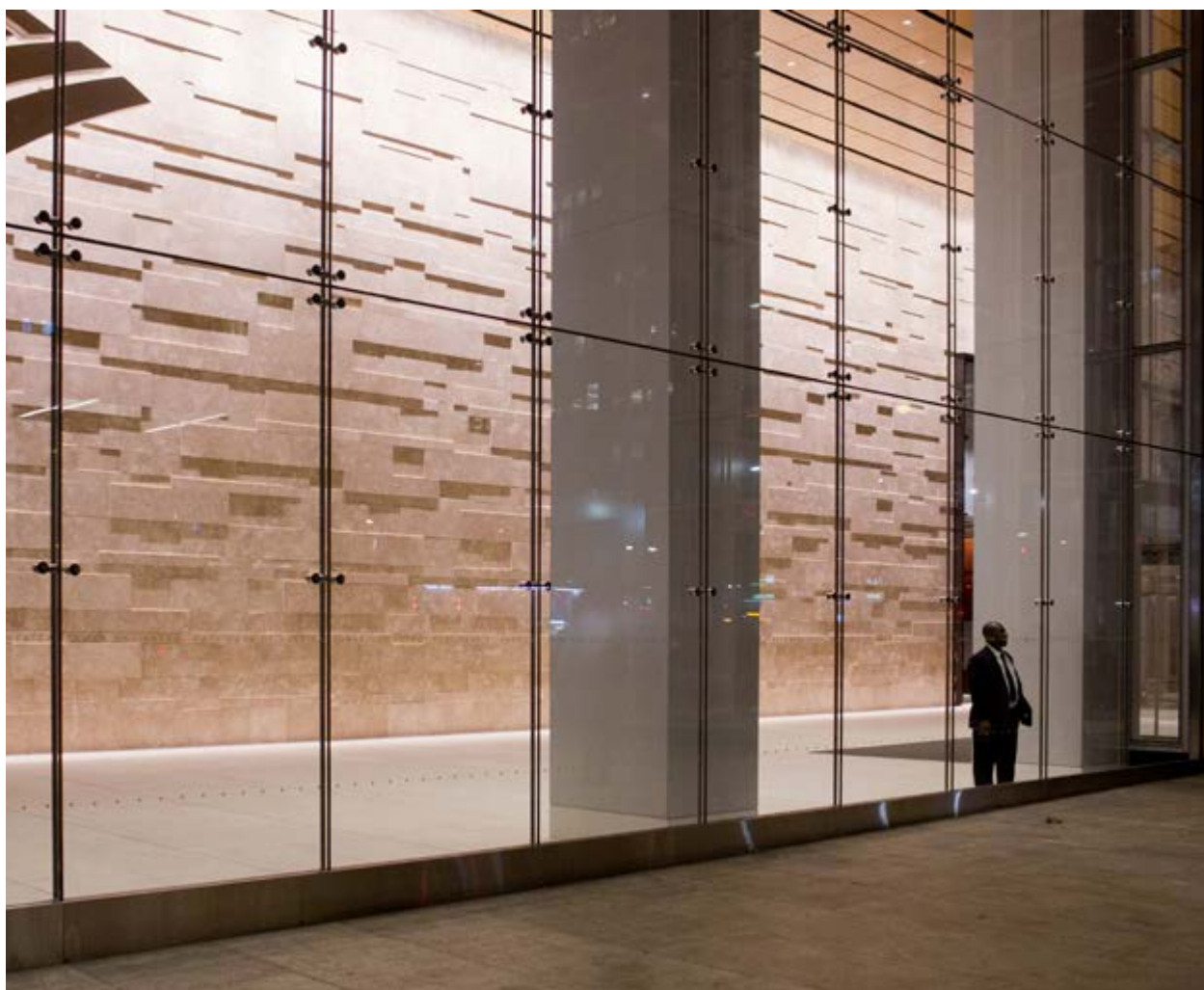


Perspectives on current issues and trends in Financial Services

Financial Focus



Contents

Introduction	3
The journey towards a stable banking industry continues...	4
IFRS 9: New accounting standard set to radically transform Kenya's banking industry	6
The Stewardship Code	8
Uncertainty continues to plague excise duty on financial services	12
Islamic Finance – a compelling approach	14
COSO Enterprise Risk Management	18
Income Tax reform in Kenya – clarity or confusion ahead for financial services?	20
An overview of the Movable Property Security Rights Act, 2017	22
Four (global) trends shaping Kenya's asset management sector	25
IFRS 17: How best to involve your auditors!	28
2017 was not a great year for deals, but not a disappointment!	30

Welcome to Financial Focus

It is my pleasure to welcome you to our 2018 edition of “Financial Focus”. We seek to provide insight and share our views on various topical issues affecting the financial services sector in Kenya and the East Africa region.



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The financial services sector, like the rest of business in general, was adversely affected by the political climate in Kenya in 2017. In the next few weeks, banks and insurance companies will be announcing their results.

Apart from the impact of the slowdown brought about by the political events, we expect to see the full impact of rate capping in the 2017 results for banks, and it will be interesting to see how different players have adapted their businesses to deal with this matter. Some of them have implemented programmes to streamline their businesses in a manner that has cut costs and it can be argued that these changes were long overdue.

I am an optimist and I believe we shall see an improved business climate in 2018. The fundamentals underlying Kenya's economy remain strong; this is an increasingly diversified economy with growing investment opportunities, expanding infrastructure, a regional footprint and a strong culture of innovation.

There are however a host of issues that business managers in the sector will have to contend with going forward. We have discussed some of these in the articles that follow and I have commented on a couple of the topics below.

IFRS 9 is finally here with us. The standard becomes effective from 1 January 2018. When the standard was released and we started discussing it with clients, 2018 seemed so far off! Banks and insurance companies in the

region were slow initiating reviews to understand the full impact of the standard on their businesses and putting in place systems to implement the standard. We have seen a lot of activity in this area in the last few months.

Banks especially will be affected because of the higher level of loan loss provisions expected when IFRS 9 is implemented, and the impact that this will have on their capital. The banking regulators in the region have already issued guidance on how the expected capital shortfalls will be addressed. IFRS 9 is a complex standard, but the article by Anthony Murage explains in simple language the impact that the standard will have on the banking industry.

The banking regulatory frameworks in the region continue to evolve in line with global practice. The central banks in the region largely base their rules on capital adequacy and other prudential guidelines on the rules issued by the Basel Committee for Banking Supervision (“Basel” rules).

These rules have evolved over time and continue to do so. Banks operating in the region need to be aware of the changes in Basel rules, as they will soon inevitably impact us. The article by Dennis Musau summarises the evolution of the Basel rules.

There are many other interesting articles and I hope you will enjoy reading them. I welcome your feedback on the publication and suggestions on how to improve it.

The journey towards a stable banking industry continues...

On 7 December 2017, the Basel Committee for Banking Supervision (“Basel” or “BCBS”) published the latest instalments of its reforms for the calculation of risk weighted assets (‘RWA’) and capital floors for banks.



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These reforms, which many within the global banking industry have unofficially branded ‘Basel IV’ given the scale of change introduced, are the culmination of a journey that started in 2012 to recalibrate the existing Basel III framework.

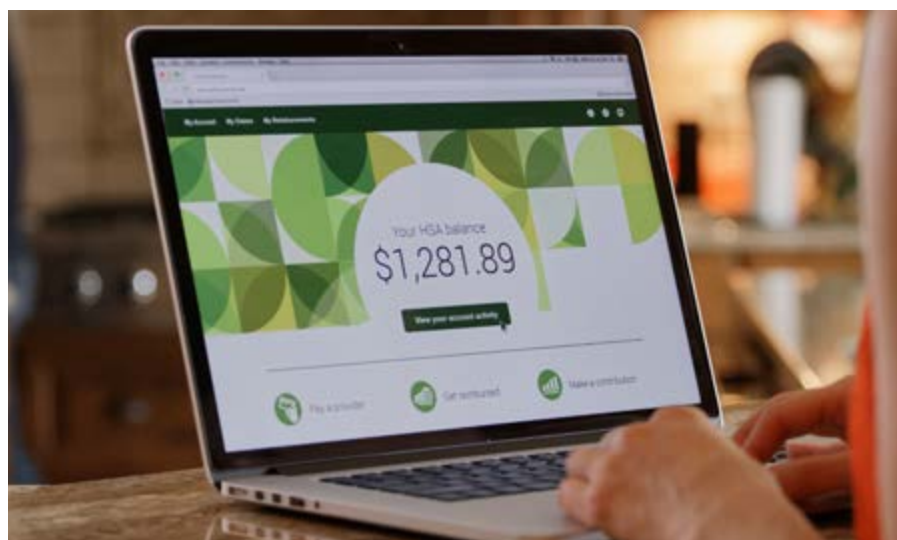
Before 1988, there were no formal globally standardised rules on capital adequacy or other prudential regulatory frameworks for banks. Banks were regulated at a country level and in some countries, no rules existed. Since 1988, BCBS, which by its nature is a voluntary association, has progressively issued regulatory standards that increasingly measure risks facing banks and provide the detail on frameworks for how these risks should be capitalised for.

The first risk to be addressed was credit, then market risk and thereafter operational risk – all before the 2008 global financial crisis. Despite the above ‘progress’, the 2008 global financial crisis illuminated numerous

weaknesses in banks’ risk management practices and global banking regulatory frameworks. Subsequent to that tumultuous period, the Basel Committee has been developing and publishing suites of regulatory standards to enhance the stability of financial markets.

The progressive publications have served to address specific focus areas. The ‘Basel II’ package released in 2008 focused on quantification of risks relating to market, credit and operational risk and setting of risk measures and ratios. Basel II.5 that followed brought about further changes to market risk and securitisations.

Finally, Basel III which came to effect in 2013, focused on the quality of capital, availability of liquidity and driving a structural improvement in balance sheet strength. In particular, with regard to capital, Basel III introduced a revised definition of regulatory capital, risk-based capital requirements, leverage ratio requirements and new



liquidity standards. Despite its breadth in addressing risks, the Basel III framework was criticised for insufficient risk sensitivity, outdated risk calibrations (including over-reliance on external ratings) and extensive national discretion.

‘Basel IV’ seeks to address these issues by introducing revisions to the RWA calculation for all Pillar 1 risk types. This will impact both standardised and internal-risk based models for measuring risk. In particular, standardised approaches have become more risk-sensitive whilst the use of internal models is somewhat constrained.

One of the fundamental shifts under ‘Basel IV’ is the introduction of a relatively high capital floor of 72.5% of RWA computed under the standardised approach (for all banks irrespective of their internal models’ RWA). This is aimed at enhancing trust in banks’ RWAs and making them comparable.

The Basel IV changes are scheduled for implementation on 1 January 2022, with the capital floor scaling up over five years from that date to reach the 72.5% peak in 2027.

Despite the long period to implementation, those banks that will be subject to these new standards will need to react proactively, while national regulators will also need to take steps to introduce the Basel “IV” package into national law and to set timelines accordingly.

Market adaptation or adoption of the Basel rules

By its nature, the BCBS is a voluntary organisation and therefore national banking regulatory authorities in different jurisdictions adopt the Basel regulations into their domestic legal frameworks, albeit to varied extents. On one hand, countries such as South Africa opt for full adoption of the Basel rules, while other markets choose to adapt various principles and incorporate them into their local regulations to cater to local economic and other market specificities.

Similar to many other African markets, the Kenyan banking regulatory

framework has continued to evolve in line with global practice. The Central Bank of Kenya issued prudential guidelines for institutions licenced under the Kenya Banking Act in January 2013.

These regulations are mostly an adaptation of Basel II and III, although not a full adoption of the Basel text. Furthermore, the regulator regularly issues circulars to banks aimed at supplementing or clarifying existing regulations. The extent to which the ‘Basel IV’ suite of regulations gets adapted or adopted into the Kenyan and other African markets remains to be seen.

Reporting and supervisory impact

The evolution and increasing technical complexity of banking prudential regulations will invariably pose remarkable challenges to banks – depending on the extent to which they are adopted in their jurisdictions.

With regard to Basel IV, firstly, changes to RWA calculations, whether using internal models or standardised approaches, and the attendant risk sensitivities of the models mean that business models, product mixes, risk management and overall strategy will be impacted.

This comes at a time where the new accounting standard, IFRS 9, has had its fair share of impact on these very attributes. Management teams are expected to spend significant time, effort and resources understanding not only the technicalities of the regulatory changes, but also their impact on firms’ specific strategies and business models.

Secondly, the new approaches call for extensive data requirements, the availability and quality of which may be a challenge. Lastly, an expansion of reporting requirements to the supervisory authorities is to be expected.

From a regulator standpoint, there is already a significant number of periodic reports (daily, monthly, quarterly and annual), that are submitted by banks to their regulators. These inform the regulator of supervised entities’ risk

profiles, management policies, and act as a general compliance barometer. In principle, these regulatory reports ought to serve a more fundamental purpose than to transmit and communicate information to the regulator – in many instances, the reports serve as the primary mechanism through which banks calculate their capital requirements and prudential ratios.

With ‘Basel IV’ adaptation/adoption, these reports and the complexity thereof is expected to notch upwards.

When aggregated, regulatory submissions form the basis from which bank-specific and system-wide supervision is carried out. Inaccuracies in computations could lead to regulators not taking appropriate remedial actions against an individual bank and/or stresses in the financial system either not being identified as they build-up or not being responded to on a timely basis.

The downside risk associated with unreliable or incorrect information being submitted to the regulator cannot be underplayed. For instance, banks’ RWA computations drive their capital adequacy ratios, which are a critical indicator of their viability, strength, investor attraction and financial performance, among others.

Consequently, there is an ever growing focus on banks’ reports and disclosures to regulators and the financial markets. With growing quantities of information being sourced, analysed and disclosed, the need to ensure accuracy, completeness and validity of such information remains critical.

Just as it would be inconceivable for the investor community to make investment decisions without the confidence that the statutory external audit brings, a growing global chorus for greater confidence in regulatory submissions is merited. When considered against the volume and extent of technical complexity and interpretation that exists in banking regulation together with the limited number of skilled practitioners in this area, the need for confidence multiplies considerably.

IFRS 9: New accounting standard set to radically transform Kenya's banking industry

With the advent of the New Year, one of the most significant changes to the Kenyan banking industry took effect.



IFRS 9 is the new financial instruments standard issued by the International Accounting Standards Board (IASB) to replace IAS 39. Adoption of IFRS 9 will impact the performance statements of banks and could alter the pattern of income recognition. However, the most significant impact on Kenyan banks is the changes to the calculation of loan impairment provisions which would lead to an increase in provisions compared to the current IAS 39.

Currently, banks hold specific provisions for defaulted loans reflecting the loss they will likely suffer from these facilities. They also hold general

provisions for the loans that could be impaired but not yet identified or reported. These provisions only captured loans that were already in default. There was no basis under IAS 39 for recognizing provisions in anticipation of losses before a default occurs. This led to volatility in the financial reporting of banks, especially as witnessed during the 2008 global financial crisis.

In a bid to address this problem, the IASB developed the new IFRS 9 standard to ensure that the impairment provisions held by banks more accurately reflect the risk of their

book of business taking into account expectations about the future. IFRS 9 therefore introduces a 3 Stage model for provisioning. All the bank's facilities are therefore classified in either Stage 1, Stage 2 or Stage 3 depending on the level of credit deterioration since inception of the loan.

Stage 1 loans are performing loans whose payments are up to date and do not show any signs of increase in credit risk since inception. For these facilities, IFRS 9 requires the bank to hold provisions equal to the expected losses the bank may suffer over the next 12 month period.

Stage 2 loans are those that are still not in default status but that show early warning signs that they may eventually default due to a significant increase in the customer's credit risk since inception.

Such early warning signs may include missed loan repayments, poor outlook of the industry the client is engaged in, a restructure of the loan due to cash flow difficulties or a change in the credit risk rating of the client.

For Stage 2 facilities, IFRS 9 requires the bank to hold provisions equivalent to the likely loss the bank will suffer over the remaining lifetime of the facilities. Stage 3 loans are the loans that are already in default and their provisions should also reflect likely loss the bank will suffer over the remaining lifetime of the facilities.

These new principles on provisioning introduced by IFRS 9 have a huge impact on Kenyan banks.

Firstly, from a financial reporting perspective, the introduction of specific provisioning for Stage 1 and 2 loans will result in a significant increase in provisions. Also, depending on the proportion of unsecured high risk loans that the bank has on its books, the eventual provision may be higher. These are likely to have ramifications on both the financial statements performance and capital position of these banks.

Secondly, IFRS 9 is not just a financial reporting issue for accountants to contend with but also a credit risk management issue for the whole bank. This is because the size of the provisions a bank will hold will depend on such factors as: risk of the clients a bank lends to, types and nature of loan products a bank offers, the credit monitoring process of the bank, the type and value of collateral the bank holds and the strength of the bank's recovery process for loans that have gone into default. This means that the bank's risk departments and oversight functions have crucial roles to play in the successful implementation of IFRS 9.

Thirdly, banks face numerous challenges in calculating their IFRS 9 provisions. This is because unlike IAS 39 which deals with loans that are already in default, IFRS 9 attempts to anticipate the losses that will occur in future.

This therefore necessitates the development of complex forward looking models and a lot of data analytics to come up with the assumptions for these models. This requires banks to have high quality historical data and also engage the services of specialists such as actuaries and economists who can make sense of this data and develop and maintain forecasting models.

Since Kenyan banks did not historically have to keep this sort of data or in-house expertise, a lot of them are experiencing significant hurdles in trying

to implement the new standard. Some of the common challenges include: lack of data, inaccurate data, data housed on multiple different systems which has to be coalesced and lack of skilled personnel who can analyze the data and come up with the necessary forecasts for the bank.

As the new standard has already taken effect, 2018 promises to be a very interesting year on the banking scene as the banks gear up to report their first set of IFRS 9 compliant numbers. For listed banks and those with international parent companies, this is likely to be the end of quarter one of 2018.

Most of these banks intend to absorb the impact of IFRS 9 through their opening reserves. This treatment will have an impact on their capital positions but will minimize the impact on their profit and loss statements this year. However, this year represents the only window to apply this treatment.

Therefore if banks do not get the impairment provisions right this year and have to take another huge adjustment in provisions in future, then this will likely have an impact on their future profit and loss positions. It is therefore imperative to get the transition right this year.

At PwC Kenya, we are currently supporting banks across the East Africa region in these transitions. Our accounting advisory and actuarial teams are offering the following support to banks to help them with the transition:

- training the relevant stakeholders on the new standard;
- advising banks on current gaps in their data, systems, portfolios and processes that need to be addressed as they implement the new standard;
- assisting banks to build impairment models and frameworks; advising them on the changes they need to make to their business models, systems and processes; and
- advising them on the financial reporting disclosures.



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The Stewardship Code: Challenging the maxim of see no evil, hear no evil, speak no evil in the Kenyan Capital Markets

There is a divergence in how the moral of this tale has been interpreted in different parts of the world. In the west, the prevalent meaning ascribed to the maxim “see no evil, hear no evil, speak no evil” is that it refers to those who witness impropriety, but choose to ignore it.

Introduction

Ancient Japanese folklore tells of 3 mystic monkeys, Mizaru, Kikazaru and Iwazaru, which are depicted as follows:

- **Mizaru is seen covering his eyes, such that he “sees no evil”;**
- **Kikazaru covers his ears so that he “hears no evil”; and**
- **Iwazaru covers his mouth so that he “speaks no evil”.**



There is a divergence in how the moral of this tale has been interpreted in different parts of the world. In the west, the prevalent meaning ascribed to the maxim “see no evil, hear no evil, speak no evil” is that it refers to those who witness impropriety, but choose to ignore it.

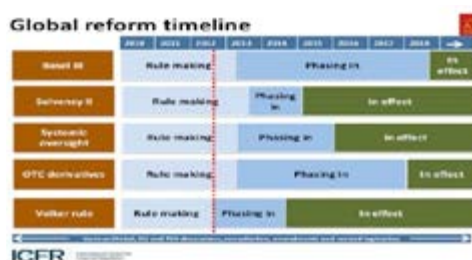
History is replete with multiple examples of corporate scandals and governance failures, which have caused massive financial losses, extensive reputational damage, loss of livelihoods and, in some cases, incarceration of key perpetrators.

These events have also triggered regulatory backlash on an unprecedented scale resulting in an avalanche of new and complex regulation, which, although a boon for lawyers and compliance officers, has made doing business a lot more complicated and expensive across the globe.

Regulators worldwide have used a range of regulatory and policy tools in a bid to rein in bad behavior in the corporate sector. Key amongst these has been the development of corporate governance standards based on global best practice.

Mandatory compliance with these standards has been enforced through embedding them in statute and/or enforceable regulatory guidelines. Boards of directors and senior management of corporate entities, particularly those that have issued securities to the public, are therefore required by law to adopt and apply corporate governance frameworks that can guide them in operating their businesses in an ethical way

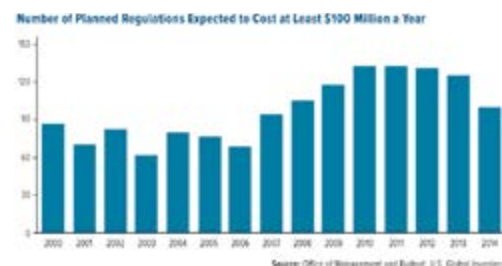




The Dodd-Frank Bill and Future Regulation

- The system of financial regulation is undergoing dramatic changes after the global financial crisis.
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: The most comprehensive financial reform legislation since the Great Depression.

ICFR



that engenders public trust in these institutions and enhances their long-term success.

Although the focus of regulation and corporate governance policy has primarily been on the corporate entities undertaking business, it has by no means been limited to them. Regulators are increasingly training their sights on the Mizarus, Kikazarus and Iwazarus of the corporate world, the institutional investors, and co-opting them in the push for better corporate governance.

Institutional investors tend to hold the bulk of publicly listed securities issued by large corporate entities and are therefore able to exert, through their corporate actions, material shareholder influence on the boards and management of such entities.

In recognition of the kind of leverage wielded by institutional investors, regulators have introduced rules imposing obligations on such investors to take action designed to promote better corporate governance practices in the corporate entities that they invest in.

Kenya's Capital Markets Authority ("CMA") has recently joined this list of regulators through the introduction of the Stewardship Code for Institutional

Investors, 2017 ("Stewardship Code"), which became effective on 9th May 2017. The Stewardship Code supplements the CMA's Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015 ("Corporate Governance Code").

The Stewardship Code

The key aspects of the Stewardship Code are summarized below.

1. What are the Objectives of the Stewardship Code?

The purpose of the Code is to:

- encourage institutional investors to become responsible stewards for their beneficiaries,
- help promote good corporate governance and the sustainable success of listed companies in the capital markets and
- enhance the growth and development of the capital markets.

2. What does stewardship mean?

"Stewardship" is defined in the Code as "the responsible management and oversight of assets for the benefit of the ultimate beneficiaries or clients of the institutional investors".

3. Who does the Code apply to?

The Code applies to institutional investors, which are defined as (i) collective investment vehicles (such as pension funds, insurance companies and investments trusts) ("asset owners") and (ii) fund managers appointed by the asset owners ("asset managers"). The primary focus is on institutional investors domiciled in Kenya, although foreign institutional investors are encouraged to sign up to the Code too.

4. How does the Code apply – "Apply or Explain"?

As with the Corporate Governance Code, the Stewardship Code operates on an "apply or explain" basis. This means that an Institutional investor that is a signatory to the Code must apply its requirements or otherwise explain any non-compliance. The investor must publicly display any explanations for non-compliance on its website and the CMA's website.

An institutional investor is also required to interrogate an investee company's non-application of the Corporate Governance Code and must monitor any explanations of non-application given by the investee to ensure that they are well-reasoned, convincing and provide for acceptable governance arrangements for non-application. If the investee company's explanations are inadequate, then the institutional investor must use its ownership rights to challenge the investee when necessary.



5. What are the core principles underlying the Code and what obligations do institutional investors have in respect of those principles?

The Code sets out 7 core principles that institutional investors are required to adhere to. The table below sets out the principles and a summary of the corresponding obligations. The Code sets out more detailed guidelines regarding how the obligations addressing the principles should be complied with.

Principle	Obligation
a. Stewardship or Responsible Investment Policies	Institutional investors should develop and publicly disclose a policy on their approach to stewardship and responsible investing. The policy should address the 7 core principles and explain how it is applied in the investment process.
b. Monitoring Companies held in Investment Portfolios	Institutional investors shall actively monitor issuers in terms of strategy, risk, performance, governance and other factors that influence sustainable long-term success. This will involve keeping track of issuer performance and holding regular meetings with the issuer's board and management.
c. Active and Informed Voting Practices	Institutional investors shall develop responsible voting guidelines to allow them to vote their equity positions diligently and in a way that supports good corporate governance practices. They shall disclose their voting record as a standard feature of reporting to their clients.
d. Engagement, escalation & collaboration with other institutional investors	Institutional investors shall engage with issuers to build dialogue and understanding and to express concerns or exert influence in areas that give rise to a concern. There should be a clear escalation process to guide the institutional investor on how difficult situations should be handled and resolved. Non-compliance by an issuer with the Corporate Governance Code should be a key area for engagement. Investors should be willing to collaborate when an engagement is most effectively or efficiently achieved by a larger group of investors.
d. Engagement, escalation & collaboration with other institutional investors	Institutional investors shall engage with issuers to build dialogue and understanding and to express concerns or exert influence in areas that give rise to a concern. There should be a clear escalation process to guide the institutional investor on how difficult situations should be handled and resolved. Non-compliance by an issuer with the Corporate Governance Code should be a key area for engagement. Investors should be willing to collaborate when an engagement is most effectively or efficiently achieved by a larger group of investors.
e. Conflicts of interests	Institutional investors shall avoid or minimize conflicts of interest. They should have an effective process for identifying and managing conflicts that might interfere with their obligations to act in the interests of their clients or beneficiaries. The process should explicitly recognize the need for institutional investors to act in the interests of clients/beneficiaries. The approach for managing conflicts of interest must be publicly disclosed.
f. Focus on Sustainability Issues	Institutional investors shall act responsibly in promoting sustainable markets and societies and shall consider environmental, social and ethical issues in their investment process. Institutional Investors should focus on those sustainability issues that may pose a material commercial risk. Attention to such issues in the investment process shall be regarded as part of an institutional investor's fiduciary responsibility to the ultimate beneficiaries.
g. Public disclosures and Client Reporting	Institutional investors shall publicly disclose their policies and activities relating to stewardship. They must, on an annual basis, confirm their compliance with the 7 principles to the CMA. The statement of compliance shall be published on the institutional investor's website and the CMA website. Institutional investors must also record their engagements with issuers, investment analysis and voting activity.

Conclusion

Kenya has had its fair share of corporate scandals and governance failures as evidenced by events in various sectors such as banking, insurance, sugar industry and motor vehicle dealerships over the years. There has been minimal shareholder activism locally in response to such corporate malfeasance and clearly the CMA has determined that this must change.

The Stewardship Code is an important tool in the CMA's policy framework for enhancing corporate governance in Kenya's capital markets.

The Code makes it clear that Institutional Investors have more than a passive role in the affairs of the companies that they invest in and that where they become aware of impropriety they have a fiduciary obligation to enquire and, if appropriate, apply their voting power to hold the boards and management of the investee companies accountable.

Our local Mizarus, Kikazarus and Iwazarus must now see, hear and speak about any evil being perpetrated in the companies they invest in. Furthermore, being fiduciaries, they must account to their clients/beneficiaries and to the regulator for how they exercise the mandate to ensure that the interests of these clients/beneficiaries are protected.

The Code is a positive development for Kenya as it will enhance transparency and discipline in our capital markets and increase confidence in our country as a favourable investment destination.



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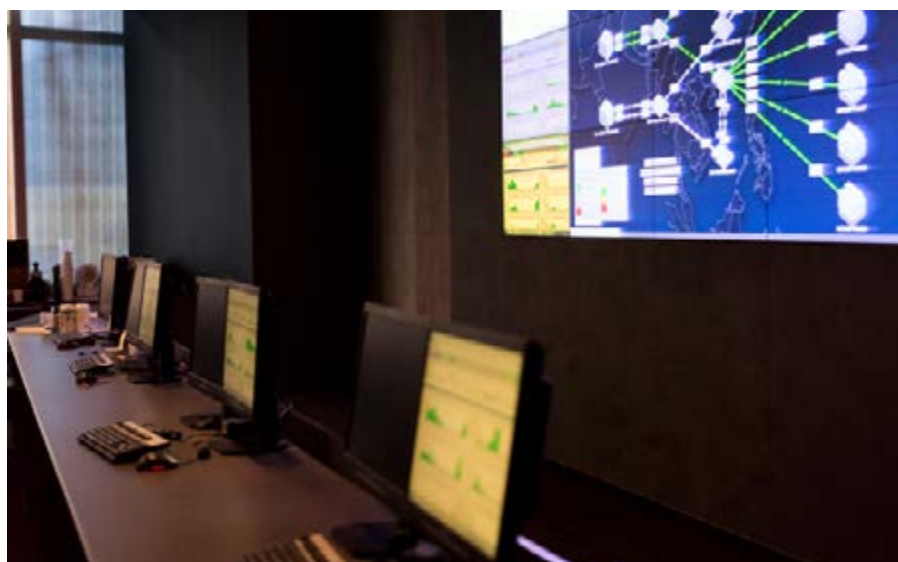
Some of the ways in which PwC can support trustees and fund managers of collective investment schemes comply with the Stewardship Code include:

- (a) reviewing policies and investment processes and recommending specific changes that need to be incorporated in them in order to meet the requirements of the Code;
- (b) Developing relevant tools for implementing the Code, for example: voting guidelines; disclosure and reporting templates; and risk assessment tools for evaluating financial and operational risks, including environmental, social and governance risks;
- (c) Liaising with the CMA on behalf of institutional investors for the purpose of seeking clarifications on the contents and implementation of the Code and also resolving identified corporate governance issues in investee companies;
- (d) Undertaking independent assurance reviews of stewardship frameworks; and
- (e) Undertaking reviews on the level of compliance with the Corporate Governance Code by investee companies.



Uncertainty continues to plague excise duty on financial services

The Excise Duty Act, 2015 imposes excise duty on “other fees” charged by financial institutions at the rate of 10%.



In our view, the way that the Act is currently written creates an uneven playing field and adversely affects the competitiveness of financial institutions vis-à-vis non-financial services providers of similar services, contrary to the globally-accepted taxation canon of equity. It is time for the financial sector stakeholders and our legislators to come together and find a permanent fix to these ambiguities in our excise duty legislation.

‘Financial institutions’ have been defined to include institutions licensed under the following pieces of legislation – the Banking Act, the Insurance Act, the Central Bank of Kenya Act, the Micro Finance Act, 2006, a Sacco Society registered

under the Sacco Societies Act, 2008 or the Kenya Post Office Savings Bank established in terms of the Kenya Post Office Savings Bank Act.

On the other hand, the term ‘other fees’ has been defined to include any fees, charges or commissions charged by financial institutions relating to their licensed financial institutions, but does not include interest on loan or return on loan or an insurance premium or premium based on related commissions.

Historically, when the Finance Act, 2012 was enacted, it inter alia amended the Customs and Excise Act, Cap 472 (now repealed) to impose excise duty on fees charged by financial institutions effective January 2013. However, the

Act did not define the term “financial institutions”. Owing to this ambiguity, the Finance Act, 2013, effective June 2013, clarified the scope of the term “financial institutions” to include the institutions licensed/registered under the above listed legislation.

This, in our view, was in keeping with the canons of a good taxation system which, among others, prescribe that tax law should be precise with regards to the income or transaction chargeable to tax as well as the person on whom the tax is imposed. However, the changes introduced by the Finance Act, 2013 did not cure all the uncertainty regarding the interpretation and implementation of excise duty on financial services.

For instance, the Excise Duty Act, 2015 (the Act) has sought to impose excise duty on Savings and Credit Cooperative Societies (SACCOs). The Act specifies that the excise duty is chargeable on a SACCO society registered under the SACCO Societies Act, 2008.

However, it is important to note that SACCOs are registered under the Cooperative Societies Act and not the SACCO Societies Act, 2008. While it might be argued that the spirit of the law is to charge excise duty on services provided by SACCOs, it is our view that the law as it is currently drafted is flawed rendering such institutions outside the scope of excise duty. This said, the drafters of the law could argue that the law intentionally sought to exempt SACCOs from excise duty to encourage the development of the cooperative movement in Kenya in a bid to mobilise savings and



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investments. Unfortunately, some SACCOs have taken a prudent approach and prefer to charge excise duty rather than face tax disputes arising from assessments by the Kenya Revenue Authority ("KRA").

Separately, the Act defines the phrase "other fees" to include any fees, charges or commissions charged by financial institutions relating to their licensed financial institutions. In the context of financial entities which offer diverse services, some of which are not licensed or regulated under any specific legislation, this definition can be construed to have intended to restrict the imposition of excise duty to licensed financial activities or operations.

However, the law is unequivocal and the lack of clarity leaves the interpretation of the law open to subjective interpretation with the KRA seeking to tax all activities of licensed financial institutions including services such as financial and general advisory services as well as rental income, which when supplied by non-financial institutions are not subject to excise duty.

Another interesting observation is that among the income streams excluded from the ambit of excise duty is interest income. Based on our research, it is generally accepted in the commerce world that "interest" denotes the total return earned by a lender on a credit/loan facilities extended to customers and is, among others, a compensation for the risk borne by the lender.

This interpretation is, in our view, encapsulated in the Income Tax Act, Cap 470 which defines interest to include interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation, and includes a premium or discount by way of interest and a commitment or service fee paid in respect of any loan or credit.

However, unlike the Income Tax legislation, the Excise Duty Act does not define the term "interest", which leaves room for subjective interpretation of the term with taxpayers opting for the wide definition vis-à-vis the narrow interpretation adopted by the KRA. This has been the subject of numerous disputes between taxpayers and the revenue authority.

Further, financial institutions earn passive income. For instance, banks passively earn agency fees from the KRA for their role in the collection of taxes on behalf of the KRA. In addition, banks get paid a pre-agreed commission by the Central Bank for their role in the trading of Treasury Bills and Treasury Bonds.

The Act imposes excise duty on fees "charged", which in our view suggests restriction of excise duty to instances where there is a mechanism for invoicing, demanding or proactive pursuit of the income by the earner. Strictly speaking, in the examples above, banks do not "charge" or issue an invoice for the passive income and accordingly the present wording of the law suggests that these incomes

ought not to be included in the ambit of excise duty/ Suffice to say the revenue authority does not agree to this interpretation of the law!

Similarly, with regards to the insurance industry, besides the reinsurance commissions earned, insurance companies get paid a share of profit arising from the business ceded to reinsurers.

The profitability of business ceded is computed after taking into account a number of factors, among them the expenses incurred on the ceded business. This ceases to be "fees earned" and ought to be outside the scope of excise duty. However, there seems to be no consensus on this matter between the industry and the revenue authority.

Finally, unlike in the case of supply of excisable goods, the Act does not provide for a net off/rebate mechanism for excise duty incurred in making excisable services. This in our view leads to inequity in the application of the law on goods versus services and results in double taxation in the case of excisable services.

The disputes that result from these uncertainties distract financial sector players from their core business activities and their growth agenda. Significant cost in the form of time and money is incurred by the sector defending their interpretation of the law vis-à-vis the revenue authority's interpretation.

Islamic Finance – a compelling approach

The last two decades have witnessed rapid developments in the Islamic Finance Industry which have transformed the face of traditional banking and signalled bright growth prospects for Islamic Finance (including Islamic banking; Islamic microfinance and Islamic insurance) across the world.



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Islamic finance refers to a financing system that conforms to Sharia law and its origins can be traced back to the very birth of Islam. Whereas forms of Islamic Finance were practiced in the early centuries of Islam, the International Monetary Fund (“IMF”) recognizes funding of the 1890 construction of the Suez Canal as the first application of Islamic finance principles in the ‘modern era’.

Egypt continued to lead developments with formation of the first formal Islamic bank in the 1960s followed by Saudi Arabia and the United Arab Emirates in the 1970s. Internationally, Islamic finance gained prominence after the recent Global Financial Crisis where it was widely seen as less prone to boom-bust scenarios and other excesses associated with conventional banking.

In the short 40-50 year modern Islamic banking period, the industry has registered superior growth rates reaching an estimated US\$ 1.9 trillion by 2015¹ from US\$ 794 billion in 2007.

During this period, the industry grew geographically from as far and wide as Australia and Canada and simultaneously gained acceptance and sophistication with special indices launched on the New York Stock Exchange, the Toronto Stock Exchange, the Hang Seng Islamic China Index and the Islamic Exchange Traded Fund in Singapore.

Across the world, in countries such as Japan, the United Kingdom and

France, banking legislation has been amended and tax codes reformed to accommodate the special requirements of Islamic Finance.

In Sub-Saharan Africa, Islamic banking was first introduced by the Al Baraka Banking Group in the 1990’s in South Africa and was boosted by the amendment of banking laws in Kenya in 2007, followed by Tanzania, and more recently, Uganda. In West Africa, Nigeria introduced reforms in 2011 that led to licensing of the first Islamic banks.

Apart from pure Islamic banks, a number of banks in Kenya, South Africa and Nigeria, to mention but a few, have introduced Sharia windows and it seems very likely that this will become more widespread particularly in those countries with significant Muslim populations. Leveraging a key benefit of Islamic finance, countries such as



¹Islamic Financial Services Industry [IFSI] Stability Report, 2016

Senegal have also launched Islamic bonds. Known as Sukuk, issuance does not necessarily require presence of an Islamic finance market in the jurisdiction and other countries like Japan have taken advantage to launch similar products. The value of Sub-Saharan Africa's outstanding was US\$ 700 million as of 2015².

Undoubtedly, Islamic finance has grown fastest in countries with majority or significant Muslim populations. In its 2016 annual IFSI report, the Islamic Financial Services Board ("IFSB") notes that not only are the banking systems in both Sudan and Iran fully Sharia compliant, but that Islamic banking increased its share of the banking market in each of the major centres of Islamic finance such as Saudi Arabia, the UAE, Malaysia, Indonesia and Bangladesh.

Apart from superior long-term growth rates, the importance of Islamic finance globally is signified by the fact that it is centred and attractive in countries with high population growth rates thereby providing a strong foundation for continued growth into the future.

In this article, we provide an overview of some of the key opportunities of Islamic banking to the East African market as well as key risks to watch out for and mitigate in order to optimize benefits for the region.



Opportunities for Islamic banking in East Africa

Growth potential

A report from the International Monetary Fund ("Islamic Finance and the role of the IMF 2017") indicates that over the last 10 years, growth of Islamic banking has surpassed that of conventional banking and increased its penetration rate above 15% in Middle East and Asia.

Whilst growth in 2015 was forecast to have slowed down due to a confluence of macroeconomic and geopolitical factors particularly in the Middle East, all the key markets have registered an increase in the share of Islamic banking against the total banking market. Perhaps more significantly, Islamic finance in total has grown by approximately 15% per annum over the six years to 2014 in US\$ terms.

By comparison, total banking assets in Kenya and Uganda grew by an average rate of 12.5% and 12% in the three years to 2015 whilst Tanzania's total banking assets grew by an average rate of 9% over the same period – in local currency terms.

Another example is Kenya's First Community Bank and Gulf African Bank which built a combined asset base as of 31 December 2016 of US\$ 421 million within approximately 10 years. These statistics tell a compelling story of the growth potential of Islamic banking and signify the opportunity for the region's banking industry that is constantly looking for sustainable growth opportunities.

Financial deepening and inclusion

The success of Islamic banking in East Africa as indeed elsewhere in the world might be seen as purely replacement of business that would have been transacted by conventional banks anyway. Whereas there is evidence of bank customers switching banking arrangements between Islamic and conventional banking where research has been conducted, Islamic banking has deepened banking services through

the very nature of asset and liability products offered.

The concept of profit or loss sharing in particular creates significant demand for trade finance particularly with wholesale trade, import and export business, as well as general trading activities particularly those with short turn-around times. Due to the focus on the business activity for viability of the lending opportunity and security, opportunities to lend are significantly deepened.

Credit relationships in Islamic banking create highly visible business partnerships between banker and borrower through the profit or loss sharing concept that reduces the information gap between the parties and therefore more actively promotes trust. It also encourages repeat business and provides a strong platform for the bank and borrower to grow together – something that every banker strives for.

From an inclusiveness perspective, Islamic banking appeals strongly to Muslim communities which may have been historically or geographically marginalized, particularly in areas located far from the large/largest commercial centres like North Eastern Kenya and Northern Nigeria. There is a tremendous opportunity to provide access to financial services and on terms that are readily palatable to those largely under-served or unbanked communities.

In addition, encounters with Muslim communities suggest that there are significant unbanked savings due to the reluctance to use conventional banking products that are seen as religiously unacceptable. This is particularly the case with long-term savings that would otherwise attract interest. Tapping into such savings creates a significant additional new market for banks and thereby represents a massive growth opportunity.

Beyond credit to the private sector, Islamic finance provides opportunities for Government financing through bonds (Sukuk). In the 10 years to 2013,

²Ibid., pg. 7

Sukuk issuance increased twenty-fold to reach US\$120 billion. There have been new issuances in Africa, East Asia and Europe. Having raised \$200 million in Senegal in 2014 and \$500 million in South Africa by offering sovereign sukuks, African capital markets transactions have been buoyed and diversified with this nouveau financing method.

The global Sukuk Report of July 2017 by International Islamic Financial Market reports 246 issuances valued more than \$21 billion. These issuances have come from Gambia, Ivory Coast, Nigeria, Senegal, South Africa, Sudan and Togo (source: World Economic Forum – October 2017).

With a massive infrastructure deficit estimated by the International Finance Corporation (“IFC”) to be US\$ 900 billion, Sukuk financing offers an attractive alternative for African governments to diversify sources of funding as well as match cash inflows on infrastructure projects with debt servicing outflows.

Risk reduction

Islamic banking offers opportunities for risk reduction at various levels including through its very set-up and focus on the underlying business activity and structuring of repayments to business cash flows. This is rarely seen with conventional banking where typically the product is set up and borrowers must fit that particular profile in order to qualify for credit, often leading to unsuitable credit issuance which increases default risk.

We typically see this with short-term loans being used to finance long-term projects. Indeed many cases where credit proceeds are ‘diverted’ are arguably related to rigid credit products and structures that force bank and borrower to work within sometimes inappropriate arrangements and ultimately increase the risk of default.

The above opportunities are complemented by the fact that Islamic banks also provide other financial intermediation services including payment services, currency exchange, etc. Furthermore, Islamic banking lends itself strongly to agency banking through the potential to leverage

existing Muslim communities that are geographically concentrated in many cases.

Risks

Whilst the opportunities for growth, deepening and inclusion as well as credit risk reduction within Islamic banking are largely self-evident, these do not come without risks which banks must pay attention to in order to optimize the opportunities. These risks include: knowledge gaps among bankers and the borrowing public, insufficient higher technical skills in Islamic banking and governance and accountability shortfalls. We consider each of these briefly below.

Knowledge gaps on Islamic banking

There is insufficient knowledge about Islamic banking as well as the products and services offered therein. This knowledge deficit is acknowledged as an issue amongst bankers and the public, and also remains a challenge even in majority Muslim countries that have enjoyed formal Islamic banking over the last 40-50 years. Significant work is therefore required for banks to educate themselves in this area and to also educate their clients/ the public in order to maximize opportunities for this banking genre.

One of the key issues that must be addressed in this regard is the sharing of profits and losses on savings products, which are the equivalent of customer deposits in conventional banking. The key premise of savings products under traditional banking is that the amount saved is safeguarded at all times.

Indeed this premise, which is the main principle underpinning conventional banking regulation, is turned on its head under the option under Islamic banking for savings to participate in profit or loss. Bankers need to understand this risk thoroughly and fully explain it to savers/ depositors, whilst the public must also be thoroughly educated to ensure they make informed choices if they decide to participate in profit or loss sharing. Equally important is the need to stress the option for not participating in profit or loss sharing.

The business model

One of the constraints observed on the growth of pure Islamic banks has been the perception by both Islamic bankers and the banking public of a restricted space within which Islamic banks operate with a lot of focus on credits and savings products.

Whilst this might partly be a perception by the public which can be addressed through consumer education, some Islamic banks have also tended to market themselves and act in ways that focus on the savings and credit products and services with the result that the public has tended not to consider Islamic banks for other traditional banking services. This has been responsible for keeping returns low and a study of Islamic banks in the Muslim world shows that profitability of Islamic banks lags behind traditional banks.

Another business model challenge lies in the adoption of advanced technology within Islamic banking both from a back office and client facing perspective. Whether it is online/ mobile banking services or automated/ semi-automated back office services, pure Islamic banks have generally lagged behind conventional banks which also contributes to inferior margins for Islamic banking.

Insufficient higher technical skills

A key condition for the operation of an Islamic banking market is the presence of the right technical knowledge and skills to serve on Sharia advisory





boards to Islamic banks. Some markets and regulators have expressed favour with a single Sharia advisory panel in the market to rule on permissibility of products and services for all participants in order to cope with the skills shortage.

Whilst this might be a useful short-term measure to kick-start an industry, many experts caution against this approach for a number of reasons including how confidentiality can be safeguarded and the fact that this set-up does not encourage further development and widening of skills.

Fortunately there is a growing number of Sharia scholars and others who have specialized in Islamic finance within East Africa, boding well for the possibility of independent Sharia advisory boards for banks that wish to operate this way.

Banks have an interest in promoting growth and diversification of skills in this area. As markets develop, recognition must be given to the necessary learning curve as even established Sharia scholars grapple with practical application issues on Islamic banking.

The trust deficit

Islamic banking operates with a much higher trust quotient than conventional banking. Whilst measures can be taken to protect against diversion of credit proceeds, the most commonly known forms of Islamic credit, particularly

within trade finance, and the application of the profit or loss sharing concept require a high degree of trust for borrowers not to dupe banks about the trading performance of funded activities. Ultimately this comes down to trust as no amount of monitoring may safeguard a bank against many of the forms of suppression of gains that dishonest borrowers could engage in.

It has to be said though that this is not a new risk for banks to safeguard and there are measures that can be taken to mitigate the risk. Banks seeking to engage in this business must therefore perform comprehensive risk assessments and continue to exercise selectivity of clients they work with. Borrowers must equally invest appropriately in earning the trust of banks in order to reap the benefits of Islamic banking.

Governance and accountability

The earliest Islamic bank in sub-Saharan Africa was closed after a few years and governance issues have been cited as a cause of its failure. It has to be said that this is often an issue for many conventional bank failures around the world and it goes without saying that governance must be prioritized in order for Islamic banking to be firmly established and thrive.

Regulators have taken the first step by placing Islamic banking regulation within the ambit of bank regulation and therefore subject to fairly stringent standards of compliance including corporate governance. Specific regulations have also been issued in various jurisdictions and are currently under development in Uganda.

Good governance is used in this context to include not only corporate governance which is an over-arching concept that extends beyond meeting requirements for a variety of governance structures, but also financial reporting and auditing.

In this regard, a key challenge faced by Islamic finance in general are the differences between generally accepted accounting principles (such as International Financial Reporting Standards [IFRS]) and generally

accepted auditing principles (such as International Standards on Auditing [ISAs]) on the one hand, and Sharia standards for Islamic financial institutions on the other hand.

Many jurisdictions, including in East Africa, IFRS and ISAs are a standard requirement for banks and whilst there are main areas of similarity, there are differences in both form and substance whose resolution remains a challenge.

Some of the immediate challenges include the fact that a dominant part accounting for financial instruments such as loans under IFRS is the recognition of interest income as the difference between the amount lent and the proceeds received from the borrower.

This flows against the prohibition of interest in Islamic banking. The resolution of differences in financial reporting requires concerted effort within the banking industry, regulators and possibly standard setters.

Overall, Islamic banking has tremendous potential to be a force for good in East Africa with its significant Muslim populations and which enjoy long histories of successful trading trans-nationally and regionally. It is also an alternative that is available to the region's majority non-Muslim populations, who like their Muslim counterparts, are seriously under-banked and under-served.

There are opportunities for both bankers and consumers to interact with one another across a broad spectrum of banking services and to add value to each other in a demonstrably fairer and more equitable manner.

Islamic banking, contrary to early fears in some markets, is not a threat to conventional banking but rather a viable option for banks and consumers and one that is capable of deepening our markets and increasing financial inclusion for many of our communities. Like all ventures, there are downside risks to be managed, many of which stand in common with traditional banking, and are therefore well within the grasp of bankers and consumers to deal with.

COSO Enterprise Risk Management Integrating with Strategy and Performance



Many organisations increasingly plan to leverage ‘positive uncertainties’ as well as manage negative uncertainties.

In East Africa, organisations have focused primarily on the negatives, because that was the traditional way of looking at risk. We tended to ask ourselves, ‘What are the problems that would prevent us from achieving our objectives?’ That mindset is shifting towards a holistic view of business objectives and the identification of events in the past or in the future that could affect their objectives - either positively or negatively.

The new COSO Enterprise Risk Management Framework is changing the conversations that we have about risk in East Africa. The framework is one of the most widely recognised and

applied risk management publications in the world.

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) is a joint initiative of five private sector organisations representing the accounting, financial management and internal audit professions. COSO develops frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

COSO’s previous 2013 risk management framework has not been replaced. That standard’s internal controls framework will remain in place. The 2013 framework and the

new 2017 framework complement each other. The implications of the 2017 framework can have a transformational effect on organisations in East Africa. Additionally, the framework is principles-based so organisations can develop and customise their own approach.

The current framework ensures that strategy is top of mind amongst the Board, management and across the organisation. Everyone should understand their organisation’s strategy and their role, so that risk moves from being a management concern to being a process owner concern.

Financial services and COSO’s new framework

Amongst financial services organisations, there has been a global shift to include non-financial risks. Basel II and Basel III on liquidity and operational risk focus on the actual culture of the organisation. The new COSO framework also focuses specifically on an organisation’s values, in terms of how they contribute to risk management.

For example, recently Kenya has experienced protracted political upheaval. Some people might take that as an opportunity to develop new products. A financial services sector organisation might develop products that allow small businesses to access goods in other markets as part of its strategy to achieve growth of X% over the next 5 years.

Its small business clients are looking for short-term financial services like emergency financing so that they can trade, even at a difficult time. Such a financial institution would view small businesses that import goods and resell them in Kenya as an avenue for growth, instead of assuming that political upheaval increases risks and the institution therefore will not target SMEs.

This is an example of the new COSO framework's emphasis on the positive implications or attributes of certain risks, rather than a purely defensive posture.

In East Africa's financial services sector, we have seen increased regulation and at the same time, consumers are becoming increasingly savvy. Financial services providers must now develop products much faster than they used to.

The old approval processes are not responsive enough for this environment of rapid change and expectations. Financial institutions have to be able to create new products but almost simultaneously test their commercial viability and seek approval for commercial use in the market -- all as rapidly as possible, to gain a competitive edge. In this environment, financial institutions need to put in place mechanisms that allow their staff a quicker way to develop new products - within a robust risk management framework like COSO's.

Focus on values

Increasingly the world is more interconnected and everything that organisations do in terms of the people they hire or how they go to market has to be considerate of that interconnectedness. The framework helps them to consider those value drivers and manage risk instead of applying a purely profit-oriented mentality.



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Organisations that have covered up misdeeds or misbehaviour contrary to their values, hoping that no one will find out or that the public will not react, find themselves more easily exposed these days.

Today, consumers vote with their wallets so organisations have an necessary obligation to demonstrate transparency. If an organisation had demonstrated that certain risks were ones that it had foreseen, there would be more trust in its actions even if something contrary to its values and planning should happen.

Values have to be internalised and embraced by the whole organisation. Every worker has to have a clear understanding of those values and that pride has to come through in a real sense and it has to be authentic. One of the things that is emphasised in the new framework is making sure that values are at the core of managing risk for the organisation.

The most well-known brands have value-driven performance, particularly when they solve a world problem, a consumer problem or enhance someone's lifestyle.

The new COSO update has enabled us to really understand what drives

performance at an organisation and focus on financial risks as well as strategic and reputational risks. The framework has also allowed for more breadth, in terms of the type of organisation (public and private) that can apply the framework.

Getting started

The first step to applying the new framework is to conduct a diagnostic test of the current risk management framework and then to identify gaps between what is in place currently and what should be in place. A good advisor will help to design the best approach for getting to that desired, future state of a robust risk framework that is integrated into day-to-day processes, with buy-in across the organisation and uptake of the risk philosophy in the context of overarching values.

Like life, the business environment constantly changes. In the past, the framework didn't capture disruptors like Uber. The COSO update allows organisations to initiate that kind of conversation about how much risk it is taking to achieve its performance objectives.

The framework is more adaptable in terms of looking at performance over time and adjusting a risk profile over time and it allows for much more robust and reflective discussion. Risk profiles tended to be stagnant previously, so that there were few updates between assessment dates.

But in reality, we know that risks are dynamic. Ten years ago, we were facing the financial crisis and the high price of oil. Today, it's technology and regional economic integration (or lack thereof).

The message for all organisations is to stop being reactive to risk and start considering how a proactive approach could turn some risks into opportunities, if viewed differently.

Income Tax reform in Kenya – clarity or confusion ahead for financial services?



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The wider tax reform agenda

During the early months of 2018, taxpayers and tax practitioners in Kenya expect to see the first draft of the revised Income Tax Bill. The overhaul of the Income Tax Act will be the final stage of the tax legislative overhaul programme that has already generated five major new acts for VAT, Excise Duty, Miscellaneous Levies, Tax Procedures and Tax Appeals within the last five years.

It was originally anticipated that the draft Income Tax Bill would be issued for public comment in 2017, but the extended presidential election period hampered progress.

The National Treasury and the Kenya Revenue Authority ("KRA") have credibly engaged with domestic stakeholders and international institutions in order to canvas opinion

on international best practice, with a view to drafting a new Income Tax Act which will be fit for purpose in the 21st Century. It is worth bearing in mind that the current Income Tax Act has its roots in the 1970s, when the Kenyan economy was driven primarily by agriculture and manufacturing.

The modern Kenyan economy, whilst still benefitting from a vibrant agricultural sector, has now diversified with IT, financial services and telecoms all having a significant (and inter-related) impact.

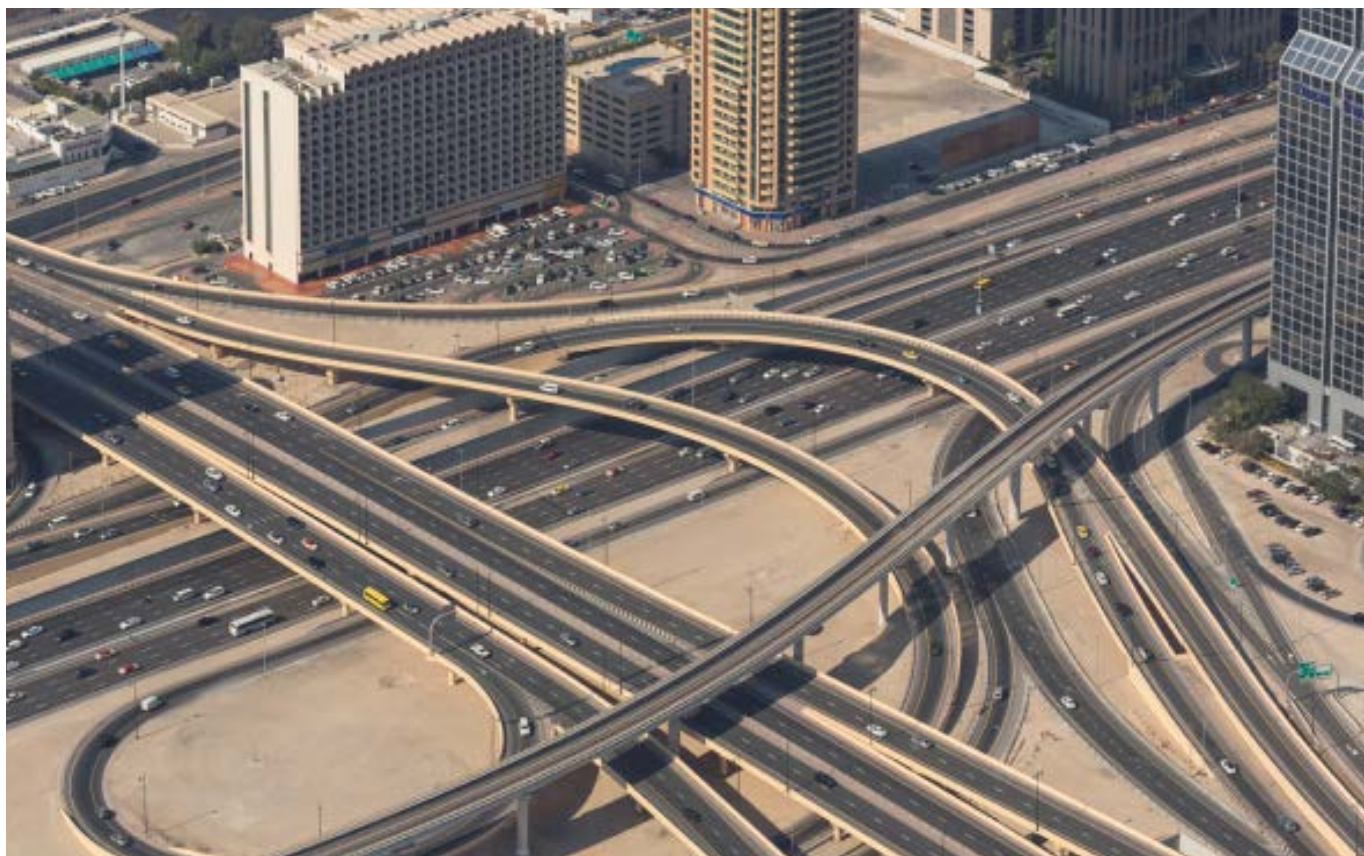
Reforming Income Tax for the modern economy

There are certain fundamental underlying principles which any taxpayer would wish for in their tax system; these would include simplicity, equity, certainty and efficiency.

Progress has been made on all of these fronts in those Acts which have already been revised, but putting them at the heart of Income Tax reform represents a significant challenge. The Income Tax Act occupies a pivotal and central position at the heart of Kenya's tax legislation. It covers the taxation of companies, employees, trusts and the self-employed.

It has provisions relating to withholding tax and the taxation of capital gains; it covers key international issues, such as transfer pricing and tax treaties; it has a Schedule devoted to extractive industries; it provides for





tax exemptions, incentives and reliefs across a broad range of sectors. So, the challenge facing The National Treasury and KRA is great.

For financial services, this comes at a particularly important moment – buffeted by interest rate capping in the banking sector. According to The National Treasury, the sector recorded a decline in growth from 8.1% in the second quarter of 2016 to 4.3% in the second quarter of 2017.

The slowdown may partly be explained by the decline in domestic credit to the private sector and weak macroeconomic performance in the latter half of 2017. Other changes affecting the sector include major accounting and technological changes affecting existing business models. Tax reform offers the potential for some positive developments, but it also brings with it the threat of a lack of clarity.

Key issues to address

Broadly speaking, income tax reform pertaining to financial services needs to be cognizant of two key differentiating factors from other sectors of the

economy: products and business models. Let us take the example of new products.

In 2015, the Nairobi Securities Exchange announced plans to launch a derivatives exchange; whilst the exchange has suffered a number of delays, trading is expected to commence soon. When it does start, traders will need to understand how gains are taxed: income or capital (30% v 5%) and how withholding tax would apply in instruments involving stock lending and interest rate swaps, if at all. The current Income Tax Act is silent on these matters; the next Act needs to provide legislative certainty in order that the nascent market will not be stifled by doubt.

In the banking industry, provisioning for bad and doubtful debts is subject to immense scrutiny from the regulator, the KRA and the external auditor. As noted above, major accounting changes (IFRS 9) will revolutionize the way that banks account for provisions on their loan book; yet, simultaneously, Kenyan banks are expected to abide by Central Bank of Kenya Prudential Guidelines and the KRA's separate guidelines on

the tax treatment of provisions.

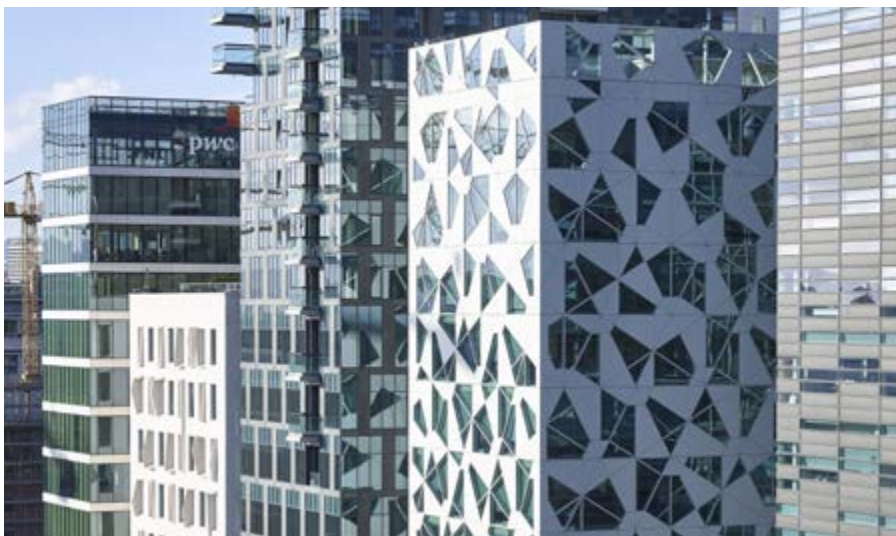
The result is complexity, inequity, uncertainty and inefficiency: precisely the opposite of what a taxpayer might hope for. Reform in this area would be welcome and a long overdue recognition that banking's business model differs from that of other sectors.

Unlike the banking industry, the insurance industry has a dedicated section on taxation of both the life and general businesses. We hope that both the banking and insurance businesses will have dedicated sections on their taxation in the overhauled Income Tax Act. In addition, we expect more clarity in the taxation of life insurance business.

The way forward

In summary, the financial services sector has much to hope for in the coming round of tax reform – the prospect of introducing legislation that understands and taxes fairly the product and industry dynamics. Failure to do so would miss a unique opportunity and bestow upon a crucial economic sector a period of continued uncertainty.

An overview of the Movable Property Security Rights Act, 2017



Access to credit for businesses in Kenya and the region

One of the main hindrances to access to credit by individuals and businesses in Kenya and the region is their lack of “security” in the traditional sense of the word, by which is meant property or large plant and equipment.

The situation has been exacerbated by the enactment of the Banking (Amendment) Act No. 25 of 2016 which, among other provisions, limited the maximum interest rate chargeable for a credit facility in Kenya to no more than four per cent above the base rate published by the Central Bank of Kenya (“CBK”) and set the minimum interest rate granted on deposits held in interest earning accounts to at least seventy per cent of the base rate.

The capping of the chargeable rate eliminated the ability of banks to incorporate additional basis points

of interest to the lending rate to compensate for the credit risk associated with individuals with no security in the traditional sense of property or large plant and machinery. The effect was that financial institutions became even more cautious in advancing credit to customers deemed not creditworthy on account of a lack of collateral to secure credit facilities.

The rate cap significantly contributed to a decline in annual credit growth from 7.0% in July 2016 to 1.4% in July 2017. Since then, credit growth has improved gradually to 1.6%, 1.7% and 2.0% in August, September and October 2017, respectively. However, despite these improvements, lending in the country has yet to fully recover from the effects of The Banking (Amendment) Act No. 25 of 2016.

The government has undertaken various reforms recently, aimed at

updating laws that have not necessarily kept up with changes in the business environment as well as enhancing the ease of doing business in the country. The enactment of the Movable Property Security Rights Act in May 2017 is one such reform.

Others include the 2015 enactment of the Companies Act 2015, aimed at efficient establishment and operation of companies, and the Insolvency Act 2015, aimed at streamlining the insolvency regime in the country and fostering a culture of rescuing viable companies.

The Movable Property Security Rights Act, 2017 (“the Act”) is expected to have a profound impact on the lending practices of financial institutions as it creates a whole new world of registrable security rights. In this article, we provide an overview of the salient features of the recently enacted Act.

Objectives and key features of the Act

The stated objective of the Act is “to facilitate the use of movable property as collateral for credit facilities, to establish the office of the Registrar of security rights and to provide for the registration of security rights in movable property and for related purposes.”

In this regard, the Act is aimed at:

- (a) promoting consistency and certainty in secured financing relating to movable assets;
- (b) enhancing the ability of individuals



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- and entities to access credit using movable assets; and
- (c) establishing the office of the Registrar and a Registry to facilitate the registration of security rights in movable assets.

The objectives of the Act are likely to help in boosting Kenya's economic growth by enhancing access to credit for individuals and companies, particularly those without adequate registrable securities.

The Act facilitates registration of security rights in movable assets by the Office of the Registrar, thereby promoting consistency and certainty in secured financing relating to movable assets.

This in turn should enable more individuals and companies to access credit using movable assets. The Office of the Registrar is tasked with overseeing the general running of the Registry whose functions are to receive, store and make accessible to the public information on registered notices with respect to security rights and rights of non-consensual creditors.

Movable assets in the Act encompass both tangible assets such as motor vehicles, crops, machinery and livestock, and intangible assets such as receivables, deposit accounts, electronic securities and intellectual property rights. According to the Act, these may secure one or more obligations of any type, present or future, determined or determinable, conditional or unconditional, fixed or fluctuating.

The Act also makes it possible for borrowers to use a single asset to potentially secure financing from a number of institutions due to the availability of a central database.

Presently, borrowers are required to deposit logbooks and other documents of title with financial institutions when securing loans making it impossible to use the same titles to secure loans

elsewhere using the same moveable assets where the value of the asset is greater than the loan amount obtained from any one institution.

In the event of failure by the borrower to pay or otherwise perform a secured obligation, the Act provides the secured financial institution a number of rights. These rights include:

- Right of the secured creditor to take over enforcement;
- Right of the secured creditor to possess the collateral;
- Right of the secured creditor to dispose of the collateral; and
- Right of redemption i.e. where the borrower of an asset which has been enforced upon is able to reclaim that asset if they are able to come up with the money to repay the amount of the debt.

The Act provides that the secured creditor can exercise these rights without applying to the Court. The Act also grants the secured creditor the right to appoint a receiver of the movable asset, among other remedies.

Scope of the Act

The Act applies to security rights in movable assets, including every transaction that secures payment or performance of an obligation; a chattel mortgage, credit purchase transaction, credit sale agreement, floating and fixed charge, pledge, trust indenture, trust receipt, financial lease, any other transaction that secures payment or performance of an obligation, and an outright transfer of a receivable.

The Act does not apply to security rights that are presumably governed by other laws such as a security right in securities under the Central Depositories Act, 2000; the creation, lease or transfer of an interest in land, excluding a right to payment that arises in connection with an interest in or a lease of land; a security right in a vessel including a mortgage right subject to the Merchant Shipping Act, 2009; a

security right in an aircraft subject to the Civil Aviation Act, 2013; and a lien, charge or other interest created by law.

Similar legislation in other jurisdictions

In enacting this Act, Kenya joins other countries in the region with similar legislation aimed at enhancing the use of movable assets in securing credit:

- In Uganda, the Chattels Securities Act, 2014 regulates the making and enforcement of security interests in chattel;
- In Rwanda, the Security Interests in Movable Property Law of 2009 governs security interests in movable property;
- In Zambia, the Movable Property (Security Interests) Act, 2016 provides for, amongst others, the creation of security interests in movable property so as to contribute to economic development. It further establishes a Collateral Office and Collateral Registry for a single comprehensive registration regime for secured transactions in movable property; and
- In Zimbabwe, the Movable Property Security Interests (Chapter 14:35) provides for the registration of movable property security interests.

Conclusion

The wide variety of movable assets encompassed by the Act, the scope of what they can secure and the remedies available to secured creditors is likely to enhance the ease of borrowing by individuals and companies owning immovable property.

Previously, financial institutions have shied away from lending against such assets due to the absence of a legal framework for registration of such security rights, which has limited the opportunities for individuals or companies to access credit facilities.

The availability of a central database will ensure that banks are able to advance financing against the full value of secured assets. Proper implementation of the Act will therefore ensure that many more households and businesses in the country are able to secure financing for business and investments leading to stronger economic growth and better living standards.

The most likely beneficiaries are those sectors that are organised in such a way that it is possible to identify the assets. Some sections of Kenya's agriculture reliant economy are well administered and regulated to provide for reasonable implementation of the Act.

For instance, given the regulatory framework around major cash crops such as tea and coffee, it is possible for farmers to secure financing against proceeds from them.

From an implementation perspective, we understand that the electronic collateral registry has already been set up and has been operational on the Government of Kenya ("GoK") run e-Citizen portal since 25 May 2017.

We are informed that lenders have lodged over 10,000 initial notices on the electronic registry worth over Kshs. 500 billion. Further, there's an Acting Registrar collateral registry in place and there are continued sensitization and training efforts on the use of the electronic registry.

While these initial steps are encouraging, it remains to be seen how far the initiative to register security rights in movable assets will be embraced by both the formal and informal sectors.

The Act has the potential to boost economic growth in the Country by enhancing access to credit for individuals and companies, particularly those without adequate registrable securities.

Four (global) trends shaping Kenya's asset management sector

Four interconnected trends are expected to transform the global asset management sector's nature and structure over the coming years.

In Kenya, these trends influence the growth of a sector that has not yet met expectations. As our financial services industry grows in relation to GDP, our asset management sector will have more assets to invest in. At the same time, the deepening of our financial services industry and improving financial literacy will spur growth in our asset management sector.

It is therefore a good time to think carefully about the global trends influencing asset management, and the particular manifestations of those trends locally.

Four global trends

First, global asset management is now a buyers' market. Fees are under pressure and individual retirement accounts and defined contribution pension plans

are democratising investing. Second, the asset management sector lags behind the rest of the financial services industry in terms of digital technology. The latest craze for bitcoin-derived investments highlights the extent to which digital assets can outpace (at least in the short term) the growth of traditional asset classes.

Third, asset managers are being called upon to 'fund the future' such as through infrastructure finance or real estate investment, with less certainty about long term performance. Fourth, investors increasingly want solutions for specific needs.

Outcomes matter to investors, now more than ever, and 'social' outcomes matter increasingly amongst millennial generation investors. Never mind the latest performance of the Dow, the

S&P 500 or the NASDAQ; there is still a great deal of uncertainty with regard to long-term interest rates and the 'real' value of assets and the returns that investors can expect.

The identification of these trends is the result of PwC's latest analysis of the sector published in our global report, Asset & Wealth Management Revolution: Embracing Exponential Change. The report follows on our Asset Management 2020 report from two years ago, and our latest report distils those 2020 predictions into four distinct trends that we believe will shape the sector in the years to come.

Local implications grounded in recent history

In Kenya, our asset management sector is at an early stage of development. Nonetheless, I believe that the four global trends identified in our report are shaping our local asset management sector in specific ways. Drilling down to the implications for our sector requires that we first take a step back and understand our asset managers' origins and recent history.

The average age of an asset manager in Kenya is less than 10 years, although a few like Stanlib, GenAfrica and African Alliance have operated in Kenya for longer. Initially, asset managers in Kenya charged a percentage of an investment portfolio's worth as a fee for managing the portfolio. Over time,





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however, this fee-based structure has come under pressure – in line with global trends towards a buyers' market, greater competition and pressure on margins. Now, asset managers are moving towards performance-based fees such that managers agree upon a particular hurdle rate and beyond that level of performance, the manager and the investor share the profits.

Performance-based fees create incentives for asset managers to beat their hurdle rates, but also expose asset managers to more risk; if they fail to exceed their hurdle rates, they lose money and credibility.

This is one of the root causes of our recent banking and asset management crisis in Kenya, and specifically the bank failures that we have seen over the last few years. Asset managers promised investors a specific rate of return, but did not necessarily disclose where that money was invested.

Asset managers then 'leaned' collective investments to banks for a higher rate of return and a lot of it ended up in banks that were struggling. Those banks were in a difficult position: they needed the investment income, but had to make very risky loans to afford the

interest. And they didn't maintain the minimum capital required to cover that risk.

When the cards came tumbling down, asset managers were left holding the cards. Clearly, the shift away from management fees to performance-based fees has contributed to instability and reputational risk. At the same time, performance-based fees speak directly to two of the global/local trends mentioned earlier: an increasingly buyers'-centric market and outcome-centric investment solutions. Outcomes (and fees) matter to investors, thus performance-based fees. But the risks are greater.

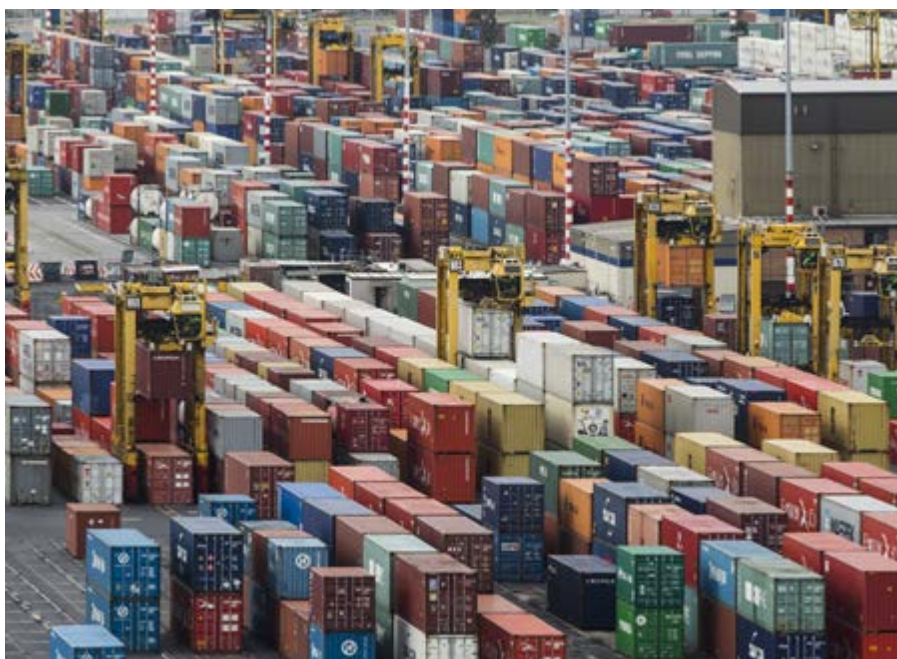
Focus on KYC, governance and technology

Today's customers are a lot more sophisticated than they were 10-15 years ago. Asset managers have to demonstrate to customers that they can beat any returns that customers can earn on their own.

Today's customers, including individual investors, pension funds and other institutional investors, are watching and looking at an asset manager's market profile, its credit rating—you name it. Reputation and stature used to help asset managers to attract customers but now, customers have more options and information. Kenya's investor class is very keen to know exactly where their money is going.

As for the 'funding the future' trend, asset managers in Kenya recently have tried to go into REITs. On the back of that investment vehicle are assets; the asset manager will have bought a share in a collection of properties. Perhaps the quality of assets that they bought was not good and questionable decisions were made about location, for example.

This will affect the performance of the REIT and the return for investors, as well as the reputation of the asset manager. At bottom, this issue of



quality speaks to the governance structures that should influence the people who are making these decisions. But those governance structures may not be appropriate or adequate enough.

Instead, asset managers could make better use of technology to drive their investment decisions, instead of making decisions on the basis of gut feel, emotions, greed or the pressure associated with chasing a hurdle rate.

Clearly technology is another related trend that is affecting the asset management sector locally. Even as margins come under pressure, asset managers are also under pressure to invest in new talent and develop innovative products and technologies. The only option is to manage costs carefully and invest wisely in people and technology that will generate returns or greater cost savings.

Some asset managers have tried to use mobile platforms to reach more customers more efficiently. The platforms generally work, powered by our highly innovative telecommunications companies and the 'know your customer' information available through M-PESA transaction histories, for example.

Some have marketed their brokerage services and tried to drive awareness of doing investments yourself on your laptop or mobile, using a platform that provides information and trading facilities. They then charge a fee for the use of the platform, or per trade.

Perhaps it was the way that these mobile investment platforms were presented to the market, or perhaps it is the small size of the individual investor market or the wide variety

of other options for investing, or the asset manager had larger brand and reputation issues, or the influence of our larger savings culture, but the success of asset managers' mobile platforms in terms of market penetration has been limited so far.

Manage costs and regulatory exposure effectively

Ten or 15 years ago, a good asset manager would not struggle to recruit and retain talented people. Because the asset manager was charging management fees and making a return on investments, they attracted talented, ambitious people.

But with pressure associated with performance and reputational risk, today asset managers are having to rethink their value proposition for their people. Ownership is one way to encourage retention, such as by creating an equity partnership. In the current environment in Kenya, a scheme like this is uncommon. Some of the schemes and benefits that were available to asset management employees like bank loans and mortgages at preferential rates are no longer available. Everyone is trying to manage costs.

Some asset managers have tried to manage costs by relying on their parent company for personnel and systems for controls but have ended up spending a lot of time on operational issues instead of reaping the benefits of improved efficiency. Others are undergoing comprehensive digital transformations that are starting to bear fruit.

Another driver of the asset management sector in Kenya is the regulatory environment. At present,

the taxation of the asset management sector is not very clear. Currently, asset managers withhold taxes as appropriate, although a lot of their business is exempt anyway since (as asset managers argue) investors themselves are responsible for paying taxes on their income. However, outside of the asset management entity itself there are the funds that they run; the taxation of these funds is not very clear.

Generally, asset managers are regulated by the Capital Markets Authority. At times, products which asset managers have introduced into the market may be withdrawn with financial consequences (i.e., losses). Last year, CMA instructed all institutions that it regulates to stop all cash management solutions.

These are products whereby market intermediaries collect deposits from investors and then sell the collection to banks that offer a higher rate of return. CMA argues that the intermediaries are acting like banking or micro-finance institutions in this capacity, that the product is unregulated and that the transactions lack transparency. Intermediaries include licensed (and unlicensed) fund managers.

A final thought on asset management globally and in Kenya: our millennial generation will force asset managers to reimagine the possible. Millennials tend to be wary of 'wealth managers' and prefer convenience and personal control (i.e., mobile apps) and investment options that are aligned to their lifestyles, social consciences and goals. I think this is a cause for optimism, for asset managers. As the author William Gibson famously said, 'The future is already here, it's just not evenly distributed.'

IFRS 17: How best to involve your auditors

With less than three years until IFRS 17 becomes effective, we would hope most insurers have already come to terms with the large role that auditors have to play in the IFRS 17 journey. The question we want to tackle in this article is how best to involve auditors to ensure the greatest benefit for your company.



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Firstly, and most importantly, don't leave it too late! IFRS 17 will apply to all insurance contracts and comes into effect 1 January 2021. There is a good reason for that long lead time: IFRS 17 is a very complicated standard and it will include some fundamental differences to current accounting in both liability measurement and profit recognition.

Decisions made on IFRS 17 implementation will be expensive, particularly those which are technology driven. But money and time can be saved by involving your external

auditor early and ensuring all decisions are supported by a professional body. Don't run the risk of incurring unnecessary costs as a result of your auditor disagreeing with you further down the line.

At a minimum, insurance companies need to conduct appropriate capacity building and an impact assessment by the end of the 2018 calendar year. A lot of companies have done some capacity building, perhaps training tailored to their business or a more generic IFRS 17 workshop. Generally there is a reasonably good awareness of IFRS 17



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in Kenya and the region, but companies need a deeper understanding of what it will mean for them going forward. Now is the time to do an in-depth impact analysis.

Learning from our experience with IFRS 9, the industry overall has been slow to adopt IFRS 9 and that delay has proven to be expensive. In Europe we had the same experience with Solvency II - those firms that started early spent significantly less than those that started late.

The earlier companies start, the better they can plan ahead from a cost and resourcing standpoint and the more time they have to consider how best to utilise internal resources to meet the requirements.

Early involvement of auditors can also help ensure consistency amongst the audit firms themselves, particularly those orchestrating IFRS 17 for a global Group. Don't forget, this is a big challenge for the auditors too, as interpretations will need to remain loose at first and tighten up as the Transition Resource Group finalises their own interpretations.

Helping auditors with practical issues arising from implementation will also help shape their views over the years to come.

It's also worth considering if your auditor can perform other roles in the project including project assurance. Auditors have a responsibility to understand large change and systems projects, so it could be a cost effective option to extend this to giving assurance that a project as big as IFRS 17 is on track.

Last but not least, the focus should not just be on external auditors. It would be an error to forget about internal audit - early engagement with internal



auditors will ensure real time advice and ensure the project is set up to succeed.

All in all, it is fair to say the more active and early a role both internal and external audit play in your IFRS 17 implementation plan, the less likely you are to hit roadblocks in the future.

As PwC, we help insurers to prepare for IFRS 17 from planning all the way through to implementation. We understand the nuances for general insurances and the complex nature and long-term duration of life insurance business.

We can help you by:

- Identifying and refining the particular metrics that best reflect the value being created within your business and provide a clear link between value, cash, capital and risk;
- Helping you to embrace the challenges of IFRS 17 and create key opportunities for communicating a differentiated strategy that plays to your company strengths.

2017 was not a great year for deals, but not a disappointment!

2017 was a difficult year for deals. In what has become a predictable phenomenon, there was a natural decline in deal activity driven by the perceived uncertainty of the 2017 general election outcome and subsequent reaction to the same.

While funds and corporate investors explored the opportunities available in the country, many never progressed activity to due diligence on the targets they were considering. A number of savvy investors, however, took the opportunity to hunt and try and close down deals at a bargain.

Beyond elections, other factors influenced the reduced deal flow. The interest rate cap that came into effect in September 2016 continues to hamper the returns in the financial services sector, constraining the growth of lending, with banks taking a more cautious approach, accompanied by an increase in non-performing loans.

Consequently, the level of credit available has declined, having an impact on the results of financial institutions and their attractiveness to investors. That said, there has been a flurry of activity from credit funds

looking to fill the gap left by the banks, with an offer for mezzanine financing as an alternative or complementary form of debt. Mezzanine debt terms however do tend to be dearer than what would typically be offered by a commercial lender, and with equity at risk.

The acquisition of Java House by the Abraaj Group from ECP Investments demonstrated that exits from large private equity deals by local standards may have to be facilitated by secondary buy outs, with the interested parties mentioned in press reports all being funds rather than corporate buyers.

The investments by IFC and AfricInvest and their partners into Britam demonstrated that insurance remains an area of interest in East Africa, perhaps driven by low penetration and improving regulation.





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It was positive to see the shilling hold steady against major currencies, in particular the US Dollar, despite the economic uncertainty around the election period.

This would have assisted Kenya in continuing to be seen as a favourable investment destination when compared to South Africa where the Rand was particularly volatile.

While concerns continue to be raised around Kenya's debt to GDP ratio, the maturity of investments in heavy infrastructure such as the standard gauge railway and road network is expected to spur economic activity and attract investments.

The recent press release on CBK and KDIC's acceptance of a non-binding offer from SBM to acquire up to 75% of the assets and matching liabilities of Chase Bank (in receivership) on the back of their acquisition of Fidelity Bank came as welcome relief to thousands of depositors.

The acquisition also sends a positive signal on the intention of KDIC to salvage ailing institutions and support continuity in the face of bank failures, as has been witnessed recently in Uganda. Depositors and the market however continue to await a final solution to Imperial Bank.

Looking into 2018, it is expected that deal flow will be significantly higher than in 2017. Deals that were suspended are expected to be revived and capital that had been reserved will certainly be deployed.

The Government's four pillar strategy, particularly around catalyzing the manufacturing sector and development of low cost housing will certainly attract investor interest, with the right incentives in place.

Access to credit for both the corporate and retail markets will be important to realise these objectives, and in that regard the rate cap law may undergo a review. Private equity deals by value and number will likely be many more than those of 2017, with a regional focus continuing to be a key deal driver.

Financial services, pharmaceuticals and other consumer and industrial products will continue to be areas of interest. Government's investments and incentives into the petroleum sector, and in particular efficient domestic energy, will also likely see greater private sector interest. Overall, we expect to be popping a lot more champagne in 2018.

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