Financial services

Financial Focus*

Financial Focus is a newsletter dedicated to topical issues that players in the financial services industry, such as yourself, face everyday. As leaders in the financial services sector, PricewaterhouseCoopers' professionals have come together to share with you their expertise and thought leadership. We hope you find the information within thought provoking and helpful.

January 2009

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PricewaterhouseCoopers

Editorial

Corporate discussions and newspaper articles nowadays are awash with opinion about the global economic crisis. In this edition of the Financial Focus, we have provided a brief review on the genesis of the economic crisis and some views about how the crisis is likely to impact our market.

In the last three years the financial services industry, and more specifically the banking sector, has witnessed a number of mergers and acquisitions. The PricewaterhouseCoopers Financial Services group recently hosted leaders in the banking industry at a focus group event to discuss experiences in mergers and acquisitions. We were pleasantly surprised by the candor with which the participants tackled the topic in the presence of competitors, something that would have been unthinkable a few years ago.

In this issue, we also highlight some developments in the taxation of life business carried on by insurance companies. Some concerns have been raised by industry players following the change proposed in the last budget. PricewaterhouseCoopers has been working closely with industry players in lobbying for changes.

An Insolvency bill has been published which proposes changes aimed at promoting the rescuing of businesses when they experience financial difficulty as opposed to placing them under receivership or liquidation.

Finally, Corporate Social Responsibility has evolved from something which is good to do to a key aspect of the strategy of major corporations around the globe. In this edition we look at some considerations for local companies.

Enjoy the newsletter.

Charles Muchene
Country Leader and also leader of the Financial Services Group in Kenya
charles.muchene@ke.pwc.com

The global economic crisis

Background

The current economic crisis has had a significant negative impact on many economies around the globe. Those that have felt it the most are the financial centres of this world led by the United States and the United Kingdom. There have been comments by some Kenyan leaders indicating that our economy is insulated from the effects of the current economic crisis. However, there are certain occurrences to date which can be directly or indirectly attributed to the current crisis.

Before we consider the impact on our economy, a brief background to the genesis of the problem. The catalyst of the current financial turmoil has been the losses on the subprime mortgage[1] market. However, the low quality of these partly collateralised housing loans was known for a while and the default on subprime mortgages was largely expected.

The subprime mortgage crisis had its genesis in the US housing boom a few years ago when lending standards began to deteriorate, with an increasing proportion of loans being made to people with poor credit credentials.

Higher US variable interest rates, stalling house prices and deteriorating lending standards have all combined to push defaults and delinquencies higher, occurring for all loans, particularly subprime. This has seen a fall in the value of subprime mortgage debt. On the back of this, Collateralised Debt Obligations (CDOs) exposed to subprime mortgages started to fall in value but as delinquencies continued to mount, ratings agencies downgraded the securities. As investor interest has dried up, it has turned into a collapse with the values of some securities down around 50%. The problem has worsened as exposed funds have been forced to sell securities to satisfy creditors or redemptions and as some investors have been forced to sell in response to ratings downgrades.

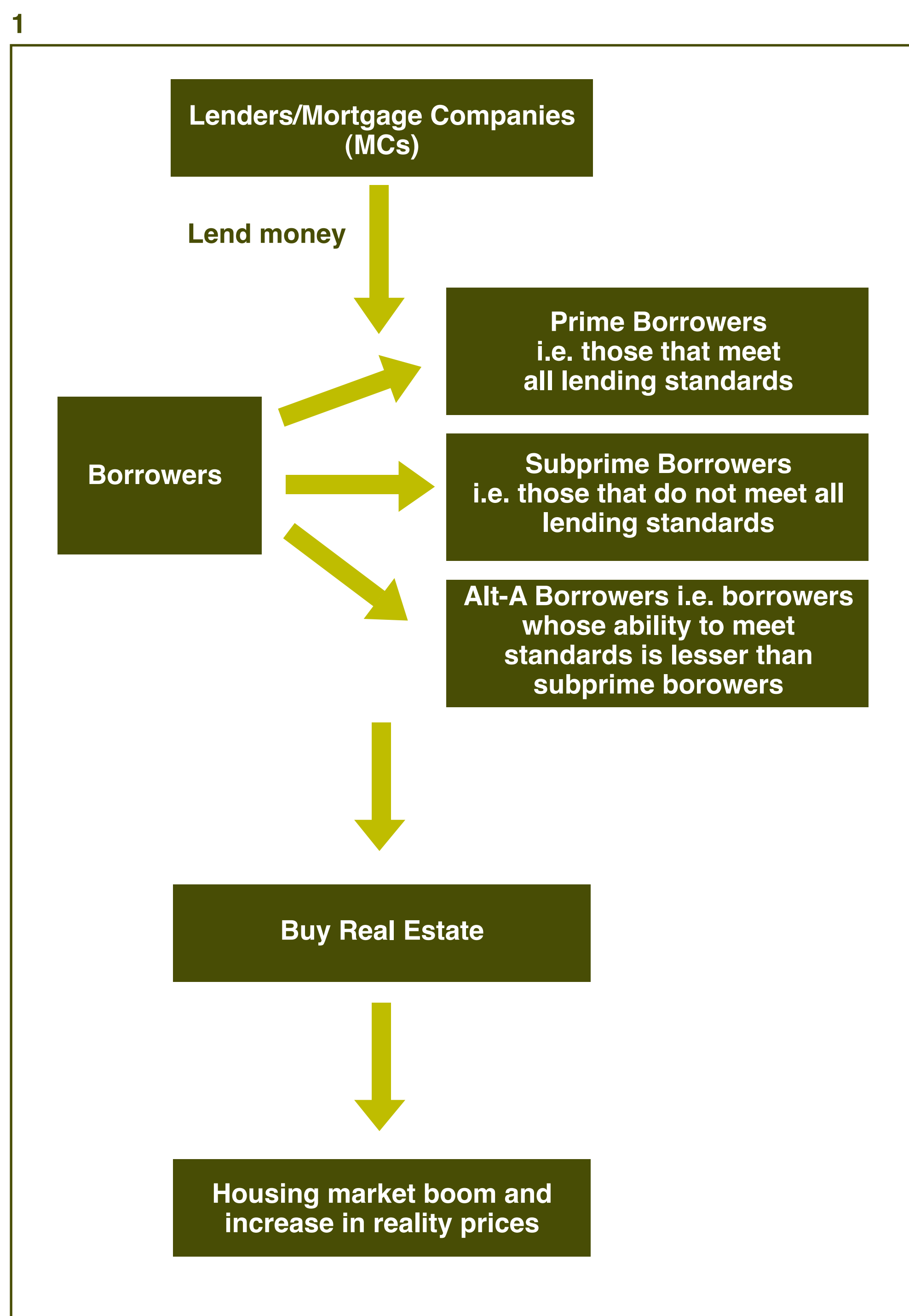
In the subprime crisis, major central banks have intervened aggressively to provide liquidity to contain disruptions and contagion in financial markets. At the same time, the US Federal Reserve has cut interest rates substantially to ease monetary conditions and the US Congress has approved a fiscal stimulus package. Governments such as the US have also injected funds to stem the collapse of financial institutions and boost their capital.

[1] Subprime lending (near-prime, non-prime, or second chance lending) is a financial term that was popularised by the media during the credit crunch and involves financial institutions providing credit to borrowers deemed “subprime” (sometimes referred to as “under-banked”). Subprime borrowers have a heightened perceived risk of default, such as those who have a history of loan delinquency or default, those with a recorded bankruptcy, or those with limited debt experience. (Wikipedia)

[2] Collateralised debt obligations (CDOs) are a type of asset-backed security and structured credit product. CDOs are constructed from a portfolio of fixed-income assets. CDOs are divided by the issuer into different tranches: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). Losses are applied in reverse order of seniority and so junior tranches offer higher coupons (interest rates) to compensate for the added default risk. (Investopedia)

Th Flow of the Subprime Crisis

1



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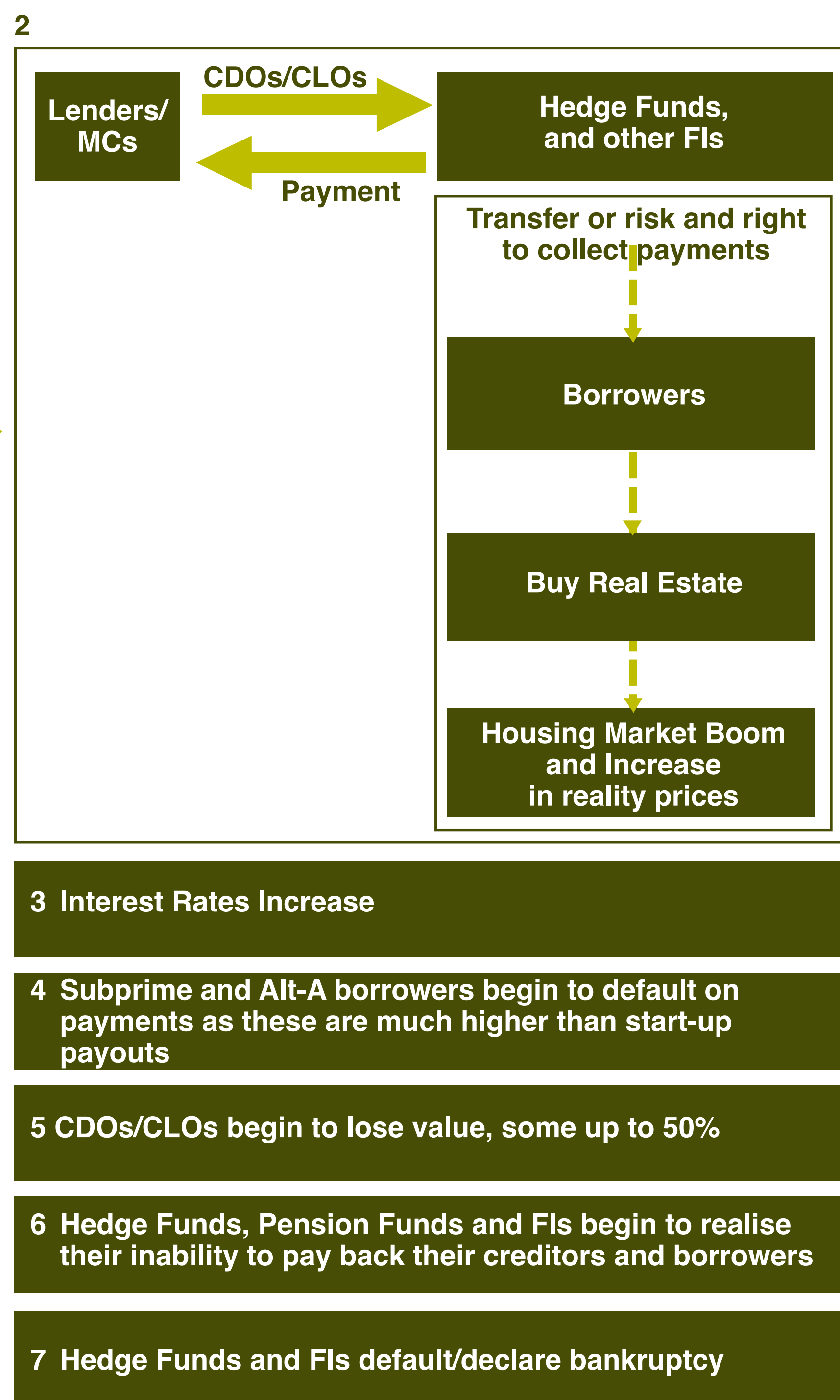


Source: PricewaterhouseCoopers Analysis

Impact of the economic crisis on world economies

With increasing default rates, banks and other lending agencies are tightening the norms for giving the loans and therefore a credit squeeze has been a natural consequence of the subprime crisis. Lending institutions are more cautious about who they lend to, even among the institutions, resulting in reduced liquidity in many economies.

The subprime crisis has had an impact on stock markets worldwide. Based on research done in July 2008, the cumulative falls on major stock markets since the crisis erupted were more than 10% which had erased a staggering 4.5 trillion US dollars from global stock markets. Recent comments indicate that the impact is currently in the region of 30 – 50%.

At the onset of the subprime crisis, mortgage companies and related lenders were the first to experience the impact of defaults and rising lending rates. However, retail and commercial banking sectors should expect some downturn as well. Against a backdrop of rising interest rates and hence mortgage instalment repayments, increasing food and fuel prices and other inflationary pressures, consumers appear to be increasing unsecured debt to maintain their standards of living. The natural consequence of increased unsecured debt is higher impairment rates.

Closer home, our clients are telling us, and our observations indicate, that the Kenyan economy will not be spared. Some of the expected direct and indirect consequences of the global economic meltdown are as follows:

1. Tourism is expected to take a dip (or not pick-up sufficiently to levels experienced prior to the melt-down) because of the fall in spending power of consumers from markets that would otherwise bring tourists to Kenya.

2. Although all the remittances that come to Kenya from the Diaspora are not necessarily channeled through the formal banking system, there is evidence that these are on a declining trend for the reason that the Kenyans out there have experienced a decline in their disposable incomes.

3. As Governments such as the US and the UK focus their energies and financial resources to revive their economies, we can expect a decline in the flow of aid which has previously come from those Governments.

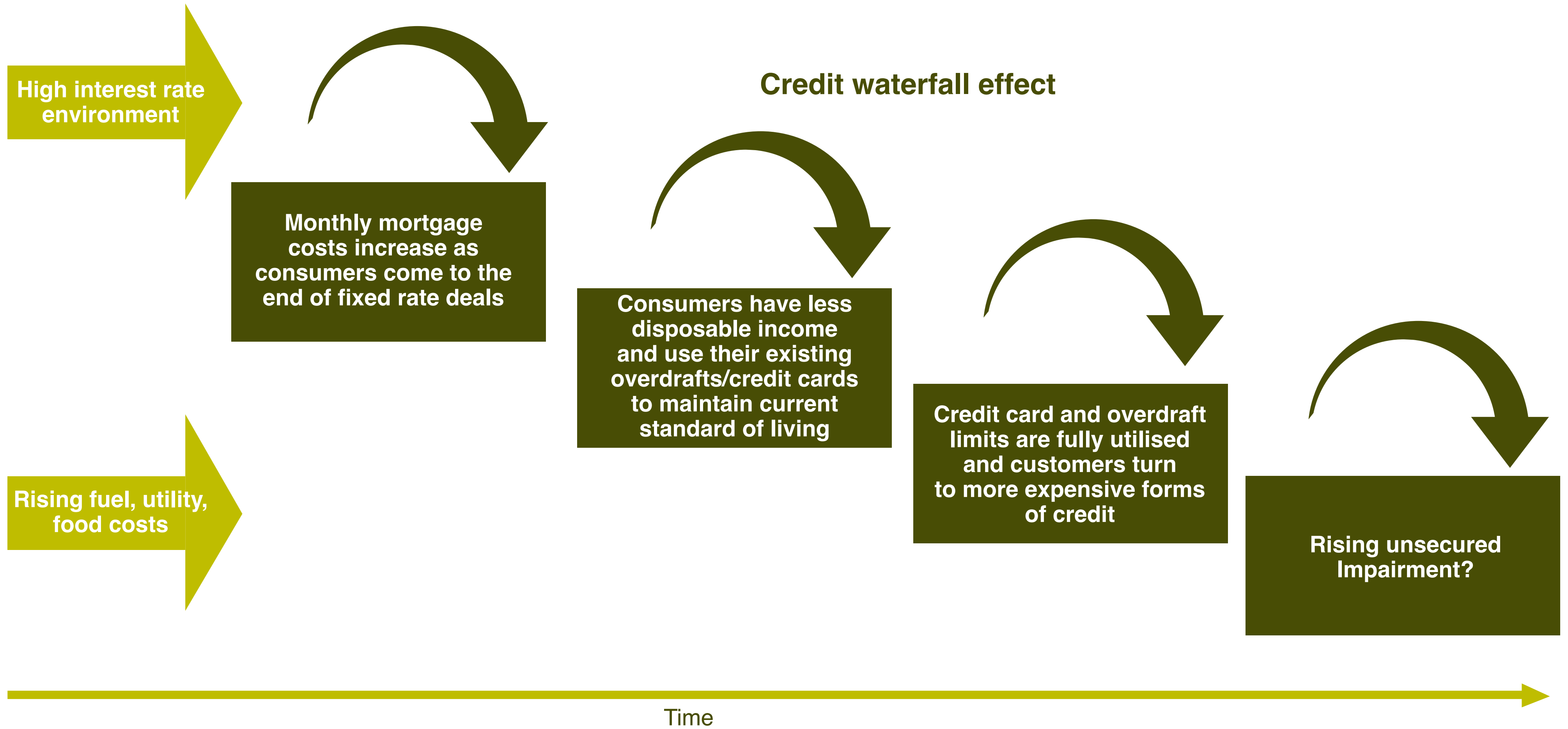
4. Some international investors are said to have liquidated their stock holding in Kenyan listed companies, which contributed to the decline in the stock market.

5. In the last budget, the Minister for Finance included infrastructure bonds as a key element of the 2008/2009 budget. There are question marks as to whether investors, both local and international, will take these up given the prevailing global economic crisis and also taking into account the potential poor sovereign rating of Kenya following the post election crisis.

6. Exchange rates globally have moved in favour of the dollar. This has been attributed to the remedial action taken by the US Government and Central Banks around the world which has created huge demand for the greenback. In turn, imports to the country and hence certain inputs into production will be more expensive.

Retail and commercial banking sectors should expect some downturn as well

Unsecured debt: Consumers appear to be increasing unsecured debt to maintain their standards of living



All is not gloom, it is conceivable that job offers in the Diaspora may not be as attractive or in the worst case scenario they may not be forthcoming and our talent out there is likely to take up jobs in Kenya.

Players' roles

A number of players in the financial market have been implicated in the current crisis. Questions have been asked about mortgage companies' decisions to lend to borrowers who they very well knew would default one day and in many cases allowed borrowers to self certify their levels of income. Where were the regulators of the financial institutions when all this was happening? What about the rating agencies, why did they continue to give good ratings to CDOs and other securities backed up by subprime debt? You be the judge.

The aftermath

We can expect a change in rules in financial markets as a reaction to the crisis. One of the immediate changes was the revision to International Accounting Standard No. 39 (IAS 39) and International Financial Reporting Standard No. 7 (IFRS 7) - (see related article - The credit crunch and fair value accounting). Further developments are expected on the regulatory front as regulators seek to have more stringent rules to monitor institutions.

Kang'e Saiti is a Partner in Assurance, specialising in providing services to clients in the banking and capital markets sub-sectors.
kange.saiti@ke.pwc.com

The credit crunch and fair value accounting

The credit crunch and meltdown of the banking sector in the United States and Europe has created many firsts and superlatives – the first run on a bank in England in 150 years, the largest fall in stock markets since the Wall Street crash of 1929, etc.

But perhaps one of the more surprising has been a first for the International Accounting Standards Board (IASB), the body responsible for setting International Financial Reporting Standards or IFRS, the accounting framework that all companies in Kenya must comply with in preparing their financial statements.

Normally it is a lengthy process to issue a new standard, or even to amend an existing standard: an exposure draft is issued, comments solicited from interested stake holders, redrafting in response to the comments, then a generous grace period before compliance with the new amendment becomes mandatory. Now, for the first time ever, the IASB has suspended this 'due process' and issued an amendment without exposure, and with back dated effect.

The amendment is to International Accounting Standard 39 – Financial Instruments, Measurement and Recognition, and allows companies to reclassify, in "rare circumstances" (such as a meltdown in the banking sector?) financial assets carried at fair value.

So why was it necessary to suspend due process and rush through this seemingly innocuous amendment? Fair value, or 'mark to market' accounting for financial assets was first promulgated in the US, but the IASB, and in particular its Chairman, Sir David Tweedie, has also been strongly in favour of it.

IAS 39, however, is a compromise, which requires management to classify financial assets into one of four categories, two of which require measurement at fair value, with the other two requiring measurement at 'amortised cost'. In determining fair value, companies must use the price quoted in an active market, if there is one.

Assets carried at amortised cost still have to be written down to their recoverable value if impaired, but this involves estimating future cash flows, and hence allows a longer term, and possibly more optimistic, view to be taken. When markets were on the rise, management were happy to 'mark to market'. When the markets crashed, however, there has been an outcry from management that market value does not necessarily represent the intrinsic 'fair' value of an asset.

This has led to lobbying by management, and even by politicians, in the western world for fair value accounting to be suspended during the period of extreme volatility currently being experienced. But the accountants' view is that the accounting rules are not to blame – measuring fair value in turbulent times can be difficult, but the huge swings in market prices reflect the realities of the market place, and financial reporting should also reflect these realities. If anyone is to blame, it is the markets themselves, not the accountants. JP Morgan analysts have said that "blaming mark to market accounting is like blaming a doctor for telling you you're ill".

However, whilst US accounting standards (US GAAP) and IFRS were broadly similar for financial assets, US GAAP allowed reclassification of financial assets from a fair value category to an amortised cost category but IFRS did not. Since most European listed companies have to comply with IFRS, they felt this difference was prejudicial to them, and the IAS Board found itself under overwhelming political pressure to bring IFRS into line with US GAAP, hence the hurried amendment to IAS 39.

The amendment is unlikely to have a significant effect in Kenya, since few companies currently classify many financial assets at 'fair value through profit or loss', the category most affected by the amendment.

What this does, however, is strengthen the case for there to be a single set of global financial reporting standards. The US regulators have accepted this in principle, but the pace of convergence is slow. Maybe one positive result of the global economic crisis will be an acceleration of this pace.

Simon Fisher is the Director of Accounting Consulting Services at PricewaterhouseCoopers, Kenya
simon.fisher@ke.pwc.com

Deal or no deal

Successful deals are made, not born

Over the past year or so, many banking sector players in sub-Saharan Africa have implemented regional expansion plans by way of Mergers and Acquisitions (M&A). For example, in Kenya, we have seen four major transactions in the banking sector in the past year (in each of which PricewaterhouseCoopers played a lead advisory role). PricewaterhouseCoopers research[1] suggests that this M&A trend is likely to accelerate in the next 12 to 18 months but also suggests that, whilst such deals are necessary, they often fail to meet their objectives.

Given these trends, PwC organised a focus group discussion in October 2008 that brought together a group of Kenyan banking leaders who have either recently completed deals or who are contemplating M&A transactions. The workshop discussed the experiences of banks that had recently completed M&A transactions, focusing primarily on the associated risks and possible mitigations. In this article, we highlight the points coming out of these discussions.

In the presentation, we highlighted trends and observations summarised from PricewaterhouseCoopers research and the practical experience from having worked with banking clients to implement successful deals.

1. The banking deals landscape in sub-Saharan Africa is evolving rapidly and the high level of deal activity over the past few years is likely to be sustained. In particular, it was noted that:

   a) The sub-Saharan African financial services sector has increasingly become a sought-after investment destination with international and regional banks seeking to get a hold of this market

   b) The sector has also benefited from market reforms in recent years. Across the region, regulators have raised or expressed an interest in raising minimum capital requirements

   c) The market is expected to experience additional mergers and acquisitions (M&As) in the short term to provide faster market entry and development

   d) The likely impact of the credit crunch will be minimal. Smaller deals and cross-border transactions are likely to dominate in the short term. With the global economic crisis taking its toll on the banking sector, there has been a slight shift of power from private equity to corporate deal makers, with many firms being forced to renegotiate their terms. However there is a silver lining for Sub-Sahara Africa where borrowing constraints still exist; there is less emphasis on leverage and more on operating synergies.

2. While organic growth is one option for growth, it can take many years to develop to competitive scale. Competition for attractive acquisition opportunities is accelerating, the current prices are high and choice of suitable targets is rapidly declining. The discerning purchaser needs to be skillfully armed to get good value for his acquisition.

3. Deals often fail to meet their objectives. Although it is often the most acquisitive companies that dominate their industries, the frustrations of M&As are well known, with surveys pointing to failure rates as high as 70% (where deals fail to generate the shareholder value they were expected to provide).

In the presentation it was also highlighted that failure of the deals to meet their objectives is often because they were either strategically wrong or the integration was ineffective.

Focus at the initial phase is often on the “hard” factors such as strategic rationale, financial value, potential synergies and top -management positions. The “softer” people issues tend to be ignored in the highly charged environment and tight time-constraints prevailing at the time.

The key to success at this stage should be focused on ensuring the proper recruitment of the leadership and building trust of the team. The top three personal attributes identified as critical in managing deals were the ability to empathise with others, balance attention to the task at hand with attention to people and consistently ‘fair’ decision-making.

The most successful deals are those in which the leaders identify with the outcome on a personal and organisational level. The leaders should also identify with the new entity rather than with their original organisations.

Another key challenge in a deal is the ability to value the company properly. “The non-disclosure of operations issues during the due diligence and limited access to liability information poses a threat to making an informed valuation” said a participant.

The successful deals must be designed to minimise transaction risks and maximise returns on investments. This should span the entire deal continuum from target identification and screening through execution to capturing synergies. Speed of execution is essential to stabilise and secure value. It is important to set the right course within the first 100 days. Shareholder value must drive resource allocation. But to realise the strategic intent of the deal, it is important to effect the long-term decisions as well as manage the short term goal of managing the new acquisition. Unfortunately there is no “one-size fits all” integration plan.

M&As, if used appropriately, can be the fastest way to grow your business. Deals put enormous pressure on managers who are often inexperienced in the particular environment. It is important that you plan your transaction carefully and seek expert advice at an early stage if you are to capture the value of the deal.

Naval Sood leads our Corporate Finance and Transaction Services team in sub-Saharan Africa.
naval.sood@ke.pwc.com

[1]Into Africa: Investment prospects in the sub-Saharan banking sector*, M&A Flyer published in September 2008 on www.pwc.com

Lobbying for tax changes in the insurance industry

When the Finance Minister presented his budget in June 2008 he proposed sweeping changes to the basis of taxation of the life business (life fund) of an insurance company. The changes were the culmination of years of negotiations between the Association of Kenya Insurers (AKI) on the one hand and the Kenya Revenue Authority (KRA) on the other.

By introducing the changes, the Minister was aiming at plugging perceived tax leakages, collecting reasonable tax revenues and bringing clarity and hence certainty to the taxation of insurance companies.

A long winding road

For a long time the KRA felt aggrieved by the fact that whilst insurance companies reported lucrative accounting profits on their life fund, the tax take was not necessarily reflective of this. Insurance companies did not agree with the taxman's sentiments.

The huge accounting profits often arose from taking the difference between the market valuation and original cost of the investments held by the life fund. This "fair value adjustments" as they are technically known do not attract taxation as they are "paper profits" and thus not taxable in accordance with conventional tax treatment that requires businesses to be subject to taxation only on "real or realised profits".

Previous legislative changes initiated by the KRA to ensure that they were getting their perceived fair share of the tax cake of life funds only served to create further ambiguity in the taxation of insurance companies.

The negotiations between the KRA and AKI commenced in the late 1990s, continued in earnest in the early 2000s and went into high gear over the last 3 or so years. The changes introduced by the Finance Minister were the result of this joint effort after an earlier botched attempt in 2003.

Invariably, as with other negotiated positions, the proposed changes are now raising concerns among industry players who want a more refined legislation.

Responding to the challenge - a PricewaterhouseCoopers initiative

Against the backdrop of the concerns being raised by industry players, PricewaterhouseCoopers responded by facilitating a forum in September 2008 that brought together key representatives from insurance companies that operate life funds. The representatives commissioned AKI to re-examine specific areas of the life insurance tax legislation highlighted below with technical support from PricewaterhouseCoopers.

- Taxation of the surplus recommended by the actuary for the benefit of the shareholders whether or not transferred to the shareholders' funds
- Restriction of the deductible actuarial deficit to the extent of the prior year surplus recommended by the actuary and
- Taxation of 30% of management and commission expenses in excess of the maximum amounts allowed in the Insurance Act.

In response to the above contentious matters, AKI with support from PricewaterhouseCoopers is seeking the following changes to be incorporated in the Finance Act 2008:

- Taxation of the surplus to be restricted to the actual surplus transferred for the benefit of shareholders as opposed to the amount recommended by the actuary
- Actuarial deficit to be a tax deductible expense in full and not restricted to the prior year surplus and
- Management and commission expenses to be tax deductible expenses even where they exceed the limits set under the Insurance Act.

A rewarding partnership

PricewaterhouseCoopers has accompanied the AKI representatives to meetings with the KRA, The Finance Committee of Parliament and to the Insurance Regulatory Authority (IRA) to lobby for the above changes. A final meeting with Treasury is awaited as at the time of going to press.

Generally our joint representations have so far been well received and even where the regulators have differed with us, their position has been explained and articulated in an atmosphere of mutual respect that will no doubt foster better cooperation in future years.

Not yet out of the woods

In summary, judging by the signals we are receiving, it looks like we are making good progress in advancing a common agenda. However, it is still too early to celebrate as the commitments made by the various stakeholders have to be brought to bear - in black and white in the Finance Act.

Patrick Karara is a Manager in our Tax practice with extensive tax experience and specialist focus on taxation of financial institutions.
patrick.karara@ke.pwc.com

Steve Okello heads our Tax practice in Kenya.
steve.x.okello@ke.pwc.com

A new Insolvency Act is coming… so lenders, borrowers and insolvency practitioners get ready!

Background

The Law Society of Kenya (LSK) has recently circulated to its members and interested parties the draft Insolvency Bill 2008 (“IB 2008”). At this stage we understand it is still a proposal and so remains “work in progress”, on which LSK and others will be able to comment before a finalised version is subsequently gazetted en route to a First Reading. So it could still be some time before this happens.

In our view a new Act dealing with insolvency is welcome. But it needs to be workable. What seems clear is that if IB 2008 ends up as legislation substantially unaltered it could result in some radical changes to the existing insolvency regime.

Say goodbye to the undertaker … and hello to the corporate saviour

It seems that the primary driver has been the recognition that Kenya should move to embrace the so-called “rescue culture”. This concept has been increasingly embraced in legislation around the world following the development of the UNCITRAL Model Law for insolvency in 2001. The main thrust of a “rescue culture”, as the name implies, is that it seeks solutions that allow ailing companies to survive.

It also draws a better balance between debtor and creditor rights. Many argue that existing insolvency law in Kenya overly favours the creditor – often banks or other charge-holders. As a result the law gives license to such debt holders to “bayonet the wounded” – i.e. kill-off stricken companies via receivership or liquidation. Advocates of this view argue that with a little more tender loving care (TLC), these companies could be nursed back to health and thereafter continue to create wealth and employment.

In any event there is a recognition that Kenya’s existing insolvency architecture is outdated and does not meet the needs of modern business. It should be remembered that the key provisions of the Companies Act are based on the 1948 UK Companies Act. Moreover, the UK got its own dedicated Insolvency Act as far back as 1986 - and then updated it in 2003 with the Enterprise Act (“EA 2003”).

There is a need to clean things up – but getting the balance right will not be easy

A second driver for change is the apparent realisation that the insolvency profession needs to up its act. As members of this profession, we know only too well that there is a generally low opinion of insolvency practitioners and a perception that they act merely as “corporate undertakers”. Worse still, there has in the past been an unfortunate number of reported cases of unethical behaviour by some “bad apple” receivers and liquidators.

Of course there has also been some unethical behaviour by directors. Often it has been too easy for borrowers to run to court to exploit existing regulations to their advantage. In some cases we have seen borrower/lender disputes bogged down in court for 20 years or more, during which time bank capital has been tied up and corporate assets run sub-optimally.

None of this has helped the image of what is seen elsewhere as an important and worthwhile profession.

Ultimately inadequate legislation to properly balance and protect creditor and debtor rights negatively affects inward investment and increases the cost of doing business. The new bill seeks to modernise insolvency legislation to the benefit of business and commerce generally.

Some changes will be quite radical…

There are many changes within the proposed legislation. Two of the most radical, in our view, are:-

(i) the move to introduce two new legal procedures – Company Voluntary Arrangements (CVAs) and Administration; and

(ii) the requirement for any “Insolvency Practitioner” to be qualified

Both of these changes, and indeed much of the bill, seem to closely mirror respective parts of the 1986 UK Insolvency Act.

CVAs and Administrations are new procedures which constitute “rescue culture” mechanisms. Both involve court participation, albeit in the case of a CVA this is limited. In addition, both involve an individual taking charge of the entity - a “Supervisor” in the case of a CVA and an “Administrator” in an Administration. Supervisors and Administrators must be qualified Insolvency Practitioners. In both cases, it would appear that once in force each procedure binds creditors.

In a CVA the directors of a struggling company can take a “proposal” to the company and its creditors. Such a proposal will set out the rescue plan. Ultimately it is the creditors who decide to approve the proposed CVA and the Supervisor.

In an Administration, court involvement is more pronounced. In this case the directors or one or more creditors of a distressed company can petition the court to make an Administration Order. The court must consider whether Administration will meet one of four “purposes”, including the survival of the company and whether it would result in a more advantageous outcome than would liquidation.

But will we really see Administrations and company rescues ?

This mechanism will be of particular interest to charge-holders which in Kenya most commonly means banks. The bill provides that charge-holders should be given notice of any petition. If at the petition stage a receiver is already in place, then the court is required to dismiss any petition unless the charge-holder

who appointed the receiver consents to the Administration Order. What is less clear from the wording is whether a charge-holder could proceed to appoint a receiver after obtaining notice of a petition – something that could have important implications on the value of fixed and floating securities. Once an Administration Order has been granted, a receiver must vacate office and thereafter no receiver can be appointed. The major change therefore is that the Administrator chosen by all creditors –rather than the receiver chosen by charge-holders– will deal with charged property and will account to the charge-holders thereon for which priorities remaining intact.

In the UK, following the update to insolvency legislation via EA 2003, there was a significant move from receiverships to Administrations with, anecdotally at least, a corresponding increase in the survival rate for struggling businesses. Why did this switch come only after the 2003 act rather than the 1986 act? The answer is simple. EA 2003 prevented the appointment of receivers on new floating charges. This does not seem to be a feature of IB 2008, something that in our view might well serve to frustrate the key intentions of the proposed legislation.

The requirement for Insolvency Practitioners to be "qualified" is certainly welcome. The bill sets out various criteria for authorisation as an IP. This could be via a recognised professional body or through a new body, the Insolvency Practitioners Board. This requirement will help the profession "clean up" its act and bar those considered unfit.

Many grey areas remain… but overall this bill is going in the right direction

There is something in this bill for all key participants to take note of – lenders, borrowers and practitioners. Overall we consider the move to align the proposed legislation to the UNCITRAL Model Law a positive step and one which will greatly help modernise this aspect of Kenya's corporate legal framework. The key will be making it workable for the "real" commercial environment we face – a world in which as we know some players will no doubt seek to abuse loopholes or grey areas to their financial advantage.

There remain areas of detail where more clarity would be desirable - for example:

- the rights of charge-holders prior to Administration
- whether any changes are planned to the rights of new floating charge holders vis a vis the ability to appoint receivers
- how the IP authorisation and administration process will be undertaken and funded.

It is notable that the UK Insolvency Act 1986 was issued with accompanying and detailed "Insolvency Rules". We have not seen any similar draft rules alongside the bill – but we feel, if properly tailored and incorporated, these would only serve to enhance this proposed Kenyan legislation. The bill is the start of a process involving a critical part of commercial law. It is therefore a welcome development. Its intentions are laudable but involve relatively radical changes which will not be easy to actualise. We need an insolvency act that will be workable, and so key interested parties – banks, corporate borrowers and insolvency practitioners – should be looking to fully participate in the process going forward.

Nothing in this article should be taken as being legal advice. Specific legal advice should be taken.

Martin Whitehead leads our Crisis Management team in East and Central Africa.
martin.whitehead@ke.pwc.com

Banking and capital markets sustainability

Sustainability – What's the big deal?

Many in business have long viewed sustainability — efforts to avert climate change, for example, or to improve education in underserved neighbourhoods — a matter of corporate philanthropy, with no relevance to their corporations' core strategies. The costs of such activities were seen as detracting from profitability and accounted for on a public relations line under marketing; their scope was limited but they were promoted with considerable fanfare. However, this perspective has changed. Corporations have come to understand that their abilities to prosper hinge upon their responses to the challenges of a resource-constrained and poverty ridden world as well as an array of other issues on the sustainability agenda.

While the global challenges related to sustainability are manifest, defining how businesses can meet the challenges can be daunting. The sustainability agenda begins with making a commitment to incorporating social, environmental, economic and ethical factors into a company's strategic decision-making. It extends to evaluating how these factors affect the business — including all of its stakeholders — and what risks and opportunities these factors present. Finally, the sustainability agenda asks businesses to adopt measures to mitigate risks and take advantage of opportunities presented by these risks.

The sustainability agenda in banking and capital markets

Although the banking and capital markets sector is not energy or raw materials intensive, many industry players have been early movers in the drive for sustainability. From initially pinpointing the opportunities for energy efficiency in their own operations as well as recognising credit-related risks, many have moved on to develop burgeoning sustainability related businesses and ultimately to incorporating sustainability into their branding.

Risks

Amongst the sector's principal sustainability related challenges is credit risk: in certain circumstances, liabilities can be transferred to creditors, thus exposing banks and financial institutions to the sins of their debtors. For example, in some jurisdictions, lenders can become directly liable for environmental problems associated with assets. If the plant of a manufacturer to whom a bank has made a loan is located on contaminated land and the manufacturer declares bankruptcy, the bank may be liable for the environmental damage in some instances while other lenders in such a situation would not be liable. However, if they took as collateral what turned out to be contaminated land, they would incur a loss on the devalued land. Credit officers must therefore look beyond balance sheets and cash flow statements in assessing credit risk.

Opportunities

The sustainability agenda affords sector participants three principal areas of opportunity. The most readily available are those within their own operations. For decades, banks and other financial institutions have realised substantial savings by making their headquarters and company-wide office space energy efficient. They have also maximised efficiency through their IT operations and travel planning. Banks and capital markets have also seized on new products linked to sustainability. These products respond to the new priorities of many investors, including a second generation of wealthy families who are intent on deploying their inheritances in socially responsible ways, institutional investors (pension funds) looking for long-term above-average returns, and sustainable companies looking to deliver on those priorities. Products already with track records include sustainability indices such as the Dow Jones Sustainability World Index, renewable energy funds, water business funds and socially responsible investing (SRI) funds.

Further opportunities lie in venture capital financing of alternative energy and other businesses aimed at protecting the environment as well as in carbon emissions trading. Banks and other financial service players can further integrate sustainability into their core strategy and highlight it in their branding. Institutions that do so stand to enjoy a range of benefits, including a critical advantage in attracting the most outstanding young talent coming into the workforce.

Questions to consider:

How can you limit your liabilities in your commercial loan business?

- Are you building businesses around financial innovations that promote the sustainability agenda? Will you be a player in carbon markets, for example?

- Are your clients and investors increasingly factoring sustainability in their investment decisions?
- How might regulators encourage industry practices that embrace the sustainability agenda?
- Can the carbon footprint of your retail and office presence be improved?
- Do you know if young graduate top talents take the sustainability performance into account when choosing their first employer?

Case study

In anticipation of the implementation of a national carbon emissions trading scheme, the commercial leasing arm of a major industrial products company reviewed what it could do not only to reduce its own carbon footprint, but also to assist its clients in reducing the greenhouse-gas emissions of their vehicle fleets. The company developed initiatives to help customers choose the most carbon-efficient vehicles, taught their drivers to operate vehicles to minimise fuel use and emissions, and offered to manage the servicing of the vehicles so as to maximise their operating efficiency. By offering purchased offsets, the company was able to offer a low carbon fleet solution for their customers. The product pilot was successful and the initiatives have been launched company-wide.

How PricewaterhouseCoopers can help

When it comes to matters of sustainability, organisations have very specific concerns. To help us respond to our client's requirements effectively and efficiently, PricewaterhouseCoopers' Sustainability practice offers a range of solutions. We can help clients to:

a) Evaluate the strategic relevance and commercial implications of sustainability, including the potential impact on revenues, costs, risk profile and acquisitions. In addition, we provide assistance with the formulation of robust business strategies which include sustainability issues

b) Put a suitable governance, organisational structure and management process in place to capitalise on the commercial opportunities arising from the sustainability agenda, as well as establish appropriate systems for managing the risks

c) Implement sustainable processes and procedures, identify key targets and performance measures, and implement corresponding monitoring frameworks

d) Design reliable management information systems and develop non-financial reporting frameworks

e) Embed compliance with policies and regulations, ensuring that our clients' reporting frameworks are robust, and assure the non-financial information they disclose and

f) Factor sustainability issues into financial market transactions and advise on new markets (such as the carbon market).

We take the time to listen to your situation and offer a range of smart choices to consider – choices based on independent and challenging insights, supported by facts and industry benchmarks.

Anthony Kimotho is a Manager in our Performance Improvement unit, specialising in the Sustainability practice.
anthony.kimotho@ke.pwc.com

Profiles

Our Financial Services team comprises of partners and managers from across all our lines of service. In this and subsequent issues, we will profile two members from this team. In this edition we have profiled Richard Njoroge and Kang'e Saiti, both Assurance partners.

Richard Njoroge

(richard.njoroge@ke.pwc.com)

Richard Njoroge is an Asurance partner in PricewaterhouseCoopers in Kenya. He joined the firm in 1988, having graduated from the University of Nairobi with a first class Bachelor of Commerce (Accounting) degree. He is a UK qualified chartered accountant, with nineteen years experience in the profession, five of them in the UK and five in Tanzania. He is also a member of the Institute of Certified Public Accountants of Kenya.

Richard is a member of the firm's specialist financial services group and over the years has had responsibilities for financial services clients in various countries in the East African region. He has been the audit partner for a number of banks in Kenya and has also been involved in special assignments in banking institutions such as financial due diligence, special investigations and audit of initial International Financial Reporting Standards (IFRS) accounts for privatisation purposes. He served as a member of the Banking Committee of ICPAK in 1996-1997.

He is also currently serving as the Learning and Education partner for Kenya and has been involved extensively in IFRS and methodology training for staff and clients in the region.

Kang'e Saiti

(kange.saiti@ke.pwc.com)

Kang'e Saiti is an Assurance partner in PricewaterhouseCoopers in Kenya. He joined the firm in 1997 after graduating from the University of Nairobi with a Bachelor of Commerce (Accounting) and having qualified as a Certified Public Accountant. During his career with the firm, Kang'e has worked in the UK and Tanzania on secondment. He specialises in providing services to clients in the banking and capital markets sub-sectors, with emphasis on corporate, retail and private banking as well as consumer finance, leasing and off-shore investment management.

Besides his specialism in banking, capital markets and investment management, Kang'e has been involved in a variety of other roles in the firm including technical training to clients and staff as well as responsibility for quality control in Kenya and across the firm's practices in the region.

Kange was admitted to partnership on 1 July 2008.

For more information, please contact

Charles Muchene	Tel: +254 (20) 2855000	charles.muchene@ke.pwc.com
Naval Sood	Tel: +254 (20) 2855000	naval.sood@ke.pwc.com
Bernice Kimacia	Tel: +254 (20) 2855000	bernice.kimacia@ke.pwc.com
Martin Whitehead	Tel: +254 (20) 2855000	martin.whitehead@ke.pwc.com
Richard Njoroge	Tel: +254 (20) 2855000	richard.njoroge@ke.pwc.com
Steve Okello	Tel: +254 (20) 2855000	steve.x.okello@ke.pwc.com
Kang'e Saiti	Tel: +254 (20) 2855000	kange.saiti@ke.pwc.com

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