INVESTMENTS (SLY CONSIDERATION)

Savings and Credit Cooperatives (SACCOs) have found themselves commanding a large percentage of savings in the financial sector. This has driven the citizenry to trust the management of the SACCOs in not only safekeeping of their money but also to provide a good return on it.

A statement of financial condition of the SACCO gives a snapshot of the ‘health’ of the institution at any given time. The statement has a liability side (sources of Funds) and Assets (Uses of Funds). Once the members deposit their money in the SACCO, the management has a responsibility to ensure the members will get their money back, and should give interest being a reward for using the members’ money for their operations.

While the sources of funds for the SACCO Marjory include members’ savings, the uses of funds are the SACCOs’ investments. The investments include loans which take a major share, financial investments, liquid investments, non financial investments and other investments in regulated financial institutions.

The SACCO while looking for where to invest members’ funds should consider the Safety, Liquidity and Yield. This should all be integrated into the SACCOs investment policy and a proper appraisal should be done on the investment vehicle being considered for use.

A. SAFETY

Safety refers to the ability to collect 100% of the SACCO’s investments plus interest earned in that period. When there are no regulations on investments and also there is no guarantee on their investment, so there is a great deal of risk. In addition, there are other certain investment risks that do exist for SACCO’s. These risks include:

1. Market risk
   It is a possible reduction in value resulting from changes in market demand. This is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

2. Interest rate or maturity risk
   A possible reduction in value resulting from increases in interest rates. It can also be described as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Also known as asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets).
The savings and loan crisis in the 1980s in the United States resulted largely from the mismatching of assets and liabilities. The savings and loan institutions (S&Ls) had financed themselves primarily with short-term deposits while investing in long-term, fixed interest rate mortgages. When the cost of short-term funding rose quickly, the S&Ls were not able to restructure their asset base fast enough.

To reduce the mismatch between short-term variable rate liabilities (e.g., savings deposits) and long-term fixed rate investments, managers may refinance some of the short-term borrowings with long-term fixed rate borrowings. This might include offering one and two-year term deposits as a product and borrowing five to 10 year funds from other sources. Such a step reduces interest rate risk and liquidity risk, even if the SACCO pays a slightly higher rate on those funding sources.

To boost profitability, SACCOs may purposely “mismatch” assets and liabilities in anticipation of changes in interest rates. If the asset liability managers think interest rates will fall in the near future, they may decide to make more long-term loans at existing fixed rates, and shorten the term of the SACCO’s liabilities.

3. Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation (IFRS). It can also be defined as a possible loss if the issuer of an investment defaults. (This could result from imprudent investments in savings and loan associations and banks in excess of insured limits, or investments in weak financial institutions where deposits are not guaranteed.)

In relation to loans, it refers to the probability that a borrower may not repay a loan. Credit risk is a significant concern for SACCOs. Decisions to grant loans are based on information about a borrower’s ability and willingness to repay a loan at the time a loan is made. Thus, credit risk can be controlled to some extent by the establishment of sound investments and lending policies and procedures. The management of the SACCO should be able to ascertain that the investing and lending policies are adequate with an elaborate account on how the SACCO intends to mitigate on these risks, and ensure it is followed as well. However, since economic and other factors may vary over the life of the investment or loan and the credit risk fluctuates over time, there is need to continuously appraise these investments in relation to the apparent risks.

In planning an audit of a SACCO, the management should be alert to factors that may indicate increased levels of credit risk. Such factors include:

- Weak or undocumented investment policies and procedures.
- Unfavourable trends in general economic conditions.
• The declining financial condition of the SACCO's sponsoring organization or field of membership.

• Significant loan concentrations (Skewness towards investing in a particular sector that is prone to risk).

As all these risks affect the safety of the investments, there is need for continuous appraisal of the investments in the wake of any signs that point towards a given risk. This goes line in line with the ‘Safety First’ principle in investment.

4. Price-level risk
This refers to a possible reduction in purchasing power of the shilling as a result of inflation. SACCO's can reduce investment risks by fully evaluating each type of investment prior to purchase, including the issuer, analyzing the financial condition and reputation of any intermediary to the transaction, such as a broker/dealer; and diversifying the investment portfolio by type, maturity, geographical location, guarantor, etc.

5. Other Risk
Substantial risk is incurred in investments. Prepayment risk is the most common of the secondary risk incurred by SACCOs and can lead to increased interest rate risk. Prepayment offset the positive gains a liability-sensitive SACCO can reap in a falling interest rate cycle because fixed rate instruments would be refinanced into lower-priced instruments. Thus, the net interest margin is squeezed. Therefore, management must carefully price its products in a falling rate cycle or at a time when the cycle is in a trough. Building a loan portfolio from low priced obligations will ill-prepare a SACCO for future market upswings. After a SACCO understands the risks of managing the balance sheet, it must be able to quantify the level of risks existing. The size and complexity will govern the tools required to do so.

B. LIQUIDITY
Investment policy must be flexible enough to allow for changes in the balance sheet items that represent member needs, i.e., savings and loans. As such, investment practices can be considered a function of savings and loan behavior. Each time there is a shift in either savings or loan volume; this may require a shift in the investment strategy. Suppose, for example, the board of directors decides to expand loan policies by offering longer-term loans to meet member needs. This will result in a slower turnover of funds, and thus will expand the loan portfolio. If savings deposits cannot be expected to meet the increased loan demand, investment policies must reflect a change. In this case, the SACCO would probably shorten investment maturities to meet the expected loan demand. Another factor, which would affect liquidity, is the movement and direction of interest rates. As they increase, the value of long-term
securities decreases. Thus a SACCO with long-term securities during a period of increasing interest rates would become illiquid unless the loss incurred through their sale could be absorbed.

C. YIELD

Only after liquidity and safety are considered should investment analysis center on yield. As a general rule, investments with higher risk factors and greater price volatility command the greater yield. Thus the potential for greater income must be weighed very carefully against the risks of reduced liquidity and/or potential losses.

The yield of each investment portfolio should be continuously appraised and should be justifiable. The SACCO should invest most of its funds in loans. However, once a SACCO diversifies to other investment channels, the SACCO has to invest in a portfolio that gives more or equal than the market rates of return.

Yield for investment X is calculated as;

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\text{Yield} = \frac{\text{Income from investment X}}{\text{Amount of Investment}} \times 100\%
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The rule of thumb is the higher the yield the greater the investment. However as previously explained, yield should not be the major factor.