Financial services

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Inside

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Editorial

The articles in this edition of the Financial Focus address some of the more significant and strategic issues that key players in the financial services sector face in the current changing landscape in Kenya. Probably the most visible of these changes are the consolidations that have taken place in the recent past as well as branch network expansion and alternative distribution channels that a number players have embarked on, particularly in banking.

The mergers and acquisitions we have witnessed include those between Commercial Bank of Africa & First American Bank, East Africa Building Society & Akiba Commercial Bank and lately Stanbic & CFC bank. A few years ago, there was also a take-over of the general insurance business of Alico Kenya by the CFC Group.

Behind the scenes, we have seen a number of key players in the financial services sector changing their core systems in a bid to achieve greater efficiency and to improve the quality of services. The move towards modern systems is also motivated by the need to comply with increasing regulatory demands or more onerous financial reporting standards. The choice of a core system that meets an institution's key requirements is no mean feat and usually calls for professional help from system experts.

The buoyant trading at the stock exchange and the interest Kenyans have shown in investing in stock has led to some individuals investing through companies or investment clubs. Unfortunately, the current tax laws do not offer much incentive to such groupings. In this edition we look at the case for investment trusts.

More generally, employers in Kenya and the world over are looking for innovative ways to recruit and retain their best employees. Whilst some multinationals have share schemes which allow Kenyan employees, especially the top executives, to participate in the parent company shares, an increasing number of indigenous companies is looking to develop share schemes. One of the key considerations for such an arrangement is the tax consequences for both the employer and employee.

I welcome you to read on.

Charles Muchene
Country leader and leader of the Financial Services Group in Kenya

Consolidation in the financial services sector

The global financial services sector has evolved significantly through consolidation

Globally, the financial services sector has been dramatically altered as a result of globalisation, deregulation and advances in information technology. Such changes have taken their toll on the margins of financial institutions, causing them to seek economies of scale and scope through consolidation.

Typically, financial institutions in mature markets use consolidation as a means to eliminate excess capacity more efficiently than bankruptcy or other means of exit, whereas in emerging markets, consolidation has largely occurred as a way of dealing with problems stemming from financial crisis.

To grow in small markets, financial institutions in emerging markets commonly look for cross border mergers. This has been the case notably in the Latin American, Central European and Asian markets with the dramatic increase in foreign ownership of emerging market banks. In Africa, Ecobank, based in Togo, has spread its wings throughout West and Central Africa, and particularly in Nigeria through a deal with First Bank of Nigeria. The role of market forces is more dominant in mature markets, whereas regulatory authorities have typically played a dominant role in the financial sector consolidations process in emerging markets.

What drives consolidation in emerging markets?

The small scale of national markets in emerging market countries is a constraint to the growth and efficiency of financial services. Modern technology platforms, increasingly essential in every bank, are dependent on scale to be cost effective. Larger banks are able to realise the benefits of scale and can create "virtual regions" by the size of their network.

The insurance sector in emerging markets is characterised by high operating costs, low penetration rates and widespread ignorance of the purpose of insurance. Insurers are limited in their ability to diversify their risk, and regulations force large insurers to reinsure a portion of their risk with local firms – who often lack financial capacity and are perceived as technically weak and poorly governed.

Small markets are often incomplete, missing certain financial services and ancillary components such as credit information services. Financial institutions are less able to diversify investment and operational risks, thereby increasing their volatility, and the regulatory infrastructure is of higher cost and lower quality.

Increasingly, regulation in emerging markets is permitting the convergence of financial services like banking, insurance, asset management services etc. Banks are merging with other banks as well as with securities and insurance firms to exploit economies of scale and scope. The strengthening of regulatory requirements has also highlighted inefficiencies and generated higher costs for medium and small-sized banks that are feeling increasing pressures to sell, merge, or exit the market.

There have been discernible patterns of consolidation across regions. In the Asian countries affected by the financial crisis of 1997-98, consolidation was a means to bring the financial sector back on track. In Latin America, the regulatory authorities in Brazil and Argentina carried through a process of guided consolidation where they separated and sold troubled banks . There were also several private sector M&A deals in the region during the late 1990s, driven by the larger domestic private banks' attempts to remain competitive, as well as many medium and small banks wishing to gain economies of scale through merger. In Central Europe, there was an entry of a large number of foreign banks in the early 1990s due to liberal entry policies and privatisation in the late 1990s. The consolidation trend started in 2000 and was driven by stronger banks being forced to absorb weaker ones to ensure continued stability, by shareholders deciding to exit the market and by mergers of the parent companies of a large number of the foreign banks that were established in the region.

In Nigeria, new minimum capitalisation for banks was announced in July 2004 as N25billion (approximately $181m) – all banks were expected to comply with this directive by December 2005. This was responsible for the spate of mergers and acquisitions seen in Nigeria in 2004 and 2005 as banks strived to comply with the directive.

There are also several factors that discourage consolidation particularly in emerging markets – lack of information and transparency, different regulatory frameworks (particularly for cross border transactions), ownership structures, and cultures. Ownership structures, in particular family ownership, regulatory shortcomings, and concerns about job losses are usually major obstacles to a market-driven consolidations process. Only a few banks are publicly listed in emerging market banking systems, and this makes takeovers difficult to carry out.

Kenya has been going through a period of consolidation and growth

Kenya is fast realising the benefits of a stronger banking sector and increased competition. Over 40 commercial banks are licensed to operate in Kenya and of the four largest banks, two are subsidiaries of foreign banks and two are state controlled. Several banks have attempted to reduce operating costs by consolidating back offices and management functions for example Citigroup and Standard Chartered Bank in Nairobi. But even so, operating inefficiencies remain due to multiple corporate structures and the need to conform to multiple regulatory and supervisory requirements. There has been significant development and growth of medium sized banks creating a new competitive environment which has forced the large banks to go out and compete in other market segments, such as SMEs, away from the traditional blue chip companies.

The banking sector has been going through a period of restructuring and consolidation over the past decade or so – with several shaky banks closing down or put under statutory management by the Central Bank. The Government has had a hand in the restructuring of the National Bank of Kenya – recently restructuring a significant NPL portfolio, and Kenya Commercial Bank has also undergone restructuring.

To a lesser extent this trend has also been seen in the insurance sector in recent years, which saw the closure of Lakestar and United Insurance due to a weak financial base, and the takeover of Alico Kenya by the CFC Group, a few years ago. The most recent merger transaction in the financial sector involving banking, insurance as well as brokerage services is the Stanbic acquisition of the CFC Group. However since the laws in Kenya do not yet allow universal banking – these operations are expected to be run separately in the foreseeable future.

Despite the above developments, the financial sector in Kenya is concentrated in the hands of a few players, while the lower end is still very fragmented with a number of small players. Many of these make little or no impact on the sector as a whole and their viability is questionable. In addition to addressing the stability issues of financial institutions, the new capital requirements announced in this year's budget will force many banks and insurance companies to reconsider their market strategies and jump start the path to consolidation. Capital requirements for banks have increased to KShs 1 billion in steps over the next three years, whilst for general insurers to KShs 300 million, long term insurers to KShs 150 million and composite insurers to KShs 450 million. As a result market players expect to see an increased level of merger activity over the next three years, particularly in the insurance sector and to a lesser extent in the banking sector, as institutions strive to meet the increased capital requirements.

In a country where political risk is perceived to be high and attracting foreign investment is important to development, the creation of a stable financial services sector is essential infrastructure.

Ananya Sen Gupta is an Assiociate Director in Transactions and Cezanne Maherali is an Executive in Transactions.

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The case for Investment Trusts

It makes good economic sense and good political sense for the burden of tax to be the same for people in similar circumstances. Where tax falls more heavily on certain transactions, people's choices will be biased against these transactions creating economic inefficiency. Where differing tax burdens fall more heavily on one group of citizens than another, political bias is created. Savings and investments are a critical source of finance to develop Kenya. Economically, do our tax laws place artificial constraints on innovative financing? Politically, does the tax system favour big money or small investors?

The basic issue in taxation of savings and investment is that direct investment suffers one layer of taxation while indirect investment leads to two. Take the simplest example: I buy shares in one company on the Nairobi Stock Exchange for Shs 100,000 and earn dividends in the year of Shs 2,500. These are paid under deduction of 5% tax leaving me Shs 2,375. Looking to spread my risks, I form a company with nine friends and we each invest Shs100,000. Our company then invests Shs 1 million in a range of companies and our company receives dividends of Shs 25,000 or Shs 23,750 after tax. We want to receive our income personally, however, and request that our company pay us the dividends it has received. It pays out a dividend of Shs 23,750 but deducts tax at 5% leaving Shs 22,562.50c for the shareholders of which my share is Shs2,256.25c. By seeking to spread my risks by combining with my friends, I have increased my tax rate on dividends from 5% to 9.75%.

Our tax system recognises that the small investor suffers a tax penalty if he combines to gain the advantages of larger scale investment. This is why the proceeds of a life insurance policy are paid tax free, why payments from an unregistered pension scheme are paid tax free and why dividends and interest from unit trusts are paid tax free. These are not tax incentives to use collective investments. They are rather the removal of the second layer of tax which is a disincentive to collective investment. Similarly, with innovative finance arrangements such as securitisation the law now removes the second layer of taxation that otherwise arises when a financial institution bundles loans together and offers them to investors. The tax exemption removes a disincentive to innovative finance rather than creating a tax incentive to use it.

The smaller investor on his own is limited in the range of investments he can make. The saccos, and banks in which he deposits his money are limited in the contribution they can make to Kenya's need for capital investment in infrastructure, housing, hospitals, schools, and new companies. Banks taking retail deposits recycle them into short term loans to established businesses and government bonds. Kenya needs to harness investors looking to move beyond bank deposits, and wary of the risks of investing in small parcels of shares on the stock market, and provide them with investment opportunities that create longer term investment capital. Unit trusts are a start in fulfilling this need but they have inbuilt disadvantages. Their potential for investment is limited by the need to have funds available to repay exiting unit holders. As such they are only suitable for investing in liquid, listed shares and bonds. A company structure, rather than a trust structure, is needed to give the managers confidence to invest long term. The departing investor recovers his money by selling his shares in the fund to a new investor rather than by withdrawing his money from the fund.

Such a corporate investment vehicle currently suffers from exactly the double burden of tax illustrated above. Such a company not only double taxes dividends and interest but as a result of compensating tax turns tax-free capital gains into taxable income. The only tax exemption is for an approved Venture Capital Company. This tax exemption has proved of limited use in Kenya because it is largely restricted to investing in the shares of unquoted small or medium, Kenyan resident companies with a number of industry sectors excluded. As such it is not a suitable vehicle for the smaller investor. Indeed, larger investors as well are looking to diversify and spread risk by investing regionally, in loans and bonds as well as shares, and in a balanced portfolio of industries. As such the Venture Capital Company is a lame, if not totally dead, duck.

In the nineteenth century, there was a huge demand for capital to develop the American west. Much of that capital came from the UK through a vehicle called the Investment Trust. Despite the name, an Investment Trust is a listed company which invests in the debt and equity of other companies. Subject to meeting certain regulatory requirements, it is permitted to distribute its income and capital gains to shareholders without the double taxation that otherwise arises when investment is channelled through a company. Kenya's corporate law is similar to the environment that invented the Investment Trust. We don't need to re-invent the wheel. Let's give Kenyan investors, large and small, the opportunity to invest long term in Kenya's infrastructure and economy without suffering double taxation. This does not mean giving a tax incentive and losing tax revenue. Instead, it is removing a disincentive to effective investment with the prospect of increased tax revenues from increased investment and economic growth.

Steve Okello is a Tax Partner and is the leader for the tax business in Kenya.

Modern banking systems

Introduction

Financial institutions all over the world continue to rely heavily on technology and continue to invest on new technologies. Financial Institutions in East Africa have not been left behind and a significant number of banks have embarked on projects to replace or upgrade existing systems.

The key drivers for the increased use of information technology are grounded on the reliance that the industry places upon financial institutions today to cope with processing large volumes of data, reduce costs and increase profits.

The most successful banks demonstrate responsiveness, flexible sourcing and balanced management of the customer experience. They integrate many access channels to offer customers a fast response to queries, more choice, good advice and valuable services.

Legacy systems

For many years, financial institutions have run their operations on legacy systems. In general, legacy systems have offered reasonable levels of support and reliability. Systems originally conceived and developed in the 1970s have proven capable of supporting banks for decades longer than their original designers envisaged. They have done this at a relatively high cost but fortunately the banking industry has generally been successful and lucrative during this period. The challenge for banks has been to ensure that their replacement systems offer the expected improvements whilst protecting the reliability and longevity of the legacy system. However, legacy systems, which are built on older technologies such as flat file databases, do not support modern data interchange methods and require secondary applications to carry out functions such as MIS.

As a result of changes in customer and operational demands, banks have been forced to introduce peripheral systems to perform a myriad of tasks outside the core banking system. With the advent of web based technologies and mobile devices, customers are increasingly demanding alternative and more convenient channels to access financial services. This has resulted in some banks managing up to 50 applications - a daunting task for IT departments, particularly with the increased risks of security lapses.

Drivers for change

East African Banks today are increasing their focus on updating their key customer contact and delivery channels — the branch, contact centres, websites, mobile applications and interactive voice response. Although some initiatives focus on technology replacements or system additions, banks are increasingly tackling the re-engineering of their customer-focused business processes.

A key impediment to the delivery of a consistent customer experience is disintegrated applications that are not designed to share information, transactions and messages. Regulatory compliance worldwide (Basel II, Sarbanes-Oxley and data privacy laws everywhere) have joined drives toward increased operational efficiency to support workflow automation. This, in turn, will support standard procedures with auditable and transparent business processes.

The following factors continue to have strong influence the uptake of modern banking systems in the financial services sector:

- continued increase in the cost efficiency of all areas of IT;.
- increased adoption of electronic delivery channels. This includes further acceptance of the internet including mobile banking;
- increased pressure on high margin business such as payments from new competitors and regulators;
- increased competition from more agile and often specialised competitors offering new and innovative products and delivery channels;
- increased commoditisation of many financial services such as payments leading to pressure on margins and encouragement to reduce costs with innovative methods such as outsourcing;
- continued increase in regulatory and compliance pressures. More specifically, we expect these to become more intrusive within the organisation, demanding greater organisational and IT change;
- increasing requirement for business technical architectures to move outside the enterprise boundaries and directly support end-to-end business processes, covering partners, suppliers and customers;
- mature realisation of value from peripheral changes such as front office solutions and CRM, meaning that the bottleneck is now the core banking system;
- expensive and complex IT environments with many specialist products. This arises from a history of piecemeal enhancement or from mergers and acquisitions; and
- more sophisticated and educated customers who are willing to switch banking service suppliers.

Modern banking systems

Modern banking systems offer rich capabilities in all functional areas of banking operations. Banks have now settled on packaged software for new core banking applications. It is now unheard of for a bank to embark on a bespoke core system build.

Fortunately, banks benefit from a mature supplier industry that offers strong software and efficient outsourcing, mature standards, such as SWIFT messaging, and are well placed to further benefit from emerging general standards such as web services and Service Orientated Architectures. Today's banking platforms are able to cope with continuously changing business environments and a continuous flood of new requirements, by staying sufficiently agile.

While some banks have already started to move toward a new banking platform, others still need to do so. Whether you are considering replacement or upgrade of your existing system, you need to undergo a thorough preparation based on a business foundation, as well as a clear set of IT requirements to select the right banking platform.

Overall, you should expect the following capabilities in your next generation banking system:

Customer centricity

Financial services institutions have moved away from the old design paradigm of product centricity and are now following the new paradigm of customer centricity. Today's banking systems offer interesting 360 degree views of customers, allowing bank employees to view customers holistically based on products purchased, wallet size, customer preferences and instantly provides a history of the customers' interactions with the bank.

Process centricity

This includes customisable standard processes out of the box as well as a process-oriented integrated desktop. This desktop, which is considered a channel, enables a bank employee to work with multiple customers and processes simultaneously.

Regulatory adaptability

A next-generation banking platform must support known and foreseeable regulatory requirements and be sufficiently agile to handle future regulatory changes in a cost-efficient way. Banks cannot afford to keep spending on the scale of a Basel II project — at least not without creating substantial business value.

Parameterisation

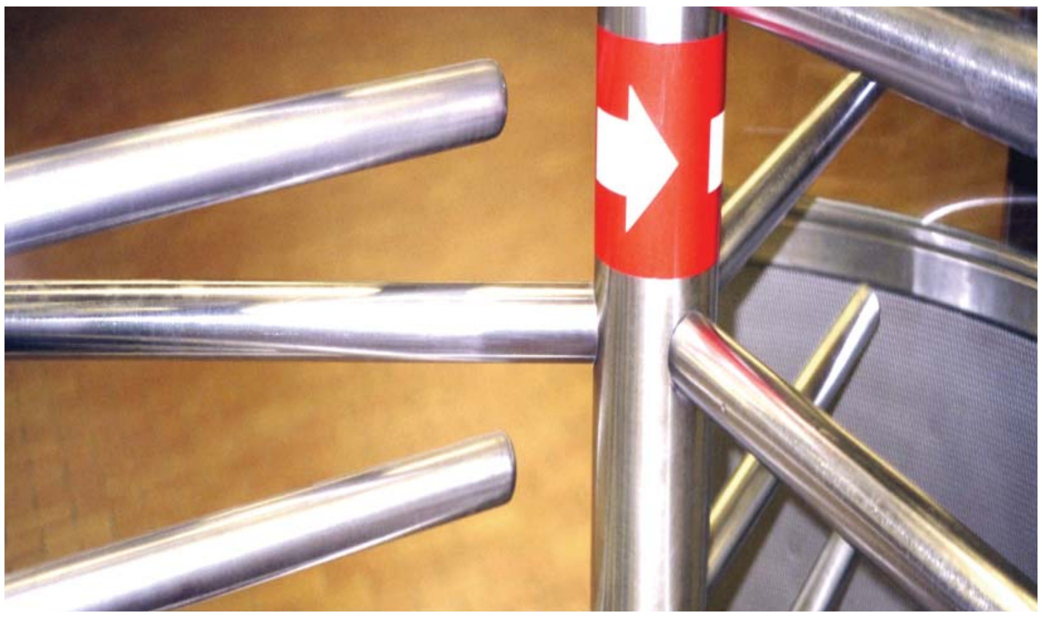
The next-generation banking platform needs a structured approach for implementation. It must handle structural organisation, branch hierarchy, authorisation, role concepts, account relationships, business process and workflow, product definition, product/channel allocation, and pricing, as well as deal with multiple countries — just to mention a few. Parameter usage also includes putting a new financial services product into production — a product that will probably span divisions, even companies — and supporting it.

Multichannel support

Support of all products and services must be seamless via all channels at all times, including both visual and non-visual formats, and support internal and external communications. Channels need to support communications within front, mid, and back-office workplaces, as well as external communications with corporate customers and other financial services business partners.

Security

A holitic approach to security includes integrating more infrastructure-oriented system security on one side and application security oriented more toward roles, functions, and structural organisation on the other. A key requirement for selecting or designing a next-generation banking platform is to avoid a "security by patches" approach but instead design the platform for security.



Real-time capability

Near-time capability can benefit many banks, considering that current banking platforms can be somewhat old-fashioned. These platforms are characterised by a patchwork of functionality added over a period of decades. Consequently, real-time capability includes both nearly immediate updates to positions and straight-through processing.

Platform agility

The banking platform must be designed around the concept of a banking backbone, integrating third-party and local or customised banking software applications or services that will be used on a service-by-service basis with varying levels of functional granularity.

Conclusion

Systems selections and implementations are intensive and time consuming projects, which if not managed carefully, may lead to costly projects that drain resources without achieving desired results.

PricewaterhouseCoopers' approach and experience in providing consulting services in system selection and implementation can help avoid many of the mistakes made by institutions in the past and create a banking platform that is as agile and flexible as possible for your institution.

Michael Shamku is a Senior Manager in Performance Improvement responsible for IT Effectiveness.

Running a bank, what is your strategy?

In 1989 when I first came to Kenya, I wanted to open a bank account. Armed with a reference from my employer (the bank's auditors) I visited my local branch, more in hope than expectation. A 30 minutes grilling by a bank clerk followed, after which I was grudgingly given a current account. Several years later, again after a mighty struggle, the bank even allowed me to use an ATM card in one of their few machines in Nairobi.

At the time, such experiences were par for the course. The conventional wisdom for much of the 1980s and 1990s was that retail customers were more bother than they were worth. They deposited small amounts of money in current accounts, involving banks in significant administrative hassle, whilst rarely using other more profitable services.

How different things are today. What we are seeing in Kenya (and elsewhere in East Africa) can rightly be described as a "Rush for Retail". Banks are now very much alive to the possibilities provided by retail customers. At a time when the cost of funds is reportedly as high as 10 per cent for some banks, retail funds are an ever more essential component of many banks' thinking.

For the consumer this is great news. As banks compete for retail business, both the level of service and the range of products offered are light years ahead of the grim days of the 1980s. Now there are premium bank accounts, credit and debit cards, readily available unsecured loans and mortgage financing, PesaPoints, sofas in banking halls, internet banking, not to mention M-Pesa which doesn't even require a bank account….

For the banks, however, this provides a dilemma. In the past, it was easy to plot the way to access retail customers: find a town that you are not in and open a branch. Today, faced with a plethora of options to attract customers life is more challenging.

And yet, at a time when in a recent PricewaterhouseCoopers survey[1] 9 out of 10 Kenyan banks rated the retail market as "intensely competitive", the same banks are, in aggregate, projecting a doubling in the customer base by 2010.

How do you maximise the opportunity provided by the retail sector? We recommend a systematic, rather than a haphazard approach to achieving the sort of growth numbers banks are targeting.

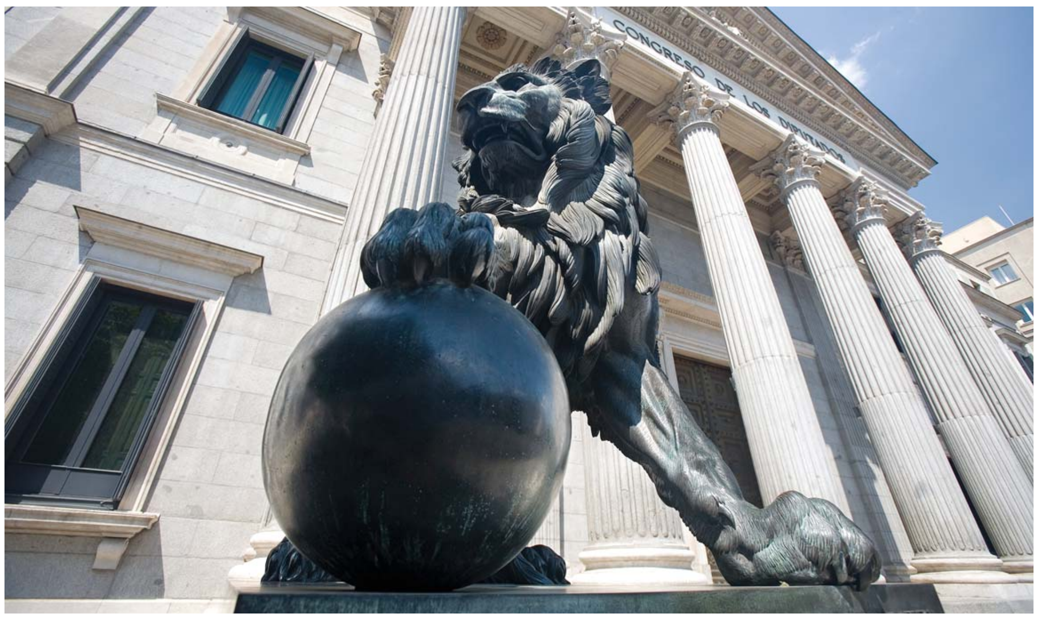
This requires that banks ask themselves some fundamental questions about the very nature of their business. In PricewaterhouseCoopers' 2005 global survey of financial services[2], five key principles were laid down; each has relevance today:

Identify and articulate what the bank does best

The first place to start is by developing or revisiting the bank's strategy. Without a focused approach that builds on the bank's core strengths, the bank's activity will be wasteful and chaotic.

It is clear that "conglomerate" or generalist strategies, in which a bank tries to be all things to all people, will no longer suffice. The more successful banks in

[1]Initial Perspectives on Strategic and Emerging Banking Issues in Key African Markets, 2007
[2]The Future of Financial Services: Piecing the Jigsaw, 2005



Kenya have emphasised traditional distinguishing features such as the customer segments in which they play or the products they offer.

Increasingly, more innovative approaches to strategy will be required. For example, a bank may wish to emphasise particular channels to market (mobile banking is the obvious example), or may have a different risk appetite from that of its peers.

Hone market positioning in line with demographic trends

It's true that there is a huge untapped market in Kenya. Notably, the unbanked rural population, the growing middle class, and small and medium scale enterprises (arguably part of retail) each represent potential for revenue growth.

However, there is a sense that many banks are still reactive to market trends rather than anticipating them. It is the first banks that recognised the rural potential who will most likely benefit. Similarly, it is the first to understand the opportunities from genuine telephone banking, in which customers are able to make all payments, transfer funds and arrange loans remotely who will win customers from this market.

All banks would be advised to regularly scan the market for trends - the external environment (the economy, social trends), the financial services market (what products and services are available here and elsewhere, what approaches are being taken by other banks), the regulatory environment, and developments in technology. Ideally, this information should be used to model various future scenarios as an input into developing and updating the bank's strategy.

Simplify the offering to customers

There is a great deal of welcome support from the Central Bank of Kenya for greater transparency in banking, particularly through the regular publication of fees and charges. This enables consumers to make informed comparisons of what is on offer.

Banks may be advised to go beyond this, by explaining both the reasons behind pricing structures, and the risk profiles of the various products that are offered. Building and maintaining trust through a genuine dialogue remains the best way to attract and retain customers.

Simplify the enterprise itself

There are significant gains to be made from running an efficient and effective operation – after all, there is little point in acquiring retail customers if each new customer is unprofitable. Key areas for simplification are technology (covered elsewhere in this issue), enterprise-wide risk management (examined in the last issue) and performance data across the organisation (to be discussed in the future).

Don't forget the most important ingredient – people

There is little point in developing a perfect strategy with efficient and effective processes targeting the right market segments if you don't have the staff with the right skills and - especially – mindsets to deliver.

Changing the minds of employees is notoriously difficult. Successful change requires a programme of 18 months and more, beginning with an assessment of existing culture (normally through structured surveys) through a co-ordinated programme of training interventions supported by improvements to processes, systems and the organisation itself – including job evaluations and grading systems that place a higher premium on customer-related activities.

These recommendations may seem daunting; indeed for some institutions they are nothing short of corporate transformation. However, without a logical, rational approach, the Rush for Retail is a perilous undertaking indeed.

Guy Maughfling is a Performance Improvement Partner responsible for the Human Resource Services and Financial Effectiveness businesses in Kenya.

Share schemes – motivation for the employee but a tax headache for the employer

Companies wishing to reward employees for successful performance or to retain key performers may offer them a stake in ownership of the company through a share award scheme. Under these schemes employees are awarded free shares or shares at a subsidised price. Alternatively, employees may be offered the opportunity to purchase shares at a future date at a preset price. The latter schemes are commonly referred to as employee share option schemes (ESOPs).

An ESOP will usually have a vesting period, which is a waiting period, typically two to three years, from the time the option is granted to the time after which the employee can exercise the option and trade with the shares. Other schemes where shares are allotted up front may have a similar period during which the employee's right to deal in the shares is restricted. Conditions, such as remaining in employment or relating to company, business unit or employee performance, may also need to be met to obtain full benefits.

An offer of shares to employees is a benefit from employment and hence is taxable. Like any taxable benefit, one needs to determine the taxable value, the due date for paying the tax and where or how the tax is to be paid. From the employer's perspective, there is the question whether the cost of awarding shares to staff is a tax deductible expense and, if so, when the deduction can be taken.

What is the taxable value?

The real benefit from a share award to an employee is the savings they make from getting shares at a price lower than market value. A further benefit arises if the employee is able to sell them a profit. The simple answer is that the taxable value should be the difference between the market value of the shares and the price paid by the employee, if any. In any other than the simplest schemes, questions arise For example, in the case of an ESOP with a vesting period should one take the market value at the date when (a) the share option is granted, (b) the employee is first permitted to exercise the option (date of vesting), (c) the option is actually exercised, and (d) the employee sells the shares and realises cash?

When is the tax payable?

Considering that the employee only derives a real benefit when they are able to take up and trade with the shares, similar questions arise over the timing of the tax charge. In one sense, a benefit is received at the time of the initial grant or award. But the employee may be unable to realise any benefit until restrictions on share awards are removed or an ESOP vesting period ends. The exercise date is more commonly used as the tax point for ESOPs but there is a good argument that it should be the date of vesting since the employee is entitled to take up the shares and sell them from this date. The fact that the employee can choose to postpone the exercise of the option should not deny the taxman his dues.

Where should the tax be paid?

Given that the critical events in a share scheme may take place over a period of years, the question of where tax should be paid arise for mobile employees. For example, where options are granted when the employee is resident in one country but are exercised when he is resident in another a real possibility of double taxation arises. The OECD has views on how the taxing rights should be shared between countries but each country has the right to determine its own rules.

Tax deductibility of the ESOP costs

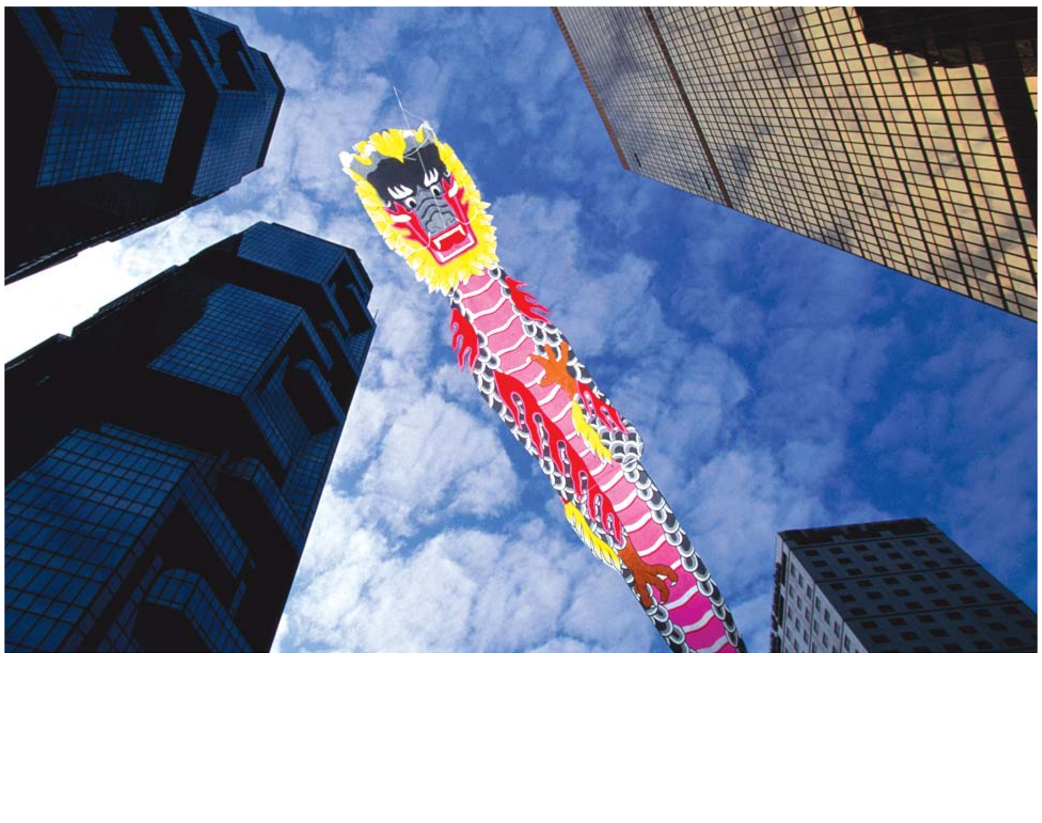
Payroll costs are typically tax deductible expenses for the employer. However, revenue authorities can challenge the costs of setting up and running a share scheme as well as the cost of granting shares at less than market value. Generally, they seek to argue that the cost of setting up and administering the scheme is capital, and that the cost of providing the shares is either not a real cost if new shares are issued or is a capital cost if the share are purchased.

What next

Until last year there was no legislative guidance in Kenya on the taxation of employee share schemes and one had to rely on the general provision for taxation of benefits from employment and best international practice. The new legislation provides guidance but it is specific to schemes registered with the Commissioner. Guidelines are yet to be given on which schemes qualify for registration although there are indications that this will be restricted to share schemes of locally registered companies. Thus for offshore schemes we are back to square one.

Revenue audits may not have focused on share schemes in the past but the introduction of registered schemes will raise the profile. With plenty scope for argument on the correct treatment, those employers who have a defence ready for the tax treatment they have applied will be prepared for the challenge.

Emily Nyandigisi is a tax manager specialising in advising employers on employment benefits



Profiles

Our Financial Services team comprises of partners and managers from across all our lines of service. In this issue and subsequent issues, we will profile two members from this team. In this edition we have profiled Janet Kabiru, a Tax Director; and Martin Whitehead, a Crisis Management Partner.

Janet Kabiru
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Janet Kabiru has over 12 years legal experience gained in leading law practices in Kenya and in Ghana as a corporate and commercial law practitioner with emphasis in the three key areas of mergers and acquisitions, tax advisory and corporate and project finance. She has acted as regional lead counsel and co-ordinator on a number of international transactions including amalgamations and group reorganisation and restructuring as well as in an advisory capacity with respect to legal structures, regulatory issues and procedures and tax implications. She also has considerable experience in due diligence and transaction structuring for tax efficiency in connection with mergers, acquisitions and reorganisations and in connection with investments financing.

Janet is relied upon as a technical resource on all tax matters including direct/ corporate tax issues, indirect tax issues, specifically VAT and Customs and Excise and Stamp Duties and has successfully represented a number of clients before tax tribunals and in the High Court including a precedent setting judgement in Kenya's first transfer pricing appeal which resulted in the introduction of statutory guidelines in this area. Janet is the transfer pricing leader for Kenya and also has responsibility for liaising with the Kenya Revenue Authority on technical issues arising from the interpretation of tax and related statutes.

Janet's clients are corporates in various industries and sectors, including banking and financial services, manufacturing, distribution, farming and horticulture, telecommunications, and the non-governmental sector. She is a member of the Financial Services industry group.

Professional Qualifications:

- University of Reading (UK), LL.B
- University of Oxford, St. Hilda's College (UK), BCL
- Advocate of the High Court of Kenya
- Barrister & Solicitor of the Supreme Court of Ghana
- Member of the Institute of Certified Public Secretaries (K)

Martin Whitehead
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Martin leads our Crisis Management group in East and Central Africa. Martin is a chartered accountant with more than 18 years of experience in helping clients around the region deal with difficult situations.

This has involved Martin working with a variety of clients in both the public and private sectors and across a variety of industries including:- lenders to assess work-out options for companies in distress both inside and outside of formal insolvency; ailing companies to chart and implement "rescue culture" initiatives; Governments and corporates hit by fraud or other economic crimes to investigate what transpired and to build evidence to support legal or recovery actions.

Martin spent the early part of his career in the UK but has been based in Africa for the last 12 years and in Kenya for the last 5. In this period he has also worked or been based at various times in a variety of countries in the region including Zambia, Ghana, Nigeria, Uganda, Tanzania, South Africa and Guinea. His work throughout the region has involved him working with numerous clients facing crisis situations to successfully navigate through the challenges and to develop solutions in cases of large-scale and high profile restructurings, insolvencies and forensic investigations.

Professional Qualifications:

- INSEAD business school, MBA
- Member of the Institute of Chartered Accountants in England & Wales (ICAEW)
- UK licensed Insolvency Practitioner
- Certified Fraud Examiner

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