

## AFRICA RISK CONSULTING

### Kenya Monthly Briefing November 2015

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#### Kenya Summary 9 November 2015

*The scale of corruption at Imperial Bank Ltd becomes clear and embarrassing for regulators and auditors alike. The Council of Governors asks the central government to suspend all new projects due to the treasury's cash flow problems. Kenya is the most improved regulatory environment in Africa according to the World Bank's Doing Business index, rising from 129 to 108. The government confirms that the three-year valued added tax (VAT) exemption on oil products will end on 2 September 2016.*

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#### Imperial Bank receivership raises regulatory and auditory concerns

The fallout from the **Central Bank of Kenya (CBK)** assuming control of **Imperial Bank Ltd** may undermine investor and customer confidence in Kenya's banking sector.<sup>1</sup> The CBK on 13 October placed the Imperial Bank under **Kenya Deposit Insurance Corp** receivership.<sup>2</sup> The CBK announced that the regulator had hired **FTI Consulting** to investigate malpractices at the bank.

*"The move caught the industry by surprise and unmasked what could possibly be the largest fraud in corporate Kenya's history."<sup>3</sup>*

It emerged a few weeks later on 28 October that Imperial Bank CEO **Abdulmalek Janmohammed**, who had died on 15 September from a heart attack, had siphoned \$340m from customers.<sup>4</sup> The late Janmohammed used a network of 20 companies and individuals to steal \$340m over a period of 13 years.<sup>5</sup> Through an elaborate scheme, Janmohammed and senior management would transfer cash to accounts of companies and close family members; the account holders would then withdraw the funds and close the accounts.<sup>6</sup> To cover up the theft, the management would manipulate banking software and burn all instructions.<sup>7</sup> Directors of the bank blew the whistle after discovering the massive fraud following Janmohammed's death. The CBK and Imperial Bank have gone to court to recover the funds, which went to questionable companies and close family members. The recovered funds are to pay some 58,000 depositors.

*"The revelations have sent shockwaves across the banking industry, regulators, law and accounting firms and have shown the dire need for non-financial due diligence for both local and international investors eyeing Kenyan companies."<sup>8</sup>*

The Imperial Bank scandal is embarrassing for regulators and auditors alike. On the day that the CBK took over Imperial Bank, the lender was supposed to debut a KSh 2 billion (\$19.6m) corporate bond on the **Nairobi Securities Exchange (NSE)**.<sup>9</sup> Imperial Bank had successfully raised \$20m through a

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<sup>1</sup> Business Daily, 19 Oct 2015.

<sup>2</sup> Business Daily, 13 Oct 2015.

<sup>3</sup> Source, journalist, Nairobi

<sup>4</sup> Business Daily, 28 Oct 2015.

<sup>5</sup> Business Daily, 28 Oct 2015.

<sup>6</sup> Business Daily, 28 Oct 2015.

<sup>7</sup> Source, journalist, Nairobi

<sup>8</sup> Source, journalist, Nairobi

<sup>9</sup> Business Daily, 19 Oct 2015.

five-year bond sold to domestic retail and institutional investors a month before its closure.<sup>10</sup> The **Capital Markets Authority** had approved the bond offer. Audit firm **PKF International** had audited and approved Imperial Bank's accounts. The accounting umbrella group, the **Institute of Certified Public Accountants of Kenya (ICPAK)**, gave Imperial Bank an award for excellence in financial reporting in 2004.<sup>11</sup>

While regulators say that they were caught off-guard having relied on audited books, a small amount of due diligence would have raised flags.<sup>12</sup> The bank did not have a chief risk officer.<sup>13</sup> Additionally, the chief finance officer did not report to the board.<sup>14</sup>

*"The board composition was also homogenous and the members relatively unknown, unlike other companies that have gone out of their way to tap into well respected and experienced individuals to occupy the vital positions."<sup>15</sup>*

It has also emerged that the money was invested in real estate projects and some of the companies that benefited from the siphoned funds have questionable histories. **W.E. Tilley Ltd**, which received \$100m from Imperial Bank, has in the past been linked with the now defunct **Charterhouse Bank**, which was shut down in 2006 after the **United States (US)** government put pressure on the CBK over its alleged involvement in money laundering.<sup>16</sup>

The receivership has proved contagious. Depositors have begun withdrawing their cash in small banks and putting their money in larger banks which are deemed to be safer and better managed, especially conglomerate and major banks such as **Kenya Commercial Bank Ltd, Equity Group Holdings Ltd, Standard Chartered Bank Ltd, Co-operative Bank of Kenya Ltd, Barclays Bank Ltd and Commercial Bank of Africa (Kenya) Ltd. Family Bank**, which was attempting to raise \$40m through a corporate bond in October, was able to raise only half the amount as investors are still cautious about investing in small banks.

Ratings agency **Moody's** noted that the closure of Imperial Bank shows that the government is not willing to provide capital injections to low or mid-tier banks.<sup>17</sup> Imperial Bank had assets of approximately KSh 70.3 billion (\$684m) at the end of June.<sup>18</sup> The absence of intervention will negatively impact market confidence towards smaller banks, making it harder for them to secure deposits and raise capital. Moody's also warned of deposit withdrawals and increases in interbank rates. Following the receivership, the CBK has said that it will offer "adequate liquidity"<sup>19</sup> to the sector.<sup>20</sup> Moody's, however, said it expects the Kenyan government to intervene if any of the six major banks that control more than half the banking sector assets and deposits face difficulty.

### Council of governors warn of cash flow problems

The **Council of Governors** has asked the central government to suspend all new projects due to the treasury's cash flow problems.<sup>21</sup> The central government will likely continue to prioritise spending on major infrastructure projects resulting in continuing delays to the disbursement of funds to counties. The Council of Governors consists of President **Uhuru Kenyatta** (2013- present) and the 47 governors. The Council of Governors convened on 23 October in **Naivasha (Nakuru County)**.<sup>22</sup> The

<sup>10</sup> Business Daily, 19 Oct 2015.

<sup>11</sup> Source, journalist, Nairobi

<sup>12</sup> Source, journalist, Nairobi

<sup>13</sup> Source, journalist, Nairobi

<sup>14</sup> Source, journalist, Nairobi

<sup>15</sup> Source, journalist, Nairobi

<sup>16</sup> Source, journalist, Nairobi

<sup>17</sup> Business Daily, 19 Oct 2015.

<sup>18</sup> Reuters, 14 Oct 2015.

<sup>19</sup> Reuters, 14 Oct 2015.

<sup>20</sup> Reuters, 14 Oct 2015.

<sup>21</sup> Standard, 26 Oct 2015.

<sup>22</sup> Standard, 26 Oct 2015.

Council of Governors chair, **Meru County** governor **Peter Munya**, warned before the meeting that delays to the disbursement of central government funds are delaying payments to contractors and other creditors at county level.<sup>23</sup> The chairman of the Council of Governors finance committee, **Kakamega County** governor **Wycliffe Oparanya**, said that county governments had not received funds scheduled for August, September and October.<sup>24</sup> Devolution cabinet secretary **Anne Waiguru** told the Council of Governors that the government will save \$2 billion in recurrent expenditure as it retrenches 40,000 public sector workers as part of the government's **Capacity Assessment and Rationalisation of Public Service Programme (CARPS)**.<sup>25</sup> Munya said that the Council of Governors backed the CARPS but that the restructuring must focus on central government ministries rather than on the county governments.<sup>26</sup> The **Intergovernmental Relations Act 2012**, which regulates the relationship between the central government and the counties, continues to cause tension, especially over revenue division.

### Kenya enjoys surprising improvement in Doing Business ranking

Kenya showed a disproportionately large improvement in its ranking in the **World Bank's Doing Business** index, rising from 129 in its 2015 report to 108 in *Doing Business 2016*.<sup>27</sup> The *Doing Business* report provides objective measures of business regulations and their enforcement across 189 countries, in an effort to identify legal and regulatory barriers facing investors.

The increase makes Kenya officially the most improved regulatory environment in Africa between the two indices, which may surprise investors.<sup>28</sup> However, the improvement does not accurately reflect changes within the past year. A rise of 90 places in "obtaining credit" from 118 to 28 distorts the ranking and hides the considerably more marginal gains in the other categories.<sup>29</sup> Kenya received the highest marks in this category for the depth of credit information and the strength of legal rights for borrowers and lenders.

The improvement was due to increased national coverage of **Credit Reference Bureaus (CRBs)**. Kenya has worked to improve its credit information system. It improved significantly following the approval of the **Banking (Credit Reference Bureau) Regulations 2008**, which governs the licensing, operation and CBK supervision of the sector.<sup>30</sup> The regulations sanctioned the sharing amongst banks of negative credit information. Before this, the only incorporated CRB, **Credit Reference Bureau Africa Ltd**, offered a voluntary reporting system for banks to share negative information on their distressed loan books. The 2008 regulations required banks to report all non-performing loans on a monthly basis to other banks as well as to mortgage finance institutions. The increased regulation in the sector encouraged the incorporation of **Creditinfo Credit Reference Bureau Ltd** and **Metropol Credit Reference Bureau Ltd** in 2010 and 2015 respectively, explaining the increase in coverage that the World Bank noted. The **Central Bank of Kenya Act 2012** also requires commercial banks to share positive information about their clients through CRBs as of March 2015.<sup>31</sup> The inclusion of positive data will allow the CRBs to develop credit scoring systems and allow banks to offer preferential interest rates to customers with a positive lending history.

Additionally, the government in 2014 gazetted the **Credit Reference Bureau Regulations 2013**. This reduced the period that CRBs can hold information about defaulters from seven to five years, bringing Kenya in line with its **East African** neighbours and reducing the number of legal cases challenging the accuracy of credit data. The **Association of Kenya Credit Providers** established an alternative

<sup>23</sup> Standard, 26 Oct 2015.

<sup>24</sup> Standard, 26 Oct 2015.

<sup>25</sup> Daily Nation, 24 Oct 2015.

<sup>26</sup> Africa Review, 24 Oct 2015.

<sup>27</sup> www.doingbusiness.org

<sup>28</sup> www.doingbusiness.org

<sup>29</sup> www.doingbusiness.org

<sup>30</sup> FinAccess, Sept 2015.

<sup>31</sup> FinAccess, Sept 2015.

dispute resolution mechanism to resolve disputes in the credit information system. The improved framework has encouraged banks to use CRBs and the majority are now doing so.<sup>32</sup> By December 2014, banks requested 5.2 million credit reports compared to 2.3 million in December 2012.<sup>33</sup>

The 'Obtaining electricity' category marked Kenya's second largest rise of 14 places. This will improve further with increased investment. Electricity distributor **Kenya Power Ltd** said on 30 October that it will borrow KSh 109 billion (\$1.1 billion) from domestic and international lenders to finance a network expansion plan.<sup>34</sup> Kenya Power said it seeks to borrow from the World Bank and the **African Development Bank (AfDB)**, as well as local banks, and possibly the domestic market.<sup>35</sup> The investment will result in the construction of 200 substations, the installation of transformers and the construction of low voltage electricity distribution lines. Kenya Power on 29 October reported an 11.5% increase in pre-tax profits to KSh 12.25 billion (\$120m) on the back of a 24% increase in revenue from electricity sales due to increased tariffs and distribution efficiency.<sup>36</sup>

Kenya made more marginal gains in a number of other areas:

- reducing the time taken to start a business (to 26 days),
- accelerating property registration (61 days),
- curbing delays in securing an electricity connection (110 days).<sup>37</sup>

This is partly the result of the government establishing its **Business Environment Delivery Unit** in October 2014. However, Kenya ranks low for starting a business (151), construction permits (149), resolving insolvency (144), trading across borders (131), ease of paying taxes (101) and obtaining electricity (127). It should be noted that the World Bank compiled the *Doing Business* index before the government introduced key business legislation in September (*see ARC Briefing Kenya September 2015*).

The *Doing Business* ranking excludes factors related to political risk and macroeconomic stability, both of which have increased investor concerns about Kenya. Corruption perceptions, security concerns and financial considerations continue to deter investment.<sup>38</sup>

*"Investors still face a trail of what I call 'half doubts' about Kenya. It's those ghosts of the past that the government can't exorcise despite the improvements to the investment climate."*<sup>39</sup>

On 29 October an **International Monetary Fund (IMF)** study on global investor appetites revealed that Kenya is at significant risk of reversing portfolio flows due to currency volatility.<sup>40</sup> The *Doing Business* report also focuses on **Nairobi** and does not factor in the differing progress of counties under devolution.

## VAT exemption on fuel to end in 2016

National treasury cabinet secretary **Henry Rotich** on 17 October confirmed that the three-year valued added tax (VAT) exemption on oil products will end on 2 September 2016.<sup>41</sup> The imposition of VAT on fuel will increase transportation and business costs in Kenya, but will shore up government revenues. The three-year exemption was included in the **VAT Act 2013**. It covers vehicle fuel, aviation fuel, kerosene and gas oil.<sup>42</sup> The IMF insisted that Kenya commit to introducing VAT on fuel at the end of a three-year window as part of the KSh 64 billion (\$663m) stand-by arrangement agreed with

<sup>32</sup> FinAccess, Sept 2015.

<sup>33</sup> FinAccess, Sept 2015.

<sup>34</sup> Daily Nation, 31 Oct 2015.

<sup>35</sup> Daily Nation, 31 Oct 2015.

<sup>36</sup> Reuters, 29 Oct 2015.

<sup>37</sup> www.doingbusiness.org

<sup>38</sup> Source, investment advisor, Nairobi

<sup>39</sup> Source, investment advisor, Nairobi

<sup>40</sup> East African, 29 Oct 2015.

<sup>41</sup> Business Daily, 17 Oct 2015.

<sup>42</sup> Business Daily, 17 Oct 2015.

Kenya in February. The 16% VAT on oil products will mean that government taxes and levies account for approximately 40% of the price of petrol.<sup>43</sup>

### Implications

The Imperial Bank scandal is unlikely to pose a risk to the stability of the wider banking sector. It will, however, encourage the government to resurrect previous proposals to increase minimum capital requirements to ensure fewer but larger banks in the sector. It will also make it harder for small banks to raise capital, strengthening the position of the largest banks. The CBK will utilise its regulatory and supervisory powers increasingly aggressively. Imperial Bank's fully audited financial records highlight the need for investors to not rely on shareholder or financial information alone when considering investment decisions.

The government will continue to prioritise infrastructure spending rather than diverting much needed funds to county governments. This will result in delayed payments to contractors and service providers resulting in cash flow projects and delaying project completion.

Kenya's ranking in the *Doing Business* index highlights the inadequacy of using rankings alone to evaluate an investment environment. One radical increase has distorted the wider perception of Kenya. It is also a category that – while important for small and medium enterprises – is not overly significant for international investors. Kenya's 2017 ranking is likely to be a more accurate reflection, with the implementation of the September business laws showing a genuine improvement in Kenya's business regulation.

The implementation of VAT will increase fuel and transportation costs, increasing the cost of doing business in Kenya. This will increase upward inflationary pressures which the CBK will need to manage appropriately to avoid public protests.

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<sup>43</sup> Business Daily, 17 Oct 2015.

### About Africa Risk Consulting:

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