Perspectives on current issues and trends in Financial Services

Financial Focus

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Welcome to Financial Focus

Rebuilding trust in financial services may seem like a very Western issue. In Kenya, we may have felt somewhat insulated from the financial crisis in 2008 that was partly blamed on irresponsible behaviour by banks. But in the last three months, we have had two bank failures that have shaken the public's trust in financial institutions. While our situation in Kenya is far from a crisis, the lessons learned in the West about rebuilding trust do apply now to our situation here. What can our financial services institutions do to build trust?

The answer to this question will depend greatly on the response of regulators. The market may worry that there are other underlying and contagion risks among Kenya's banks, even though it is clear that the two recent bank failures were singular events. The Central Bank of Kenya (CBK) has boldly stepped in at the right time and continues to work hard to reassure the market.

A regulatory framework to strengthen trust

Overall, we can expect the regulatory framework to tighten with regard to supervision of institutions by the CBK. The Governor has already indicated that CBK will be revamping its supervision capacity and the CBK has already issued instructions to external auditors to carry out more detailed review of banks' ICT systems and report to the CBK. Developments elsewhere, including the new audit reporting rules, which we expect the CBK to adopt, will result in more information provided to shareholders of banks in audit reports.

Banks will have to grapple with tighter rules on governance and we expect the CBK to be more vigorous in enforcing the new capital requirements that became effective from 1 January 2015 as the CBK focuses on risk-based capital. The amount of capital required is driven by the quantum and type of assets that a bank holds, as well as other risks facing banks (market risk and operational risk). In an effort to raise capital to comply with these requirements and to fund expansion programmes, we have recently seen several banks going to the market to raise funds through rights issues and bond issues.

For insurers, the regulator is also moving towards risk-based supervision and although the exact model has yet to be finalised, we can expect that insurance companies will need to inject more capital into their businesses.

The love affair between insurance companies and property investments may fade as a result of the punitive capital shares imposed on such investments under the proposed capital model. Some of them may need to review their operating and investment models entirely.

The new regulations, although they may appear onerous to some players, will actually help the financial services industry to build trust and confidence.

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Engender trust through self-regulation

Another aspect of trust in respect of banks involves interest rates. As in years' past, calls to control interest rates increase whenever we have an upsurge in interest rates, as we are currently experiencing. Banks are often accused of profiteering at the customers' expense in such situations.

As I have said in this column before, I think controlling interest rates, as popular as such a move would be with the population, would actually be counter-productive and would reverse the gains made in extending credit to previously unbanked strata of the population.

However, this is one area where the industry needs to be pro-active and consider well thought out self-regulation, rather than leaving it to Parliament.

If you do not regulate yourself, someone else will attempt to do it, most likely to your detriment. The Kenya Banks' Reference Rate framework appears to have collapsed in the last few weeks, with the unprecedented increase in rates. Banks and the regulator need to work on a more viable system that will engender more trust with the public.

Contrast our interest rates in Kenya with those in Europe, which are currently at near zero. For banks operating in that environment, margins are very thin and they have had to re-engineer the way that they operate and revise their growth strategies. You do not have to wait for such a crisis to review your business model.

Several banks in Kenya have undergone similar transformational processes to reduce the cost of funds, increase non-interest income and restructure their businesses to become more efficient, leaner and smarter. High cost of funds, limited non-interest income and high cost to income ratios is a challenge for the smaller banks especially, who also experience much more intense competition in their segment.

Agile financial services build trust in tomorrow

To reimagine their businesses, agile financial services institutions invest in innovation. Many of these innovations derive from the power of technology and the remarkable capacity of technology to provide cheaper and smarter distribution channels. The success of M-Shwari and the partnership between KCB and Safaricom, for example, illustrates the power of the mobile platform in Kenya.

Innovative banks and insurers also employ mobile solutions for their employees, allowing for more efficient service delivery and deeper relationships with customers without the geographic limitations of a physical branch network. The growth of advertising through social media shows that financial institutions can tap into the powerful demographic of data-enabled mobile service subscribers. We know that these and other innovations can also contribute to profitability and smarter growth.

The Kenyan economy is going through some challenging times, but the prospects of the financial services sector remain bright and inspire confidence in growth. Some of our economic problems are probably exaggerated; we are not at crisis level yet. We should not base our confidence on the financial services sector in isolation; our confidence should be inspired by the market as a whole and all of the integrated, interrelated product and service industries that make growth possible—including financial services.

I remain optimistic about the prospects of the financial services sector, but the sector will need to work on enhancing public trust. The most successful players will be those that embrace innovation to respond to changing customer needs.

I hope you enjoy reading the following articles in Financial Focus and as always, we welcome your comments.

IT risk is changing for Kenya's financial institutions

No one is immune from IT security-related risks anymore. In the financial services sector, the question is not if an IT security incident will occur but when, how and at what cost.

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In the last two years, sophisticated cyber adversaries around the world have launched powerful attacks against banks and other financial institutions, siphoning off billions of dollars from deposit accounts, stealing millions of payment card records and infiltrating many national stock exchanges.

Globally and in Kenya, financial institutions are implementing superior technologies to prevent, detect and respond to IT security risks. Regulators are taking a more active role as well; the Central Bank of Kenya now requires banks to conduct ICT external audits at least once every two years. Technologies and regulations are important but the most effective approach to managing IT risk is to maintain a foundation of sound governance, operational processes and people skills.

PwC's 2015 Global State of Information Security Survey of 758 IT professionals working for financial institutions showed that IT security-related incidents are increasing in volume and cost, with more incidents perpetrated by company insiders and suppliers. At the same time, our respondents said that IT security budgets are inadequate and the 'tone from the top' (meaning executive and Board-level engagement) is often lacking.

An IT risk assessment is an opportunity to review sustainability, profitability and reputation in the context of IT risk.

Many organisations will seek initially to test one aspect of their IT risk security process or customer relationship management system only to find that they need to revisit their whole IT risk management framework. Very often, the solution entails embedding IT risk management fully within the business's strategy and ensuring consistent application.

Customer centric vs. product centric

Greater competition among Kenya's banks and insurers, led by innovation and financial inclusion in the sector as well as new market entrants, has caused many institutions to revise their strategic orientation from being product-centric to customer-centric. An institution may have had a system in place that suited one product but is not suitable for an expanded portfolio of products.

A customer may require multiple financial services products, each with its own unique identifier. The institution needs one view of the customer as well as the ability to aggregate information about similar customers to better anticipate their needs. An integrated application will serve different product lines, business units and customers on one platform.

Another challenge is a financial institution's reporting mechanism. Service providers or agents may not have a record of services delivered. An integrated system will provide this information in real time, wherever the agents are located.

These kinds of challenges are opportune times to assess holistically an organisation's IT risk security framework. Just because an organisation has a cutting-edge approach to technology, content or customer relationship management does not mean that it will also have an appropriate IT risk management framework. In fact, some of the greatest threats to IT security come from within the institution or originate with suppliers and other third-parties.

Finally, risk analysis, including IT risk, tends to be historical in nature among financial institutions. Analysis is anchored in historical fact. There are no facts about the future, but financial institutions can shift to forward-looking analysis tools that are built around scenarios. Stress testing and sensitivity analyses are useful for managing IT risk in the present as well as potential risks and incidents in the future.

The aim of risk management, including IT risk management, is two-fold: achieve sustainability and maximise the ability to capitalise on change. As financial institutions in Kenya (and globally) become ever more sensitive to the complex interplay between risks and opportunities, they need to take a more holistic, long-term view of IT risk management.

Just because an organisation has a cutting-edge approach to technology, content or customer relationship management does not mean that it will also have an appropriate IT risk management framework.

The journey and the rewards of Enterprise Risk Management

Imagine building a bridge without knowing which river it should span, or how wide the river is, or whether the environment has a history of flooding, or what kinds of vehicles need to cross it. Now imagine building a bridge that is fit for purpose. It is useful and appropriate for the surroundings. It is strong and resilient.

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Enterprise risk management (ERM) done right is like building a bridge that is fit for purpose. An organisation's ERM journey provides opportunities for clarifying business objectives and articulating risks, designing strategies for managing them and determining the organisation's resilience and appetite for risk. Most importantly, however, is that ERM done well not only provides comfort to management but also enables risk to be seen as an opportunity towards pursing the firm's goals.

Key benefits of successfully implementing an ERM framework include:

- Business objectives get clearly articulated and understood;
- Consistent risk language across the organisation, clearly defined risk terminology;
- Increased transparency;
- A fully-embedded risk culture that is central to performance, management and reward;
- Risk is considered a core part of the business and not a barrier or compliance exercise;
- Risk is a firm basis for input to strategic business decisions;
- More efficient use of scarce risk-related resources, e.g., capital and liquidity; and
- Strengthened confidence of external stakeholders, including shareholders and regulators.

Risk terminology

Whilst industry standard terminology does not exist, it is important to have clear and consistent definitions across the firm

Risk strategy
- Aligned to business strategy and process through which firm decides risks that can be assumed or managed to gain competitive advantage or create value

Risk appetite
- The amount of risk that an organisation is willing to seek or accept in the pursuit of its long term objectives on the basis of strategy, risk management competencies and core values

Risk tolerance
- The boundaries of risk taking, outside of which the organisation is not prepared to venture, in the pursuit of its long term objectives.

Risk limits
- Most granular level used within the business on day to day basis to ensure that business activities are within the desired risk appetites and tolerances.

Risk capacity
- The resources, including financial, intangible and human, which an organisation is able to deploy in managing risk.

Enterprise Risk Management Framework

"The only alternative to risk management is crisis management—and crisis management is much more expensive, time consuming and damaging to reputation."

Financial services industry focus

Most organisations in financial services consciously endeavour to integrate risk management throughout their organisations. Typically however the focus tends to be around the business management aspects, such as developing risk management policies and procedures and some risk metrics. Often firms' ERM frameworks lack thorough consideration of the business strategy and business platform. Globally, PwC uses an Enterprise Risk Management Framework to advise organisations about risk management integration. The framework supports a strategic focus on risk strategy and risk appetite to the policies and procedures needed to support business management and the required business platform.

Common ERM pitfalls in the insurance industry

For insurers, premium income informs one of the most common management information metrics. Many insurers will observe patterns in premium income on a monthly or a quarterly basis. A sudden rise or drop in premium income could signal a risk event. Good risk management is about knowing what signals to look for and how to capture the data that informs decision-making by the right people at the right time.

All too often, management sets limits for insurance underwriters, for example, without considering the impact of these limits on the overall strategy. This top-down approach has to be used in tandem with a bottom-up approach to fully engage underwriters in strategic discussions and set limits based on their buy-in and the organisation's risk appetite.

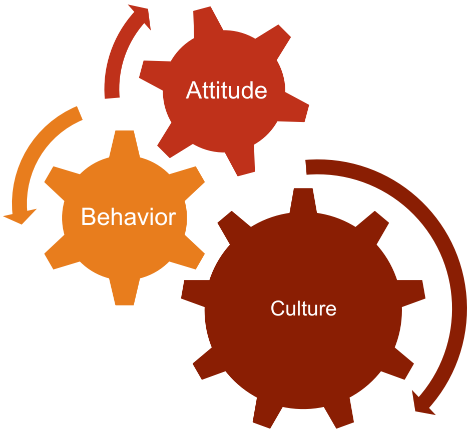
Enterprise risk management operates hand-in-hand with capital considerations. Insurers tend to measure available capital (assets in excess of those covering liabilities) and the capital required by the regulator to cover liabilities. Their economic capital, however, is the amount needed to protect the business from all but the most extreme unexpected losses. Future-focused risk-based capital requirements are bringing regulatory and economic capital into alignment. As insurers and other financial services providers work to develop their ERM frameworks and particularly their risk appetite statements, they must know how much capital they need; these capital considerations are entirely influenced by risk.

The challenge of risk appetite

In almost all organisations, risk appetite setting and articulation simply does not receive the airtime it deserves. For most, their risk strategy forms part of the business's overall strategy but when it comes to risk appetite the same firms tend to get a bit "lost". Putting pen to paper for clear articulation of risk appetite statements poses significant challenges. Partly this is because a clearly documented risk appetite necessarily implies accountability and a metric for evaluating performance. In addition, different board members will have different risk appetites. A combination of these and a lack of experience in setting risk appetites means that this is usually a half-baked cookie for most firms.

Risk appetite statements are owned by the Board of Directors and board members are increasingly aware of the benefits of having well-articulated risk appetites that are used to run and manage the business. In our experience, the most effective way of defining your risk appetites is

Most importantly, you face the windscreen and your perception is real-time. Perhaps it is raining, or a cow crosses the road in front of you. There could be an accident ahead. Or the weather is bright and sunny. Risk management done right is like the windscreen: it gives you a real-time view of what is coming up ahead. Enterprise risk management comprises all of the different views and indicators that allow you to drive safely and strategically forward to reach your goals.



The culture of a business arises from repeated behaviour; behaviours are shaped by attitude and both behaviour and attitude are influenced by culture.

through a Board workshop allowing for deep discussion and with a view to agreeing and setting the appetites. An independent third party can facilitate at any point helping drive consensus more effectively, helping to clarify, providing data and benchmarks and developing a draft risk appetite document for discussion.

The best risk appetite documents are living documents and renewed or refreshed at least once every year, and they inform business plans for future years. The operating environment will change and a third party can also help Board members and others to peer around the corner and anticipate changes that could inform risk appetite and, therefore, business strategy.

Organisations that set their risk appetite through an integrative process and articulate it clearly find that cascading it through the business is much simpler to accomplish and buy-in much easier to obtain.

But even the most specialised risk expert cannot individually enforce the risk appetite and the wider ERM framework without the explicit involvement of everyone from the Board of Directors through to support staff. Risk management is reinforced by the right risk culture, and that culture should instil confidence and reward staff and management for good risk behaviours. No one should be afraid to talk about risk.

Enterprise Risk Management is a journey

Another analogy illustrates the power of ERM. Imagine driving a car. The rear-view and side mirrors provide different perspectives; for financial services companies, these perspectives could be informed by regulator risk assessments or potential risks that may arise. The car's dashboard provides information indicating oil level or battery charge or speed; these indicators tell you whether the car is safe to drive and if you can move forward.

Top tips

Enterprise risk management facilitates better business decisions through a consistent language and common expectations. Ideally, ERM is part of an organisation's DNA. The following 'top tips' can help organisations to evaluate their ERM:

1. Integrity to discipline: A strong tone at the top and integrity must pass through every level and activity within the organization in relation to risk management.
2. Constructive Board engagement: Board members must be actively engaged and able to exercise judgment as to the changing risk profile in relation to the organization's performance objectives.
3. Effective risk positioning: Knowledgeable professionals must be responsible for executing effective risk management programmes by taking an objective perspective without consequences to their compensation and careers.
4. Establish a learning curve, ERM is a journey: Mistakes must be acted upon, shared, and discussed across the company—not hidden—in order to learn and improve policies and processes.
5. Set Appropriate Incentives: Incentives should be used to recognize individuals, departments, and the enterprise for enhanced risk awareness behavior in pursuit of goals and objectives.

Kenya's Insolvency Act helps to rescue value

Over the last two to three years, banks' non-performing loan portfolios have increased sharply in Kenya. Declining tourism and agricultural exports together with higher interest rates have contributed to a riskier environment for bank lending. Many bank customers are feeling more pressure.

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The Central Bank of Kenya (CBK) recently warned that non-performing loans rose by 30.9% to KES 107.1 billion in the year ending 31 December 2014, the highest level in six years. Although Kenyan banks are generally profitable and well capitalised, changing economic circumstances require even more vigilance to ensure that they adequately provision for potential bad loans. Recently, the National Treasury developed a budget policy paper directing CBK to implement strict Prudential Guidelines governing capital adequacy.

Against this backdrop, Kenya's first stand-alone Insolvency Act came into force. The reform in the Insolvency regime is part of an overall strategy by the government to make Kenya a more attractive place to do business. When it comes to measuring Kenya's ease of doing business, as the World Bank does in its Doing Business report, a country's legal framework is a very important consideration. The Insolvency and business rescue provisions in the law are a critical component of this framework.

From recovery to rescue

In line with the culture adopted by many other modern insolvency regimes, Kenya's reformed insolvency legislation shifts the focus from recovery to rescue. Previously, the prevailing insolvency regime focused on recovery for creditors who commenced insolvency proceedings—often resulting in the liquidation of assets. It is hoped that the new law will help to reverse the notion created in the past that insolvency regimes under the previous law often resulted in destruction of value.

The Honourable Mr. Justice Ringera put this aptly in one matter before the court: "And I think it is a notorious fact of which judicial notice may be taken that receiverships in this country have tended to give the kiss of death to a business". Now, the Insolvency Act provides a framework that seeks to facilitate the rescue of troubled businesses in the interest of all stakeholders. The framework maintains a fair balance between the interests of creditors and the interests of the insolvent company/borrower so that:

- If the insolvent's financial position is redeemable, then the Act aims to enable continued operation on a going concern basis and
- If the financial position is irredeemable, then to provide an orderly system to wind down their affairs and the efficient and optimal distribution of their assets to their creditors.

This change in focus reflects a recognition that rescue leads to a better

30.9%

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overall outcome for all parties involved. The Insolvency Act aims to achieve this through the introduction of new alternatives to liquidation procedures.

Financial institutions' exposure to insolvency

The Insolvency Act does not apply directly to banks, but it is going to be of interest to them because it addresses the problems associated with non-performing loans and insolvency of their clients. The Insolvency Act is better for all lenders and other stakeholders; from a bank lender's point of view, a focus on rescue could help the bank to keep its customer and the customer to keep his business. By bringing more stakeholders to the table, there is more incentive to maintain a going concern.

Banks will benefit by responding to underperformance in ways that will facilitate rescue. The new law provides alternatives for restructuring the affairs of the borrowers in cases where they have experienced significant changes to the performance that they had projected when they sought the loan. These changes can be brought about by external shocks and circumstances outside of their control. An example is foreign exchange. If an entity borrows in dollars and earns revenue in Kenya shillings, the shilling's depreciation, which is outside of the control of the borrower, may result in an inability to service the loans despite the underlying fundamentals of the business remaining sound.

Distress can also result from a mismatch of the timing between the realised cash flows and the repayment schedule based on the cash flows envisaged at the time of borrowing. For example, an entity may borrow to build a factory or expand production capacity on the basis that their market will immediately absorb the extra volumes they produce or on the basis of an expansion plan where everything runs to schedule.

In reality, the extra volumes the business generates may result in a depressed price for their commodity, or there may be delays in completing their expansion project. However, even if the entity's business fundamentals are sound in the longer term, if it is unable to make its repayments when they fall due, the entity becomes vulnerable to enforcement action by its lenders. As such, the entity may never get to the 'long term' envisaged should the lender choose to take action. While short term funding fixes may be applied, these could be difficult to obtain and very expensive.

In the past, the bank would place the entity in receivership and the focus of insolvency was on recovering the debt on the part of appointing creditors. Sales of assets could commence quite quickly with less regard to what happened to the entity.

Now, the focus of the Insolvency Act is on maintaining the going concern status of the businesses in distress. As such, once an administrator is appointed, the law requires them to develop a proposal for preserving the company as a going concern as a first option in the interest of all stakeholders, including unsecured creditors and employees.

Insolvency practitioners

In a welcome departure from previous legislation, the Insolvency Act also introduces strict requirements for persons who will be permitted to undertake insolvency assignments namely the Insolvency Practitioners.

The aim of this is to introduce regulation to the insolvency profession. Previously, it was possible for just about anyone to be named a receiver and potentially take advantage of the situation.

Now, insolvency practitioners will have the relevant training and experience to undertake insolvency, which is often technical and complex.

Insolvency practitioners can play a significant role in Kenya's new rescue culture. Practitioners can help entities to avoid getting into a distressed situation by undertaking timely reviews of the entity and helping them implement strategies for helping them to conserve and manage cash flows.

Practitioners can also work directly with banks and lenders to develop measures at the point of lending that lead to proactive follow-up and involvement long before a crisis develops. Additionally, practitioners can help banks to evaluate options or provide a point of view on whether and how a restructuring will facilitate recovery.

A business review can help to explain the reasons for underperformance and establish if the business is facing a fundamental issue or simply a transient cash flow management challenge or a weak management team that cannot effectively execute its strategy.

A good understanding of these and other factors can reveal whether these factors are controllable by the business and if there are avenues for re-orienting the business. Typically a business review would also establish the cause of the troubled entity's current underperformance and in particular the ability of the entity to service its obligations like loans.

Kenya's new Insolvency Act provides a framework for rescue that can help preserve value for troubled entities and prevent their troubles from blooming into larger problems. Financial institutions and other stakeholders now have a more formal say in how those troubles are resolved.

Distress is usually related to an event like a delay repaying a loan. Our work involves understanding the event and asking questions such as, 'Was the event unexpected or related to decision-making?'

We look for the causes of distress and if the entity can be recovered. Distress tends to build up over time but many people ignore the signposts along the way, including management and lenders, and often because there is no knowledge of the important milestones indicating the borrower's performance.

If decision-making is bureaucratic, it can take time to make proactive decisions that would help the entity to avoid distress. Information about performance may not be forthcoming, or the quality of the information is poor, or the information is wrong. As it descends further and further into distress, the options for managing the causes of distress become more limited.

We advise banks to keep a close eye on their loan portfolio and to watch for any indication of distress. In cases when there is significant lending, like a capital project, there can be a benefit in bringing in a third-party or specialist who can monitor milestones and indicators according to metrics used to measure performance for that entity and its industry. Sometimes lenders try to cut costs in this area but they can end up losing a lot more.

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Should VAT be charged on disposal of salvage?

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Insurance companies underwrite the property of their clients against certain identified risks. Usually, when such goods are damaged, the insurer may bear the cost of repair and pass on any excess costs to the insured or, in cases where replacement is required, the insurer sells the salvaged property as part of the indemnification process to recoup part of the indemnity payment to the insured.

The treatment of such sale for Value Added Tax ('VAT') purposes is worth consideration and while this article focuses on the sale of motor vehicles, a similar approach applies to the disposal of other damaged goods surrendered by the insured to the insurer.

When a motor vehicle is badly damaged in an accident, it gets written-off, i.e. surrendered to the insurer and subsequently sold as scrap by the insurer. On the other hand, a vehicle that can be repaired and re-used is considered a salvage vehicle. Before the insured is indemnified for salvage, he/she is usually required to sign transfer documents and after the insurance claim is settled, the insured is required to hand over the salvage vehicle to the insurer who in practice disposes of it at an auction and uses the proceeds to recover a portion of the claim paid out to the insured.

Understand VAT legislation as well as compensation principles

In contemplating whether proceeds from salvage vehicles should be subject to VAT or not, various aspects need to be considered. The sale of the salvage vehicle could be argued to be an intrinsic component of the VAT exempt claim settlement by the insurer and should not be treated as a separate transaction for tax purposes.

In addition, since the insurer is solely interested in recovering part of the claim amount paid out to the insurer, it can be argued that there is no value addition to the disposed salvage vehicle and therefore the transaction should not in principle attract VAT.

In the case of passenger vehicles, one could also contend that the proceeds should not be taxed since no input tax recovery was allowed when the vehicle was brought in line with the prohibitions in the VAT law.

A look at the VAT legislation reveals that the sale of salvage vehicles may be considered a stand-alone supply of goods. Supply of salvage is neither expressly exempted nor included in the list of zero-rated goods and by default should be subject to VAT at the standard rate of 16%.

However, given the nature of the issue, there is a need for proper guidelines and regulations to ensure that the industry specific circumstances are properly considered in determining the VAT status of salvage.

In this regard, it is our view that two principles applied by the insurance industry in relation to compensation are critical to the determination of VAT treatment of salvage.

The first is the principle of 'indemnity' which is aimed at restoring the insured to his original position before the motor vehicle accident. The second is the principle of 'subrogation' which allows the insurer to assume the legal rights of the insured with respect to the salvaged goods.

For example, the title to the salvage motor vehicle passes to the insurer upon indemnification of the insured and therefore it can be argued that in terms of the principle of subrogation the disposal of the salvage vehicle constitutes a supply of goods by the insured to the insurer followed by an onward supply of the salvage by the insurer to third parties (at the auction).

No consideration is given by the insurer for the first transfer and it can therefore be argued the transfer value of the salvage vehicle is nil. Separately, the law provides that for passenger cars or mini buses where the insured is prohibited from claiming input tax credits in relation to the VAT incurred on the acquisition of the motor vehicle, no VAT should be charged upon the disposal of the motor vehicle.

Whilst it is clear that any VAT registered insured is not obliged to levy VAT on the supply (surrendered) of salvage passenger motor vehicle to the insurer, it is arguable whether such VAT exemption extends to the onward disposal of the same motor vehicle by the insurer.

It is questionable whether any input tax is disallowed on the part of the insurer especially bearing in mind that no VAT is charged by the insured or even if VAT is charged, the liability is based on the nil value of the salvage, and thus subsequent disposals of a passenger vehicle may not be excluded from VAT on the basis of the above noted prohibition provisions of the law.

16%

Supply of salvage is neither expressly exempted nor included in the list of zero-rated goods and by default should be subject to VAT at the standard rate of 16%

There is a need for proper guidelines and regulations to ensure that the industry specific circumstances are properly considered in determining the VAT status of salvage.

Apply a case-by-case approach

In our view, with VAT being a transactional tax, the circumstances surrounding disposal of salvage need to be considered on a case-by-case basis to determine the VAT implications. Whilst the revenue authority might be quick to tax every salvage disposal, there are factors as noted above that may exclude certain disposals from the ambit of the VAT legislation.

VAT interpretation challenges are not restricted to Kenya. Other jurisdictions have grappled with questions of a similar character. In the UK for instance, Her Majesty's Revenue and Customs (HRMC) has had to issue guidelines on the treatment of proceeds from salvage goods and the decision to tax the proceeds or not hinges on, inter alia, the VAT status of the insured party.

In Brazil, the Supreme Court has taken a completely opposite view that the proceeds from sale of salvage are not taxable.

Clearly, this is a subject that demands thorough review and clear guidelines through the VAT law or interpretation notes from the revenue authority.

The bigger picture: Saccos and the excise duty net

Savings and Credit Co-operative Societies (Saccos) aim to promote welfare and economic interest of their members through resource mobilisation. Like-minded individuals pool their savings together and earn interest on their savings and can access loans directly through the Sacco. Formally, co-operative societies can be defined as autonomous associations of persons united voluntarily to meet their common economic, social and cultural needs and goals through a jointly-owned and democratically managed entity.

In Kenya, all co-operative societies including Saccos are registered under the Co-operative Societies Act, 1997. As such, for all intents and purposes Saccos are co-operative societies which engage in savings and credit activities. This article focuses on the applicability of excise duty on fees charged by the Saccos based on amendments made to the Customs and Excise Act.

Background

Historically, Saccos have served as an alternative to mainstream commercial banks. Saccos also serve a development purpose by offering school fees financing programs, housing development schemes and property ownership projects at negotiated terms for their members which help ease the month-to-month burdens faced by most households in Kenya.

The Finance Act 2012 amended the Customs and Excise Duty Act to introduce excise duty on, inter alia, 'other fees' charged by financial institutions. Some contentious issues that came with the introduction of this duty were lack of clarity on who qualified as a financial institution and what constituted 'other charges'. These issues were addressed by the Finance

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Lawmakers may have thrown the net intending to catch some fish but one wonders whether the net was up to the task

Act 2013, where 'financial institutions' were defined to include 'persons registered under the Sacco Societies Act, 2008' and 'other fees' were defined to include fees, charges or commissions charged by financial institutions but not including interest.

While it is unclear what the intention of the law was, it is worth noting that there are no Sacco Societies registered under the Sacco Societies Act, 2008. Sacco Societies are registered under the Co-operative Societies Act, 1997 as opposed to the Sacco Societies Act, 2008.

Saccos are generally regulated under the Sacco Societies Act, 2008 which also requires Saccos carrying out deposit-taking business to be licensed under this Act. Therefore, a strict interpretation of the law as currently drafted would imply that no Sacco is subject to excise duty since no Sacco is registered under the Sacco Societies Act, 2008.

Lawmakers may have thrown the net intending to catch some fish but one wonders whether the net was up to the task. We can ask whether the law intends to capture the deposit taking Saccos, all Sacco Societies or all co-operative societies. It is our view that it is only a matter of time before the loophole in law is closed.

Excise tax considerations

While we wait for clarification in law, a few fundamental questions should be addressed: What is the rationale of charging excise duty on Sacco Societies? Should the government not exempt Saccos from excise duty?

Given the significant role that Saccos play in society, we would argue that excise duty is an uncalled for burden on an already disadvantaged populace. The tax is regressive as it seeks to tax Saccos at the same rates as banks who are more advanced and resourceful than Saccos.

The excise duty is also counterproductive in the sense that it makes Saccos more expensive and thus discourages the members from saving and investing. Excise duty also erodes savings. If tax collection is meant to foster national development, why then would the government impose a duty that hinders development and growth for modest income earners?

Another aspect to consider is the fact that Kenya already has a multiple tax system. Saccos obtain funds from members who have already been taxed through the employee tax or business tax regimes. Furthermore, any excise duty burden on Saccos is likely to be shifted to their members since we expect this tax to result in inflated costs for Saccos. Unlike other businesses which may absorb additional excise duty costs with a view to maintaining competitiveness and attractiveness to consumers, co-operatives like Saccos do not have the same flexibility. In our view the government should exercise its discretion to exempt Saccos from excise duty.

Conclusion

Kenya's government needs to build the nation using taxes collected especially at a macro level but not at the expense of development, particularly at the micro level. Development is a two-way street in the sense that both macro and micro development stimulate each other.

For Kenya's government, the challenge is to see the bigger picture and make decisions that will encourage development and investment by all Kenyans. Saccos owe it to their members to lobby for complete exclusion of their activities from the purview of excise duty.

IFRS 4 Phase II is coming very soon

Are you prepared for this new reporting standard for insurance contracts?

Introduction

A new standard for insurance contracts is an opportunity to create more consistent and comparable reporting among insurers and to improve the way in which the performance of an insurance business is demonstrated to investors and consumers. The increasing use of IFRS globally means that any change will be relevant for a wide range of companies operating in highly diverse economies. The global reach of the insurance industry in particular points to the increasing importance of having a single measurement and financial reporting methodology. IFRS 4, Phase II, is part of this larger effort to improve consistency and transparency.

In Kenya, insurance companies are growing through regional expansion, mergers and strategic alliances and product and distribution innovations. Local insurance companies compete with global entrants and large, broad-based financial institutions with established customer bases that can cross-sell insurance products. Companies offering insurance products in Kenya are experiencing transformative changes that are common globally: to operate with more transparency, more accountability and more accessibility.

When insurers present their financial performance on a uniform basis, customers and investors can make more informed choices based on a more accurate impression of insurance companies' performance in the marketplace.

Background

The International Accounting Standards Board (IASB) plans to complete all deliberation on insurance contracts in 2015 and draft the standard in 2016 with a goal of issuing the new insurance standard in late 2016.

The IASB is undertaking this project on insurance contracts because the current standard was only ever intended to be a transition standard and it does not provide the level of transparency and comparability needed by insurers, their customers or the users of their financial statements. Currently, there is a variety of accounting treatments depending upon the type of the contract and the company issuing it; estimates for long-duration contracts are not necessarily updated; discount rates do not reflect economic risks; there is a lack of understanding and experience in estimating a "true" best estimate for the liabilities and there is little information on options and guarantees.

The IASB's exposure draft of IFRS 4 Phase II would be one of the most complex standards to be adopted by the insurance industry. Some complexity is necessary for the wide variety of insurance contracts and insurance business models that exist worldwide. At the same time, there is a clear need

At a glance

- The proposals continue to require entities to measure their insurance contracts using a current measurement model, where current estimates are re-measured each reporting period.
- Included in the exposure draft is the main measurement approach based on the building block approach of a current, discounted and probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract, an explicit risk adjustment and a contractual service margin.
- A simplified approach is permitted if the coverage period is one year or less or if the measurement provides a reasonable approximation of applying the building block approach.

for a high quality standard that will stand the test of time.

The most significant change within IFRS 4 is concerned with valuation of liabilities of insurance contracts. Currently, insurers can use a range of methods and approaches to value liabilities and there is limited, if any, disclosure regarding the methods used and their appropriateness. IFRS 4 Phase II would replace IFRS 4 and will bring more harmony in estimating and reporting liabilities so that insurers' balance sheets are more comparable.

On the operational side, IFRS 4 Phase II will cause substantial procedural changes. It requires insurers to manage more granular data requirements and the ability to pull the right data the first time around, conduct more analysis and employ the right systems and the right people with the right skills.

IFRS 4 Phase II is scheduled to come into force from 2018, however there is an expectation that it may be delayed slightly. As such, it may be tempting to wait, but due to the fundamental changes to the valuation basis and its related impact and volatility on the financial statements, insurers are well advised to act now.

Firms need to assess the implications of the new proposals on both their contracts and their businesses. This assessment can be directly incorporated into their short and medium-term strategic planning.

Technical discussion

IFRS 4 Phase II proposes adjustments to the way that the current value of the future cash flows and services of insurance contacts are measured. The measurement of an insurance contract reflects, on an expected value basis, the entity's view of how the policyholders in the portfolio that contains the contract will exercise options available to them, and the risk adjustment will reflect the entity's view of how the actual behaviour of the policyholders in the portfolio of contracts may differ from the expected behaviour.

The graph below shows how the changes in the building block measurement approach flow into the income statement and into the Other Comprehensive Income (OCI) in shareholder's equity on the balance sheet. The changes related to future services will be recognised against the contractual service margin as long as it has a positive balance.

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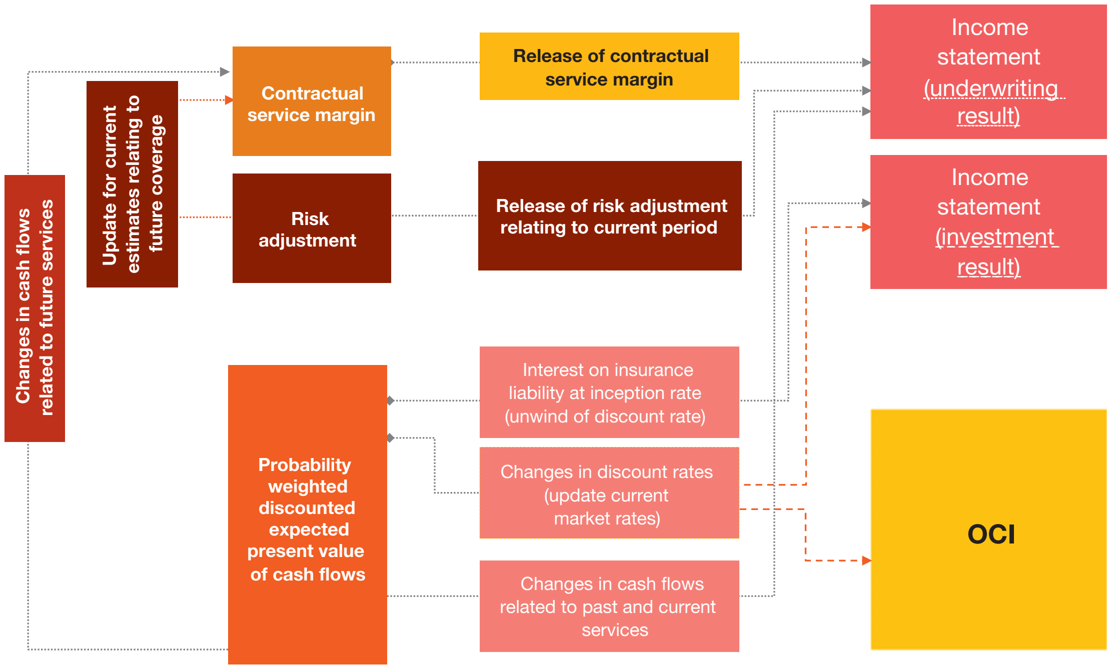
Insurance contracts: Building block approach



Some areas in which IFRS 4 Phase 2 will significantly impact on financial reporting for insurance companies are:

1. ***No allowance for premium income:*** For accounting purposes, IFRS 4 Phase II proposes that premium income will accrue over time. This change applies to the valuation of the liability all the way to the income statement. Previously, when a customer paid a premium, it was recognised as income on day 1 and subsequently the expected profit from the policy was recognised on day 1. This substantial change not only influences the way that insurers report financial performance on their income statements, but also how they manage and monitor the long-term performance and profitability of their business. Firms need to understand the impact of the change on their performance and manage the communication of these changes clearly to all the relevant internal and external stakeholders.

2. ***Contract service margin:*** The contractual service margin represents the unearned profit in an insurance contract that is amortised over the remaining coverage period in a systematic way that best reflects the remaining services provided under the contract.

   IFRS 4 Phase II proposes that when an entity recognises the contractual service margin, they should use a level of aggregation that ensures that the contractual service margin is recognised in line with the pattern of services provided under the contracts to which they relate. This would mean that when the coverage period of each contract has ended, the contractual service margin relating to that contract should be fully recognised in profit or loss.

3. ***Liability valuation:*** One of the most fundamental changes as part of IFRS 4 Phase II is under the liability valuation. Whilst there are still contentious matters to be addressed for participating contracts, the approach for all other insurance contracts has been set down. Insurers will have a choice of 3 approaches (building block approach - BBA, premium allocation approach - PAA, and the simplified PAA) that can be used, but essentially a “true” best estimate must be obtained and there must be an allowance for an explicit risk margin made.

   This will not only cause a fundamental change to the way in which liability valuation is approached, but firms will need to spend sufficient time ensuring that management fully understands the assumptions driving the liability valuations. The assumptions used to value risk must take into account all probabilities (even remote ones) and they must be considered and weighted. The objective is to incorporate all of the relevant information and not ignore any information that is difficult to obtain. No doubt this will have additional data and systems implications.

4. ***Volatility in income statements over comparable periods:*** In response to concerns raised with regard to volatility in the income statement, the difference between the liability discounted at the current discount rate and the rate at initial recognition will be recognised in OCI, rather than in profit or loss. The interest expense recognised in profit or loss will be based on the discount rate at initial recognition.

An entity is effectively required to measure the insurance contract on a current basis in the statement of financial position and on an amortised cost basis for presentation in profit or loss.

This will require an entity to apply different discount rates to different contracts according to their date of initial recognition, rather than applying only the current discount rate to all cash flows. Another source of volatility if not well managed is the classification and measurement policies for financial assets under IFRS 9 (effective 1 January 2018).

Under IFRS 9, classification determines where gains and losses on financial assets are reported (income statement or OCI). The IASB plans to allow entities to reassess their classification of financial assets on the adoption of the new insurance standards. However, entities need to act now on both these standards to reduce volatility and surprises.

Conclusion

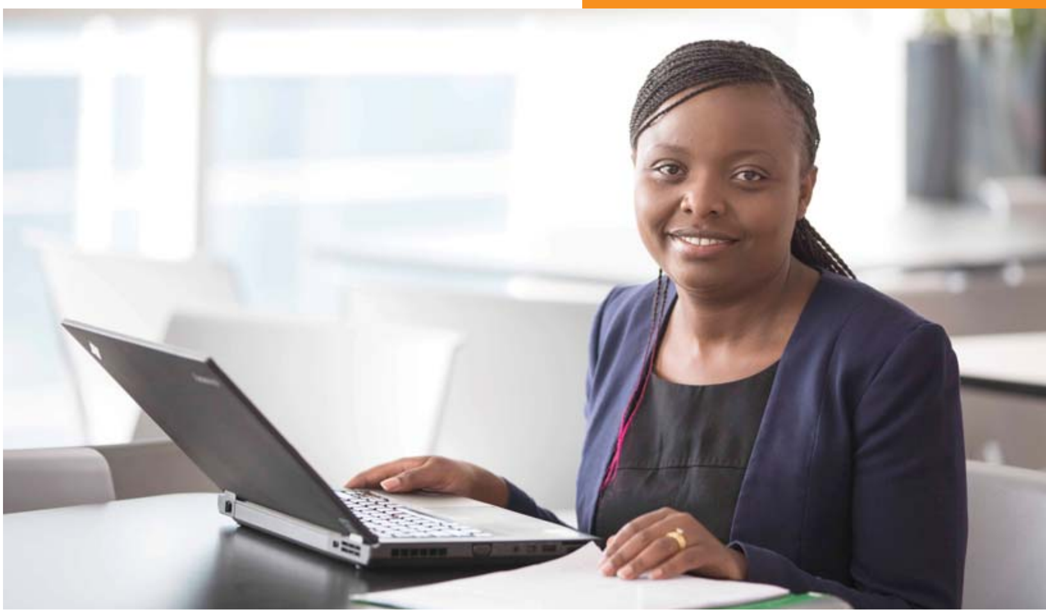
The continued lack of an understandable, consistent global standard of accounting for insurance contracts is reducing the attractiveness of the industry to investors.

The proposed IFRS 4 Phase II standard will significantly affect all entities that issue insurance contracts. The new proposals add considerable complexity and create added demands on resources, data and modelling systems, and stakeholders need to understand the changes. The impact of the proposals will also vary depending upon local accounting and regulatory requirements.

It is important for insurers and other entities issuing insurance contracts to assess how all the requirements in the IFRS 4 Phase II measurement model fit together and to seek guidance to ensure that their strategies for implementing these changes are incorporated fully into their larger business objectives.

Key questions to ask now:

Financial reporting and performance measurement	What will this look like in the new world of IFRS 4 Phase II? How do you want to be viewed in the market? New KPIs will be critical for day to day business management right through to investor communications so it is vital to start thinking about this now.
Systems implementation	Do you have sufficiently granular data? Do you have lots of legacy systems? Can you leverage your current systems? Are you going through systems changes now? Save time, effort and costs now by integrating IFRS 4 Phase II implementation plans into existing systems upgrades, e.g. risk-based capital projects.
Actuarial, Risk and Finance Modernisation	Are your processes as streamlined as they could be? Do you have harmonisation between these functions? Greater collaboration, understanding and knowledge sharing will be required and in this time of change now is the opportunity to make sure that you factor in all the changes that will be required.
Simplified measurement model – Premium Allocation Approach (PAA)	Can you identify your multi-year policies and their terms and conditions? Do you know how many you have and how material they are to your business? Multi-year policies do not automatically qualify for the PAA so you need to start investigating now to assess if the PAA is right for you.



Prepare for the possible impact of BEPS on financial institutions

Tax has always played a critical role in society, generating the funds for investment by governments in public services and infrastructure. However, the recent global economic downturn has seen public finances come under heavy pressure in Africa and many parts of the world.

This fiscal squeeze has led tax authorities to focus on increasing tax compliance, yet companies continue to grapple with tax laws not necessarily designed for today's business activities.

Wider factors have also come into play. The debate over whether companies pay their "fair share" has seen many multinational companies criticized publicly for implementing tax structures allowable under tax law in force at the time.

Given this trend, businesses need to be ready to engage and to respond to questions around tax in a clear and understandable way, and to a much wider base of stakeholders than before. The financial services sector has been at the forefront of such scrutiny, particularly in jurisdictions where banks have benefitted from government bailout packages.

The response of the OECD & G20

The increased scrutiny of multinationals' international tax policies has led the Organisation for Economic Co-operation & Development (OECD) to tackle the perceived issue of base erosion and profit shifting (BEPS). With the backing of the G20, the OECD published a 15 point action plan in July 2013, setting out proposals to address base erosion and profit shifting.

The project has developed in response to concerns that the interaction between various domestic tax systems and double tax treaties (DTTs) can often lead to profits falling outside the charge to tax altogether or be subject to an unduly low rate of tax. The OECD published its final BEPS package in October 2015.

Although Kenya is not a member of the OECD, it was invited to be one of the 14 non-member states to participate directly in the Committee of Fiscal Affairs and the Working Party meetings on the BEPS project.

In addition, the African Tax Administration Forum (ATAF), within which all five members of the East African Community (EAC) are represented, was directly involved from the outset. We should therefore expect BEPS to be high on the agenda for tax administrators in our region.

Base erosion, double non-taxation, treaty abuse, permanent establishments and transfer pricing reform are collectively and commonly referred to as 'Base Erosion and Profit Shifting' or BEPS.

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What impact will BEPS have in the FS environment?

Given the degree of financial sector (FS) regulation which already exists, FS institutions may believe that they have less to take note of from BEPS; however, any multinational or regional business needs to be cognizant of the possible impacts that BEPS may have.

Some of the key areas which have been addressed by the various action points are as follows:

- Addressing the specific tax challenges posed by the digital economy;
- Neutralising the effects of hybrid entity/instrument mismatches;
- Preventing base erosion through the use of interest expense and other financial payments that are economically equivalent to interest;
- Countering the use of harmful tax practices, e.g. preferential tax regimes;
- Preventing treaty abuse, e.g. "treaty shopping";
- Preventing the artificial avoidance of Permanent Establishment status;
- Aligning the location of profits for tax purposes with the location of the activities giving rise to those profits;
- Providing mandatory disclosure rules;
- Re-examining Country by Country Reporting (CbCR) and Transfer Pricing documentation:
- Delivering more effective Dispute Resolution Mechanisms.

Highlights for the financial sector include:

Action 2: Hybrid Mismatch Agreements

The OECD's concern is that different countries treat certain entities or instruments differently resulting in double non-taxation or double tax deductions. For example, one country treats payments arising from an instrument as debt (generating tax deductible interest) and another country treats the same instrument as equity, in the form of tax exempt dividends. Such hybrid financial instruments will need to be reviewed thoroughly, from a tax risk perspective.

Actions 8 – 10: Intangibles, Risk & Capital

Under this group of Actions, the OECD is seeking to ensure that companies performing important functions, controlling economically significant risks and contributing assets will be entitled to an appropriate return. Particular emphasis is given to the allocation of risk and capital, two areas of primary importance to the financial sector. The co-location of key people activities with the return on capital will be of particular significance.

Action 13: CbCR & Transfer Pricing (TP) documentation

Any institution with cross-border activities will already be familiar with the need for robust, contemporaneous TP documentation. In developing CbCR, the OECD has mandated much more detailed levels of information to be shared, e.g. global allocation of income and tax paid, which could set the tone for more detailed enquiries from tax authorities. Note also that Tax Information Exchange Agreements have increased more than tenfold, as tax authorities seek to widen their formal access to taxpayer information.

Conclusion

Businesses need to constantly keep themselves updated of changing tax law, but the pace of change is growing. For those operating in the FS space, regional expansion and product diversification may be trigger points for more attention from an increasingly hungry and well-informed tax authority.

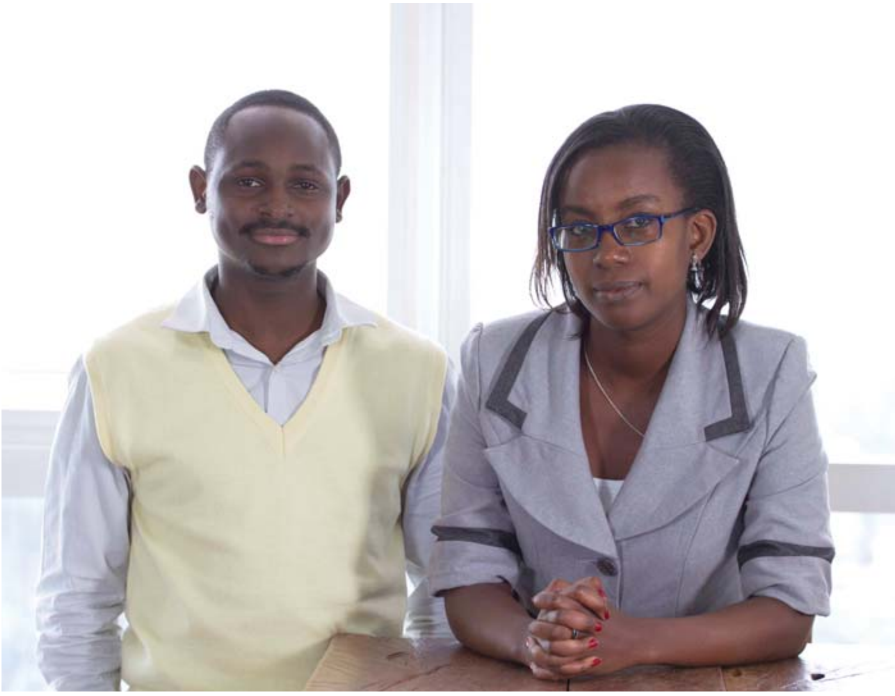
Evaluating excise duty: the banking industry dimension

Excise duty is a consumption tax charged on the sale, or production for sale, of specific goods or services within a country. It is collected at the point of production of goods or provision of services. Historically, excise duty has been viewed as a tax aimed at influencing certain consumer behaviours by punishing or deterring those consuming products that are viewed as having major externalities in the economy either to the consumer or to the society at large.

Recently in Kenya, the government has expanded the scope of supplies subject to excise duty by bringing into the excise duty net such products as plastics, bottled drinking water, cosmetics and soft drinks, among others. In addition, the government has shifted the focus of excise duty from goods to services perhaps with the aim of revenue generation.

With regards to the excise duty on services, the scope was expanded in 2013 to bring financial services and money transfer services into the net. Excise duty at the rate of 10% was introduced with effect from 18 June 2013 on any fees, charges or commissions charged by, inter alia, persons licensed under the Banking Act and the Central Bank Act with the exception of interest.

Owing to the challenges around implementation of the excise duty requirements, the banks under their umbrella body, the Kenya Bankers Association (KBA), engaged and agreed with KRA on a commencement date of 1 August 2013. This meant that the first excise duty returns and payments by banks were to be made on or by 20 September 2013.



Additionally, through the consultative process the KRA and KBA agreed to exclude certain revenue streams earned by banks from the ambit of excise duty. The revenue streams excluded from the taxation as per this agreement include interest, commissions from treasury bills/bonds and foreign exchange gains among others.

The lack of clarity in the law has left banks grappling with uncertainty

However, despite the agreement between the KRA and KBA the Customs and Excise Act, Cap 472, which is the legislation that governs excise duty, was not amended to provide for duty exemptions or clear the guidance of the definitions of the exempt income streams.

The lack of clarity in the law has left banks grappling with uncertainty; for instance it remains unclear whether the returns/profit earned from sharia banking business can be construed to be of similar nature to interest and as such exempted from the excise duty as well. Perhaps the Customs and Excise Duty legislation could adopt the Income Tax Act definition of interest.

The other income streams that require clarity include transfer of funds from unclaimed balances, renewal fees for loans, loan processing/administration fees, commitment fees on hire purchase among others.

Separately, most local banks seeking to establish a regional presence have set up shared service centres to allow them to take advantage of economies of scale. Costs are therefore incurred centrally by the Kenyan shared service centres and recharged to the regional affiliates. In this regard, the law is silent on whether such group recharges should be subjected to excise tax or they qualify for exclusion from duty owing to the fact that the services offered to the regional affiliates are for use/consumption outside Kenya.

It is our view that excise duty was meant to capture services regulated under the Banking Act (alongside other regulated financial services). However, given the broad definitions in the law, the scope of this excise duty is currently wider than the regulated financial services, which creates inequity on the taxation of revenue earned by banks vis-à-vis other taxpayers providing services similar to those offered by banks.

For instance, transactional consultancy services offered by a bank may be a target for excise duty whilst if similar services were offered by a professional services firm such as PwC they would fall outside the reach of excise duty laws. Furthermore, some of these non-banking based services also attract VAT at 16% hence increasing the cost of providing these services.

At the end of it all, it is the *mwananchi* that suffers the blunt of the uncertainty and seemingly imbalanced trading field in the form of increased charges from the banks. Given the current environment of increased interest rates, any reprieve that the government can provide by way of clarity with regards to the taxation of services offered by banks would be greatly welcome.

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Canary in the mine: Asset management in Kenya prepares to fly

Kenya's asset management industry is the second-fastest growing industry of its kind in Africa. The reasons for this growth trajectory as well as the challenges faced by the industry serve as a 'canary in the mine' for Kenya's financial services industry. Those investors who listen carefully will discern the risks from the rewards.

Our research and expertise related to the asset management industry show that it is poised to deliver significant value to more Kenyans by 2020. The performance of foreign funds which invest a percentage of their portfolio in Kenya is a less-than-ideal harbinger of things to come for Kenya's asset management industry.

It is far more instructive to evaluate the impact of 'game changing' factors like economic growth, a rising middle class, technology adoption and urbanisation as well as asset class performance over the last several years.

Domestic institutional investors like insurance companies, wealthy and middle class Kenyans and foreign investors all want the same thing: a return on investment that outpaces inflation, currency depreciation, political instability and other risks. In simple terms, the asset management industry provides vehicles for investors to realize a return on their investment.

Our research, published recently in Africa Asset Management 2020, compares Kenya's financial services sector with Kenya's GDP growth to inform predictions about the growth of assets under management. As the financial services sector grows in relation to GDP, the sector will have more assets to invest.

Strong capital markets together with macroeconomic stability also point to significant potential. Voluntary pension schemes for middle class workers and investment product innovation, together with improving financial literacy and a strong savings culture, complete a virtuous circle of better returns that will encourage more investment.

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Assets under management are growing by double-digits

In Kenya, investment funds are known as Collective Investment Schemes and the most common type are Unit Trusts. According to our analysis and publicly available information, Unit Trusts' assets under management grew from KES 17.6 billion in 2010 to KES 38.1 billion in 2014, a compound annual growth rate of 21.2%. Domestic equities and fixed deposits are the most common asset classes among Kenyan fund managers, accounting for 62% of portfolio allocation, while government securities account for 17%.

Pension funds' asset growth has increased 15.6% from KES 451 billion in 2010 to KES 806 billion in 2014 with most pension fund assets invested in government securities, listed equities and property. Insurance industry assets increased 18.9% from KES 233 billion in 2010 to KES 435 billion in 2014. Primarily, insurance industry assets are invested in government bonds, property and equities. Banks' assets are by far the largest in Kenya, growing 18% from KES 1,374 billion in 2010 to KES 2,521 billion in 2014. Given their large assets, we expect many of Kenya's banks to open asset management subsidiaries and to leverage their well-developed distribution networks.

Looking forward, we anticipate significant growth in assets under management and particularly those that are invested in REITs and private equity funds. Kenya is the leading market in East Africa for alternative investments largely thanks to a booming real estate sector. Real Estate Investment Trusts (REITs) provide a broader range of investment opportunities and support growth in the real estate sector. Private equity investment activity is increasing, but pension funds are restricted from allocating more than 10% of assets to investment.

'Game changing' mega-trends impacting asset management

In Kenya, mobile access to financial services may very likely leapfrog traditional brick-and-mortar distribution channels for asset management products. Insurance companies host the majority of asset managers and assets under management, and although insurance penetration in Kenya is still very low, there is strong potential for growth. Insurance companies and other financial service providers like banks increasingly use technology for 'know your customer,' data-driven market analysis as well as effective distribution of products and services. Technology is a clear 'game changer' for insurers, other financial services providers and the asset management industry as well as consumers of their products and services.

Demographic shifts will also impact Kenya's asset management industry. As governments and families dedicate more resources to education, the human capital (i.e., productivity) per worker will also increase. Job creation will reduce the dependency on each worker and lead to increased savings and investment. Institutions and individuals alike will demand savings and investment products that suit their appetite for risk, their time frames for investing and improve their confidence in these products.

There is good reason to expect both financial sector deepening and greater financial literacy between now and 2020. The financial services industry has shown a keen interest in developing financial literacy as well as servicing remote areas. Recent proposals to develop an alternative market with Real Estate Investment Trusts and Private Equity funds, as well as ongoing plans to establish Islamic Sukuks and Sharia-compliant mutual funds, will further deepen the financial market and serve the needs of more Kenyans.

At present, Kenya's regulatory framework is not well developed for global asset management products like money market funds or hedge funds. Regulatory changes like allowing pension funds to invest in a wider range of assets and the establishment of a three-tier pension system can be implemented in lock-step (or preferably a step ahead) of growing demand.

However, there is strong evidence to show that a relatively undeveloped regulatory framework is not a deterrent to investors, who have shown a medium- to long-term view of investment in Kenya. One of the most worrisome risks to investment is security. Addressing Kenya's security risks will contribute directly to investor confidence.

Asset management is a complex industry and many of Kenya's most talented asset managers have worked in developed markets. Their exposure to global asset management products and regulatory frameworks contributes to confidence among their investors. Skilled management of assets has a demonstrable impact on returns. Some skills will need to be developed further but our research shows that Kenya's financial services sector will invest in those skills, anticipating the demand for them.

Overall, Kenya's asset management industry shows great promise. The quality of institutions and infrastructure supports the expansion of the financial services sector relative to GDP and Kenya's position as a hub for financial services in the region will have far-reaching effects in East Africa and beyond. Kenya's asset management industry is one of many 'canaries in the mine' in the financial services sector. But in my view, this particular canary is singing very sweetly indeed.

REITs: Unlocking value in real estate

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The STANLIB Fahari I-REIT has become the first REIT to receive Capital Markets Authority (CMA) Approval and is on course to be Kenya's first listed property income fund.

REITs allow investors to share ownership in large real estate properties like major office buildings or hotels that would otherwise be difficult to afford. Investors buy units in the REIT and earn dividends based on the value of their investment and the income performance of the trust. REITs offer high liquidity, relative to outright real estate ownership, by enabling investors to sell units quickly.

Another benefit is the tax exempt status accorded to REITs. Payments for redemption of units or sale of shares received by unit holders or shareholders are exempt from tax on capital gains which was recently re-introduced after being suspended for three decades.

Legal form

A REIT may be structured in two forms:

- D-REIT: A development and construction real estate investment trust; or
- I-REIT: An income real estate investment trust.

A REIT is structured as an unincorporated common law trust which is divided into units, established under a trust deed and has a trustee who is independent of the REIT, manager and the promoter. It also must have a REIT manager and a trustee who are licensed persons.

A REIT can be open ended or close ended. An open ended fund means a person may acquire additional units from time to time and dispose of them by having the units redeemed by the trustee. The size of the fund may expand or contract as investors acquire or dispose units. The value of units

in an open ended fund is determined by the net asset value of the fund. On the other hand, in a close ended fund, the number of REIT securities issued remains constant over time except where a new issue of REIT securities is made or there is reduction in the capital of the fund initiated by the trustee or as a consequence of termination or winding up of the trust. The value of the units in this fund is driven by investor demand.

Taxation of REITs

The income of a REIT registered by the Commissioner is exempt from income tax except for the payment of withholding tax on interest income and dividend. However, withholding tax does not apply in cases where the REITs unit holder or shareholders are generally exempt from tax. Unit holders who are exempt from tax may include among others registered retirement schemes.

In addition, payments for redemption of units or sale of shares received by unit holders or shareholders are exempt from tax on capital gains which was recently re-introduced.

With regards to VAT, rental income earned from the sale, renting or leasing of non-residential premises would be subject to VAT. The sale, renting, leasing, hiring or letting of land and residential premises is exempt from VAT. In addition, if a REIT has been set up as a charitable organisation and it obtains tax exemption as provided under the Income Tax Act, such a REIT will also be exempt from VAT on the supply of social welfare services which are not made by way of business.

Offers in respect of a REIT

An offer or an issue of REIT securities shall be made either as

- A restricted offer to professional investors in accordance with an offering memorandum; or
- An unrestricted offer in accordance with a prospectus.

A "professional investor" means any person licensed under the Act, an authorized scheme or collective investment scheme, a bank or subsidiary of a bank, insurance company, co-operative, statutory fund, pension or retirement fund; or a person including a company, partnership, association or a trustee on behalf of a trust which, either alone, or with any associates on a joint account subscribes for REIT securities with an issue price equal to at least KES 5 million.

Capital requirements

The minimum value of the initial assets of a real estate investment trust in a D-REIT is KES 100 million and in an I-REIT is KES 300 million.

Listing requirements

D-REITs may only be offered as a restricted offer to professional investors and can only be listed on a market segment of a securities exchange approved by the CMA which limits trading to a restricted minimum parcel size of KES 5 million. I-REITs on the other hand may be offered as a restricted offer to professional investors in accordance with an offering memorandum (in which case the foregoing restrictions apply) or as an unrestricted offer in accordance with a prospectus. The STANLIB Fahari I-REIT has chosen the latter option thus allowing a lower minimum subscription of KES 20,000.

Asset/Income/activity tests

The trustee of a REIT may invest in:

- Eligible real estate directly;
- Eligible real estate assets through investment in an investee company incorporated in Kenya which directly owns the eligible real estate and which is wholly beneficially owned and controlled by the trustee in its capacity as the trustee of the REIT;
- Eligible real estate assets through an investee trust in which the trustee of the REIT in its capacity as trustee is the sole beneficiary and has absolute control of voting and right to appoint and remove the trustee of the investee trust;
- Cash, deposits, bonds, securities and money market instruments;
- A wholly beneficially owned and controlled company subsidiary which conducts real estate related activities; and
- Other income producing assets including shares in property companies incorporated in Kenya whose principal business is real estate related or REIT securities in other Kenyan REITS, provided that the shares or REIT securities are listed on an approved securities exchange.

An I-REIT shall in each financial year after the second anniversary of its authorisation earn at least 70% of its income from rent, licence fees or access or usage rights or other income streams of a similar nature generated by eligible investments in income producing real estate. Any profits or capital gains from the sale of real estate shall be excluded in determining the income of the I-REIT.

Distributions

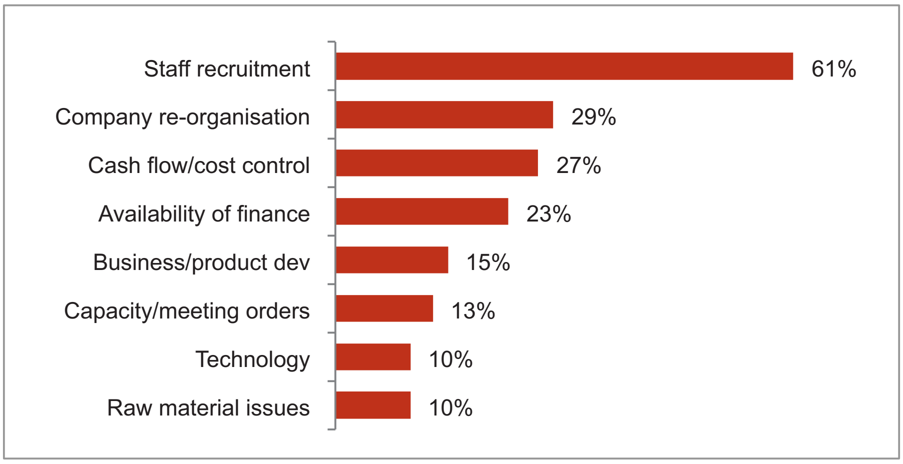
The trustee may only make distributions to REIT securities holders from realized gains, realized income or from cash held in the fund which is surplus to the investment requirements of the trust. The trustee of an I-REIT shall, subject to a higher minimum being specified in the scheme documents and to the provisions of the CMA Regulations, distribute, within four months after the end of each financial year, a minimum of 80% of the net after tax income.

For a D-REIT, where the trustee is of the opinion that the level of distribution recommended by the REIT manager is not in the interests of REIT securities holders, the trustee shall call a meeting of REIT securities holders to approve, by way of ordinary resolution, a lower distribution.

How can financial institutions navigate the owner's agenda?

Cash is king, so they say! Effective cash management is imperative for a family business. Cash is one of the most common vehicles for financing growth among private companies in Kenya. According to the results of our recent survey of owners of private companies, PwC's 2014 Private Company Survey, 23% of private companies identify availability of finance as a key issue to the success of their business.

Key internal issues in next 12 months



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In order for financial institutions to better understand how private companies operate, the traditional principles of business relationships such as mutual commitment, building trust, dedication and reliability are very important.

The bottom line for what private companies expect from financial institutions is clear: They want their financial institutions to stay close, understand their needs and consistently deliver quality services.

These less tangible aspects of financial institutions' relationships are key considerations when family businesses select and retain external financial advisors including asset managers, fund managers or banks among others.

What makes family businesses different?

Appreciating family businesses requires an understanding of how mixing business with family results in unique characteristics.

At the outset it may be hard to tell whether a company will become a family business. An entrepreneur may choose his spouse as his first co-director, followed by trusted siblings, cousins or other family members whom he knows well.

In time, the factors that distinguish a family business are its ownership and a corporate culture that transcends generations. Their different values lead to different strategic overarching goals. A family business's appetite for risk will drive them towards focusing on stability, returns and thereafter growth. In comparison, a publicly listed company may tend to focus on growth first followed by return and stability.

In light of the above, the owner's strategy will influence the business strategy in different ways. Family businesses can often answer the question 'where do you see your business heading in ten years' but family business owners usually struggle to answer 'who and why that person will be running the business in ten years from now'.

Possession and emotion

It is quite natural for families in business to be possessive and emotional about their business and assets. Over the years, a strong bond is woven between the family and business. Apart from the fact that a family's social standing becomes linked with its business, family members also see it as a symbol of the older generation that struggled to build the business.

Unfortunately, sometimes the emotional ties end up working to their disadvantage. For instance if a business is not faring well for various reasons (such as lack of adequate funds, loss of creditors, mismanagement) the founders could recognise the need to be more professional and consider outsourcing / buying in services from third party service providers.

Financial institutions should do their homework

Financial institutions' alignment of interest to that of the family is vital. If a family business has taken a long term approach to building a successful business, managing their wealth to ensure longevity will be essential. As such, by hiring financial institutions who then choose to pursue opportunistic investment strategies designed to help the institution more than the family will be catastrophic for

23%

Of private companies identify availability of finance as a key issue to the success of their business.

the relationship. So an open, honest and coherent governance structure should be set up to help financial institutions understand the owner's agenda.

It is important to appreciate that family businesses associate debt with fragility and risk. Typically, family businesses manage their downside better than the upside. They generally do a better job of keeping their expenses under control due to leaner cost structures and consequently they have limited exposure to black holes during a crisis. Particularly in Kenya, financing is expensive in the current economic climate.

With the rise of interest rates to 11.5% since July 2015, if companies borrow in Kenya shillings the interest rate is higher. With the shilling remaining increasingly vulnerable, to borrow dollars companies must earn dollars.

Further complicating the situation, the banking sector's reputation among family businesses may not immediately engender trust and family businesses may avoid giving too much power to banks by leaving most of the cash in the company.

Increasingly, financial institutions must also become more agile and respond to market changes by adapting and offering more innovative products to private companies. For most private companies, cash-driven growth is not going to be adequate in the long term, no matter how carefully or strategically it is employed.

Financial institutions must understand the challenges facing family businesses, and the owners' agenda to initiate broader discussions to build trust and confidence. One way to do this is for financial institutions to hire staff with relevant skills and relationships in the business communities, who can communicate the value of products and services available to private companies and family businesses. Financial institutions must be able to engage in deeper conversations to help family businesses enhance wealth protection for generations to come and to grow the company sustainably and profitably.

Sustainable finance strategies differentiate Kenya's banks

Banks catalyse change and help build sustainable economies through their allocation of capital to specific activities. In Kenya, banks are significant contributors to education, health, financial literacy and environmental causes through their social investment programmes.

The Kenya Bankers Association (KBA) estimates that Kenya's banks contribute more than KES 1.2 billion every year to these and other causes. Banks' social investments have helped to transform lives as well as strengthen their reputations in the market.

The banking industry is also one of the largest contributors to tax revenue in Kenya and through various banking activities directly contributes to Kenya's economic and social development.

Now, another route to change is opening up in Kenya: sustainable finance.

Sustainable finance is the process of creating economic and social value through sustainable financial models, products and markets. Examples of sustainable finance initiatives include sustainable funding, green bonds, impact investing, microfinance, active ownership and credit for project finance.

A strategic framework supporting sustainable finance requires a significant shift in how banks view themselves and how they participate in the market. Traditionally, many social investments and sustainable finance initiatives have operated within 'silos'.

In partnership with the International Finance Corporation (IFC), KBA recently convened a group of local consultants, bank employees and others in Nairobi, Kenya, to help build a better understanding of sustainable finance strategies that are holistic and measurable. The IFC/KBA training focused on the benefits and the process of building such a strategy.

There are several elements of a successful sustainable finance strategy:

1. Develop clear Key Performance Indicators (KPIs) and tacit targets for various business units within banks. The supervision of these targets and the integration of the KPIs should run from business unit level to Board level.

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2. Include developing new financing structures that capture and monetise non-financial value for unlocking new areas of loans and investments.
3. Align the sustainable finance strategy to the overall business strategy and ensure that it is both qualitative and quantifiable. Communicate the sustainable finance strategy to investors, shareholders and other stakeholders.
4. Ensure that the sustainable finance strategy has a solid capital allocation and comprehensive budgeting process.
5. Design the strategy to be opportunity-driven and systematic in approach.

Sustainable finance in action

A bank that included sustainable funding in its sustainable finance strategy would take into account the environmental and social implications of a project before agreeing to provide the funding for it.

There are no common global standards defining a 'green project' but a bank's sustainable finance strategy would identify standards governing the metrics that it would use to evaluate the project, essentially focusing on the project's environmental and social risks and impact.

Some of those standards could factor in cultural heritage, indigenous peoples, involuntary resettlement, biodiversity, labour and working conditions, resource efficiency and community health, security and safety. These standards would also contribute to the bank's procedure for measuring the performance of its investment.

This process would apply to projects where the bank provides the funding and co-owns the project, as opposed to project finance or debt finance where the bank expects to be paid back.

The IFC has an interest in this process because if the project requires significant capital, the bank may co-fund the project with the IFC or other development finance institutions. When the IFC becomes a stakeholder in the project, the local bank has already assessed the investment according to these metrics.

One of the main risks to the success of a sustainable finance strategy is that the focus remains firmly rooted in the reputational benefits of the strategy and any activity of a 'sustainable' nature remains the purview of the bank's corporate social responsibility team. Instead, a bank can create a direct linkage between sustainability performance and overall performance and convey this linkage to its stakeholders through clear communications like integrated reporting.

Banks are agents of change

For a sustainable finance strategy to be successful, a bank must view itself as an agent of change and a direct contributor to Kenya's sustainable development.

For example, a bank providing project finance for a new shopping mall deliberately evaluates the impact of the mall on various stakeholders. The bank's project finance team uses standards guiding the identification of these stakeholders. Part of the deliberation would include a discussion of the mall's contribution towards building Kenya's consumer class, particularly the middle class. The mall's anchor tenant might be a supermarket whose suppliers include many local manufacturers.

Building the mall will have an environmental impact and could displace people living on the land, and the land could have cultural heritage value to the community. These and other factors would contribute to the bank's decision to provide the project financing. For this to happen, the bank's sustainable finance strategy and its core business strategy must be aligned and integrated through business unit levels all the way to the Board level.

The bank may need to review its lending and investment processes and design, implement and monitor process changes to incorporate the sustainable finance strategy. 'Know your customer' data collection and analysis may also require review and changes and bank personnel trained to implement the strategy.

Kenya's banks are already making significant contributions to Kenya's economic and social development. A systematic, strategic approach to sustainable finance will help take them to the next level.

Mohamed Karama is a Partner with PwC East Africa's advisory consulting practise. Drawing upon his deep expertise in guiding business transformations among financial institutions, Mohamed recently shared his views on the make-or-break requirements of today's business transformations.

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Successful business transformations focus on measurable benefits

Organisations large and small are talking about business transformation. Implementing lasting, positive and integrated change to their business functions can help organisations to gain a competitive advantage. Many organisations may have no choice but to change in order to act on new opportunities.

Mohamed, what does transformation mean to you?

Business transformation is about creating lasting change—the type of change that really sticks. For that to happen, there has to be a clear understanding of the business' strategic objectives particularly from a c-suite standpoint. Managing a business transformation requires versatility and the ability to work well with people through different processes and technologies. Finally, a business transformation will only succeed if the focus is on the benefits of the transformation and there are analytical tools in place to track these benefits.

Our approach is scalable and essentially simple. There are three underpinning components of the transformation journey: people, process and technology. Absent one of the three, organisations run into headwinds. Do they have the right people in the right positions? Are their best people in the areas of opportunities or the areas where they have challenges? Great companies put their best people in the areas of greatest opportunity. As for business processes, how are challenges surfacing to the right people at the right time? Are opportunities surfacing at the right time to the right people?

What are the benefits?

A transformation journey leads to the optimum combination of the following: true focus on customer experience where the full capacity of an organisation is mobilised and focused on delighting that defined customer, market-share growth, geographical expansion, revenue and profitability growth far exceeding industry averages, and highly motivated, performing and engaged workforce.

How do you start a conversation about business transformation?

We start with an understanding that a transformation is unlike any other project or anything that has been done before. With business leaders in the financial services industry, the conversation often begins with technology but I try to steer the conversation towards their larger business strategy. Then we can refocus on how to enable the business strategy through more efficient processes, making sure that the business has the right structures and people to deliver the transformation and deploying enabling technologies.

Can you give an example from a real transformation, in the financial services industry?

We talked to Britam's leadership team about enabling their business strategy which we supported them in developing. We showed them that their strategy was not going to help them to achieve their goals without IT as an enabler. Our technology strategy was going to identify every single roadblock to enable the business strategy. Part of the roadmap identified all of the challenges; the other part prioritised all of the areas of opportunity. We gave them a short, medium and long-term roadmap that they could continue to refer to and that allowed them to achieve 'low hanging fruit' successes. The beauty of this approach is that it gave Britam assurance because they were able to achieve something with an immediate outcome, giving them the confidence to achieve the next step. Each project has a defined impact and benefit.

Technology was the grease in the wheels; they knew where they wanted to go and our strategy team helped them to conceptualise how to get there, end to end. It is a very methodical approach.

How does leadership influence the success of a business transformation?

As the Group Managing Director, Dr Benson Wairegi's leadership style brought Britam's transformation strategy to life. He accepted nothing short of excellence. No excuses, just results. He made us perform and he made his management team perform to make their strategy a living document. He set the tone from the top. He knew that Britam's IT enabled business transformation—Project Jawabu—is the answer to delivering excellent customer service.

Jack Maina is the Group CIO who made Jawabu come to life. Jack owns and oversees the technology-enabled business transformation on behalf of Britam. The impact of Jawabu as Jack has stated, is that it has ushered in a new era of convenience for Britam's customers and workforce.

What has made Jack successful is not the focus on technology, which he does very well, it is the engagement with Britam's business unit leaders to ensure that technology delivers on the business's objectives.

The transformation's steering committee is made up of all the business unit leaders and co-chaired by a Board member and Benson. In practice, this means that business unit leaders become the transformation's champions.

One of the unique aspects of this approach is to utilise the steering committee not only to implement the transformation but also to own the benefits that are derived through the enabling technology. The business unit leaders report to the rest of the steering committee on a monthly basis on the benefits achieved and the impact to the business.

What steps would a transformation typically entail?

The first step is to ensure that the relationships are there to achieve the transformation. As consultants, we have to earn the confidence of our clients through relationships founded on trust. The next step is to really understand the business strategy: where does leadership want the business to be in one year, in five years? What are the opportunities of tomorrow? We can work with leadership to look at this carefully and critically.

The next step is to craft a roadmap guiding the business transformation with technology as an enabler, every step of the way. This is because business and IT are now completely integrated. There is no business process that I can think of that is not technologically enabled today.

A step-by-step approach, or a phased approach, can take time. Business transformation requires the right people, the right teams, the right training. Process re-engineering, organisational design, job descriptions, internal and external communications—all of these may need to change, and therefore change management is critically important.

How do you secure the buy-in of the client's staff—the people who will live and breathe the transformation?

With any transformation, people need to be empowered. The business unit leaders selected their best people and put them in the Jawabu team on a secondment basis for over a year.

Many organisations talk about putting their best people forward on strategic initiatives, but few do. Instead, they tend to put the people who are available. If they put forward their best people, they still task them with business-as-usual.

Another strategy is that training is tracked and instructors are fit for purpose. We have found that making Britam's own staff the instructors is an effective strategy. We survey trainees and ask them if the training was relevant, was it useful, will it help them to do their jobs better, will they be able to service their customers better. We capture this feedback from every single participant and we aim for 90% satisfaction.

Are you ever in a position where you need to challenge leadership during a transformation?

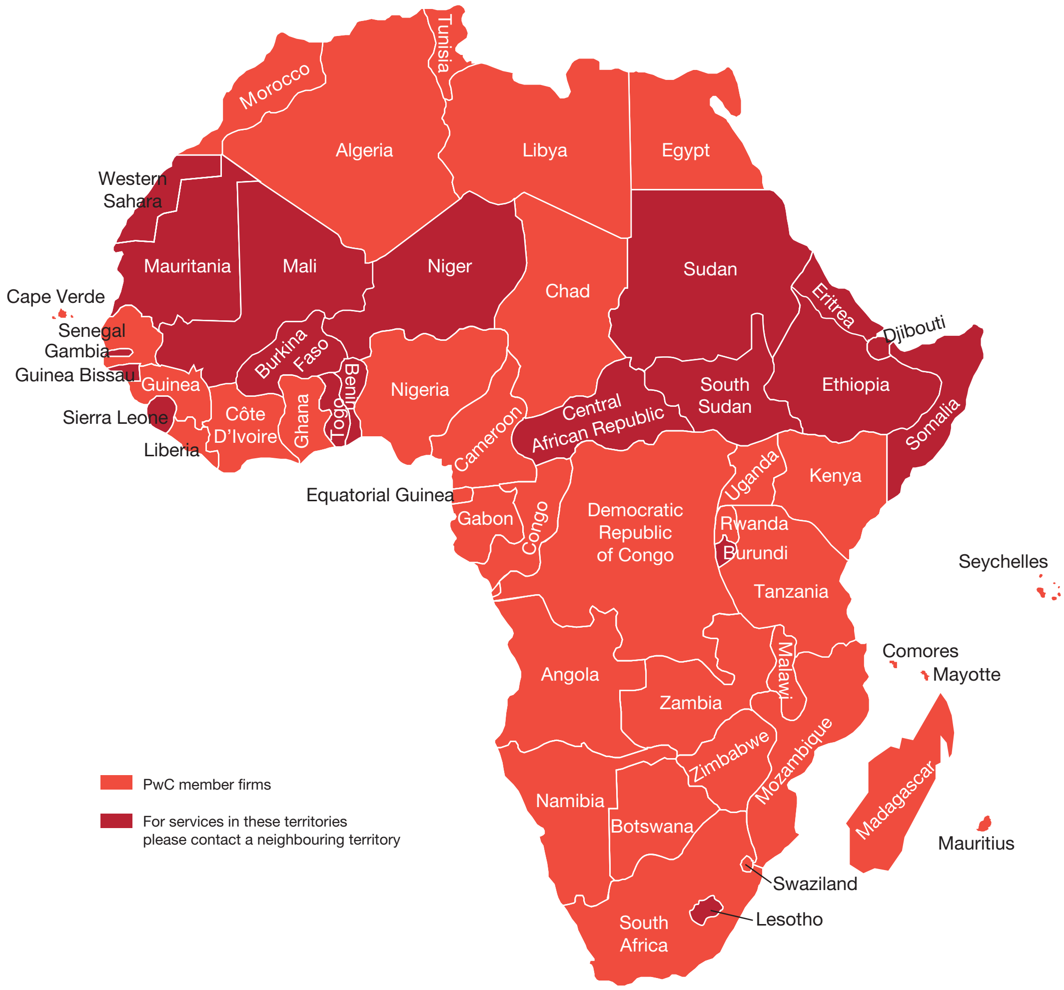
Absolutely. I've challenged them and they know I care. They can handle my serious disagreement because they know that I'm coming at this from the right place. They know I'm posing these challenges because they are necessary. Equally, they are not reserved nor shy about challenging us in our approach. Collectively this has created a healthy environment for innovation. The Britam transformation journey continues and PwC is privileged to be a trusted advisor.

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at **www.pwc.com**

In Africa, we're the largest provider of professional services with offices in 31 countries and over 8,000 people. This enables us to provide our clients with seamless and consistent service, wherever they're located on the continent.

In East Africa, our member firms in Kenya, Uganda, Rwanda and Tanzania work to build trust in society and solve important problems. Our in-depth knowledge and understanding of operating environments in the region enables us to put ourselves in our clients' shoes and offer truly tailored Tax, Assurance and Advisory solutions to unique business challenges.



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