ENWEALTH FINANCIAL SERVICES LIMITED
NEW ASSET VALUATION REGULATIONS

PRESENTATION BY RCL

February 2024

About Us

ABOUT US

- ❖ RCL is an East African-based consultancy providing actuarial, financial modelling and risk management advice.
- ❖ Registered by both RBA and IRA.
- ❖ 2017, awarded the Fund Actuary of the Year by the Institute of Pension Management in Kenya.
- ❖ 2018, accepted into the International Benefits Network.
- ❖ 2020, winners of the Employee Benefits Consultancy Firm of the Year category in the 2020 Global Advisory Experts Annual Awards.

FOOTPRINT

Global
United Kingdom
Middle East
India
Mexico

Rest of Africa
Nigeria
Sierra Leone

Eastern Africa
Kenya
Tanzania
Uganda
Rwanda
Mauritius

VALUES

- ❖ Client Focus
- ❖ Reliable
- ❖ Agile
- ❖ Clear
- ❖ Informative
- ❖ Integrity

Speaker Profile

Darshan Ruparelia FIA FeASK FAST – Director at RCL

Darshan Ruparelia is a Fellow of the Institute & Faculty of Actuaries (UK) with over 15 years of experience in advising public and private sector employee benefits' schemes.

Darshan relocated to Kenya from the UK in 2013 to set up the new actuarial consultancy, RCL.

Darshan advises both trustees and sponsors of employee benefits' schemes in the areas of scheme funding, scheme design, investment strategy, accounting valuation, risk benefits, cashflow modelling and projections, actuarial factors and member communications.

He also advises both life and general (re)insurance companies in the areas of pricing, reserving, quarterly and annual liability valuations, reinsurance arrangements, asset-liability modelling and preparation of Financial Condition Reports.

Darshan is also a Fellow of The Actuarial Society of Kenya (TASK).

Introduction

- RCL is pleased to provide an essential update to Enwealth Trustees regarding recent regulatory changes affecting asset valuations and income distribution to members.

- Retirement Benefit Regulatory Changes
- Pros and Cons of the Valuation Approaches
- Views from stakeholders in the industry
- The Way Forward for Enwealth BOT
- Embracing Asset-Liability Matching
- Q & A

Retirement Benefit Regulatory Changes

Legal Notices No. 18-22

- Legal Notice No. 18 of 2024 – Managers and Custodians Regulations, and Legal Notices No. 19 to 22 of 2024 – Amendments to Retirement Benefit Regulations, amended the requirements for asset valuation of pension schemes in Kenya and returns credited to members' accounts.

- These legal notices came into effect from 21 December 2023, and investment reports and financial statements as at 31 December 2023 are expected to comply with the amendments.

Retirement Benefit Regulatory Changes

Legal Notice No.18 of 2024

- This legal notice refers to an amendment made to Regulation 5 (Managers and Custodians Regulations, 2000).

- The amendment specifies the content requirements for investment reports submitted by managers of retirement schemes.

- Investment reports must now include performance figures for financial assets available for sale and financial assets intended to be held to maturity, separately.

- Performance figures (a one-year and three-year time-weighted performance figure) for *financial assets available for sale* should be calculated using a ***fair value approach***. (Debt + Equities)

- Performance figures for *financial assets intended to be held to maturity* should be based on an ***amortized cost approach.*** (Debt instruments)

Retirement Benefit Regulatory Changes

Fair Value Approach (LN18)

Values assets based on their current market prices, which can fluctuate over time due to changes in market conditions.

Amortized Cost Approach (LN18)

Values assets based on their historical cost and is typically used for financial assets held to maturity, aiming to reflect the original investment value rather than market fluctuations.

Retirement Benefit Regulatory Changes

Illustration

Fair Value Approach	Amortized Cost Approach
Initial Investment: \$10,000 zero coupon bond. Yield to Maturity at start: 14% Assume the yield of a 10-year zero coupon bond has gone up over the year to 18% Purchase price of bond at start: $\left(\frac{10{,}000}{(1+0.14)^{10}}\right) = 2697$ Return of the bond at the end of year 1: $\left(\frac{\left(\frac{10{,}000}{(1+0.18)^{10-1}}\right)}{2697} - 1\right) \times 100 = \mathbf{-16.4}\%$	Initial Investment: \$10,000 zero coupon bond. Yield to Maturity at start: 14% Assume the yield of a 10-year zero coupon bond has gone up over the year to 18% Purchase price of bond at start: $\left(\frac{10{,}000}{(1+0.14)^{10}}\right) = 2697$ Return of the bond at the end of year 1: $\left(\frac{\left(\frac{10{,}000}{(1+0.14)^{10-1}}\right)}{2697} - 1\right) \times 100 = \mathbf{14.0}\%$

Retirement Benefit Regulatory Changes

Legal Notice No.19-22 of 2024

The legal notice made amendments to:

1. Regulation 16 of the Retirement Benefits (Income Drawdown Funds) Regulations, 2023
2. Regulation 28 of the Retirement Benefits (Income Drawdown Funds) Regulations, 2023
3. Regulation 28 of the Retirement Benefits (Individual Retirement Benefits Schemes) Regulations, 2017
4. Regulation 36 of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000 and
5. Regulation 42 of the Retirement Benefits (Umbrella Retirement Benefits Schemes) Regulations, 2000

Retirement Benefit Regulatory Changes

Interpretation

- Unrealized gains and losses resulting from the valuation of financial assets **using the fair value approach** will not be considered part of the distributable income for income drawdown funds, individual retirement benefit schemes, occupational retirement benefit schemes and umbrella retirement benefit schemes.

- RBA has clarified that the above applies to debt instruments (bonds). Equities?

- The regulations are silent on how to treat unrealized gains/losses under the amortized cost approach.

- This is a new provision which was not provided for in the regulations previously.

Retirement Benefit Regulatory Changes

Fair Value Approach (LN19-22)

Under this approach, unrealized gains/losses resulting from changes in the value of financial assets, such as bonds, are not considered part of the distributable income for retirement benefit schemes. These gains/losses are only realized and included in the income when the assets are sold or disposed of. Coupons are realized.

Amortized Cost Approach (LN19-22)

While regulations are silent on unrealized gains/losses under the amortized cost approach, either of the following treatments can be inferred:

1. Similar to the fair value approach
2. Declare a return taking into account unrealized gains/losses, but assuming that assets are indeed held to maturity in practice. If assets end up not being held to maturity, then this could result in an actual gain or loss being realized. Where a loss is realized, it is unclear who will meet members expectations of transfer value.

Retirement Benefit Regulatory Changes

Illustration

Fair Value Approach	Amortized Cost Approach
Value of the bond at start: \$10,000	Value of the bond at start: \$10,000
Value of the bond at end of year 1 (based on return calculated in above example):	Value of the bond at end of year 1 (based on return calculated in above example):
$10{,}000 \times (1 - 0.164) = 8{,}360$	$10{,}000 \times (1 + 0.14) = 11{,}400$
Unrealized gain/loss = Value now less value of initial investment	Unrealized gain/loss = Value now less value of initial investment
$8{,}360 - 10{,}000 = \mathbf{-1,640}$	$11{,}400 - 10{,}000 = \mathbf{1,400}$

Pros and Cons of the Valuation Approaches

Fair Value Approach	Amortized Cost Approach
Pros: ▪ Aligns with market realities ▪ Provides an accurate valuation ▪ Allows for more timely recognition of changes in asset values ▪ Promotes consistency by valuing assets at their current market prices ▪ Consistent with global best practice ***Cons:*** ▪ More volatile due to asset value fluctuations ▪ The focus is mainly short-term ▪ Involves subjective judgements (non-marketable assets)	***Pros:*** ▪ Simplistic and requires less frequent assets revaluation ▪ Long-term perspective on investments ▪ Less volatile ▪ Consistency in financial reporting between years ***Cons:*** ▪ Inflation may not be properly priced in ▪ Assets may be undervalued or overvalued ▪ Potential misrepresentation of the scheme's financial position ▪ May be less relevant in rapidly changing market conditions

Industry Stakeholder Views APTAK

APTAK clarifications on LN 18-22 of 2024

- The Association of Pension Trustees and Administrators of Kenya (APTAK) held a consultative forum on 2 February 2024

- The forum aided discussion on concerns related to the application and administration of the Legal Notices No.18-22 of 2024.

- The forum included key representatives from the pensions industry such as:
  1. Scheme Administrators
  2. Actuaries,
  3. Accountants,
  4. Auditors,
  5. Trustees and Secretariats of pension schemes

Industry Stakeholder Views APTAK

Key Areas of Concern Raised

- Classification of financial assets (how much HTM vs tradable?).
- Treatment of unrealized losses and gains in the pension scheme statement of financial position, **including approaching member sensitization on the proposed changes and their benefits** (ICPAK notice sheds some light here – covered on next slide)
- Possibility of having reserve funds for unrealized gains or losses and limitations – mismatch between value of assets and member balances
- Who owns the reserve funds?
- Unusual occurrences eg liquidation of assets
- Implementation timing and process (eg how prior years should be treated), including fees charged by service providers who quote on the basis of asset value.
- Legal concerns in legal notices 18 to 22 of 21st December 2023 covering how this new regulation was introduced in the market eg no public participation, quoting non-existent laws for the amendments etc.

Industry Stakeholder Views ICPAK

- Financial Reporting Standards:
  - Retirement Benefits Schemes will continue preparing financial statements in accordance with International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) – ie market value of assets.
  - Legal Notice 18 of 2024 applies to reports prepared for trustees, not financial reporting.

- Disclosure Requirements:
  - Amendments focus on disclosure requirements by Trustees to Members.
  - Net return declared and credited to members' accounts should exclude unrealized gains and losses from changes in the fair value of financial assets (bonds).

- Basis of Determination:
  - Reports by Trustees to members should include a memorandum detailing the basis of determination of the net return.

Industry Stakeholder Views FMA

- RCL sources have reported that the FMA has asked for clarification from the RBA on whether their current reporting structures need to change or not

- Fund Managers already meet, to an extent, the valuation requirements (short term bonds less than a year held to maturity, while long term bonds and other financial instruments are tradable) though there may be more focus now on which assets are held to maturity

- Fund Managers do not get involved with distributing income to members

The Way Forward

- There is an RBA public participation happening in Nairobi on 29 February to 1 March which we will be attending to gain further views on the development of the new regulations

- We will be glad to share with you the industry stakeholder documents from APTAK and ICPAK for your reference

- How to benefit from amendments?
  - Trustees are guided to follow updates and guidance on this from all stakeholders in the industry
  - If reporting does change, be aware of the market value of assets (true value) and member communication is vital!
  - Encourage provision of liability cashflows to FM's so that they can structure their investments to meet cash outgo (where multiple FM's exist, they shouldn't be operating in silos)

- Big picture goal – how to target better returns for members?
  - Consider undertaking ALM exercise for the next IPS update
  - Offshore and alternative assets

Embracing Asset-Liability Matching

What is ALM?

- This is a powerful tool that aligns investments with future obligations, safeguarding the financial well-being of pension funds.

- It involves investing in assets that generate cash flows in line with the timing and amount of the pension payments that need to be made.

Embracing Asset-Liability Matching

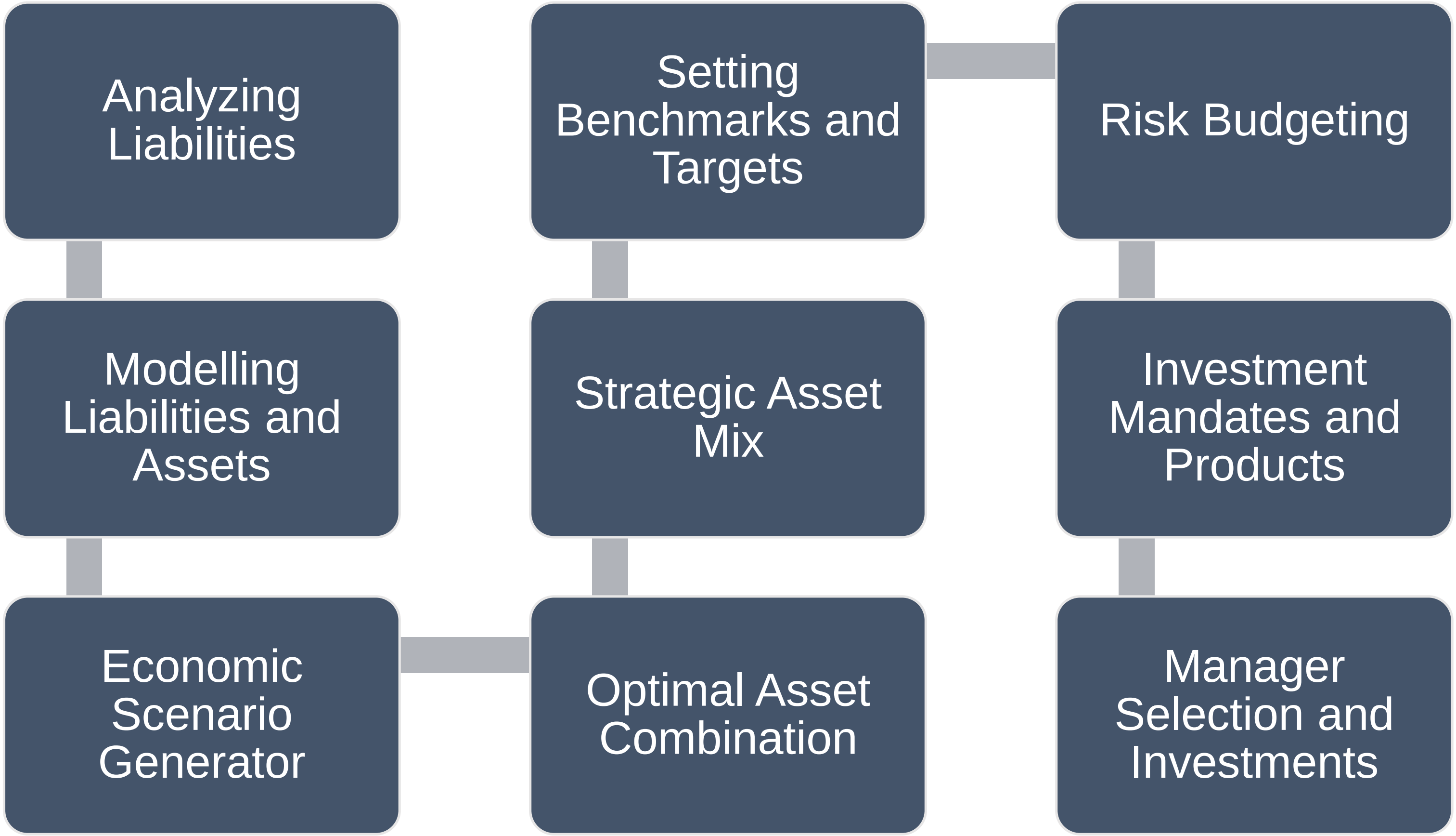
Why does ALM matter?

It is crucial in pension schemes for several reasons:

- Certainty of future payments: Ensures that pension promises are met through liability profiling and as a result cashflow planning.
- Volatility mitigation: By investing in assets with cashflows that align with the timing and amount of future liabilities, pension funds can reduce the risk of sudden fluctuations in the value of their investment portfolio.
- Long-term sustainability: By adopting an ALM approach, pension schemes can better manage their cashflow requirements and maintain the financial health of the fund over the long term.
- Maximizing investment performance and/or minimizing risk
- Regulatory compliance: ALM helps in making prudent investment decisions to ensure maintenance of sufficient assets to cover future liabilities.
- Member confidence

Embracing Asset-Liability Matching

The ALM Process



Embracing Asset-Liability Matching

Implementing ALM: A Tactical Approach

Investment Policy Statement (IPS):

- IPS serves as a long-term guidepost, outlining goals and systematic review processes.
- It clarifies responsibilities and provides a baseline for monitoring performance.

Development of Asset Class Structures:

- Implement the asset allocation resulting from the ALM process.
- Establish asset allocation ranges to manage deviations from the long-term strategic allocation.

Review of Investment Mandates:

- Assess the suitability of investment mandates and manager architecture based on the Investment Policy Document.

Liquidity Considerations:

- Address liquidity constraints when implementing mandates in each asset class.

Closed vs. Open-Ended Portfolios:

- Consider the advantages and complexities associated with closed-ended and open-ended portfolios.

Time Horizon:

- Tailor investment strategies to align with varying pools of liabilities and their respective time horizons.

Tax Considerations:

- Monitor and adapt the investment strategy in response to changes in tax policy.

Q & A

GET IN TOUCH

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