SUPERVISION DEPARTMENT

IMPLEMENTATION OF RISK BASED SUPERVISION FOR BETTER GOVERNANCE AND ADMINISTRATION OF ALL SCHEMES

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In accordance with section 55(3) of the Retirement Benefits Act the Authority hereby issues a Statutory Guideline on the implementation of Risk Based Supervision for better governance and administration of all retirement benefits schemes. The Guideline describes the risks schemes are faced with, the pre-requisite conditions for implementation of risk based supervision, the standards of risk based supervision and the way forward in the implementation of risk based supervision.

1. CURRENT RISKS TO WHICH OCCUPATIONAL PENSION SCHEMES ARE EXPOSED

Occupational retirement benefits systems vary in benefit design and mode of benefit payment. Notwithstanding the variations in schemes, there is a degree of commonality regarding the risks facing the retirement benefits sector, as well as risks facing individual retirement benefits schemes and scheme members. The Authority has identified the risks which need to be examined and which form the basis for introduction of risk based supervisory framework. There are three broad categories of risk faced by retirement benefits sector in Kenya; namely:

- Systemic risk
- Portfolio risk
- Agency risk

i. SYSTEMIC RISK

Systemic risk arises when all retirement benefits schemes are affected by financial meltdowns or other economic catastrophes. In this case other financial institutions are likely to be in similar trouble, perhaps even worse. This is likely to take the shape of large numbers of schemes being unable to receive contributions and severe arrears building up. Some schemes may close in an unfunded position and some may be unable to meet benefit

obligations. This is a risk which is arguably difficult to guard against and might require the Authority to work with the sector players for purposes of bringing affected schemes back into financially acceptable position. To some extent however, schemes have an opportunity of guarding against this risk by ensuring that the funding of schemes especially defined benefit schemes are adequately funded.

A further aspect of systemic risk is liquidity risk or **"run on the scheme"**. This is less likely to happen in schemes because members must retire or terminate employment to have access to their funds, but mass lay-offs might put a significant liquidity strain on pension schemes. Schemes should generally have sufficient liquid assets to be able to meet reasonable cash flow requirements without compromising on the investment opportunities for scheme assets.

The sector will face the risk of fiscal sustainability if contributions are irregular and inadequate to fund promised benefits. In the case of defined contribution plans, this would translate into inadequate accrued assets to buy annuities resulting in low replacement rates. This aspect invokes the need for adequate standards for scheme actuarial valuations especially to address funding deficiencies in defined benefit schemes. A lack of such standards may result in schemes adopt inappropriate or unsound valuation practices.

Another systemic risk in the sector is that of erosion of the whole pension system. Recently there is a trend where pension plans are shifting to provident funds where the pay-out is by way of lump sums. In the system there is considerable "leakage", where much of the accrued benefits are accessed on termination of employment and the remainder commuted as pension leaving insufficient assets to purchase a pension. Furthermore, the lack of indexation in the face of a sustained high inflation environment reduces confidence in the system and in particular with defined benefit plans and annuities in lieu of lump sums.

ii. PORTFOLIO RISK

Portfolio risk can be caused by:

- Inappropriate risk profiles
- Inadequate returns in relation to the income targets
- Cyclical risks in interest markets affecting annuity purchase
- Actuarial risk on the liability side

The Authority can control some of these risks, while others are beyond supervisory control.

(a) Inadequate Risk Profiles

In the case of a defined benefit schemes, the basic concept is one of "immunization", in other words, the assets should broadly match the liabilities. Often this concept is not always translated into reality. The reasons for this are as follows:

- Pension liabilities tend to be linked to increases in wages and prices – there are no assets that are directly linked to these factors, although some governments issue price indexed bonds.

- The duration of liabilities is very long, often longer than the duration of assets in the market.

The consequences of this are that defined benefit pension schemes inevitably run a mismatch risk of considerable magnitude. Long terms bonds will partially immunize such long liabilities because bond and liability periods may be the same which means that small changes in the interest rate will have the same impact on both sides of the balance sheet, and hence the difference (surplus or deficit) will not change materially.

Schemes thus need to mitigate the risk by establishing an investment policy that recognizes the interaction between assets and liabilities and so encourages them to adopt more suitable long term asset mixes. This would also include the consideration of legally acceptable foreign investments. To

mitigate further this risk defined benefits schemes should adopt a more realistic view of long term investments in actuarial valuation bases.

(b) **Inadequate Returns**

This risk is related in many ways to the previous risk, but applies to defined contribution schemes as well as defined benefit schemes. In the case of defined benefit schemes, inappropriate asset profiles will often give rise to inadequate returns in the long run. In addition, defined benefit schemes run the risk of liabilities increasing more rapidly than assets, showing up as reduced surplus or a surplus turning into an unfunded liability or solvency deficiency, or indeed an existing deficiency getting worse. In the case of a defined contribution scheme, no such "liability" exists, so if asset values fall, this is a risk borne by the scheme member, not the scheme sponsor.

Nonetheless, defined contribution schemes should, at least in principle, have an income target and if assets earn inadequate investment returns, the given level of contribution will fail to produce the expected level of retirement income. Again, this is related to inappropriate asset profile.

In the case of defined benefit schemes, one way of mitigating this risk the Authority will require more rapid funding of schemes in deficit, especially those with a solvency deficiency. It will be appropriate for sponsors not to over promise. A less ambitious pension but more secure, is preferable as it will be most likely honored and hence less supervisory intervention. While it is not normally the supervisor's role to influence scheme design, the Authority may deem it appropriate under given circumstances to encourage the development of a sound retirement benefits sector.

(c) **Cyclical Risks**

Defined contribution scheme members, in particular, are subject to the specific risk of converting a lump sum accumulation at retirement to an income. Interest rates fluctuate widely and historical comparisons have shown that a given level of contribution can give rise to annuity amounts that vary by a factor of two or more, depending on whether a scheme

member converts the accumulation at a time of high interest rates or low interest rates. This risk can be mitigated to some extent by schemes allowing scheduled draw down of accumulations by members or by members delaying the purchase of annuity until such time when interest rates are favorable. Defined benefit schemes which secure pension entitlements at retirement by annuity purchase also run this risk.

This risk can be mitigated by the development of a competitive annuity market (possibly with partial indexation features) and other forms of scheduled payout for defined contribution members reaching retirement. Defined benefit schemes can mitigate this risk by continuing to pay out of the fund if annuity rates appear particularly unattractive, but this means that an actuarial risk is being run, especially for small schemes.

(d) **Actuarial Risk on the Liability Side**

While reference has been made above to asset liability mismatch risk, and some reference to actuarial risk has been mentioned in regard to systemic risk, plans can and do run specific actuarial risk. Examples of this would include inappropriate actuarial valuation methods and assumptions, as well as insurance type risks within the pension scheme.

Actuarial methods and assumptions are particularly problematic as they refer to the ability of the scheme to meet pension promises with a high degree of probability *in the future* without further recourse to the scheme sponsor's resources. Such key components as rate of return on assets, salary increases, inflation and employee turnover are hard to predict a year into the future, let alone 40 or 50 years.

Nonetheless, realistic long term financial and economic assumptions need to be made, based on past experience, economic theory and expectations as to long run parameters in the economy. Even such relatively stable areas such as mortality can be problematic, as unknown degrees of mortality improvement have been experienced in many countries, with no end in sight. This can have a considerable impact on actuarial liabilities. If this process is not followed rigorously there is a danger of overestimating, or more problematically, underestimating the value of the liabilities.

Often "actuarial values" of assets are used, which depart from market values. This could be acceptable, as pension schemes' results should be measured over decades, not quarterly or more frequently, but inappropriate methods that consistently over-estimate the values ascribed to assets could lead to actuarial risk.

Finally, schemes often pay lump death sum benefits, several multiples of annual salary, or disability benefit from the schemes. Also, annuities are often provided at retirement. Given statistical fluctuations in mortality, fairly large numbers scheme members exposed to risk are required for us to rely on the "law of large numbers". If these risks are not insured in some fashion, the scheme would be running considerable actuarial risk unless the schemes were of sufficient size to be able to absorb the risk.

iii. AGENCY RISKS

Apart from financial risks related to investments and funded ratios, the key risks that the Authority will be concerned about, and the risks that are most susceptible to regulatory intervention, will be agency risks. These can be classified into three broad areas:

- Excessive fees and expenses
- Conflicts of interest
- Fraud, misappropriation and misallocation

Agency risk can arise from simple ignorance of law and best practices, unwillingness to adopt best practices, or through willful negligence and corrupt practices. In some cases it can be corrected by education but in some cases, the Authority will take more coercive measures, including prosecution of the guilty parties, to the full extent of the law. One of the main functions of the Authority will be to guard against agency risk, and this will be a focus of risk based supervision.

(e) **Excessive Fees and Expenses**

While this risk impacts defined contribution members most directly, as they generally receive net investment income after expenses, it also has an effect on defined benefit schemes as well, as funding ratios will deteriorate if expenses are excessive. In principle, full disclosure of such fees and expenses will ensure that competition will bring them down to the lowest levels consistent with good service and minimize the agency risk.

Fees and expenses can also provide temptation for corrupt practices, such as directing contracts to favored firms who do not charge the lowest fees or provide the best service. Full disclosure of the process for selecting third parties as well as competitive bidding will mitigate this risk. The Authority will review such processes and enforce conflict of interest rules, possibly leading to prosecution if corrupt practices are found. The Authority in its obligation to deter wrong, which is one of the principles of risk based supervision will expose corrupt practices and at least **"name and shame"** if not actually prosecute offenders.

Each scheme will be expected to develop a strict code of conduct and prohibition of non-arm's length transactions to help in limiting this risk.

(f) **Conflicts of Interest**

Some conflicts of interest are inevitable in schemes, although they may be minor in nature. For example, the governing body will inevitably include members of the scheme. They can vote for improvements in the scheme, even if it benefits them personally, provided that such improvements apply uniformly to all members and does not provide additional benefit to the voting members. Other conflicts are not so benign. Member of the governing body should not benefit personally from the operation of the scheme, other than as members of the scheme and only in accordance with the scheme's terms and conditions. Any conflicts must be declared and members must exclude themselves from a vote if they are in a conflict situation. The Authority will examine minutes of meetings to ensure that this happens. Again, competition and separation of functions will minimize these risks. For example, if assets are held separately by a custodian, while

being invested by an investment manager, subject to the scrutiny of a trustee, problems are less likely to arise with the investment process. Professional qualifications of third party providers would also mitigate these risks.

(g) Fraud and Misallocation

As noted above, many of the agency risks are due to ignorance or somewhat less benignly by personal or selfish motives that do not constitute fraud *per se.* For example, a human resources director may wish to retain the pension function even though outsourcing might be more cost effective. On the other hand, there may be out and out fraud, where pension funds are diverted for the personal gain of various parties. This might be difficult to detect, but clues such as excessive fees, or less than transparent outsourcing processes, might lead the investigator to probe more deeply.

One significant risk in both defined benefit and defined contribution schemes is that of non-payment of contributions. This is particularly serious if it relates to employee contributions that are deducted but not remitted to the pension fund. In the case of defined contribution schemes, employer contributions are equally important, as scheme members benefit directly from contributions made both by themselves and on their behalf by employers. The issue of employer contributions is more complex in the case of defined benefit schemes. In some case the scheme will be in surplus and the employer may be taking a “contribution holiday”. This is generally permissible, but it is important to ensure that the scheme truly is in surplus. For example a scheme may be showing a surplus at the previous valuation date, but due to adverse experience the surplus may have been eroded. It is important to ensure that contributions resume as soon as it appears that a surplus no long exists.

The supervisory authority has difficulty in tracking this risk. Generally, financial reports are filed many months in arrears, so the non-payment of contributions may not be apparent until it is too late. The law should put a responsibility on all parties to report inadequate or missing payments. Again, separation of functions will assist in this – a third party

administrator has an interest in ensuring that payment are made on time and will be less reluctant to inform the supervisory authorities than the scheme sponsor itself.

The supervisory authority will need to remain vigilant about the status of the economy. Contribution delinquencies are often linked with financial crises in a particular firm or industry. Payment of pension contributions is often a low priority item and firms struggling with cash flow problems may use this cash for payments other than contributions. Such financial difficulties should trigger suspicion among the supervisory authority and pro-active inquiries as to the status of pension contributions. While the supervisory should do everything in its power to ensure the continuation of a pension scheme, even when a firm is experiencing financial difficulties, the supervisor should ensure that contribution payment are being made on time. Supervisory forbearance might only serve to widen the gap between assets and liabilities.

(h) Regulatory Risk

One final risk that needs to be discussed is regulatory risk. Regulation and supervision is based on policy objectives. Especially in the case of voluntary pension schemes, which are not profit undertakings, a light touch will be expected by the industry. Excessive regulatory burden which is not directed towards achieving specific objectives related to protection of scheme members' rights, equity and disclosure may likely discourage the establishment of such schemes. Excessive regulation may also add unnecessary cost to both the schemes themselves and the Authority.

Excessive regulation might also have the effect of exacerbating rather than mitigating some of the other risks. For example, scheme sponsors might adopt unacceptable conducts to avoid the burden of petty bureaucracy.

2. PRE-REQUISITES FOR A RISK-BASED APPROACH TO SUPERVISION

This section is intended to be a more practical guide on how to put in place the necessary pre-requisites for a risk-based approach to supervision.

Before embarking on a program of risk-based supervision, it is necessary to outline a certain number of essential pre-requisites for a successful system of risk-based supervision. The pre-requisites are discussed below:

(a) Familiarizing all Parties with Best International Practices

All the interested parties, including scheme administrators, third party professionals and personnel of the Authority need to gain greater familiarity with international best practices. This will ensure that areas such as governance, investment policy setting and the investment process, scheme administration and expense control are being performed to best practices standards.

(b) Implementing a Screen Based System of Triage

The Authority is updating its IT system which currently is not premised on risk based supervision. The Authority is to a large extent automated in document handling although greater standardization and electronic filing will be necessary to streamline the process. Ideally, the first screening (triage) of quantitative and qualitative data will be processed automatically. This will free up supervisory analysts for more value added tasks and allows for a more rapid triage. The screens will show analysts where schemes are at low risk, and hence need little or no further scrutiny on a priority basis, and where schemes contain some risk which needs to be examined in greater detail. The IT system will quickly identify schemes that are high risk and are in need of more rapid analysis and possibly intervention.

(c) Implementing electronic filing

Linked with the point above, the Authority is working towards provision of electronic templates for all filing and will encourage scheme administrators to use the templates for filing. The submission templates will be carefully reviewed to ensure that only essential information required for statistical and risk screening purposes is filed, and all submissions be done in a standardized electronic format. Subject to statutory amendments, some of the current submissions may be dispensed

with or request summary level filing, rather than the entire report. Documents that are not required to be filed shall be made available for inspection by on-site inspectors.

(d) Reviewing Act, Regulations and other Statutory Instruments to Ensure they are Consistent with Risk Based Supervision

The Authority is currently engaged in further review of the Retirement Benefits Act with a view to Risk Based Supervision. The review will not fundamental. Much of the powers exist to enable the Authority implement Risk Based Supervision. Most changes will be in the regulations especially dealing with the type and manner of making of submissions. The Authority is currently mandated to issue a number of practice notes and other communication to the industry to enable implementation of Risk Based Supervision.

4. RISK-BASED STANDARDS

It is important to note that a change from a compliance based approach to a risk-based approach requires a change in mind-set in all players. The compliance approach allocates approximately equal time to all pension schemes, at least in the initial screening phase, and aims to ensure that schemes comply with a set of complex regulations. Inspections tend to be financial and management audits rather than an assessment of governance and other key systems and strength of management. Even if the scheme complies with all the relevant regulations, failures can still occur. The Authority has now resolved to shift to risk based supervision without fully discarding some aspects of compliance based approach. It is also important to note that the risk based system is forward looking, trying to spot problems before they become major and remedying them while they are easily fixed. It looks more to processes than to output.

The risk-based approach attempts to quickly determine which schemes are in a satisfactory status, and which require more attention. The Authority would then spend minimal amount of effort on the schemes that are determined to be in a satisfactory status, and concentrate on the schemes needing more attention. This has a number of advantages, for example:

- It encourages scheme administrators to run their schemes well, as a well run scheme receives minimum attention from the supervisory authorities
- It maximizes the use of scarce regulatory resources
- It increases the probability that significant problem will be spotted in a timely fashion and remedied in the most effective manner

While the risk-based approach is based to some extent on numerical analysis of various financial indicators, the ultimate application of this approach requires the application of judgment to the financial and non-financial information received by the Authority.

It should also be noted that the Authority cannot be in all places at all times. The first line of defence is the scheme administrator itself and all parties are encouraged and expected to operate in a sound manner. The Authority will also rely on professionals involved in the process.

This approach is often called the "supervisory ladder" approach as it considers five risk levels as shown in the table below.

TABLE

Risk level	**Indicators**	**Actions**
Risk level 0 – green light	Scheme well run, all financial and non-financial indicators within acceptable range	No action required, regular filings continue
Risk level 1 – light amber	Scheme reasonably well run, most financial and nonfinancial indicators within acceptable range, but few	Regular filings continue, but more intensive monitoring indicated, until scheme returns to risk

	outside range or deteriorating	level 0
Risk level 2 – dark amber	Scheme generally in acceptable status, but a number of indicators outside range, or have been deteriorating	Supervisor questions scheme administrator regarding the issues raised by analysis. Monitoring continues until scheme returns to risk level 0
Risk level 3 – red	Significant number of indicators outside acceptable range, or have shown significant deterioration	Supervisor requests recovery plan from Trustees. Recovery plan is examined and monitored until scheme can be returned to at least risk level 1
Risk level 4 – ultra-red	Scheme is in significant difficulty – scheme member interests significantly threatened	Intervention needs to be considered, including requirement for additional funding, reduced benefits, placing scheme in trusteeship, or eventually closing scheme, if all else fails

This five step approach has been adopted by the Authority as appropriate in Kenyan environment.

The risk categories adopted for purposes of implanting risk based supervision are as follows:

1. **INHERENT RISK**	2. **MANAGEMENT AND CONTROL**	3. **CAPITAL SUPPORT**
1.1 Investment risk	2.1 Trustee oversight	3.1 Fund
1.2 Insurance risk	2.2 Operations and control	3.2 Employer sponsor
1.3 Non-financial risk	2.3 Independent review	

Each of the above indicated risk components will be analyzed using the description below. The scheme trustees and or administrator need to appreciate the description of each of the risks because that will form the broad guidelines of what the analyst will be considering when rating the scheme. The description will be as follows:

- Brief explanation of the risk factor
- Source of information
- Which risk factor or factors it is related to
- Examples of satisfactory results
- Examples of unsatisfactory results
- Numerical ratings

In the first instance, the Authority will attempt to identify the data sources which will allow a triage based on off-site inspection. In this case, the analyst will have access to a limited amount of information – basically summary information that is required to be filed, although the analyst will

be able to request further information if he is not satisfied with a particular response. The basic principle is that the analyst shall not put a file away until satisfied that the scheme can be placed in the appropriate risk category. On-site inspection will have access to a full range of documents, allowing the supervisory team to deepen knowledge of the scheme. The process of offsite and on-site inspections will be discussed later.

Use of numerical ratings

As above mentioned, numerical ratings will be employed with care in placing schemes in various risk categories or the supervisory ladder shown above. The numerical scale of less than 1 (very low risk) to 4 (extreme risk) is taken to the fourth power to give a probability of failure index going from 1 (very low probability of failure) to 256 (high probability of imminent failure). The basis of this calculation is that probability of failure does not increase in a linear fashion, but increases exponentially, for each increase of one unit of risk. The fourth power calculation is an approximation and simplification of this exponential formula.

The proposed procedure for applying this rating approach is as follows:

- Ratings of between .25 and 4 are assigned separately for each of the three areas, namely inherent risk, management and control and capital support
- These separate ratings are combined by weighting each area. Weightings are quite subjective. The Authority has adopted a weighting which more or less equal for the three categories. The weightings will be 30% for inherent risk, 35% for management and control and 35% for capital and support. This will be varied as the system develops and more experience gained.
- The combined score, between .25 and 4, is then taken to the fourth power to indicate the risk probability and assign the scheme to one of the risk levels identified above, as follows:

Combined score	Risk probability index	Risk level
Less than 0.5	1	0
0.5 – 1.5	1 - 5	1
1.5 – 2.5	5 - 39	2
2.5 – 3.5	40 - 140	3
3.5 - 4	141 - 256	4

1. INHERENT RISK

1.1 Investment risk

Description

In principle, assets should be of high quality and well diversified and should match the liabilities for defined benefit schemes and should be appropriate to meet investment targets for defined contribution schemes.

The investment policy statement should provide the strategic overview of the investment process, and should address the issues of asset quality, diversification, target rates of return, asset liability matching in defined benefit schemes and monitoring of results. It should also address mechanisms for ensuring the investments adapt to a changing environment.

The analyst will be concerned about the execution of the investment policy. Investment managers should be selected in a transparent manner and should be closely monitored to ensure they adhere to the policy and attempt to maximize the rate of return, subject to risk constraints.

Another issue related to investment risk is liquidity. The Trustees should be aware of regular cash flows and any potential requirement for cash. In most cases contributions and investment income should exceed benefit payments, so liquidity risk would normally be low. The fund should be

able to face extraordinary calls for cash (for example a large number of terminations) by liquidating assets without significant loss.

Source of information

While in the future the investment policy may not be filed with the Authority, the interrogatories questions will require that its existence and updating be responded to. Trustees will be required to state that fact in the interrogatory. Questions regarding management of liquidity risk will be included in the interrogatory. This would be the main source of the information. However, investment policy statements themselves will be examined during the on-site inspection.

To some extent output measures, such as the rate of return compared to a peer group of similar schemes, will give the analyst some idea of the success of the investment process. However, the analyst will also be concerned about the riskiness of the portfolio. In the case of defined benefit schemes, the major issue is asset liability matching, while for defined contribution schemes return volatility versus long term rate of return is the prime concern. There are some ratios, such as the Sharpe ratio[1], that might be applied in this regard. Schemes will be required to report both rates of return and appropriate risk measures, so that the analyst can conduct a peer review analysis of both of these factors.

Risk factors

Clearly, the assets are closely related to portfolio risk, as inappropriate asset profiles will be caused by an incorrect policy. If all pension schemes have inappropriate asset profiles this would contribute to systemic risk. A significant fall in long term interest rates would cause hardship to all defined benefit and defined contribution schemes, although this might be less acute if it is accompanied by a fall in salary increases and inflation

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1 The standard deviation of return divided by the return – a lower Sharpe ratio indicates in theory a less risky portfolio, if the rates of return of two portfolios are equal – there are more sophisticated measures available, but this is a fairly standard measure of portfolio risk for defined contribution type schemes

rates. There is also agency risk, if investment management is not undertaken in a transparent and arm's length manner.

Satisfactory results

If the duly filled interrogatory indicates that the investment policy statement is up-to-date and has been reviewed in the past year, then this is considered satisfactory. A more detailed examination of the investment policy statement during the on-site inspection would be satisfactory if the statement contained all the necessary items, was regularly updated and if the investment process was monitored in accordance with the policy. Presence of cash flow projections and a plan for unexpected cash needs would also be a positive. Satisfactory results would also be indicated by output measures such as a higher than average rate of return within the peer group and a lower than average portfolio risk factor. A well diversified portfolio would also be a satisfactory outcome.

Unsatisfactory results

Unsatisfactory results are indicated by negative answers in the interrogatories, for example absence of an investment policy statement, failure to update the statement, or failure to monitor the results in a satisfactory manner, or lack of awareness of cash-flow issues. It will be a breach of duty and regulatory requirements to fill the interrogatory untruthfully. On-site inspection will reveal the untruths and consequences will follow.

Lack of proper asset liability management in defined benefit schemes is also an unsatisfactory outcome.

Poor output measures, such as low rates of return compared to the peer group, or higher portfolio risk measures would also be negative factors. The analyst also will look at higher risk asset classes, such as property or foreign investments, and judge how well these asset classes are managed. If individual holdings appear to be above the norm (for example greater than 2% of the portfolio, or whatever threshold is considered reasonable), this would be considered unsatisfactory to the analyst.

Numerical ratings

The analyst would score 0 if asset classes were no more than 20% above or below the industry average. If the equity content were between 22% and 34% this would be considered satisfactory. If outside this range, score of 0.25. The analyst would need to use judgment. If for example the scheme is closed to new members or is heavily weighted towards pensioners then a higher percentage in fixed income and cash could expected. If the portfolio does not comply with limits related to foreign securities and/or securities of the scheme sponsor then score 1 (and in any event flag the scheme for non-compliance and the need for a remedial plan to bring these percentages down).

Absence of an investment policy statement or lack of recent review of an existing statement would also score 1 on this risk scale. If an investment policy statement is present, but there is lack of evidence that it has been kept up to date, score 0.5.

If there were one or more individual holdings above the threshold for such holdings (2% is suggested) then score 0.25 to 0.5.

Any other concerns arising from answers to the interrogatory would add a further 0.25 to 1, depending on the nature of the problem. For example, any concern that the assets were not sufficiently liquid could add0 .25 to 0.5.

1.2 Insurance risk

Description

This risk refers to the presence of insurance benefits, such as life insurance or disability benefits in the scheme. In large schemes, such risks can rely on diversification (the "law of large numbers") to minimize this risk, but in smaller schemes this risk should be reinsured, otherwise one claim could put excessive strain on funding. In the case of defined contribution schemes, self-insured annuities would represent insurance risk.

Source of information

The presence of these benefits will be indicated by examination of scheme documents. It is not expected to change very frequently. This issue will also be included in the interrogatory for trustees to respond to.

Risk factors

This risk is basically a non-financial portfolio risk. In the case of defined contribution schemes and defined benefit schemes where annuities are purchased at retirement, insured annuities represent a cyclical risk.

Satisfactory results

Ideally, this risk should not be present in the scheme at all. If such a risk is present, then it should be reinsured. If the risk is not reinsured, then the actuary would need to do stress testing to examine the impact of feasible scenarios on the scheme funding. It would be satisfactory if such stress tests indicated minimal impact on funded status.

Unsatisfactory results

If these benefits are of significant magnitude and not reinsured this would be an unsatisfactory result, especially if stress testing would indicate negative impact on funding under feasible adverse scenarios. In the case of defined contribution schemes, self-insured annuities would represent a risk area. The analyst will judge how well this risk is managed.

Numerical ratings

The presence of uninsured life insurance benefits or disability benefits would add 0.5. Self-insurance of annuities in a defined contribution scheme would add 0.5 if there are regular actuarial valuations, 1 if there are no valuations, or the analyst judges the valuations to be unsatisfactory. While somewhat less of a concern in defined benefit schemes, as these have actuarial valuations in any event and there are other sources of gains and losses (which would not be the case in defined contribution schemes), small defined benefit schemes would be running some risk by not insuring such pensions at retirement. In this case “small” scheme would be a scheme with less than 100 members would be and in this 0.25 will be added.

1.3 Non-financial risk

Description

This risk refers to the complexity of administration of the scheme and/or investment administration. It relates to the potential for "things to go wrong".

Defined benefit schemes are inherently more complex than defined contribution schemes. Schemes with more complex benefits (for example survivor benefits) or many options would be riskier than simpler schemes. Outsourcing to a reputable third party would potentially reduce this risk, but might introduce outsourcing risk.

Similarly, investment administration risk is high if there are more investment classes, especially if some of these classes are less than standard, such as property or foreign investment. Investing through mutual funds or other collective investment vehicles might reduce this risk. In the case of defined contribution schemes, having a large number of options would increase risk, while having limited number of choices would be considered lower risk. On the other hand, having just one fund with opaque interest declaration and the presence of "reserves" would be a risk factor.

Source of information

The scheme documentation would indicate how these issues are managed. It is not anticipated that there would be significant changes in these factors over time. Schemes are required to develop policies which govern all the issues relating to this risk.

Risk factors

This is mainly related to agency risk, as these are areas where mistakes are likely to be made. In the case of defined contribution schemes which lack transparency in allocation of investment earnings this is probably a systemic risk.

Satisfactory results

Satisfactory results are indicated where capacity is appropriate to the degree of complexity. Outsourcing to a third party professional would generally be considered to be satisfactory, but the analyst will check that outsourcing was performed in a transparent manner; the process is well documented and monitored.

Generally, simpler provisions will be preferred to more complex ones, but there may have to be trade-offs. For example, multiple options for defined contribution schemes might be more complex, but more satisfactory for scheme members. This would be satisfactory, if the capacity for a more complex administration is present.

Unsatisfactory results

Where a scheme appears to be excessively complex, or where there does not appear to be capacity present for the degree of complexity, this would be unsatisfactory. In the case of small schemes, in-sourcing would be considered a risk factor. Where there is outsourcing, lack of evidence of transparency and monitoring would be considered unsatisfactory. For defined contribution schemes, opaque methods of allocation of contributions and returns would be unsatisfactory.

Numerical ratings

Ratings for this area are fairly subjective. If a defined benefit scheme has a number of complicated features, such as early retirement benefits, indexation and so on, the analyst would add .5 to the score. In a defined contribution scheme, a large range of investment options, rather than having just a few investment funds would add .5. Similarly, having one fund for all, but not allocating investment earnings on a market basis, but "declaring" the rate on a non-transparent smoothing approach and

building up "reserves" would score .5 to 1 point, depending on the degree of opacity or transparency. Small schemes that do not outsource their functions, or schemes that outsource in a non-transparent manner, add 0.5.

2. Management and control

2.1 Trustee oversight

Description
This factor refers to overall scheme governance, and in particular the strategic direction of the scheme, as well as the relationship of the between the scheme sponsor and the Trustees. This factor also refers to the competence of the Trustees.

Source of information
Again, scheme documentation and the interrogatories will indicate the extent to which this issue is well handled. Schemes will also be encouraged to complete a governance self-assessment questionnaire, and attend to issues revealed. Trustees will be expected to comply with the "fit and proper" tests, as well as having completed the appropriate training programs and continuing education. These matters will be reviewed.

Risk factors
Risk factors associated with this element are agency risks.

Satisfactory results
A well documented process for Trustee oversight and satisfactory completion of the self assessment questionnaire would be indicators of satisfactory results. Clear allocation of responsibility and lines of accountability would also be good indicators. Members who have met the fit and proper tests and have passed the appropriate tests will indicate a positive result. Well documented Trustee oversight procedures and evidence that such oversight is occurring is a positive result.

Unsatisfactory results

Lack of adequate documentation or the absence of evidence of completion of the self assessment questionnaire would be negative. Conflicts of interest and unclear lines of reporting would be considered negative.

If some of the Trustees have not met the fit and proper test, or have not completed the education program and passed the appropriate tests, then this is negative. Absence of a Trustee oversight procedure is a negative factor.

Numerical ratings

If filings are late and/or incomplete, or if the scheme does not fully cooperate with RBA, the score will be 0.5. If there are concerns about the probity of those in control, this would increase the score by 1. Lack of proper control and lack of proper documentation would also increase the score by .5. On-site inspection would deepen the analysis of this factor.

2.2 Operations and control

Description

This factor encompasses the issues of operational management, financial and administrative control and compliance. This factor includes the issue of efficiency of administration and particularly but not solely in terms of expenses.

Source of information

Such items as timeliness and accuracy of filing submissions would be indicative. Generally positive results for completion of the interrogatories would also be a good sign. Other indicators are the level of complaints and the manner in which they are resolved, especially if a significant number of complaints are lodged at the Authority. The analyst will also be able to judge the level of expenses from financial reports.

However, the main source of information regarding the quality of management can only come from on-site inspections, where the inspector will be able to interview those directly and indirectly responsible for

pension administration, and will be able to examine minutes of meetings among other documents.

Risk factors
This factor presents a number of agency risks, as there is ample opportunity for conflicts of interest, as well as for unintentional organizational failure. In a broader sense, there is also systemic risk, as high risk economic sectors may present possibilities of failure, even if the pension scheme itself is well run.

Satisfactory results
A generally positive interrogatory will be a satisfactory indicator, as will be timely filings and payment of contributions. The quality of management can be judged indirectly by the quality of the filings. A low number of complaints or complaints that are rapidly and satisfactorily resolved are also a good indicator.

Relatively low levels of expenses, as a percentage of assets or contributions, as compared to peers, would be a positive result.

In the case of on-site inspections, a cooperative attitude, well kept documentation and overall impressions are very important, although somewhat subjective. The on-site inspector can also check the veracity of the interrogatories and the accuracy of other filings. If these are satisfactory, this would be a good indicator.

Unsatisfactory results
Even if it is truthful, interrogatories with many negative answers is a sign of poor management, as is late filing or delayed payment of contributions. If there are a significant number of member complaints, and if they remain unresolved or not satisfactorily resolved and the Authority is involved in resolving them, then this is an indicator of poor management.

Relatively high levels of expenses need to be investigated – if there are no well documented reasons for this, this would be a negative sign.

If the on-site inspector finds the documentation in poor shape, or inaccurate filings, including the interrogatories, this would be an unsatisfactory result. It is likely that the on-site inspector would be able to detect poor management more readily than he could satisfy himself that the management is satisfactory.

Although beyond the control of the pension scheme management, a pension scheme sponsor in financial difficulties, or in an industry in financial distress, would also be an unsatisfactory result.

Numerical ratings

Lack of completion of interrogatories, or unsatisfactory completion would add 0.25 to 0.5. Unsatisfactory filing record, including history of late payment of contributions, would add 0.5. If there are outstanding complaints this would add a further 0.25 to 0.5. Expenses per member that are more than 20% above the average would also add 0.25. Any other negative features, including lack of cooperation during on-site inspections, would add a further 0.5.

2.3 Independent review

Description

Review by independent professionals is an important component of risk based supervision. Reliable independent review will give the Authority greater confidence in the administration, funding and investment of the pension scheme. This factor refers to the independence and competence of the actuary and the auditor and the quality of their reports.

Source of information

The off-site analyst will have access to the summary results of the actuarial report, as well as information about the actuary and auditor. Interrogatories will give the analyst indications of how independent these professionals are. The on-site inspector will be able to review the reports themselves.

Risk factors

Again, this issue is related to agency risk. The greater the independence of these professionals, the more confidence the Authority can have in their reports.

Satisfactory results

Satisfactory results will be indicated by complete independence of the professionals from the scheme management. The professionals should be fellows or equivalent in good standing in their professional organizations. Easily understandable and well prepared reports are also good indicators.

Unsatisfactory results

The actuary could be an employee of the pension fund or the scheme sponsor. This is not necessarily a strong negative, but should be reviewed carefully. Reports that are not prepared by experienced professionals are also a negative. Poorly prepared reports are also a negative.

Numerical ratings

If the actuary is an employee of the sponsor, this would add 0.25. If there are any other concerns about the professionals (for example, not members in good standing in the respective Kenyan or international professional bodies), then a further 0.5 to 1 would be added. If reports are difficult to follow or are not well prepared or have qualifications, an additional 0.5 would be added.

3.1 Fund

Description

The most important issue with regard to the fund is the question of surplus or deficit for defined benefit schemes. The analyst needs to review both the going concern and solvency basis results.

This factor is also related to the earnings on the fund. This applies to both defined benefit and defined contribution schemes.

Ideally, this factor should also include dynamic solvency testing. Schemes will be encouraged to voluntarily adopt this process rather than making it mandatory.

Source of information
Actuarial and financial information will be available from regular filings. The system will also perform an approximate updating of solvency valuations on an annual or even semi-annual basis, and further information could be requested from the scheme in the event of deteriorating results.

Risk factors
This factor is linked to portfolio risk, both in relation to possible inappropriate asset profile (mismatch risk) and inadequate returns.

Satisfactory results
Satisfactory results are indicated by assets exceeding both going concern and solvency liabilities. The analyst will also look at the level of conservatism of the actuarial basis, although that assumptions and methods will become more standardized in the near future. Relatively high investment returns as compared to peers would also be a satisfactory result. Voluntary application of dynamic solvency testing would also be a satisfactory result.

Unsatisfactory results
Assets that are below both solvency and going concern liabilities are clearly a strongly negative factor. Where assets exceed solvency liabilities, but not going concern liabilities, is also negative, but somewhat less so. Again, the actuarial assumptions and methods need to be taken into account in looking at these comparisons. Poor investment earnings would also be a negative indicator.

Numerical ratings
In this section, ideally, solvency ratios and funded ratios should be used as a measure. Unfortunately, the lack of consistency makes this difficult to apply under the current circumstances. The following ratings will be applied:

- No unfunded liability, solvency ratio 0.8 to 1 – score 1

- Solvency ratio 0.8 to 1, but also unfunded liability – score 1.5
- Solvency ratio below 0.8 (whether or not there is an unfunded liability as well) – score 2
- No solvency deficiency, but funded ratio between 0.8 and 1 – score 0.75
- No solvency deficiency, but funded ratio below 0.8 – score 1.25
- If valuation assumptions judged to be weak (e.g. interest rates more than 20% above average) add additional 1 to score

If there is a solvency deficiency and/or an unfunded liability, but the scheme has a written recovery plan complying with the legislation, then 0.25 will be deducted from the score. If there is evidence that this plan has been adhered to since the previous valuation, then a further 0.5 can be deducted.

The analyst will also compare rates of return on the portfolio and compare it to the average rate of return. If this is 20% below the average, then this would score a further 0.25 – 0.75. This would apply to negative rates of return as well as positive. For example if average returns for the year were -5%, then anything below -6% would score 0.25.

If average returns were 5%, then the threshold would be 4%. Score 0.25 for each of the last 3 years when the scheme results were below the threshold.

3.2 Employer sponsor

Description

The two main issues here are the question of the payment of contributions, and the general financial health of the scheme sponsor.

Source of information

The financial report should indicate the level and timeliness of contributions, although often with a lag. The actuarial report will indicate

the method of calculation (including the actuarial assumptions on which the calculation is based) and the resulting contribution rate. The actuarial report will also indicate whether a contribution holiday could be taken, if assets exceed liabilities.

In terms of the general health of the scheme sponsor, the analyst will need to use external sources of information, including knowledge of the industry the scheme sponsor operates in.

Risk factors

Contributions are subject to systemic risk and agency risk. Systemic risk refers to the sufficiency of the contributions to fund the benefits; in the case of defined benefit schemes benefits that are promised by the scheme; in the case of defined contribution schemes target benefits based on scheme members' reasonable expectations. Agency risk is related to diversion of contributions away from the pension scheme and towards other cash requirements of the scheme sponsor.

Satisfactory results

Satisfactory results for this factor would be timely contribution of both employer and employee contributions to the scheme fund and minimal delay in investing the funds. In the case of defined benefit schemes, a satisfactory result is indicated if the analyst is satisfied that the method and bases used to calculate the employer contribution are reasonable. This requires judgment. The analyst will review the assumptions in the actuarial report and compare them with those for peers, as well as absolute levels in the economy (for example for interest, salary increases and inflation).

If the sponsor has been able to take a contribution holiday because scheme assets exceeded liabilities at the previous valuation, a mechanism should be in place to monitor the funded status and restart contributions if assets no longer exceed liabilities under current conditions. For defined contribution schemes, good communication indicating objectives of the scheme, target benefits and progress towards target.

Employers that are in healthy industry, and have good financial results are good indicators.

Unsatisfactory results

Unsatisfactory results include inordinate delays in making employer contributions or transferring employee contributions to the fund. If delays are repeated and persistent for both defined benefit and defined contribution schemes, this is a major risk element. If contributions remain unpaid for significant lengths of time, this would put the scheme into a higher risk level that would require immediate attention from the Authority.

In the case of a defined benefit scheme, contribution levels based on excessively optimistic assumptions would be a risk factor. Another risk factor is schemes that are in a contribution holiday status and are not monitoring the relationship of assets and liabilities to ensure that the holiday comes to an end in a timely manner if assets no longer exceed liabilities.

For defined benefit schemes that have an unfunded liability or solvency deficiency, a schedule of payments should be in place to eliminate these within the periods specified in the recovery scheme. Absence of such a schedule is a significant risk factor and would elevate the scheme to a higher risk level.

For defined contribution schemes, where communication regarding target rates of return and retirement income targets are poor or non-existent.

Finally, where the industry and/or the company are in poor financial shape, this would be considered a negative factor and would need to be monitored.

Numerical ratings

The main numerical tool is the question of contributions, both in defined benefit and defined contribution schemes. The following ratings will be applied:

- If contributions are occasionally 7 days in arrears or more, but less than 30 days, score 0.5

- If contributions are persistently in arrears score 1
- If contributions are in arrears for 30 days or more score 2
- If there is a pattern of late payment score 3
- If contributions are less than 90% of the recommended current service cost and amortization payments score a further 0.5
- In a defined benefit scheme, if there is a contribution holiday and this not being monitored to ensure it ends when the surplus is used up, score a further 1
- If there are any other concerns about the adequacy or timeliness of contributions score an additional 0.5 to 1

The first two bullets apply if there are no significant arrears, but late payments occur either occasionally or persistently. The next two bullets apply if arrears have built up (which would be reflective of late payments). Apply either the scores for the first two bullets if there are no significant arrears, or the second two if there are, but not both.

If communication is poor in defined contribution schemes score 0.5.

The analyst will also look at the overall health of the industry and the company itself. While again this is subjective, and the analyst is not supposed to have an in-depth knowledge of the financial health of the company, an additional score of 0.25 to 1 could be added if there are some general concerns.

5. PROCEDURE FOR RISK-BASED SUPERVISION

This model of supervision will work if each party to a scheme plays its role effectively. Risk based supervision will be implemented by various parties in the steps indicated briefly below:

- Application by scheme trustees, mandatory service providers, sponsors and other third party professionals of best international standards to investment of scheme assets, funding and administration of schemes

- Reliance on independent professionals to apply standards and advise the Authority of any failures to meet standards

- Communication of standards to schemes, service providers, sponsors and other third party professionals, to ensure effective deterrence against lack of risk management and compliance

- And finally supervisory oversight on a risk based basis

The first two items are related to education and standard setting among industry participants. For risk based supervision to be successful, the Authority shall rely on schemes which are strictly following best international practices in relation to governance, and on the professionals giving service to schemes (actuaries, accountants, lawyers, investment professionals) operating at the highest standards of integrity. In this way, the supervisor can have some confidence that schemes are being operated in a satisfactory manner. It is estimated that over 80% of errors in the management of scheme affairs are due to lack of knowledge and understanding and a relatively small proportion due to willful acts of fraud or deception. The Authority in consultation with scheme trustees and service providers will endeavor to reduce the errors caused by ignorance and poor practices. This will enable the Authority to concentrate its efforts on finding genuinely problematic cases.

In regard to prudential oversight itself, the current procedures are moving towards a risk based approach. The movement will be steady and may retain current procedures which are positive and strengthening their weak points. Those procedures which do not support risk based approach to supervision will be gradually discarded.

Below, we indicate a structure of risk based off-site and on-site supervision as a model to move towards. Supervisory oversight is performed in three stages:

- Off-site inspection

- On-site inspection

- Intervention, if necessary

Off-site inspection

The objectives of off-site inspection are:

- To place schemes in appropriate risk categories
- To investigate incomplete, inconsistent or unsatisfactory information contained in filings
- To require or suggest remedial action to ensure that schemes in high risk categories quickly return to lower risk categories
- To prepare a report for the use of management and on-site inspectors alerting them on risks that need further investigation

The off-site analysts' challenge is that the information is relatively limited. Filings provide limited information, which may not always be accurate or even truthful. In order to minimize the amount of information to be provided (and to be analyzed), filings will be limited to:

a) Initial prescribed filings, including scheme provisions and information about the structure of the scheme

b) Annual filing of financial information

c) Summary filing of investment report every six months

d) Summary of outstanding contributions each quarter

e) Annual filing of interrogatories

f) Triennial filing of actuarial information, for defined benefit schemes and some defined contribution schemes

Insofar as the interrogatories are concerned, an important issue is that for them to be relied on, they must be completed accurately and more importantly truthfully. The safeguards are:

- The Trustees will be asked to certify them – it will be in the interest of trustees to ensure that they are completed accurately and truthfully
- The Authority will also rely on independent professionals to review the responses to ensure accuracy and truthfulness
- Finally the Authority will rely on deterrence – even low risk schemes will be subject to on-site inspections, so that the Authority will have the opportunity to examine and verify a sample of such filings

The off-site analyst's role will involve both categorizing schemes risk levels and actively working with schemes to have higher risk schemes move into lower categories by implementing an agreed recovery plan. If off-site inspection fails, the Authority will pursue On-site inspection. It is important that schemes co-operate with off-site analysts to manage identified risks in order to avoid on-site inspections.

On-site inspection

On-site inspection is very labour and time intensive, so minimizing the impact of on-site inspection on the work of the Authority will be an important aspect. This will be achieved by:

- Maximizing the use of off-site inspections to maintain schemes in the lowest risk categories

- Careful planning of the on-site inspection

- Concentration on areas identified by the off-site inspection for examination of high risk schemes

- Using a "theme" approach for examination of low risk schemes

- Preparing reports that are brief, timely and to the point

While one of the key objectives of the on-site inspection is to probe issues identified by the off-site analysts in regard to high risk schemes, a sample of low (and medium) risk schemes will also be subject to on-site inspection, for the following reasons:

- There is an element of deterrence in this – short notice examinations tend to improve compliance.

- It gives the Authority some idea of systemic issues, for example certain aspects of scheme administration may be carried out poorly by all schemes, even ones that are deemed low risk

- It also provides Authority with evidence of "best practices" that it can share with others in the industry.

1. **High risk cases**

In some cases, the inspectors will be alerted to risk areas by the report of the off-site analyst. Schemes in imminent danger will be examined as a matter of urgency without necessarily waiting for an off-site inspection report. The Authority might be alerted to such high risks through scheme member complaints, input from actuaries or other third party professionals who are concerned about the status of the scheme or even by external warnings such as newspaper reports. In this case the on-site inspector will concentrate exclusively on the particular area in contention (for example consistently delinquent contributions, or a high profile merger, acquisition or spin-off). The visit might last for a day or two (although repeat visits might be required to follow up on previous recommendations) and will be followed up with a written letter with specific recommendations very quickly. Since each case will be somewhat different it is difficult to provide hard and fast rules on the conduct of such an inspection. The inspector will be flexible and on the look-out for any particularly suspicious behaviour. He will not leave a particular area until he is completely satisfied that he has understood the issue.

2. **High to medium risk cases**

Where the off-site analyst has identified cases where there are considerable weaknesses, but there does not seem to be imminent danger, an on-site inspection will be used to probe issues more deeply than can be done on an off-site basis and ensure that a recovery plan is in place. The analyst shall follow up to make sure the plan is being put into effect and is having the desired effect. As noted above, such plans will have been identified as having management and control weaknesses by the off-site analyst. A low funded and/or solvency ratio may not be sufficient reason to require an on-site inspection, unless the off-site analyst is convinced that the unsatisfactory ratios are symptomatic of an underlying management weakness.

The following process will be generally followed in order to ensure the on-site inspection is performed in the most effective manner. In the planning process, the on-site inspector will study the report of the off-site analyst and discuss it with the off-site analyst to ensure that all problems areas are well understood. This may not be necessary where the same officer is required to carry out the on-site inspection. The inspectors will then draw up an inspection plan consisting of:

- Initial meeting with the trustees and senior members of the scheme administration
- Meeting with independent professionals of the scheme
- Examination of specific areas of weakness
- Overview of other areas that might not have been identified by the off-site analyst
- Preparation of draft report
- Wrap-up meeting with responsible parties

- Finalization of report, including input from trustees, scheme administrators and others

- Request of an appropriate recovery plan, or alternatively direction of RBA for plan to reduce risk level

The Authority will then contact the trustees and scheme administrators, to arrange for a visit, letting them know who the inspectors would like to meet. There shall be no more than one or two week's notice. This will be followed up by a letter listing the documents that the inspectors would like to have access to. The list would be related to the particular risk areas, although other documents would probably also be requested for completeness. If the Authority suspects that documents might be altered or destroyed, then even less notice (or even an unannounced visit) might be contemplated. This would only be used if there are suspicions of criminal activities (in which case police presence might also be required). Inspectors will never visit premises alone; there shall always be at least one witness, in case charges have to be laid.

Once on site, the inspectors will have a preparatory meeting with as many of the parties as possible, outlining the issues to be discussed and inviting the participants to present any mitigating arguments. The inspectors shall outline the plan of the inspection, including examination of documents and separate meetings with various parties.

The inspectors will then follow the plan, taking copies of documents if they can (some documents, such as Board minutes, may be confidential and may not be copied, in which case the inspector will just take notes at this stage). The inspector will not confine himself to scheme documents; he will also ask to see Sponsor Board minutes that relate to the scheme.

The inspector will also interview individuals (such as the actuary or the auditor) if need be to deepen his knowledge of the situation. He might also interview junior personnel to investigate such things as controls and reporting.

Inspections will generally be at a high level. In other words, the inspector will look at policies, controls, risk management etc. He will interview key players to understand their roles. He examines policy documents (governance documents, delegation, outsourcing agreements, investment policies, scheme amendment discussions etc) and ascertains the extent to which these are actually followed and monitored. He might also look at IT systems, but this is a more specialized activity and if there are real concerns with computer systems an independent expert might have to be called in. This is also the case with some other areas, such as the actuarial report. If there are grave concerns about this, an independent actuary might need to join the team. Similarly the inspector will look at the reports of independent professionals, such as actuaries, investment managers and auditors and may interview them, to ensure that the reports are properly prepared and procedures followed.

The inspector will avoid getting bogged down in detail, firstly because it is very time consuming and secondly it is not useful, because the Authority will be looking for systems failures not minute errors. The scheme auditors will focus on the detailed issues in the scheme.

Once the inspector has gathered all the pertinent information a draft report (in point form) shall be prepared. This report shall:

- Be factual
- Be backed up by evidence
- Avoid value judgments
- Distinguish clearly between breaches of the legislation on the one hand and lapses of best practice on the other
- Be polite, but firm and clearly pointing out problems
- Invite the responsible parties to suggest appropriate remedies, or offer solutions if requested

- Propose solutions, if none are forthcoming from the responsible parties

This summary report will form the basis for the wrap up meeting. The wrap up meeting will give the responsible parties the opportunity to either refute some of the allegations, or alternatively to offer solutions. The inspector shall be prepared to alter some of his conclusions if counter facts are proposed, but will stick to his conclusions where he is convinced of his facts on the ground.

This will be the end of the on-site visit. It shall not last more than 3 to 5 days.

The on-site inspectors will then present a formal report, in cooperation with the off-site analyst within a week covering issues raised in the summary report and the wrap up meeting and not introduce new topics. If requested, the inspector might present a formal report detailing failures that are breaches of the legislation and a "management letter" that will be less formal and provide guidance on how to improve standards. The scheme administrator and others who are named in the report will have an opportunity to review it. Again, the inspector will be prepared to change the report where convincing arguments are given, but shall stick to his findings where these can be factually backed up. The final report that goes to both Authority management and Trustees would include the comments from the scheme trustees, personnel and others (e.g. actuary or auditor).

The Trustees will be asked for a recovery plan, or failing that Authority would impose a recovery plan on the scheme, and this would form an appendix to the inspection report. A follow up visit (or perhaps just a written report and a conference call) would be scheduled for some time in the future to monitor progress. The frequency of these monitoring calls would depend to some extent on the nature of the issues to be resolved, but monitoring would continue, mostly by the off-site analyst, until the scheme had returned to risk level 0.

3. **Inspections of low to medium risk schemes**

The pattern of these inspections would follow those given above. In this case it might be appropriate for the off-site analyst to take part in some or all of the inspection.

This type of inspection will have a “theme” each year. Rather than having a comprehensive inspection of a scheme, one issue may be chosen each year, for example, investment, governance, controls, actuarial reports, defined contribution schemes, and so on. The inspectors would then spend only a few days (less than a week) on each scheme, perhaps examining 3 schemes in a week, but concentrating on this one issue. The objective is to examine best practices and to find common practices. While the scheme sponsor will receive a short letter outlining his performance in this area, more importantly, the results would be disseminated to the industry with the aim of raising standards all round.

The planning for these inspections is important and will follow the pattern outlined above for high risk scheme inspections. Both the initial meeting and wrap meeting are important, especially if problems are found. A short written report is also prepared. Depending on the findings, follow up may or may not be required.

4. **Intervention**

Clearly, the objective of a risk based supervisory system is to minimize the need for supervisory intervention. By attempting to keep schemes in the two lowest risk categories, few if any scheme should need intervention. If schemes move into a higher risk category, the Authority will become aware of this rapidly and actions will be established to return the pension scheme to the lower risk categories as soon as possible. The interventions will take the form of sanctions and directives which the Act has provided for.

If all else fails, the Authority may have to order a scheme closed and wound up, in which case the essential issue is to maintain the assets for the beneficiaries and to distribute them as equitably as possible.

6. IMPLEMENTING RISK BASED SUPERVISION

It will take some time to fully implement the process suggested above. It will require changes in working methods of both inspectors as well as industry participants. It will also require some changes in legislation and regulations. Training of both inspectors and industry participants is a pre-requisite for a successful implementation, as is performance of pension scheme administrators and other third party professionals in accordance with best standards. The road map for the successful implementation of this process, including an in-depth training plan for RBA staff, has been set out in this report. Some further aspects of the transitional arrangement include:

i. Simplifying filing of documents
ii. Coordination between off-site analyst and on-site inspectors
iii. Staff training
iv. Communication and outreach to the pension scheme industry
v. Review Act and Regulations
vi. Ensure industry education is at the appropriate level
vii. More advanced education for RBA staff

WAY FORWARD

Schemes are required to take note of the above processes which will be applied by the Authority in implementing risk based supervision. In the meantime, schemes are required to fill truthfully and accurately the interrogatories which will provide the basic information for assessment of the scheme's risk level. The interrogatories will be filled annually by all schemes.

Issued this **1st** Day of **October** 2010

EDWARD O ODUNDO

Chief Executive Officer