile a list of threats that are present across the institution and use this list as the basis for all risk management activities.

5.7 Risk Assessment, Measurement and Monitoring

To determine the likelihood of a future adverse event, threats to an ICT system must be analysed in conjunction with the potential vulnerabilities and the controls in place for the ICT system. Impact refers to the magnitude of harm that could be caused by a threat's exercise of vulnerability. The level of impact is governed by the potential mission impacts and in turn produces a relative value for the ICT assets and resources affected (e.g., the criticality and sensitivity of the ICT system components and data).

5.8 Risk Measurement

A Sacco should put in place a set of ongoing risk measurement and monitoring

- Pre and post-implementation review of ICT projects;
- Benchmarks for periodic review of system performance;
- Reports of incidents and complaints about ICT services;
- Reports of internal audit, external audit, and issues identified by SASRA;

- ⇨ Arrangement with vendors and business units for periodic review of service level agreements (SLAs);
- ⇨ The possible impact of new development of technology and new threats to software deployed;
- ⇨ Timely review of operational risk and management controls in operation area;
- ⇨ Assessment of the risk profile on IT outsourcing projects periodically.

5.9 Risk Mitigation

Risk mitigation involves prioritizing, evaluating, and implementing the appropriate risk reducing controls recommended from the risk assessment process.

Because the elimination of all risk is usually impractical, it is the responsibility of senior management and functional and business managers to use the ***least-cost approach*** and implement the ***most appropriate controls*** to decrease mission risk to an acceptable level, with ***minimal adverse impact*** on the Sacco's resources and mission.

A Sacco should therefore implement a comprehensive set of risk mitigation measures complying with the ICT risk management policies and commensurate with its risk assessment. At a minimum the mitigation measures should include:

a) A set of clearly documented ICT risk policies, technical standards, and operational procedures, which should be communicated to the staff frequently and kept up to date in a timely manner;

b) Areas of potential conflicts of interest should be identified, minimized, and subject to careful, independent monitoring. Also it requires that an appropriate control structure is set up to facilitate checks and balances, with control activities defined at every business level, which should include:
   - ⇨ Top level reviews;
   - ⇨ Controls over physical and logical access to data and system;
   - ⇨ Access granted on "need to know" and "minimum authorization" basis;
   - ⇨ A system of approvals and authorizations; and
   - ⇨ A system of verification and reconciliation.

5.10 Internal Control and Audit

5.10.1 Role of Internal Audit

Whether performed by a separate specialised ICT audit function or as a function within the internal audit, the responsibilities of the ICT audit function are:

- ⇨ To establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the institution's systems and internal control mechanisms and arrangements;
- ⇨ To issue recommendations based on the result of work carried out;
- ⇨ To verify compliance with those recommendations;
- ⇨ To carry out special audit on the information system. This involves investigating, analysing and reporting on the information system as a result of an information security incident or from a risk assessment report by the internal audit or risk management function.

5.10.2 Scope of IT Internal Audit

Based on the nature, scale and complexity of its business, deployment of information and communication technology and ICT risk assessment, a Sacco's Board audit committee should determine the scope and frequency of ICT internal audit.

The ICT internal audit should at minimum cover the following aspects:

- ⇨ Risk assessment of the ICT systems.
- ⇨ Review of the ICT Policies, strategy and direction.
- ⇨ Business continuity management program.
- ⇨ Systems change control process.
- ⇨ Reporting, logging and auditability of the systems.
- ⇨ Input-process-output controls.
- ⇨ Adequacy of identification and authentication system.
- ⇨ Protection against malicious malware.
- ⇨ Operations and network management.

5.10.3 Internal Audit Role in Implementing New Systems

A Sacco should engage their Internal Audit and Risk Management functions when developing and implementing a new system to ensure it meets ICT risk management standards and best practices.

6. LIQUIDITY RISK MANAGEMENT

6.1 Introduction

Liquidity means the ability to respond to demands for new loans and provide for unexpected savings withdrawals at a minimum cost. Liquidity risk is the risk to a Sacco's earnings or capital due to the inability to meet its obligations as they fall due.

Persistent illiquidity or liquidity stress can lead to financial distress or even insolvency of a Sacco.

6.2 Board and Management Oversight

6.2.1 Role of the Board

The role of the board of directors in the management of liquidity risk includes:

a) Establishing the Sacco's liquidity risk tolerance and formulating the strategy for liquidity risk management commensurate with the Sacco's complexity, risk profile and scope of operations.
b) Establishing policies and procedures to manage the Sacco's liquidity risk. These policies and procedures should be reviewed periodically; at least annually.
c) Selecting senior managers with the authority, responsibility and competence to manage liquidity risk.
d) Monitoring the Sacco's performance against the established liquidity risk profile.
e) Ensuring that liquidity risk events are identified, measured, monitored and controlled.
f) Establishing and reviewing limits on sector (tea, coffee, dairy, small businesses) concentration (Asset concentration), the Sacco's capital structure, quality and adequacy of liquid assets and contingency funding plans.
g) Specifying the content and frequency of submission of management's reports on liquidity risks to the board.
h) Promptly communicate any material adverse changes in the Sacco's current or prospective liquidity position to the SASRA.

6.2.2 Role of Senior Management

A Sacco should have in place an appropriate senior management structure to oversee the day to-day and long-term management of liquidity risk in line with the strategy, policies and procedures approved by the board.

The responsibility for managing the overall liquidity of the Sacco should be placed with a specific, identified department or committee within the Sacco. The committee might be in the form of an Asset/Liability Committee (ALCO) comprising senior management from key functional areas.

The management structure should ensure that the liquidity strategy approved by the board can be effectively implemented.

Senior management should ensure that there is effective coordination between the department or committee that manages the liquidity and other functional areas.

Among other responsibilities, senior management should:

a) Translate the board's approved strategy, objectives and risk tolerances into operational standards;
b) Actively monitor and review its risk management framework to ensure resilience of the strategies in place.
c) Ensure comprehensive projections of cash flows are carried out over an appropriate set of time horizons;
d) Implement management information systems that facilitate effective liquidity management through adequate identification, measurement, monitoring and control of liquidity risk;
e) Institute effective internal controls over the liquidity risk management process by establishing clear lines of responsibility and escalation procedures to address liquidity short falls.
f) Ensuring the Sacco maintains adequate and unencumbered high quality and liquid assets to cushion against liquidity shortfalls.
g) Promptly communicate any material adverse changes in the Sacco's current or prospective liquidity position to the board of directors.

6.2.3 Asset and Liability Committee

Liquidity risk tends to increase with the size and sophistication of the operations of a Sacco. Thus large Saccos should establish a committee of senior managers, known as the Asset/Liability committee (ALCO) to proactively manage their assets and liabilities. As a minimum, Saccos with total assets exceeding ten billion should establish ALCO. The range of the Sacco's activities will determine the size of such a committee.

The following are minimum responsibilities for the ALCO:

a) Developing and recommending liquidity policies for approval by the board.
b) Overseeing the implementation and maintenance of management information systems that effectively identify, measure, monitor, and control the Sacco's liquidity risk.

c) Ensuring adherence to the lines of authority and responsibility that the board has established for managing liquidity risk.
d) Reviewing periodic liquidity management reports.
e) Reporting comprehensively on the liquidity management programme to the board on a regular basis (at least quarterly)

6.3 Policies and Procedures

6.3.1 Liquidity Management Policy

A Sacco's liquidity management policy, which can be within its Asset Liability Management (ALM) policy, should at a minimum:

a) Establish clear guidance on the composition and role of the asset/liability committee (ALCO) if the Sacco has one.
b) Provide for periodic review of the deposit structure. The review should include the volume and trend of various types of deposits offered; maturity distributions of time deposits; interest rate paid on each type of deposit; prevailing market interest rate; limits on large time deposits; sectoral deposits, public funds; and individual/institutional deposits.
c) Address the diversification of funding by origin and term structure. The policy should guard against concentration by individuals or groups of depositors; types of deposit instruments; market sources of deposit; geographical sources; term to maturity; and deposit currencies.
d) Address the establishment of adequate information systems for accurate and timely reporting to management.
e) Setting additional targets in relation to its internal measures of liquidity, as appropriate to the nature of its business.
f) Detail the method for computing the cost of funds and other key liquidity and maturity gap ratios. Setting specific limits and thresholds.
g) Establish in conjunction with the loan policy, the method of loan pricing, including cost of funds, overhead and administrative costs; the types of loans that are permissible and desirable; the desired mix among loan types; and desired profits.
h) Establish the desired volume of loans compared to total deposits, total loans, upcoming loan maturities, and outstanding loan commitments.
i) Establish in conjunction with the investment policy, the desired mix among investments, maturity distributions, projecting interest rate movements lending commitments and available funds.

j) Provide for periodic projection of cash flows based on both supply and demand for liquidity to determine the extent to which the Sacco is funding long-term assets with short-term liabilities. Target ratios or parameters for the funding of long-term assets with short-term liabilities should be established.
k) Provide for the review of alternate funding sources including stand-by facilities and lines of credit.
l) Provide for the maintenance statutory liquidity ratios within the prudential requirements stipulated by SASRA.
m) Provide for periodic/frequent scenario analysis/ stress test of the Sacco's liquidity position so as to adjust its liquidity risk management strategies and policies and adjust its contingency plans appropriately.
n) Detail procedures for effectively utilising excess liquidity.
o) Identify potential sources of contingency liquidity funding including cost, access requirements. Appropriate borrowing limits should be approved.

6.4 Liquidity Risk Measurement

The following are the indicators that a Sacco should utilise at a minimum, to measure its liquidity position. A Sacco must establish appropriate internal guidelines on the level of the ratio and ensure prompt corrective actions are undertaken to address any liquidity shortfall.

6.4.1 Statutory Minimum Liquidity Ratio

Section 30 of the Sacco Societies Act requires that ***'A Sacco Society shall maintain such minimum holding of liquid assets of its members' deposits and borrowings as may be prescribed by the Authority (SASRA)'***

Currently every Sacco is required to maintain a statutory minimum of fifteen per cent (15%) of all its deposit liabilities, matured and short term liabilities in liquid assets. A Sacco can however have a higher minimum liquidity ratio, say twenty percent.

6.4.2 Other Liquidity Ratios

A Sacco should use a variety of other ratios to measure its liquidity position and trend, including:

a) Asset based ratios that a Sacco can use include:
   - ⇨ Cash Position Indicator
   - ⇨ Capacity Ratio

b) Liability based liquidity measures
   - ⇨ Total deposit ratio
   - ⇨ Purchased funds ratio
   - ⇨ Core deposit ratio

c) Combined Asset-Liability Liquidity ratios
   - ⇨ Loan to deposit ratio
   - ⇨ Net non-core funding dependence ratio

The computation and explanation of these ratios are presented in Annex 1 of these guidelines.

6.4.3 Liquidity Maturity Gap Analysis

The liquidity maturity mismatch (gap) approach measures a financial institution's liquidity by assessing the mismatch between its inflows (assets) and outflows (liabilities) within different time bands on a maturity profile. The extent of the difference between the maturities of inflows (assets) and outflows (liabilities) is termed as a mismatch.

In the maturity profile, inflows (assets) and outflows (liabilities) are slotted into time bands.

The maturity profile should encompass adequate time bands so that a Sacco can monitor its short-term (91days) as well as medium- to longer-term liquidity needs.

While the focus of the maturity mismatch (gap) analysis is on short-term cash flows, a Sacco should also review the mismatch positions for the medium- to longer-term time bands to identify any early sign of potential liquidity problems.

A sample maturity mismatch (gap) analysis is presented in Annex 2 of these guidelines

6.5 Liquidity Monitoring

6.5.1 Management Information

Saccos should have adequate management information systems ("MIS") for measuring, monitoring, controlling and reporting liquidity risk under normal and stressed situations.

The MIS should encompass all significant causes of liquidity risk, including those associated with new products and business initiatives, and be capable of evaluating the effect of such causes on a Sacco's cash flows and liquidity ratios.

In particular, the MIS should be capable of:

a) Calculating cash flows and maturity mismatch positions arising from the full range of a Sacco's assets and liabilities on a day-to-day basis over a series of specified time periods;
b) Calculating and projecting various limits and ratios in relation to liquidity for both statutory and internal risk management purposes;
c) Checking compliance with established liquidity policies and limits, and generating exception
d) Reporting risk measures and liquidity trends to management on a timely basis; and

The MIS should also be capable of providing on a timely basis accurate and relevant liquidity reports to senior management / ALCO and other responsible personnel for evaluation of the level of liquidity risk under different operating circumstances.

The appropriate content and format of MIS reports would depend on a Sacco's liquidity management practices and the nature and complexity of its business. Such reports should enable senior management / ALCO to review and monitor the following aspects of liquidity:

a) The maturity profiles of a Sacco's cash flows under normal and stress scenarios;
b) The stock of liquid assets available and their market values;
c) The concentration in sources and application of funds;
d) The compliance with liquidity management strategies and risk tolerance levels set by the board of directors;
e) The ability to borrow or undertake asset sales with various counterparties;
f) The capacity of providers of standby facilities to meet their obligations; and
g) The impact of adverse trends (e.g. decline in asset quality, market or operational disruptions etc.) on future cash flows.

6.6 Liquidity Contingency Planning

6.6.1 Overview

Every Sacco should formulate a formal contingency plan that sets out a strategy for dealing with a liquidity crisis and the procedures for making up cash-flow deficits in emergency situations. It is also important that Saccos identify and understand the types of events that may trigger the contingency plan. Mechanisms should be in place to facilitate monitoring of these trigger events.

The contingency plan should be updated and reviewed regularly (at least annually) by senior management / ALCO to ensure that it remains robust over time. In addition, Saccos are encouraged to conduct rehearsals of the contingency plan from time to time to better prepare themselves for unfavourable situations.

6.6.2 Early Warning Indicators

To assess whether a potential liquidity problem may be developing, Saccos may have regard to various internal and market indicators, including:

a) Internal indicators
   - ⇨ Deteriorating asset quality;
   - ⇨ Excessive concentrations on certain assets and funding sources;
   - ⇨ Decline in earnings and interest margins;
   - ⇨ Increase in overall funding costs;
   - ⇨ Rapid loan and fixed asset growth being funded by high cost institutional loans and deposits; and
   - ⇨ Worsening cash-flow positions as evidenced by widening negative maturity mismatches, especially in the short-term time bands.

b) Market indicators
   - ⇨ Significantly higher costs on the Sacco’s institutional borrowings
   - ⇨ Reduction in available credit lines from institutional lenders;
   - ⇨ Lenders and institutional investors unwilling to extend unsecured or longer term loans and investments to the Sacco; and
   - ⇨ Rising trend of deposit withdrawals.

Saccos should have a system for identifying and tracking such indicators to spot potential problems at an early stage.

6.6.3 Strategy and Procedures

A contingency plan for dealing with liquidity problems or crisis situations should cover at least the following components:

a) *Managerial coordination* – reporting procedures should be in place to ensure that all necessary information is available for senior management / ALCO to make quick decisions. A clear division of responsibility should be set out so that all personnel understand their roles in a crisis situation. This should include designated personnel who would be responsible for identifying crises and crisis management as well as those for promptly notifying SASRA of the problems;

b) *Early warning signals* – Saccos should specify the warning signals to be used for identifying an approaching crisis and the mechanisms to facilitate constant monitoring and reporting of these signals;

c) *Backup liquidity* – procedures should be set out for making up cash-flow shortfalls in crisis situations.

   They should clearly spell out all key sources of funds (including unused credit facilities), their expected reliability and under what conditions these funds should be used. Saccos should not excessively rely on backup lines and need to understand the various conditions, such as notice periods, that can affect their ability to access such lines quickly. An assessment of the cost of alternative funding strategies and the impact on capital should also be included;

d) *Change in asset and liability behaviours* – Saccos should outline the courses of action for altering asset and liability behaviours to deal with crisis situations. For example, to cater for the increased deposit run-off during a crisis, more aggressive sale of marketable assets or plans to raise deposits would be necessary. The likely impact of particular courses of action on market perception should also be assessed;

e) *member relationships* – procedures should be provided for determining the priority of member relationships during a crisis, e.g. the order in which entitlement to credit facilities would be withdrawn from specific members or types of customers. In deciding which assets are to be disposed of, Saccos would typically select the ones that are least detrimental to business relationships and public perception about their financial soundness. Saccos should also maintain strong on-going links with institutional depositors and lenders to be able to access secure sources of funds under crisis situations; and

f) *Communication plan* for staff and the public (Members, key market participants and the media).

   Good public relations management can help a Sacco counter rumours that can result in a significant ran on the Sacco by members. For example, if material adverse information about a Sacco is made public, it should be prepared to announce corrective actions immediately. This will help reduce the uncertainties of market participants and demonstrate that the highest levels of management are attentive to the problems that exist.

Public disclosure is also an important element of liquidity management. Saccos should provide adequate information on an on-going basis to the public and, in particular, to major creditors and depositors so that it is easier for them to manage market perceptions during crisis situations.

6.7 Independent Review

Saccos should conduct periodic reviews of their liquidity risk management process to ensure its integrity, accuracy and reasonableness. Independent parties, e.g. internal or external auditors, should conduct the reviews.

Such reviews should, among other things, cover the following areas:

a) The adequacy of internal systems and procedures for identifying, measuring and monitoring liquidity risk;
b) The appropriateness of various risk limits for controlling liquidity risk;
c) The suitability of the underlying assumptions for conducting cash-flow scenario analyses;
d) Scenario analysis incorporating the funding and market liquidity risks the Sacco is exposed to indicating the scenarios employed and recommendations.
e) The integrity and usefulness of MIS reports on liquidity risk; and
f) The adherence to established liquidity policies and procedures.

Saccos should have their internal models and calculations validated by internal audit and if possible, an external reviewer too.

Any weaknesses or problems identified in the review process should be addressed by senior management in a timely and effective manner.

7. MARKET RISK MANAGEMENT

7.1 Introduction

Market risk is the risk of loss of a Sacco's earnings and/or capital arising from sensitivity to movements in interest rates, foreign exchange rates or in prices. An alternative definition for market risk is the potential for loss resulting from adverse movement in market risk factors such as interest rates, foreign exchange, equity and commodity prices.

The most common exposure to market risk for Saccos is the interest rate risk due to mismatch of loans and funding sources, deposits or debt. Sectoral concentration can exposure a Saccos assets or liabilities to price risks aggravating the credit risks to the Sacco.

The risk arising from market risk factors can be categorized as follows:

- Interest rate risks
- Price risk
- Foreign exchange risk

Interest rate risk most often arises from differences between the timing of rate changes and the timing of cash flows (re-pricing risk) and price risk arises from changes in the value of portfolios of financial instruments or from fluctuations in exchange rates.

7.1.1 Interest Rate Risk

Interest rate risk is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. The changes in interest rates affect a Sacco's earnings by altering its interest-sensitive income and expenses. Interest rate changes also affect the underlying value of Sacco's interest bearing assets and liabilities through changes in the present value of future cash flows and in some cases the cash flows themselves.

7.1.2 Price Risk

Price risk is the risks that a Sacco may experience loss due to unfavourable movements in market prices. It arises from the volatility of positions taken in the four fundamental economic markets: interest-sensitive debt securities, equities, currencies and commodities. Except for interest sensitive debt instruments, Sacco's are not directly exposed to the other three economic markets.

7.1.3 Foreign Exchange Risk

Foreign exchange risk is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates. The potential for loss arises from the process of revaluing foreign currency positions on both on- and off- balance sheet items. Again, Saccos are not active in the foreign exchange market reducing their exposure to this type of market risk.

7.2 Board and Senior Management Oversight

Effective oversight by a Sacco's Board of Directors and senior management is critical for sound market risk management practices. The Board must identify and document which market risk the Sacco is exposed to given its significant activities in order to development appropriate mitigation strategies. But a Sacco must at the minimum institute sound interest rate risk management practices.

The Board of Directors may delegate responsibility for establishing interest rate risk policies and strategies to a designated technical committee of senior staff or the Asset and Liability Committee ("ALCO"), where established.

Large Saccos (total assets exceeding Kshs 10 billion) should have the ALCO responsible for the design and administration of interest rate risk management.

7.2.1 Board Responsibilities

Responsibilities of the board are to:

a) Establish and define the Sacco's tolerance for interest rate risk, including approving relevant risk limits and other key policies;
b) Ensure that senior management has full understanding of the interest rate risks incurred by the Sacco;
c) Provide clear guidance to management regarding the board's tolerance for risk;
d) Approve in advance broad objectives and strategies and major policies governing interest rate risk management;
e) Approve policies that identify lines of authority and responsibility for managing interest rate risk exposures;
f) Ensure that adequate resources are devoted to interest rate risk management;
g) To periodically review information that is sufficient in detail and timeliness to allow it to understand and assess the performance of senior management in monitoring and controlling interest rate risks in compliance with the Sacco's board-approved policies;
h) Assess the performance of senior management in monitoring and controlling interest rate risks in compliance with approved strategies and policies; and

i) Periodically assess compliance with approved policies, procedures, and risk limits

7.2.2 Senior Management Responsibilities

Senior management is responsible for ensuring that board-approved strategies, policies, and procedures for managing IRR are appropriately executed within the designated lines of authority and responsibility. Management should also:

a) Develop and implement policies and procedures that translate the board's goals, objectives, and risk limits into operating standards that are well understood by the Sacco's staff and that are consistent with the board's intent;
b) Ensure that appropriate policies and procedures are established to control and limit interest rate risks;
c) Ensure adherence to the lines of authority and responsibility that the board has approved for managing, measuring, and reporting interest rate exposures;
d) Oversee the implementation and maintenance of management information and other systems that measure, monitor, control and report the Sacco's interest rate risk;
e) Establish and maintain effective internal controls over the interest rate risk management process;
f) Monitor the Sacco's overall interest rate risk profile and ensure that the level of interest rate risk is maintained at prudent levels;
g) Ensure that the Sacco's operations and activities are conducted by competent staff with technical knowledge and experience consistent with the nature and scope of their activities;
h) Provide the board with periodic reports and briefings on the Sacco's interest - risk related activities and risk exposures; and
i) Review periodically the Sacco's risk management systems, including related policies, procedures, and risk limits.

7.3 Policies and Procedures

A Sacco should formulate interest rate risk policies which should be approved by the board. These policies should reflect the strategy of the institution, including its approach to controlling and managing interest rate risk. The Board should approve any changes and exceptions to these policies.

The policies should clearly:

a) Prescribe how interest rate risk is measured and communicated to the board;

b) Spell out the process by which the board decides on the maximum interest rate risk the institution is able to take, as well as the frequency of review of risk limits;
c) Delineate the lines of authority and the responsibilities of the board, senior management and other personnel responsible for managing interest rate risk; set out the scope of activities of the business units assuming interest rate risk; and
d) Identify and set guidelines on interest rate risk limit structure, delegation of approving authority for interest rate risk limit setting and limit excesses, capital requirements, and investigation and resolution of irregular or disputed transactions.

A Sacco should establish appropriate procedures and processes to implement the interest rate risk policy and strategy.

These should be documented in a manual and the staff responsible for carrying out the procedures should be familiar with the content of the manual. The manual should spell out the operational steps and processes for executing the relevant interest rate risk controls. It should also be periodically reviewed and updated to take into account new activities, changes in systems and structural changes in the market. The procedures should cover all activities that are exposed to interest rate risk.

7.4 Risk Measurement

Saccos should have interest rate risk measurement systems that capture all sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The measurement system should have its core generally accepted financial concepts and risk measurement techniques. The assumptions underlying the risk measurement system should be well documented and clearly understood by the board and senior management.

A Sacco should establish a sound and comprehensive interest rate risk management process. This should, among other things, comprise:

a) A framework to identify, measure and monitor interest rate risk;
b) An appropriately detailed structure of risk limits, guidelines and other parameters used to govern interest rate risk taking;
c) An appropriate management information system (MIS) for controlling, monitoring and reporting interest rate risk, and;
d) Accounting policies on the treatment of interest rate risk.

A Sacco should incorporate its interest rate risk management process into its overall risk management system. This would enable it to understand and manage its consolidated risk exposure more effectively.

The risk management system should be commensurate with the scope, size and complexity of the Sacco. It should also enable the interest rate risk exposures to be accurately and adequately identified, measured, monitored and controlled. All significant risks should be measured and aggregated on a Sacco-wide basis.

A Sacco's risk management system should be able to quantify risk exposures and monitor changes in interest rates. The risk management system should enable a Sacco to identify risks promptly and take quick remedial action in response to adverse changes in interest rates.

Static Maturity Re-pricing (Gap) Analysis

The basic techniques for measuring a Sacco's interest rate risk exposure begin with a maturity/re-pricing schedule that distributes interest-sensitive assets, liabilities into "time bands" according to their maturity (if fixed rate) or time remaining to their next re-pricing (if floating rate).

To evaluate earnings exposure, interest rate-sensitive liabilities in each time band should be subtracted from the corresponding interest rate-sensitive assets to produce a re-pricing "gap" for that time band. This gap should be multiplied by an assumed change, for example 1% (or 100 "basis points"), in interest rates to yield an approximation of the change in net interest income that would result from such an interest rate movement.

The size of the interest rate movement used in the analysis can be based on a variety of factors, which include historical experience, simulation of potential future interest rate movements, and the judgment of the management team. Limits should be set on the maximum allowable total loss for a given shifts in interest rate. Any potential loss in Net Interest Income (NII) above the set limit should be addressed by restructuring the Sacco's assets and liabilities to shift their re-pricing maturities accordingly.

A sample of this analysis is presented in Annex 3 of these guidelines.

7.5 Monitoring and Limits

A Sacco should establish and enforce operating limits that maintain exposures within levels consistent with its internal policies and that are in accordance with its approach to measuring interest rate risk.

The limit system should enable management to control interest rate risk exposures, initiate discussion about opportunities and risks, and monitor actual risk taking against predetermined risk tolerances.

Interest rate risk limits should be approved by the board of directors and reviewed at least once a year. These limits should be appropriate to the size, complexity and capital adequacy of the Sacco as well as its ability to measure and manage its risk.

At a minimum, Saccos should have limits in the following categories:

- ⇨ Change in net portfolio value;
- ⇨ Factor sensitivity;
- ⇨ Interest rate sensitivity gap;
- ⇨ Impact on earnings

Interest rate risk limits should be linked to specific scenarios of movements in market interest rates. Specified scenarios should take account of the full range of possible sources of interest rate risk to the Sacco.

7.6 New Product or Service Introduction

Products and activities that are new to the Sacco should undergo a careful pre-acquisition review to ensure that the Sacco understands their interest rate risk characteristics and can incorporate them into its risk management process. When analysing whether or not a product or activity introduces a new element of interest rate risk exposure, the Sacco should be aware that changes to an instrument's maturity, re-pricing or repayment terms can materially affect the product's interest rate risk characteristics.

Prior to introducing a new product, management should ensure that adequate policies and procedures are in place. The board should also approve major risk management initiatives in advance of their implementation. Proposals to undertake new products or strategies should contain these features:

- ⇨ Comprehensively describe the product or service;
- ⇨ Identify the resources required to establish sound and effective interest rate risk management of the product or service;
- ⇨ Analyse of the reasonableness of the proposed activities in relation to the Sacco’s overall financial condition and capital levels; and
- ⇨ Articulate policies and procedures to be used to measure, monitor and control the risks of the proposed product or service.

7.7 Management Information System

An accurate, informative, and timely management information system is essential for managing interest rate risk exposure, both to inform management and to support compliance with board policy. Reporting of risk measures should be regular and should clearly compare current exposure to policy limits. In addition, past forecasts or risk estimates should be compared with actual results to identify any modelling shortcomings.

The board on a regular basis should review reports detailing the interest rate risk exposure of the Sacco. While the types of reports prepared for the board and for various levels of management will vary based on the Sacco's interest rate risk profile, they should, at a minimum include the following:

a) Summaries of the Sacco's aggregate interest rate exposures;
b) Reports demonstrating compliance with policies and limits;
c) Key assumptions, for example, non-maturity deposit behaviour and prepayment information;
d) Summaries of the findings of reviews of interest rate risk policies, procedures, and the adequacy of the interest rate risk measurement systems, including any findings of internal and external auditors or any other independent reviewer.

7.8 Internal Control

Saccos should have adequate internal controls to ensure the integrity of their interest rate risk management process. These internal controls should be an integral part of the institution's overall system of internal control aimed at promoting:

- An adequate process for identifying and evaluating interest rate risk;
- Reliable financial and regulatory reporting, and
- Compliance with relevant laws, regulations and institutional policies.

7.9 Independent review

Saccos should have their measurement, monitoring and control functions reviewed on a regular basis by internal auditor and annually by an external reviewer. It is essential that any independent reviewer ensures that the risk measurement system is sufficient to capture all material elements of interest rate risk on the balance sheet and the Sacco's activities. Such a reviewer should consider the following factors in making the risk assessment:

a) The quantity of interest rate risk, e.g.
   - The volume and price sensitivity of various products;
   - The vulnerability of earnings and capital under differing rate changes; and
b) The quality of interest rate risk management, e.g.
   - Whether the Sacco's internal measurement system is appropriate to the nature, scope, and complexities of the entity and its activities;
   - Whether the Sacco has a function responsible for the design and administration of the risk measurement, monitoring and control functions;

- ⇨ Whether the board of directors and senior management are actively involved in the risk control process;
- ⇨ Whether internal policies, controls and procedures concerning interest rate risk are well documented and complied with;
- ⇨ Whether the assumptions of the risk measurement system are well documented, data accurately processed, and data aggregation is proper and reliable; and
- ⇨ Whether the institution has adequate staffing to conduct a sound risk management process.

Where internal auditors conduct the independent review, Saccos are encouraged to have the risk measurement, monitoring and control functions periodically reviewed by external reviewer(s) including the external auditors.

7.10 Internal Audit

The internal reviewer or the independent auditor in making their risk assessments should consider the following factors:

a) The volume and price sensitivity of various products;

b) The vulnerability of earnings and capital under differing interest rate changes including yield curve changes;

c) The exposure of earnings and economic value to various forms of interest rate risk, including basis and option risks;

d) The extent of the board and senior management involvement in the interest rate risk control process;

e) The adequacy with which the Sacco documents internal policies, controls and procedures concerning interest rate risk and the extent to which they are complied with;

f) The adequacy of, and personnel's compliance with the Sacco's interest risk measurement system;

g) The appropriateness of the Sacco's risk measurement system given the nature, scope and complexity of its activities;

h) The accuracy and completeness of the data inputs into the Sacco's risk measurement system, data accurately processed and data aggregation is proper and reliable;

i) The reasonableness and validity of scenarios used in the risk measurement system. The validity of the risk measurement calculations should be tested by comparing actual versus forecasted results.

The scope, formality and frequency of conducting internal reviews or independent audits will depend on the size and complexity of the Sacco. The findings of the review or audit should be reported to the board.

8. COMPLIANCE RISK MANAGEMENT

8.1 Introduction

Compliance risk is the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices, or ethical standards, as well as from the possibility of incorrect interpretation of effective laws or regulations. Institutions are exposed to compliance risk due to relations with a great number of stakeholders, e.g. regulators, customers, counter parties, as well as tax authorities, local authorities and other authorized agencies.

8.2 Board and Senior Management Oversight

8.2.1 The Board's Role

The board of directors is responsible for ensuring a Sacco's compliance with all relevant laws, rules and standards. As such, the board and senior management should allocate sufficient resources for compliance programs covering legal, regulatory and compliance issues associated with the Sacco's operations. Management should establish an internal compliance function or designate a capable officer to oversee it.

Effective board oversight is the cornerstone of an effective compliance risk management process. The board should understand the nature and level of compliance risk to which the Sacco is exposed and how its risk profile fits within the overall business strategy.

The responsibilities of the board of directors should comprise the following:

a) Approving the Sacco's departmental policies, including how the compliance function will be executed on a day to day basis;
b) Keeping themselves updated and apprised on changes in national law and Sacco regulatory requirements
c) Ensuring that management takes the steps necessary to identify, measure, monitor, and control compliance risk
d) Ensuring that compliance breaches are resolved effectively and expeditiously
e) Reviewing how the Sacco's management team are managing its compliance risk;

8.2.2 Senior Management Role

Senior management is responsible for the effective management of a Sacco's compliance risk. As such, the Sacco's senior management is responsible for establishing departmental policies and procedures that are to be observed in the day to day operations of the Sacco.

Senior management should;

a) Identify and assess the main compliance risk issues facing the Sacco and the plans to manage any shortfalls as well as the need for any additional policies or procedures to deal with new compliance risks;
b) Ensure that the Sacco's compliance risk management framework has clear lines of authority, reporting and communication;
c) Ensure that there is sufficient depth and skill in staff resources to manage legal and regulatory compliance
d) Periodically report to the board of directors or a committee of the board on the management of compliance risk;
e) Report promptly to the board of directors or a committee of the board on any material compliance failures (e.g. failures that may attract a significant risk of legal or regulatory sanctions, material financial loss or loss to reputation);
f) Conduct periodic compliance risk assessment
g) Periodically review the institution's compliance risk management framework to ensure that it remains appropriate and sound.
h) Provide reasonable assurance, through the audit function, that all activities and all aspects of compliance risk are covered by the Sacco's risk management framework and processes;

8.3 Policies and Procedures

Effective compliance by the Sacco (including those functions performed by third party service providers) with applicable laws and regulations and internal policies can be accomplished through a number of ways:

a) Ensuring that staff are accorded adequate training on the Sacco's policies and procedures and the laws and regulations governing the operations of the Sacco.
b) The Board of Directors should keep themselves updated and apprised on changes in national law and Sacco regulatory requirements.
c) Specifying how the compliance responsibilities are allocated among the various departments of the Sacco
d) Senior Management should monitor changes to laws, regulations and regulatory guidance potentially affecting compliance and undertake the appropriate interpretation of laws and regulations that affect the Sacco and ensure that changes to policies, procedures and processes are implemented in a timely manner.
e) The necessary changes should be made to the Sacco's policies, procedures, and programs to ensure they do not conflict with changes in laws and regulations.
f) In order to fully understand and assess the risk associated with third party service providers, internal audit with the assistance of external legal counsel where

necessary should scrutinise all proposed contracts with the Sacco's service providers to confirm that such contracts:

- ⇨ Require the service provider to comply with applicable laws and regulations and the Sacco's policies; and
- ⇨ Contain reporting and other provisions needed to enable the Sacco to assess the service provider's compliance with such laws, regulations and policies.

g) Conducting objective, thorough and credible investigations of possible breaches of laws, regulations and internal policies.

8.4 Internal Audit

A Sacco should have proper internal control systems that integrate compliance risk management into its overall risk management process. The audit of compliance risk management should be incorporated into the annual plan of the Internal Audit function.

The Internal Audit function should, within its scope of operations, cover the following aspects of compliance risk management:

a) Verifying that compliance risk management policies and procedures have been implemented effectively across the institution;
b) Assessing the effectiveness of controls for mitigating fraud and risks to reputation;
c) Determining that senior management takes appropriate corrective actions when compliance failures are identified;
d) Ensuring that the scope and frequency of the audit plan/program is appropriate to the risk exposures;
e) Determining the level of senior management compliance with SASRA directives;
f) Monitoring compliance risk profiles on an on-going basis; and
g) Analysing the timeliness and accuracy of compliance risk reports to senior management and board of directors.

ANNEXURES

A1.Sample Outline of Strategic Plan

A Sacco's strategic plan development process and the resulting strategic plan should at a minimum contain the following components:

i Definition of Mission, Values, and Vision at the Core of Strategy

a) Define/Refine the Mission of the Institution
b) Identify The Institution's Values
c) Define the Institution's Vision

ii Diagnosis of Current Strategic Position

a) Operating Environmental and Market Analysis
b) Competition Analysis
c) Institutional Performance Analysis (performance to date)
d) Consolidated analysis of institutional Strengths, Weaknesses Opportunities and Threats (SWOT) analysis

iii Key Strategic Objectives and Sub-objectives analysis

a) Key Strategic Objectives or Goals
b) Strategic sub-objectives in support of the key strategic objective

iv Implementation Activities, Indicators/ Measure and Targets

a) Define Implementation Activities
b) Select Activity Indicators or Measures
c) Targets

v Budgets and Financial Projections

a) Activity implementation budgets
b) 3 or 5 Year Financial Projections

A2.Liquidity Measurement Ratios

Asset Based Liquidity Ratios

Cash Position Indicator:

The cash position indicator compares vault cash and demand deposits at other financial institutions to the total asset base of the institution:

$$\text{Cash Position Indicator} = \frac{\text{Cash and deposits due from other financial institutions}}{\text{Total Assets}}$$

With a measurement range from 0 to 1, the higher the ratio the better the liquidity to fund immediate cash needs.

Capacity Ratio:

$$\text{Capacity Ratio} = \frac{\text{Net loans}}{\text{Total assets}}$$

Ranging between 0 and 1, the higher the ratio the stronger the Sacco's ability to meet immediate cash needs.

Liability Liquidity Measures

Liability liquidity refers to the ease with which a financial institution can obtain new debt to acquire cash assets at low reasonable cost. A potential lender to a Sacco will look at the loan performance, capital base and the composition of the outstanding deposits and other liabilities of the Sacco.

Total Deposit Ratio

It is usually easier to raise debt from commercial lenders, if the institution does not already have most of its business financed with short-term commercial borrowings (purchased funds). A Sacco institution should ideally rely on a large and diversified retail deposit base, which would be indicated by a high total deposit ratio.

$$\text{Total Deposit Ratio} = \frac{\text{Total member deposits}}{\text{Total assets}}$$

The higher the total deposit ratio, the lower the perceived liquidity risk is because contrary to purchased funds, retail deposits are less sensitive to a change in interest rates or a minor deterioration in business performance.

When calculating customer deposits, it is important to exclude any deposits made by other financial institutions.

Saccos who are in the early stages of operating front office savings activity (FOSA) service will have a low total deposit ratio, this does not indicate a liquidity crisis because in this situation the majority of the funding would come from equity rather than customer deposits.

A low total deposit ratio should therefore be interpreted together with the purchased funds ratio.

Purchased Funds Ratio

The purchased funds ratio measures the amount of commercial short-term funding in relation to the total balance sheet volume. It is defined as:

$$\text{Purchased Funds Ratio} = \frac{\text{Short term borrowings + Purchased funds}}{\text{Total assets}}$$

A large proportion of commercial short-term borrowings and other purchased funds represents a liquidity risk, because this is subject to recall and sensitive to interest rates and the perceived credit risk of the borrowing Sacco. This funding is usually the first to dry up at the slightest appearance of financial difficulty, which again is when it is needed most.

Core Deposit Ratio

This a refinement to the total deposit ratio above. The core deposit ratio eliminates the volatile portion of the deposit mass and emphasizes the stable base of deposits which the institution can rely on, regardless of seasonal swings.

$$\text{Core Deposit Ratio} = \frac{\text{Core deposits}}{\text{Total assets}}$$

Core deposits can be estimated by plotting the volume of total deposits over time and drawing a line through the low points of the graph. This base line represents the trend in the minimum or core deposits, below which in all likelihood the actual deposit level will never fall.

Combined Asset-Liability Measures of Liquidity

Loan-to-Deposit Ratio

This is a general measure of liquidity:

$$\text{Loan-to-Deposit Ratio} = \frac{\text{Net loans}}{\text{Total deposits}}$$

Loans are presumably the least liquid of assets, while deposits are understood as the primary source of funds. A high ratio indicates illiquidity, because in this case a Sacco is fully loaned-up relative to its stable funding. Implicitly, it is assumed that new loans must be financed with large purchased liabilities. A low ratio suggests that a Sacco has additional liquidity, since it can grant new loans financed with stable deposits.

Net Non-Core Funding Dependence

$$\text{Net Non-Core Funding Dependence} = \frac{\text{Non-core liabilities} - \text{Short term investments}}{\text{Net loans}}$$

Non-core liabilities are defined as non-core (volatile) deposits, purchased funds and other interest-rate sensitive short-term borrowings.

The net non-core funding ratio indicates how dependent a Sacco is on volatile sources to finance its non-liquid earning assets, i.e. its net loans. The argument is simple: One does not have to worry about the volatility of non-core liabilities in as far as they are offset by relatively liquid short-term investments. Subtracting short-term investments from non-core liabilities gives the net non-core funding, which then is compared to the net loan portfolio.

A3.Sample Static Liquidity Gap Analysis

USAIDIZI SACCO: MATURITY ANALYSIS OF ASSETS AND LIABILITIES AS AT 31 DECEMBER 2012

	Matured	Maturing in less than 1 month	1 month less than 3 months	3 months less than 6 months	6 months less than 1 year	1 year less than 3 years	3 years less than 5 years	Over 5 years	Total
Cash Reserves	4,514,305								4,514,305
Cash at Bank	16,655,506	5,000,000	15,000,000						36,655,506
Prepayment and Sundry Debtors		80,000,000	31,000,000	52,000,000	32,614,961				195,614,961
Investment in Government Securities		7,000,000	8,000,000						15,000,000
Investment in Other Securities									-
Balances with Other Saccos				25,620,132					25,620,132
Investment In Companies						35,059,219			35,059,219
Net Loan Portfolio		9,156,920	25,112,928	32,119,606	16,640,521	1,435,118,023	1,992,686,109		3,510,834,107
Property & Equipments & Other Assets								105,135,274	105,135,274
Total Assets	**21,169,811**	**101,156,920**	**79,112,928**	**109,739,738**	**49,255,482**	**1,470,177,242**	**1,992,686,109**	**105,135,274**	**3,928,433,504**
Total Deposit Liabilities	289,884,551	160,113,115	51,818,091	27,992,101	11,288,856			1,755,837,663	2,296,934,377
External Borrowings			51,223,112	89,793,022	40,921,021	200,161,983	685,446,725		1,067,545,863
Tax payable and other liabilities		23,112,009	52,001,952			162,893,834			238,007,795
Equity								325,945,469	325,945,469
Total Liabilities and Equity	**289,884,551**	**183,225,124**	**155,043,155**	**117,785,123**	**52,209,877**	**363,055,817**	**685,446,725**	**2,081,783,132**	**3,928,433,504**
Gap	(268,714,740)	(82,068,204)	(75,930,227)	(8,045,385)	(2,954,395)	1,107,121,425	1,307,239,384	(1,976,647,858)	-
Cummulative Gap	(268,714,740)	(350,782,944)	(426,713,171)	(434,758,556)	(437,712,951)	669,408,474	1,976,647,858	-	

A4.Sample Interest Rate Re-pricing Maturity (with NII Simulation) Analysis

MAENDELEO BORA SACCO: INTEREST RATE REPRICING MATURITY ANALYSIS OF ASSETS AND LIABILITIES AS AT 31 DECEMBER 2012

	On Demand	less than 1 month	1 month less than 3 months	3 months less than 6 months	6 months less than 9 months	9 months less than 1 year	1 year less than 3 years	3 years less than 5 years	Over 5 years	Non-Interest bearing	Total
Cash Reserves										861,332	**861,332**
Cash at Bank	17,324,720	3,117,900	2,000,000	4,000,000							**26,442,620**
Prepayment and Sundry Debtors										4,132,983	**4,132,983**
Investment in Government Securities		15,000,000									**15,000,000**
Investment in Other Securities											**-**
Balances with Other Saccos	912,335	250,000	960,115	400,212	365,900		756,870				**3,645,432**
Investment In Companies											**-**
Net Loan Portfolio		2,516,601	6,781,131	7,113,451	18,456,920	22,167,000	28,291,263				**85,326,366**
Property & Equipments & Other Assets										6,978,784	**6,978,784**
Total Assets	**18,237,055**	**20,884,501**	**9,741,246**	**11,513,663**	**18,822,820**	**22,167,000**	**29,048,133**	**-**	**-**	**11,973,099**	**142,387,517**
Total Deposit Liabilities	4,552,113	3,352,116	1,540,115			12,112,450		1,111,948			**22,668,742**
External Borrowings -Short term			3,567,700		5,700,500	5,079,429	14,000,000				**28,347,629**
Borrowings- Long term		2,114,000	2,560,000	6,478,472							**11,152,472**
Tax payable and other liabilities										1,838,369	**1,838,369**
Equity										78,380,305	**78,380,305**
Total Liabilities and Equity	**4,552,113**	**5,466,116**	**7,667,815**	**6,478,472**	**5,700,500**	**17,191,879**	**14,000,000**	**1,111,948**	**-**	**80,218,674**	**142,387,517**
Repricing Gap	**13,684,942**	**15,418,385**	**2,073,431**	**5,035,191**	**13,122,320**	**4,975,121**	**15,048,133**	**(1,111,948)**	**-**	**(68,245,575)**	**-**
Cummulative Gap	**13,684,942**	**29,103,327**	**31,176,758**	**36,211,949**	**49,334,269**	**54,309,390**	**69,357,523**	**68,245,575**	**68,245,575**	**-**	
Proportion (months) of current year left: mid-point	12	11.5	10	7.5	4.5	1.5					
One Year Change in NII at +/- 200 bp (2%)	273,698.84	295,519.05	34,557.18	62,939.89	98,417.40	12,437.80					