

## AFRICA RISK CONSULTING Kenya Monthly Briefing May 2016

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### Kenya Summary 16 May 2016

***Chase Bank Ltd re-opens only three weeks after the Central Bank of Kenya (CBK) places it under receivership. The government considers a merger between state-owned National Bank of Kenya, Consolidated Bank and the Development Bank of Kenya. Government provides additional information about Mining Bill 2014. The collapse of a building in Nairobi's low-income Huruma District increases pressure on the government to improve construction regulations.***

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### Chase Bank re-opens after receivership

**Chase Bank Kenya Ltd** re-opened on 27 April, after the **Central Bank of Kenya (CBK)** placed it under receivership three weeks earlier.<sup>1</sup> The speedy resolution will increase banking sector confidence. Chase Bank re-opened after Kenya's largest bank, **Kenya Commercial Bank (KCB)**, acquired in principle a majority stake in a **Central Bank of Kenya (CBK)**-brokered deal.<sup>2</sup> The deal remains subject to KCB due diligence which may impact the final price and exact size of the stake, neither of which KCB has disclosed. Chase Bank allowed depositors access to a maximum KSh1m (\$10,000) on the back of KCB and CBK liquidity injections. Larger depositors and Chase Bank's creditors must, however, wait until the takeover is complete.

Chase Bank's closure came after financial consultant **Deloitte** criticised Chase management on the way they accounted for director loans, which triggered a run on the bank.<sup>3</sup> The issue of contention was how some loans worth approximately \$130m were advanced to Chase Bank chairman and founder **Zafrullah Khan** and managing director **Duncan Kabui**.<sup>4</sup>

*"The duo took loans to purchase prime real estate under Islamic banking but at \$130 million they had exceeded CBK's rules that put a cap on insider loans. In this case Chase Bank had \$110 million in core capital as at the end of 2015 and under the banking act insider loans cannot exceed 25% of core capital. The two Chase Bank directors therefore exceeded the CBK limit by more than four times."*<sup>5</sup>

Additionally under Sharia banking, profit from assets such as rental properties is supposed to be shared with the lender, which was not the case for Chase Bank, implying that the loans were "*grossly advanced at generous terms*".<sup>6</sup> Details of the extent of misconduct became clearer after CBK assumed control of Chase Bank before appointing KCB to manage it.

Chase Bank's receivership followed that of **Imperial Bank Ltd** and **Dubai Bank Kenya Ltd**, further undermining confidence in the banking sector.

*"All three banks' demise were the result of poor corporate governance that has seen directors and owners scheme to loan themselves huge amounts of cash while jeopardising deposits. Depositors are asking how the two could have borrowed such huge amounts without the board of directors noticing that something was amiss."*<sup>7</sup>

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<sup>1</sup> Daily Nation, 27 Apr 2016.

<sup>2</sup> Daily Nation, 27 Apr 2016.

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

<sup>4</sup> Source, journalist, Nairobi

<sup>5</sup> Source, journalist, Nairobi

<sup>6</sup> Source, journalist, Nairobi

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

The state-owned **National Bank of Kenya (NBK)** also faced collapse if it did not receive additional capital. The government has responded with a proposal for the merger of three state-owned banks – the NBK, **Consolidated Bank**, and the **Development Bank of Kenya** – into one.<sup>8</sup>

The receivership of Chase Bank has highlighted not just weaknesses in the banking sector but also indicated reputational risks for investors.

*“Chase Bank’s debacle has highlighted that even savvy and seasoned investors are not immune to reputational risks.”<sup>9</sup>*

Shareholders in Chase Bank include **Germany**-based development finance institution **Deutsche Investitions- und Entwicklungsgesellschaft mbH (DEG)** and **France**-based private equity company **Amethis Finance**. Both DEG and Amethis were represented on the Chase Bank board, *“yet they were caught unawares by the actions of the two directors”*.<sup>10</sup>

There is also criticism of the CBK and the **Capital Markets Authority**. The CMA authorised Chase Bank to list a \$48m bond on the **Nairobi Securities Exchange (NSE)** in June 2015. The CMA also approved Imperial Bank’s \$20m bond that was floated on the bourse. Despite popular criticism that CBK governor **Patrick Njoroge** acted in haste in placing the three banks under receivership, he retains political support. His stance has additionally improved standards in the banking sector.

*“The CBK is now thoroughly looking at financials and banks are now starting to report more accurately. Tougher enforcement of reporting standards has slowed down the profitability momentum as banks increase their provision for bad debts but at the same time the CBK is coming out as a credible institution and players are beginning to toe the line and improve on governance.”<sup>11</sup>*

The main challenge is whether Njoroge will allow enough room for private sector activity. Observers critically contrast Njoroge’s conservative stance to that of his predecessor **Njuguna Ndung’u**.

*“Vodafone mobile money platform M-Pesa’s phenomenal success is partly attributed to former CBK governor Njuguna Ndung’u who was open to companies trying out new ideas that can increase access to financial services.”<sup>12</sup>*

## Government provides details of mining bill

Mining cabinet secretary **Dan Kazungu**, on 9 May, provided additional detail about the **Mining Bill 2014** currently under discussion in parliament.<sup>13</sup> The new mining code will reassure investors, after county governments in several mineral-rich areas flexed their muscles and announced they would be levying taxes at county level on mining operations. Mining executives consider Kenya one of the least attractive investment destinations due to policy uncertainty and concerns about state interference.<sup>14</sup> The new mining code introduces a 10% free carried interest on all mining activities including exploration, extraction and processing.<sup>15</sup> The code establishes the state-owned **National Mining Corporation** to manage the state’s holdings.<sup>16</sup>

The government is keen to end contractual disputes that have deterred foreign investment. The code provides for a dedicated tribunal service to resolve contractual disputes, which will reduce the risk of unilateral state contract revision or revocation.<sup>17</sup> The code limits state intervention to cases of

<sup>8</sup> Source, business analyst, Kenya

<sup>9</sup> Source, journalist, Nairobi

<sup>10</sup> Source, journalist, Nairobi

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

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

<sup>13</sup> www.oraro.co.ke

<sup>14</sup> Source, mining executive, South Africa

<sup>15</sup> Standard, 9 May 2016.

<sup>16</sup> www.oraro.co.ke

<sup>17</sup> Source, mining executive, South Africa

underperformance. Under Kazungu's predecessor, **Najib Balala**, the government in August 2013 revoked 40 mining licences, and a further 65 licences in April 2015.<sup>18</sup> **Canada-based Pacific Wildcat Resources** subsidiary **Cortec Mining Co** was one of several mining companies that had its licence suspended.<sup>19</sup> Cortec claimed the suspension was political after it had reported Balala to the **Ethics and Anti-Corruption Commission** for allegedly demanding a bribe.<sup>20</sup> The high court upheld Cortec's revocation in March 2015. Cortec and its financial backer, **United Kingdom-based Stirling Capital**, filed against the Kenyan government at the **International Centre for the Settlement of Investment Disputes (ICSID)** in November 2015, seeking \$2.08 billion in compensation.<sup>21</sup> Attorney general **Githu Muigai** had warned in October 2015 that the government is likely to lose the ICSID case which is still pending.<sup>22</sup> The dismissal of Balala and appointment of Kazungu in November 2015 indicates the government's inclination to reform the sector despite the most potentially lucrative mining deposits – the mineral sands in **Kwale County** – mainly being concentrated in the opposition **Coalition for Reforms and Democracy (CORD)** strongholds in the **Coast Province**. Kazungu is a sensible appointment as he is the member of parliament (MP) for **Malindi County** in the Coast Province, and a former member of the opposition **Orange Democratic Movement (ODM)**.<sup>23</sup>

The mining code clarifies land rights and increases certainty over land ownership by stating that the government will only grant mining rights once either private land owners provide their legally binding consent or, in the case of public land, the **National Land Commission** provides its consent.<sup>24</sup> Balala originally introduced the mining bill in April 2014. The amendments do not impact its key provisions. The National Mining Corporation will manage the state's holdings. The amendments also give the cabinet secretary the right to declare a mineral 'strategic', giving the state greater rights over it, and to revoke or suspend mining licences if the venture breaches regulations. The amendments increase mineral royalties from the current 3% to 5% for gold and 10% for most other products. The amendment dropped an earlier proposal that Kenyan nationals take a 35% stake in mining ventures.

The bill provides guidelines for local provisions, but much is ambiguous and subject to negotiation with the mines ministry.<sup>25</sup> The bill differentiates between large-scale and small-scale mining activities. Only Kenyan-owned companies may apply for small-scale licences. The bill states that where a company's planned capital expenditure is above a certain limit, the company will within four years of obtaining a mining licence list as least 20% of its equity on the NSE.<sup>26</sup> The cabinet secretary may extend this period. The mining bill requires licence holders to give preference where possible to materials and products produced in Kenya, Kenyan-offered services, and Kenyan-owned companies. Licence holders are under obligation to give preference to Kenyan nationals over employment opportunities. The cabinet secretary will determine the number of expatriate employees depending on capital investment.<sup>27</sup> The number and location of workers is likely to prove contentious.

*"The key question is how local is local? Having Kenyan employees in your head office in Nairobi won't wash with county governors."<sup>28</sup>*

Kenya is the third largest producer of soda ash, used in the manufacture of glass, and the seventh largest producer of fluorspar.<sup>29</sup> Kenya also has deposits of rare earth minerals including niobium and titanium ores, coal, and gold.<sup>30</sup>

<sup>18</sup> Bloomberg, 6 August 2013

<sup>19</sup> The Star, 8 August 2013

<sup>20</sup> East African Business Week, 11 August 2013

<sup>21</sup> East African Business Week, 11 August 2013

<sup>22</sup> www.africaintelligence.com

<sup>23</sup> www.africaintelligence.com

<sup>24</sup> www.oraro.co.ke

<sup>25</sup> www.oraro.co.ke

<sup>26</sup> www.oraro.co.ke

<sup>27</sup> www.oraro.co.ke

<sup>28</sup> Source, extractives executive, Kenya

<sup>29</sup> Source, mining executive, South Africa

## Collapse of Huruma building highlights land malpractice

The collapse of a building in **Nairobi's** low-income **Huruma District** on 29 April has increased pressure on the government to improve construction regulations. The land and real estate sector in Kenya is notoriously corrupt, with speculators often prioritising speedy construction over adherence to building regulations as they look to take advantage of the property boom. The collapse of the residential building near **Nairobi River** was due to heavy flooding and resulted in at least 51 deaths.<sup>31</sup> The building was constructed as recently as 2013, but was declared structurally unsound and due for demolition. However, its owners allegedly failed to act on an evacuation order.<sup>32</sup> Interior cabinet secretary **Joseph Nkaisery** reiterated that authorities will arrest and prosecute individuals involved in the construction of substandard buildings.<sup>33</sup> Five people currently face manslaughter charges related to the collapse of the Huruma building.<sup>34</sup>

Following the collapse, deputy president **William Ruto** called on county governments to tighten construction regulations to ensure that all projects adhere to safety standards.<sup>35</sup> A draft building development bill is awaiting cabinet approval, and the government expects it to become law before the end of the year.<sup>36</sup> The bill will consolidate all building permits into a single online form.<sup>37</sup> The government is also digitalising all land registries to reduce corruption risk.<sup>38</sup> **Nairobi County** governor **Evans Kidero** blamed the development of the unsafe Huruma building on corruption, ethnic politics and the failure to issue title deeds.<sup>39</sup> In December 2015, the Supreme Court ruled in favour of the land ministry in its dispute with the **National Land Commission** over which body had the authority to register land and issue land licences.<sup>40</sup> However, institutional uncertainty continues with the government on 28 April dissolving all **Land Control Boards** in an effort to curb corruption in the land sector.<sup>41</sup>

### Implications

The Chase Bank receivership raised questions about the CBK's internal supervision department and its capacity to detect causes of collapse before their occurrence. The speedy resolution, however, bodes well for the sector's stability as mergers will encourage the emergence of stronger institutions. Banks that are more stable and that have strong corporate governance will continue to benefit as customers move deposits to these institutions and away from banks that are perceived to be more risky.

The mining bill, if passed in its current form, will increase Kenya's attractiveness to mining companies. However, in the current depressed commodity cycle, it is unclear when investors might be in a position to develop projects. The ambiguity over local provisions will encourage political disputes as county governments seek to maximise their returns from mining projects.

Land reform is long overdue in Kenya. It is politically sensitive both due to a colonial legacy of land-grabbing, and ongoing real estate speculation. Property will remain contentious in Kenya, with clear land titles remaining scarce making it difficult to determine legal ownership. With persistent corruption and uncertainty in the land sector, there is a high risk of competing claims of ownership.

<sup>30</sup> Source, mining executive, South Africa

<sup>31</sup> Capital FM, 2 May 2016.

<sup>32</sup> AFP, 2 May 2016.

<sup>33</sup> Capital FM, 2 May 2016.

<sup>34</sup> AFP, 2 May 2016.

<sup>35</sup> Capital FM, 2 May 2016.

<sup>36</sup> Xinhua, 2 May 2016.

<sup>37</sup> Xinhua, 2 May 2016.

<sup>38</sup> Xinhua, 2 May 2016.

<sup>39</sup> Reuters, 1 May 2016.

<sup>40</sup> Daily Nation, 12 Dec 2015.

<sup>41</sup> Daily Nation, 28 Apr 2016.

### About Africa Risk Consulting:

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