East Africa Banking Survey

2019

Introduction

Macroeconomic trends and their influence on the East Africa banking industry

The retail banking industry in the East Africa region is undergoing transformational change. In fact, change is the new normal and it has been for a while now. Recognising the importance of the industry to our regional economy, as well as the transformative forces well underway, PwC has published our East Africa Banking Survey to share insights about how industry players are managing change.

Our survey includes insights from CEOs, CFOs and other senior representatives of the banking industry in Kenya, Uganda, Rwanda and Tanzania. One of the first questions that we asked them was to identify one macroeconomic trend that will shape their bank's business the most in the coming five to ten years. Their responses are enlightening and even surprising.

To put this question in context, PwC has helped to frame the global discussion about change by identifying five macroeconomic trends. In any country, region or industry, we believe that there are five fundamental trends that drive change: technological evolution, social and behavioural change, the rise and interconnectivity of emerging markets, demographic shifts and climate change/resource scarcity.

In our East Africa banking survey, respondents told us that technological evolution and social and behaviour change impact their businesses most of all, followed by technological evolution. Interestingly, demographic shifts was a trend chosen by just 17% of our respondents.

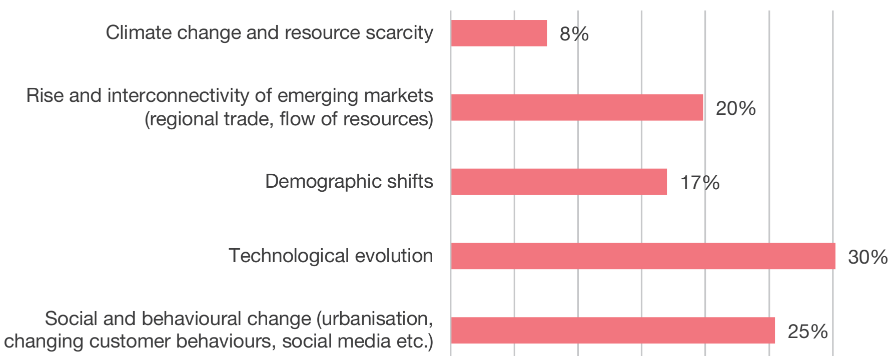
Peter Ngahu
Regional Senior Partner,
Eastern Africa
peter.ngahu@pwc.com
+254 20 285 5000

Before conducting this survey, we would have thought that demographic shifts - particularly East Africa's youthful population of consumers - would have been a top choice. But responses to other questions in our survey show that indeed, customer behaviour change and technology drive growth and profitability in a sector that is increasingly competitive and cross-border. Most banks recognise the potential of a youthful, urban demographic of customers. Their outreach contributes substantially to greater financial inclusion overall, but they target and try to retain these customers by understanding their behaviour and using technology.

In addition to responses to our survey, this publication includes insights from our practitioners and senior leaders of the East African banking community. We are grateful for the contributions of our survey respondents and our contributors, who have helped to make this a meaningful and interesting publication.

Our team is ready and prepared to help you achieve your business goals in the East Africa region and beyond. If you have any questions or would like to discuss this report with us, please reach out to any of the PwC people profiled in this report. You are also welcome to contact me or our Financial Services Industry Leader, Richard Njoroge, at any time.

FIGURE 1: Which of the following macroeconomic trends do you believe will shape your bank's or group's business in the next 5 - 10 years?



Foreword

Our East Africa Banking Survey was conducted from August - November 2018 amongst Chief Executive Officers, Chief Financial Officers and other senior representatives of banks in Kenya, Rwanda, Uganda and Tanzania. The survey focused on five key areas:

1. General industry trends
2. Banks of the future: technology & innovation
3. Risk management perspectives
4. Impact of adoption of IFRS 9
5. Financial crime & Anti-Money Laundering/ Counter Financing of Terrorism (AML/CFT)

In our survey, bank executives acknowledge the threat and potential posed by non-traditional competitors, such as financial technology (FinTech) intermediaries and mobile service providers. While they do not offer complete suites of banking services like licensed banks do, these intermediaries - which are highly specialised and focused - attend to specific sweet spots in the banking value chain.

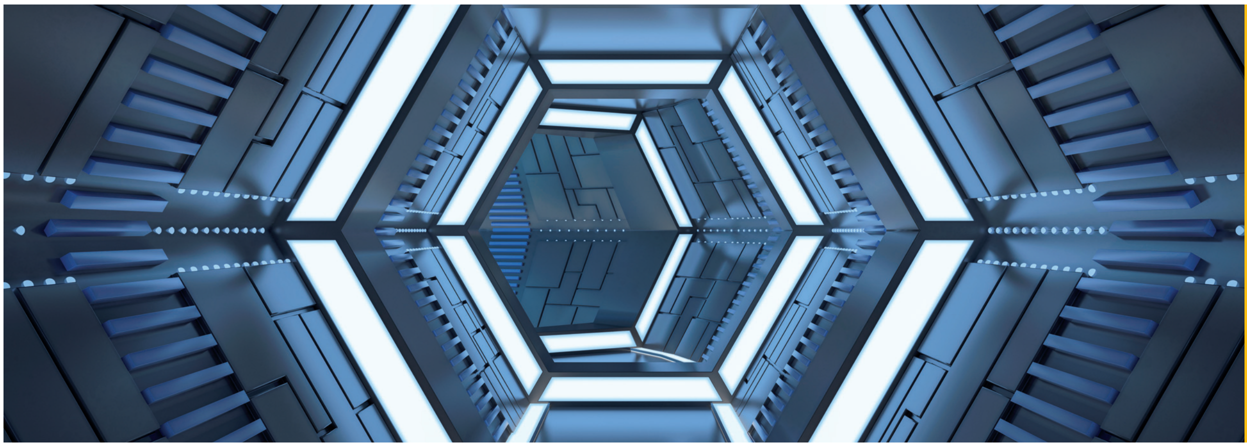
Our survey also reveals that executives appreciate that the industry is evolving fast, with a number of trends and developments currently shaping the banking landscape for financial services and in particular the banking industry. Depending on individual players' positioning, these trends could either contribute to or detract from their ability to achieve sustainable revenue growth.

To supplement our survey, we conducted in-depth interviews with six of East Africa's most thought-provoking leaders in the banking industry. Their interviews feature in this publication and directly complement our survey findings in areas like innovation, customer experience, consolidation of the industry, risk management and regulatory change. They expressed a passionate interest in the qualities and capabilities of 'banks of the future' and a deep concern for the risks facing the industry.

Richard Njoroge
Partner and Financial Services Leader for East Africa Region
richard.njoroge@pwc.com
+254 20 285 5604

We are grateful for their contributions and those of our PwC experts, whose insights also feature in this publication. As always, we welcome your feedback about this publication and in particular, any areas that we can address in future surveys or that you may wish to discuss with us. Please feel free to reach out to me, Peter or any of the PwC practitioners featured in this report.

Finally, I would like to thank Dennis Musau, a former Senior Manager in PwC Kenya's Assurance practice, who led this project from a practice standpoint. He has recently moved on to another organisation. Dennis features as a contributor but he was also instrumental in leading the development of this publication.



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Our contributors

We are grateful for the contributions of our clients and contacts across the region, who contributed substantially to this report. Thank you for your time and insight.

With gratitude, we would like to appreciate:

Dr James Mwangi,
CEO, Equity Group Holdings Plc

Patrick Mweheire,
Chief Executive, Stanbic Bank Uganda and Chairman, Uganda Bankers Association

Dr Diane Karusisi,
CEO, Bank of Kigali

Theobald Sabi,
Managing Director, NBC Bank

Kihara Maina,
CEO, I&M Bank and

Abdulmajid Mussa Nsekela,
Managing Director, CRDB Bank

We would also like to appreciate the PwC team members who contributed to this publication:

Kenya:

Richard Njoroge
Partner and Financial Services Leader for East Africa Region
richard.njoroge@pwc.com

Dennis Musau
Senior Manager
dennis.musau@pwc.com

Brian Ngunjiri,
Associate Director
brian.ngunjiri@pwc.com

Gauri Shah,
Associate Director
gauri.shah@pwc.com

Joseph Githiga
Associate Director
joseph.githaiga@pwc.com

John Kamau
Associate Director
john.kamau@pwc.com

Alex Muriuki
Associate Director
alex.muriuki@pwc.com

Esther Njiru
Manager
esther.njiru@pwc.com

Philomena Onsomu
Manager
onsomu.philomena@pwc.com

Uganda:

Uthman Mayanja
Partner
uthman.mayanja@pwc.com

Rwanda:

Moses Nyabanda
Partner
moses.o.nyabanda@pwc.com

Tanzania:

Cletus Kiyuga
Partner
cletus.kiyuga@pwc.com

Zainab Msimbe
Partner
zainab.msimbe@pwc.com

Jackson Ogallo
Manager
jackson.ogallo@pwc.com

Stellah Mutuku
Manager
stellah.mutuku@pwc.com

Samwel Karoli
Manager
samwel.karoli@pwc.com

General industry trends

Global and Africa trends

Powerful forces are transforming the retail banking industry. Growth remains elusive, costs are proving hard to contain and return on equity remains stubbornly low. Regulation is impacting business models and economics.

Technology is rapidly morphing from an expensive challenge into a potent enabler of both customer experience and effective operations. Non-traditional competitors are challenging the established order, leading with customer-centric innovation. New service providers are emerging, with new business models. Trust is at an all-time low and customers are demanding ever-higher levels of service and value.

According to PwC's Global Retail Banking 2020 survey[1],

- Fewer than 20% of banking executives feel well-prepared for the future,
- 55% of bank executives view non-traditional players as a threat to traditional banks; and
- 70% of global banking executives believe it is very important to form a view of the banking market in 2020, to understand how these global trends are impacting the banking system in order to develop a winning strategy.

Six priorities will help guide the way forward:

1. Developing a customer-centric business model
2. Optimising distribution
3. Simplifying the business and operating model
4. Obtaining an information advantage
5. Enabling innovation and the capabilities to foster it and
6. Proactively managing risk, regulation and capital.

Against this backdrop, Africa's banking industry is also undergoing transformational change. Three trends impact the African banking industry and profitability:

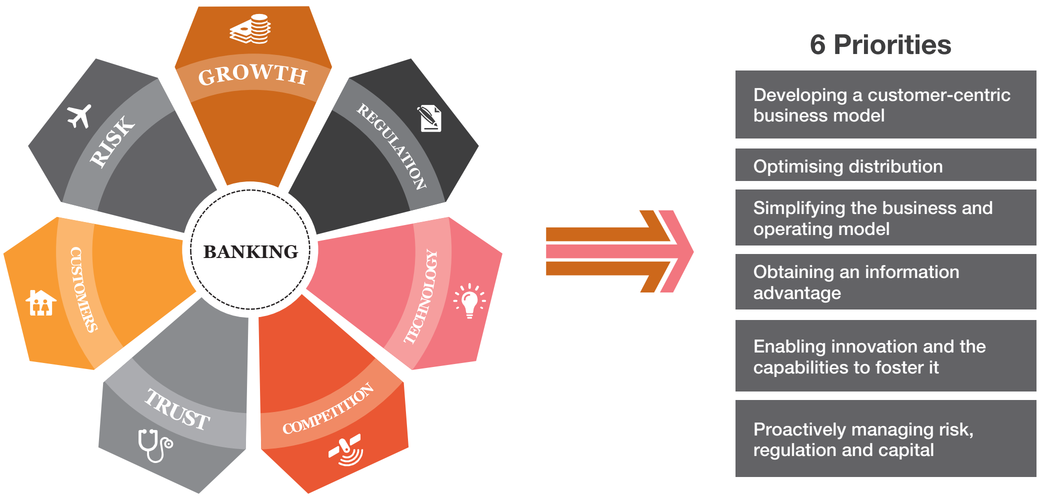
1. Relatively high rates of economic growth;
2. Financial sector deepening to fulfil a huge unmet need for financial services; and
3. The emergence of digital solutions with lower-cost models.

Many have predicted the fall of the traditional bank, as disruptive new entrants win market share by offering a better customer experience through new products and channels.

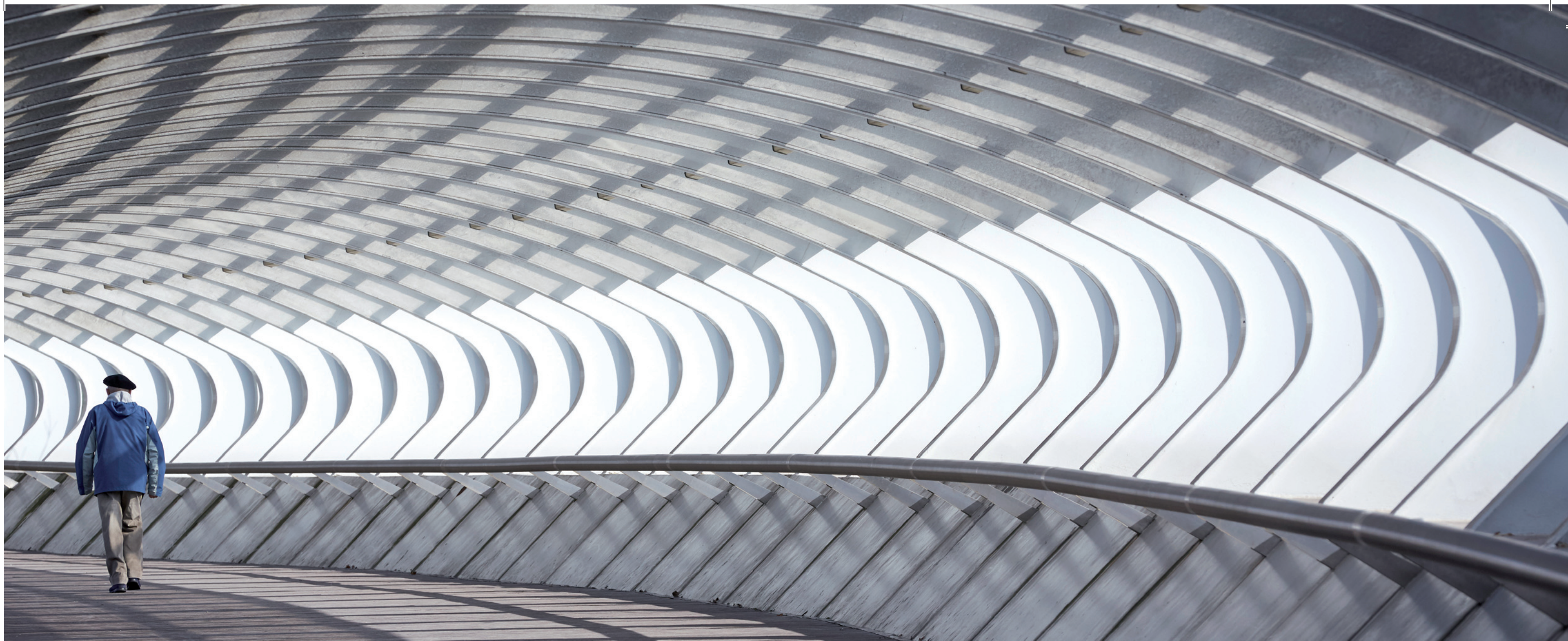
And yet 65% of consumers believe that it is still important to have a local bank branch, according to PwC's 2018 Digital Banking Consumer Survey[2], and 25% would not open an account with a bank that did not have at least one local branch.

Consumers still value the ability to ask for help and be guided through the process – in person. At the same time, traditional banks' business is at risk from FinTech disruption. FinTechs are targeting services like payments, funds transfer and personal finance.

FIGURE 2: Powerful forces are transforming the global banking industry



[1]https://www.pwc.com/gx/en/banking-capital-markets/banking-2020/assets/pwc-retail-banking-2020-evolution-or-revolution.pdf
[2]https://www.pwc.com/us/en/financial-services/publications/assets/pwc-fsi-whitepaper-digital-banking-consumer-survey.pdf



INDUSTRY PERSPECTIVE:

Dr James Mwangi
CEO,
Equity Group Holdings Plc

In your view, what will distinguish successful banks in the future? Which attributes will they have?

Successful banks will embrace emerging and disruptive technologies and shield themselves from disruption and competition. They will invest in research and innovation, at the channel and product development levels, and leverage technological disruptions to execute on the findings of their research.

Successful banks will also embrace and develop capabilities to develop and forge partnerships and alliances. And they will be very good at risk management. Their biggest risk will be compliance with legal, regulatory and licensing requirements. The jurisdiction of compliance is now global and there is much more work involved in complying with international reporting and standards.

The next generation of banks could be much more transactional, such as by being the leaders in payments. Size will also be important; there will be niche players, but those who engage in inclusive mass banking will be the most successful.

The costs associated with compliance, technology, research, innovation and risk management are high and the market is unwilling to pay a premium. We are entering an era of mergers and acquisitions where we will see the creation of more mass banks.

Mass banks will provide inclusive services, with proper customer segmentation and delivering specific services to these segments rather than focusing exclusively on a niche within a segment.

Patrick Mweheire,
Chief Executive,
Stanbic Bank Uganda and Chairman,
Uganda Bankers Association

I envision an ecosystem of financial services where banks will remain the owner of the customer relationship but then start working with other service providers for certain services or capabilities quickly and efficiently. This will benefit our customers – which is the ultimate goal.

Traditionally, banks have done a very poor job of understanding the dynamic and changing environment. It's not because it costs USD 1 million to start up a branch that determines who is bankable or who is not. Reduce the costs of the branch.

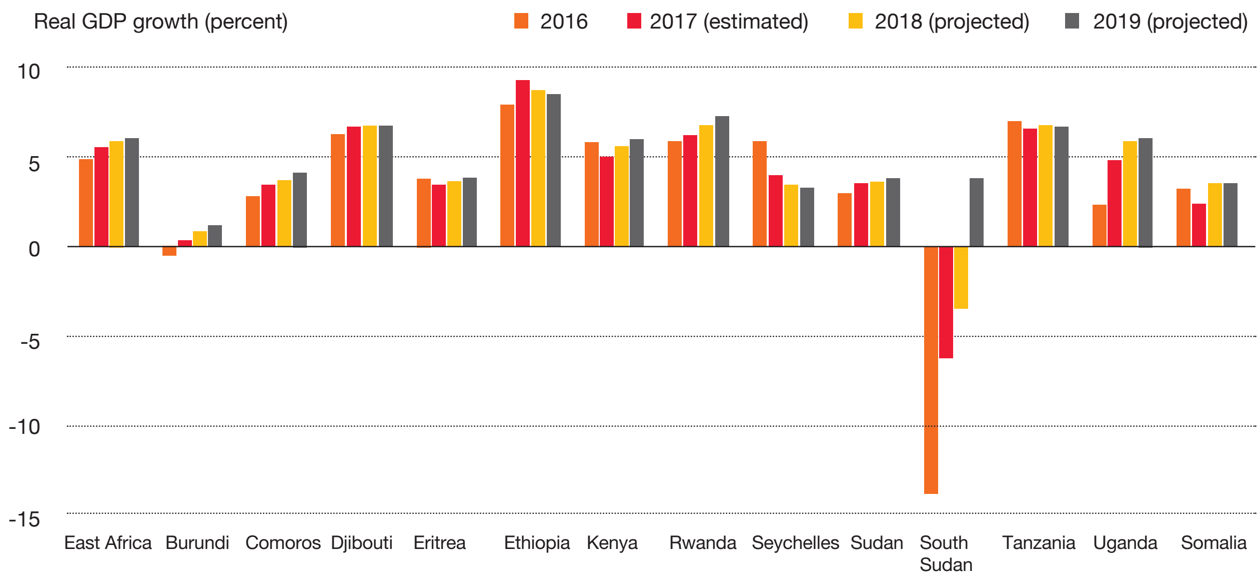
Collaborate. That is one of the things that I am driving at the Uganda Bankers Association, as the current chairman – to foster cooperation and collaboration in the sector.

A recent example of this is our Lira branch that we are partially converting into a Bank of Uganda cash centre. It can be used by all banks in the area instead of the current arrangement of transporting cash to and from the next closest cash centre in Mbale, a distance of 192 kilometres. Using the Lira cash centre will generate instant savings for each participating bank.

East Africa perspectives

Overall, GDP has increased slightly since 2016 in the East Africa region; even so, particular issues have challenged performance in the banking sector.

FIGURE 3: Regional economic growth in East Africa, 2016-19



Source: AfDB Statistics

The banking landscape in Kenya continues to be dominated by the interest rate capping regime that came into effect in the fourth quarter of 2016. While engagements between the industry, the regulator(s), the courts and the political class continue, it remains unclear – at least to investors and other observers – what the result of these engagements will yield.

Meanwhile in the rest of East Africa, lending rates range between 18% - 21% in Uganda, Tanzania and Rwanda, much higher than in Kenya. High interest rates in these countries have provided banks with the ability to price for underlying risks, although to some extent this has been coupled with inadequate risk assessments leading to increased exposure to non-performing loans.

In Tanzania for example, the regulator issued a circular in February 2018 which introduced measures aimed at reducing non-performing loans (NPL) and increasing credit to the private sector. Among others, was a requirement to write off loans which stayed under loss category for four consecutive quarters. This resulted in huge write offs for banks which had a number of these non-performing loans but were fully covered by collateral. The requirement to write off does not take into account strength of collateral.

While this regulation introduces an accounting challenge when considered against IFRS 9 impairment requirements, that challenge pales in comparison to the practical business implications for banks seeking to remediate such accounts. It remains to be seen whether the regulation, which has been challenged by various practitioners, will remain. Importantly, regional regulators watch the Tanzania developments closely as they also grapple with NPL ratio challenges.

As the first year of IFRS 9 compliance came to a close in 2018, with its forward-looking approach to loan provisioning, there is reason to hope that the rates of non-performing loans will decline as banks report and plan for the impact of non-performing loans more proactively on their balance sheets. It is also hoped that going forward, banks' pricing models will incorporate an amplified element of forward looking pricing adjustment to accommodate the impact of the new accounting rules.

Capital adequacy requirements and more supervision by the region's central banks should contribute to more consolidation in the sector. In Tanzania specifically, in the beginning of 2018, the Bank of Tanzania closed five relatively small banks for failing to meet capital requirements for an extended period. In July 2018 one of the top 10 banks in that country was put under Bank of Tanzania administration following persistent liquidity challenges.

In Kenya, the Central Bank put two banks under receivership in 2015 and 2016 respectively. Published results from banks show that some of the lower tier banks continue to experience capital and liquidity challenges. Although no specific matters have come to light (publicly) about how these challenges will be managed, it is not unreasonable to believe that action will be taken to address their challenges.

Kenya's banking sector welcomed the announcement of a merger between two of its top banking players in December 2018, subject to regulatory and shareholder approvals. The merger between Commercial Bank of Africa Limited and NIC Plc, both of which have sizeable market presence in the East Africa region, is expected to set the stage for more market driven consolidations in the industry. What shape those will take, and when they will happen, is up for debate.

Global players have expressed an interest in the region and local banks are becoming more competitive regionally with their mobile money solutions, agency models and digital platforms that appeal to East Africans.

With a population growth rate of 3%, and with increasing financial inclusion and uptake of financial services, East Africa's banking sector is poised to grow substantially and profitably in the years to come. That said, the balance between return optimisation versus cost and risk management will remain a top challenge for Kenyan banks as they adjust themselves to this new normal.

INDUSTRY PERSPECTIVE:

Dr Diane Karusisi,
CEO,
Bank of Kigali

How do you expect banking services to evolve over the next 10 years? How has Bank of Kigali evolved and where is it headed?

As Bill Gates famously said, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."

It is difficult to predict where banking services will be in ten years because we are seeing unprecedented disruption due to technological advancements, digital innovations and the evolution of customer behaviours and expectations.

Certain technological advancements help banks to understand their customers' needs in more detail. Most banks are mining data to support cross-selling as well as to improve customer loyalty, but legacy infrastructure and systems remain a challenge to digital transformation overall.

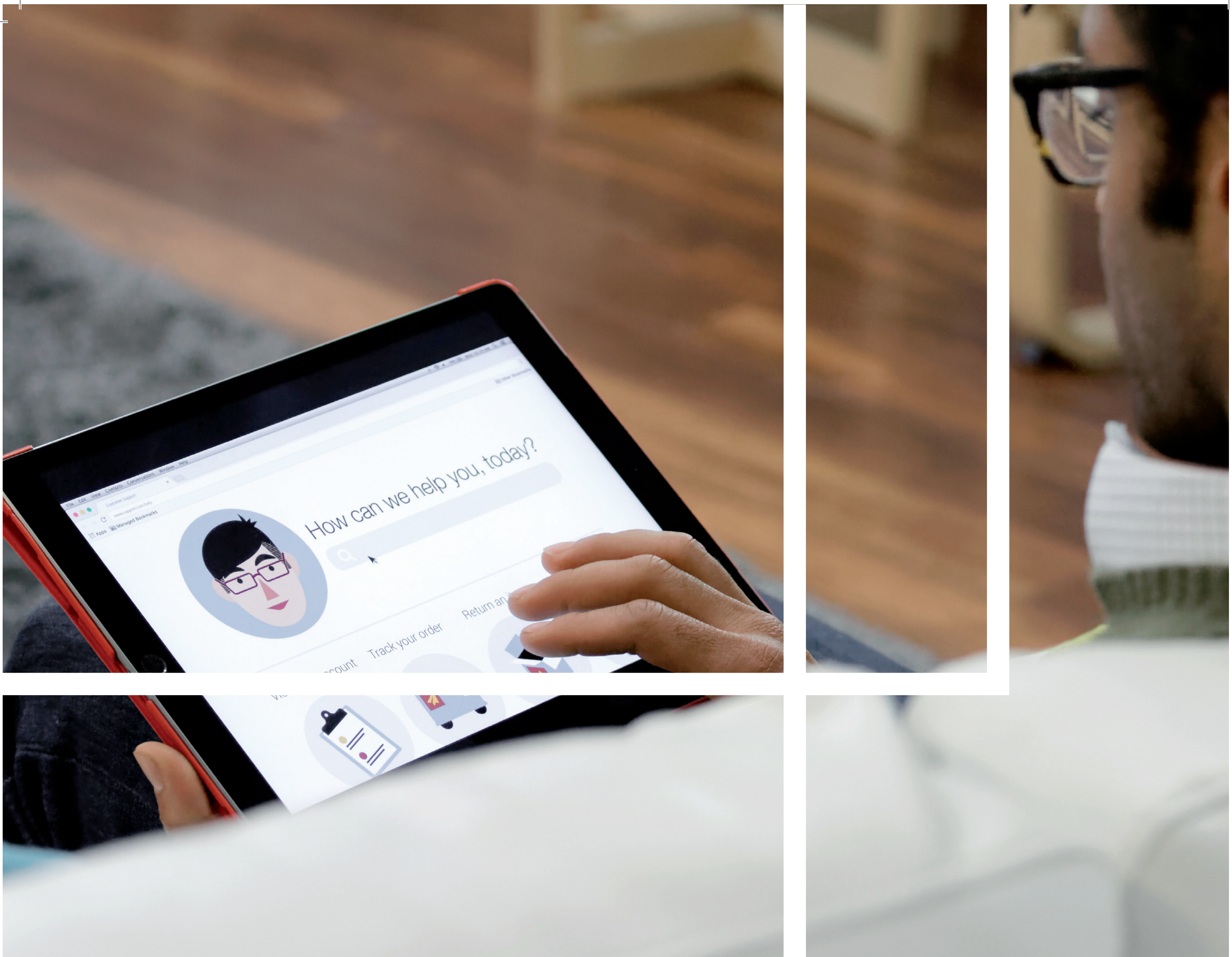
Banks can look for ways to refresh and extend legacy systems such as through application programming interfaces, or APIs, that allow applications to interact and share data. APIs enable banks to embrace new technologies, work with third parties and build new services in a time- and cost-efficient manner.

In the digital era, customer experience is a differentiating factor – and not just for banks. People generally transact more and more through digital channels. The customer experience on our digital channels is therefore crucial. At the Bank of Kigali, we keep the customer experience in mind when we design digital solutions because we know that experiences on our digital channels are now just as important as experiences at our physical branch locations.

Our growth strategy has been driven by the objective of meeting our clients' financial needs through great customer experiences. We have invested in various convenient channels to deliver banking services including 75+ branches countrywide as well as digital channels so that anyone, anywhere can access our services. Superior customer service, speed and technology are vital to our transformation strategy which will drive continuous growth in our profitability and market share.

Bank of Kigali's successful rights issue and cross listing on the Nairobi Securities Exchange was a first for Rwanda and it has greatly increased our stock liquidity, unfolding value for our shareholders and allowing regional and global investors to invest in the Bank of Kigali Group and Rwanda.

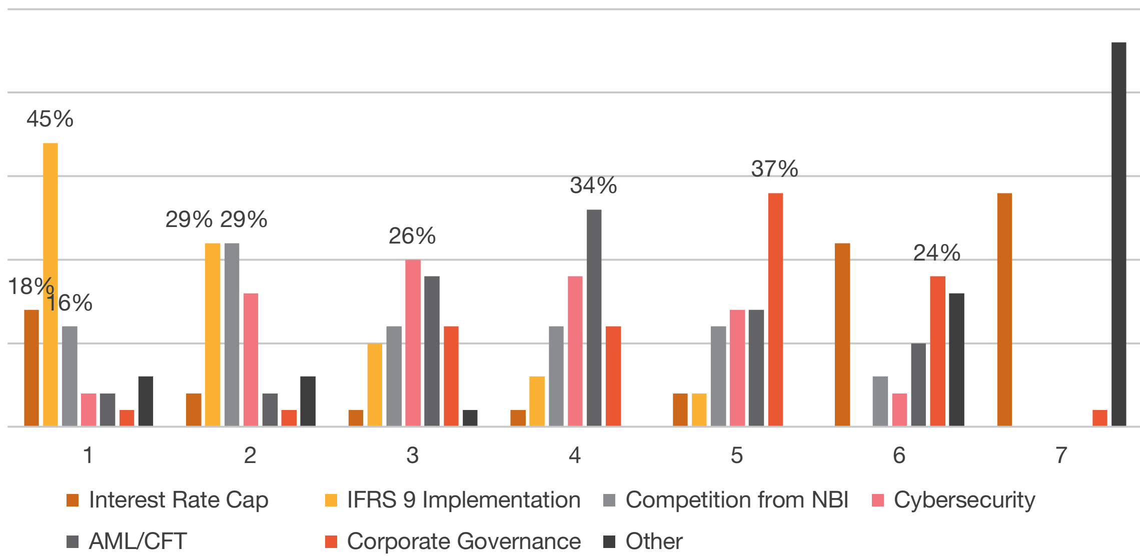
We can now benchmark ourselves against top banking groups in the region, across all key metrics. Going forward, we will need to up our game, improve our efficiency and continuously invest in digital innovations to remain relevant to investors.



Overview of our survey

Respondents to our survey identified common issues that impact their respective businesses. Amongst East Africa respondents overall, 45% of respondents identified IFRS 9 implementation as the most immediate external factor facing their institutions. Twenty nine percent of respondents ranked IFRS 9 and competition from non-bank institutions as the second-most significant factor, followed by 26% of respondents who ranked cybersecurity third most challenging. Most East Africa respondents ranked corporate governance in fifth (37%) or sixth (24%) place.

FIGURE 4: **The banking industry has been affected by various external developments in the last 12 to 18 months. Please rank the following developments starting with the one that posed the most challenge (1) to your Bank/Group, to the least most challenging (7).**



In Kenya, 86% of respondents rated the interest rate cap as the most significant external factor for their institutions followed by 43% of respondents who chose IFRS 9 implementation as the second-most significant factor. Seventy-one percent of Kenya respondents ranked corporate governance as the sixth-most significant factor, perhaps because corporate governance is already well-institutionalised at their organisations.

TABLE 1: **Industry-wide survey results of the issues ranked most challenging (ranked 1st of 7 choices)**

EAST AFRICA		**KENYA**	
IFRS 9 implementation	(45%)	Interest rate cap	(86%)
Interest rate cap	(18%)	Competition from non-bank institutions	(14%)
Competition from non-bank institutions	(16%)		
Cybersecurity	(5%)		
AML/CFT	(5%)		
Corporate governance	(3%)		
Other	(8%)		

IFRS 9 implementation

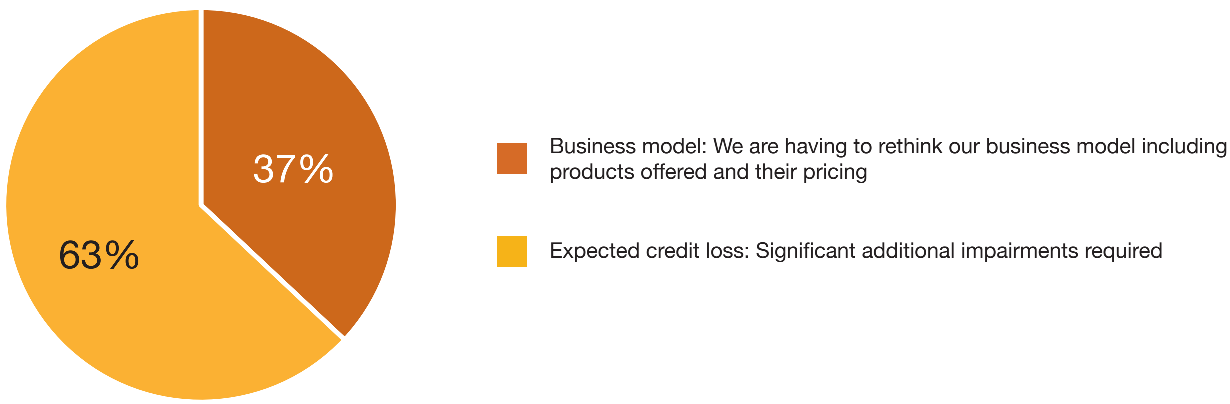
Considering the significant changes presented by the adoption of IFRS 9: Financial instruments, which came into effect on 1 January 2018, it is perhaps not surprising that in East Africa, banks have ranked this issue first amongst challenges.

The expected loss model introduced by IFRS 9, a seismic shift from the incurred loss model that was applicable in the previous standard, IAS 39, is at the centre of the numerous challenges that banks have to overcome.

The areas most impacted by implementation of IFRS 9 are expected credit loss / significant additional impairments required (63% of respondents) and business model / rethinking the business model including products offered and their pricing (37%).

We discuss the impact of IFRS 9 implementation and detailed survey results later in this report.

FIGURE 5: Which area of your Bank has been most impacted by the implementation of IFRS 9?



Regulatory change

Respondents highlighted regulatory compliance as an area of significant concern. The compliance spectrum is broad and includes dealing with Central Banks, other regulators and local Know Your Customer (KYC) and ICT requirements.

The time spent and human resources dedicated to various compliance-related matters has significantly risen in recent years, including the attention required by senior management. The cost of compliance has also risen.

Increasingly banks have found themselves complying with regulations from different regulators that ultimately have the same objective. Streamlining these requirements would undoubtedly reduce the compliance load.

A clear view on the final position of some of these regulations would help banks to determine their compliance obligations and resource appropriately.

INDUSTRY PERSPECTIVE:

Dr Diane Karusisi,
CEO,
Bank of Kigali

How can banks 'go the extra mile' beyond compliance and monitor KYC more effectively?

KYC requirements are increasing and all banks are carrying out KYC remediation and data cleansing to ensure compliance. At the same time, it is absolutely critical to engage our regulators as we develop and deploy advanced KYC technologies. As an industry, we also need to collaborate more effectively and to educate our clients more fully.

Quality KYC data is fundamentally important in the long run but we need to absorb the cost burden now. As an industry, we should invest because it is in our best interest to go the extra mile and get more accurate and detailed information about our clients. Ideally, we would work to integrate our reliable sources of data even as we incentivise clients to update their information automatically.

In Rwanda like in many other African countries, civil registration is being enhanced and in time, we hope that clients will allow banks to access their information in the civil registry to update their KYC information. Banks have a role to play in sensitising and informing clients about data privacy and protection, even as they pursue compliance.

Theobald Sabi,
Managing Director,
NBC Bank

Tanzania has an unusually onerous, rule-based KYC regime. Banks hope that the regime will be reviewed in the near future and updated to risk-based KYC requirements.

The current KYC requirements affect the cost of acquiring and maintaining customers and customer service as well. Tanzania's rule-based KYC regime does not apply to telecommunication companies, making it slightly easier for them to recruit customers.

Regulators should move to a risk-based approach and avoid being overly prescriptive so that banks can benefit from technology and innovation. However, banks need to continue to invest in internal capabilities in order to tap into technology and innovate solutions which will also help them to manage KYC in a more efficient manner.

How can banks prepare for the challenges associated with diverging regulatory frameworks?

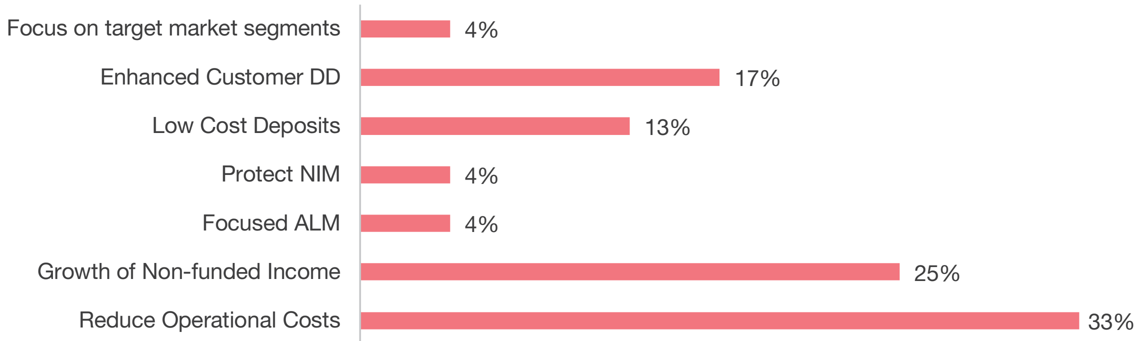
Banks can and should anticipate changes in the global and regional regulatory environment such as when the interest rate cap was enacted in Kenya and fees were capped in Zambia.

Interest rate cap

A total of 63% of respondents in Kenya indicated that the introduction of the interest rate cap reduced their Net Interest Income by 1% - 15%, whereas 37% reduced it by 16% - 30%. When asked about the tactical or strategic steps that they are taking to respond to challenges posed by the interest rate cap, the majority of respondents indicated that they are reducing operational costs (33%) and growing their non-funded income (25%).

All Kenya respondents (100%) indicated that where available, they have used Credit Reference Bureaux to identify borrowers with good credit scores.

FIGURE 6: **Strategies employed by banks to counter the effect of interest rate capping**



INDUSTRY PERSPECTIVE:

Kihara Maina,
CEO,
I&M Bank

What are the main trends that you see in the regulatory space?

There are two main trends, as I see it. First, there is an increase in regulation. Data protection laws like General Data Protection Regulation in the EU have become critically important to ensure the safety and integrity of customer information. Anti-money laundering regulation has been driven mainly by concerns over terrorism and terrorist financing and enhancing the integrity of the global Financial system by ensuring proceeds of crime do not get moved within the financial system.

Second, there are also questions around the fairness of different regulations and penalties imposed on banks. Deterrence and enhancing compliance through penalties also needs to take into account the levelling of the playing field particularly as digitisation disrupts the financial services industry.

Can banks self-regulate?

Self-regulation is important and it is something that banks should work towards, such as through what the Kenya Bankers' Association (KBA) intends with their Code of conduct etc. KBA could help its members self-regulate, monitor them and impose serious consequences on errant members. However, the real challenge to self-regulation is the ability of banks to manage underlying issues. The industry should support stronger, bigger and better capitalised banks and more competition.

In your view, what has been the impact of Kenya's interest rate capping regime?

Banks have analysed the impact of the regime and what has become clear is that interest rate capping has led to margin compression and a decline in returns on capital. This has, in turn, forced banks to assess their ability to accept risk in certain market segments.

The challenge with the interest rate cap regulation is that compliance was unconditional and sudden with no opportunity to phase compliance like you would have seen in the past say with Minimum Capital requirements. Banks therefore sought to grow their non-funded income streams and looked for other strategies to grow their income within the law. The negative impact has been felt in other areas such as increases in non-performing loans.

The best approach would be to deal with the underlying issues in the market that lead to the perceived or real high costs of banking such as the costs and inefficiencies related to government registries and the courts as well as the high costs brought on by fraud risks and financial crimes in general. Government borrowing has also increased significantly and this is driving costs up.

Finally, attempts to increase minimum capital requirements have not been successful, even though it would lead to a stronger and better capitalised industry, more competition and lower rates.

INDUSTRY PERSPECTIVE:

Abdulmajid Mussa Nsekela,
Managing Director,
CRDB Bank

How has your regulator challenged banks to demonstrate their risk management related to technological innovation?

Bank of Tanzania (BOT) has been on the forefront in building a robust banking sector through regulation and industry oversight. Over the past few years, and especially in the wake of the increased adoption of digital banking technologies, BOT has incessantly engaged with players and provided regulatory frameworks and Risk Management Guidelines for banks and financial institutions.

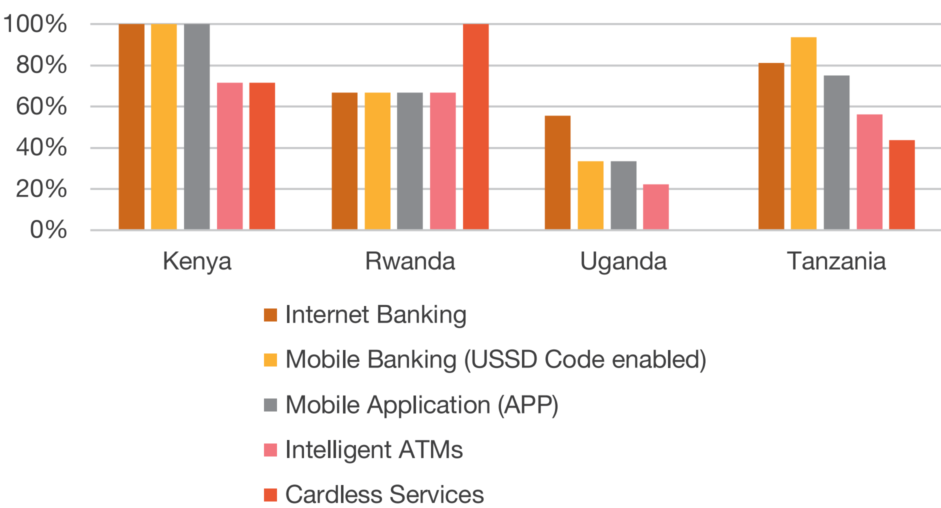
The Regulator has also been steadfast in conducting onsite examinations and offsite surveillance, which has enabled banks to improve their internal audit functions.

The resultant effect of this has been creation of robust risk management systems and practices covering credit, liquidity, market, operational, strategic and compliance risks.

Competition from non-bank institutions

Internet and mobile banking are the most popular digital channels offered by banks in the East Africa region, whereas intelligent ATMs and cardless services lag behind in all countries other than Rwanda. Given the diversity of channels and their maturity, it is not surprising that many respondents identified competition from non-bank institutions as a challenging issue. These are the services that non-bank institutions are targeting to deliver through their platforms more efficiently and cost-effectively (for the institution and the consumer).

FIGURE 7: Distribution of digital channels in East Africa



Industry challenges – as identified commonly by banks in annual reports

In their 2017 annual reports, banks used a number of common phrases to describe their operating environment and its challenges in the short- to medium-term. Respondents identified the top three that resonate with them, as follows:

TABLE 2: Top three challenges from 2017 annual reports, as ranked by respondents

East Africa	Kenya	Uganda	Tanzania	Rwanda
Regulatory change (21%)	Regulatory change (26%)	High cost-to-income ratio (27%)	Regulatory change (25%)	Regulatory change (22%)
High cost-to-income ratio (17%)	Cybersecurity (21%)	Capital adequacy (15%)	Competition from non-bank institutions (20%)	Capital adequacy (22%)
Capital adequacy (16%)	Extended electioneering period (21%)	Talent (15%)	Capital adequacy (20%)	Cybersecurity (22%)
Competition from non-bank financial institutions (16%)				

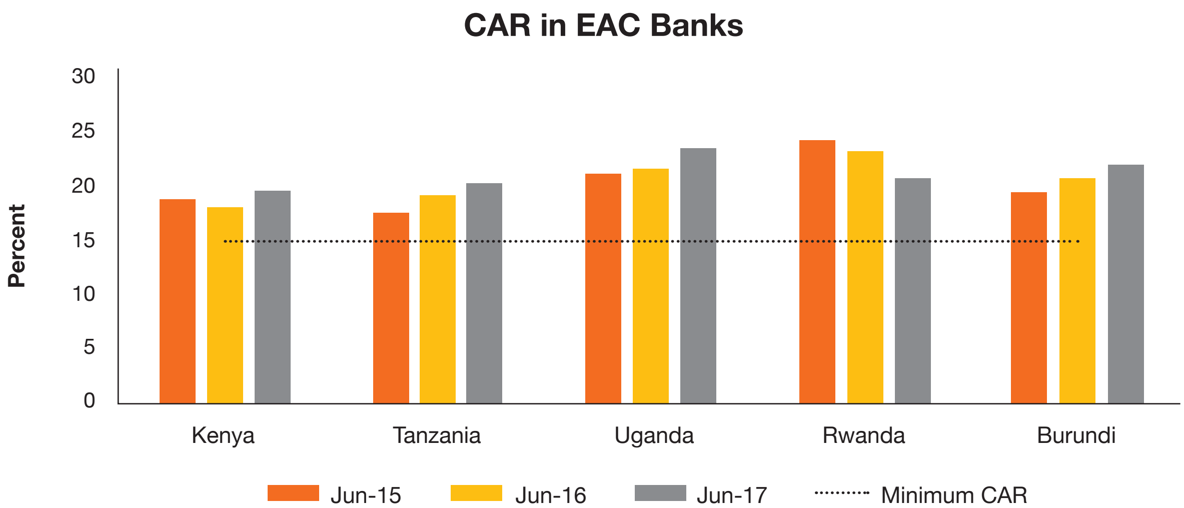
Regulatory change and capital adequacy were two of the challenges identified most often by banks in their 2017 annual reports and they were ranked foremost amongst our respondents as challenges that they are facing in the short- to medium-term.

Capital adequacy

Over the past 10 years, banks in the East Africa region have largely been well capitalised when measured against Basel dictated minimum requirements, adjusted for local regulatory conservation buffers. This is not to say there were no capital breaches during this period. However, where there were funding challenges, shareholder actions such as additional capital raising coupled with regulator directed capital plans such as mergers and buyouts were noted. Overall, other than for specific cases, most banks enjoyed core and total capital ratios of between 12-14% and 16-18% respectively.

However, one of the most impactful aspects of the new accounting standard IFRS 9: Financial instruments, is the fact that additional expected credit losses immediately eroded available capital bases such as retained earnings. Depending on how much additional credit reserving/provisions were required, some banks' capital buffers were fully or partly eroded. However, compared to other

FIGURE 8: Shows industry Total Capital to Total Risk Weighted Assets ratio for the period 2015 to 2017[3]



Source: *EAC Central Banks*

territories, the impact of initial application of IFRS 9 credit provisions' requirements on East African banks was partly softened by:

(a) the fact that in some countries, central banks already required higher credit provisions to be set aside in a statutory credit reserve, over and above the IAS 39 required provisions. For institutions where such statutory credit reserves were held, subject to the applicable rules, the initial IFRS 9 impact was partly offset by the credit reserves; and

(b) in some territories e.g. in Kenya, the Central Bank provided an expedient to remediate against the initial impact of IFRS 9 over a period of time.

In the end, the combined effect of the previous good capital bases as well as the factors above have served to alleviate an industrywide blow of the new accounting standard. This however cannot be said of all players. Some banks that had idiosyncratic capital adequacy concerns continue to fight their way out of the regulatory and business challenges such low capital bases pose.

[3]https://www.bnr.rw/fileadmin/AllDepartment/MonetaryPolicy/upload/annualreport/AnnualReportOnTheFinancialStability/Annual_Financial_Stability_Report__2016-2017_.pdf

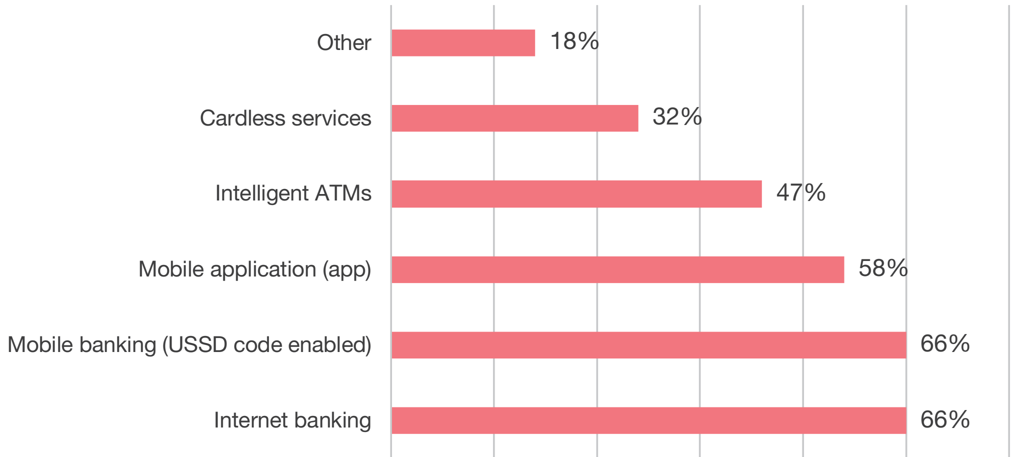
Banks of the future: Technology & innovation

Technology-enabled products and services are now firmly at the forefront of product and service development and enhancing the customer experience in East Africa. Technology also provides an opportunity to lower costs and enhance staff productivity.

Most banks indicated the existence of several technology-enabled channels through which customers can transact. Sixty-six percent of respondents have internet banking and/or mobile banking, whereas fewer have an app and fewer still have intelligent ATMs. Less than a third offer cardless services.

In 2017, several players took advantage of the increased availability of smart phones in East Africa to launch apps, expand app-enabled services or market them more visibly.

FIGURE 9: Digital channels offered by banks in the East Africa region



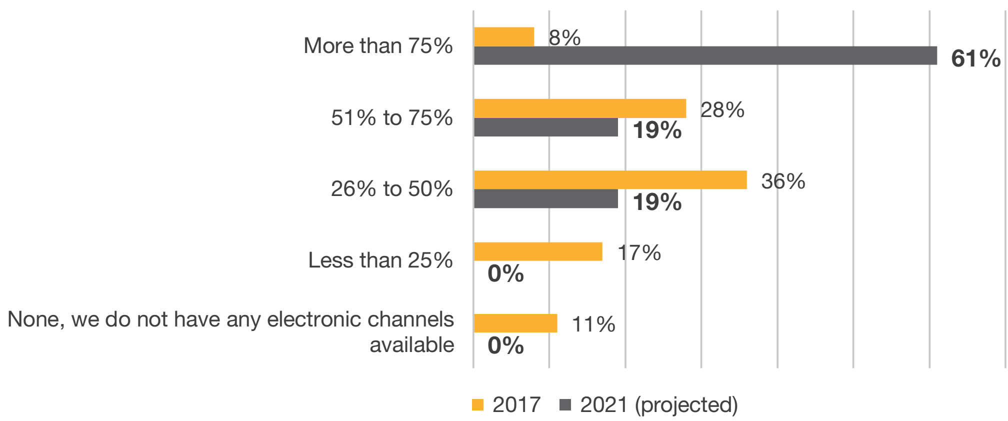
Thirty-six percent of respondents reported that between 26% - 50% of applicable transactions (deposits, withdrawals and transfers) were made using digital channels, whereas 28% reported that 51% - 75% of transactions were conducted through these channels.

(Please refer to Figure 4 for a breakdown of digital channel distribution by country and Figure 8 for the proportion of customer transactions undertaken using digital channels.)

Banks in the East Africa region acknowledged that they are not always best-in-class with regard to developing and rolling out electronic solutions, even though 61% anticipate that more than 75% of transactions will be conducted through digital channels by 2021.

Therefore, partnering with others – such as mobile phone operators – to offer complimentary services provides an opportunity for growth and financial inclusion.

FIGURE 10: Proportion of customer transactions undertaken using digital channels in the East Africa region, 2017 - 2021



It is definitely a case of 'watch this space' in as far as the further evolution of technology, device accessibility, customer needs and demands are concerned.

INDUSTRY PERSPECTIVE:

Abdulmajid Mussa Nsekela,
Managing Director,
CRDB Bank

How do you expect banking services to evolve over the next 10 years?

Banking is increasingly becoming a lifestyle, considering the technological innovations and shifting consumer attitudes, especially among young people. In another ten years, most of the millennial generation will have moved towards their thirties or forties and this means that they will have more spending power.

This group is technologically savvy and considers convenience to be more important than a brand. This is partly the reason why there's a sudden emergence of all sorts of financial applications, even as banks continue to build infrastructure towards digitizing services to effectively offer convenient banking services, currently dominated by Mobile Network Operators (MNOs).

Retail banking will have to innovate and offer convenience, with an emphasis on the diversification of alternative banking, so as to capture and retain this dynamic group of customers.

With these changing customer attitudes, banks will be compelled to invest in enhancing customer experience, given that the modern-day consumer is very knowledgeable and has the power (courtesy of smartphones and the internet) to call out a brand using social media, in the event that he or she is dissatisfied with a service.

Traditional banking will still be in play, since penetration of banking services remains low in this part of the world. There are also social and cultural factors that put banks at the centre of financial transactions.

Generally, there's a high likelihood of reduced investment in the traditional brick and mortar model - though this will be mainly informed by individual bank strategies. But we expect to see more digital banking solutions and specialised products, which will be modelled along 'new' and unique needs among consumers; for instance the growing need for instantaneous access to credit, cash advance services, crypto currency and other digital payments.

Kihara Maina,
CEO,
I&M Bank

What does the 'bank of the future' look like to you?

Financial services institutions have always been early adopters and drivers of technology. Technology is an important consideration in assessing a bank's business model and competitiveness.

A 'bank of the future' would have a digital strategy encompassing a few core areas:

- Better connectivity means better interfaces; a bank of the future would be taking full advantage of these innovations to connect with their customers through multiple channels.
- Automation tends to be very focused on risk and risk management tends to be very reactive. There are better ways to do things and automation can help. Routine tasks can be done by machines, including some customer services which can be automated and likewise free up service time for more value-adding activities.
- Advanced analytics including analysis of customer trends can help inform decision-making.
- Partnering with others can help drive the speed of innovation.

INDUSTRY PERSPECTIVE:

Patrick Mweheire,
Chief Executive,
Stanbic Bank Uganda and Chairman,
Uganda Bankers Association

How can banks help to build the foundations for sustainable SMEs?

We've been doing a lot of research around SMEs to understand why 75% of SMEs fail to reach their third-year anniversary. The two fatal challenges that SMEs face are access to markets and access to resources like governance, bookkeeping and management skills – not capital or high interest rates. The analogy I like to use is that if you are building a house, the foundation is your access to markets and the walls are all of these things – governance, book keeping and soft skills that help to sustain a business. The roof is the capital. It's the final thing. And actually if you fix the first two, capital will come.

There is also that misunderstanding that you can finance a business 100% from bank credit. There should be an equity conversation. But no one is going to partner with you if your house is not in order. So how do we get these SME houses in order? What can banks do to support SMEs to build more sustainable businesses going forward?

Our Stanbic SME business incubator is our response to these questions. We take selected businesses through a four month training programme and thereafter attach each business to a mentor for a year.

PwC POINT OF VIEW:

Uthman Mayanja
Partner
PwC Uganda
uthman.mayanja@pwc.com

Alex Muriuki
Associate Director
PwC Kenya
alex.muriuki@pwc.com

Perspectives on banks of the future

Current trends in the financial services industry are driving the need for banks to rethink their customer experience, growth and retention strategies. In particular, technological innovation and changing customer expectations are accelerating the pace of disruption for the industry and reshaping how banks do business.

Over the last few years, almost every bank has prioritised the introduction of digital channels. To earn a competitive advantage, however, banks need to enhance their services by emphasising product innovation driven by technology, relevance and personalisation.

Today's banking customers are influenced by their experiences outside of banking. From retail shopping to taxi hailing, traditional service models have been disrupted by digital players. Likewise, today's banks should engage their customers through personalised channels, identify them through advanced facial or voice biometrics and deploy data analytics to predict behaviour patterns. Robotic process automation can help to accurately conduct repetitive, standardised transactions in a much shorter time, thus delivering operational efficiencies whilst also managing financial crime risks.

The goalposts for customer satisfaction have also shifted. Customers are more aware of their choices and seek out the opinions of their friends, influencers or online product reviewers before making their decisions.

Their satisfaction is predicated on their expectations being met, and these expectations are informed by their experiences with products and services far removed from banking.

To develop and implement an effective customer experience (CX) strategy, banks must focus on five core building blocks:

1. **Develop the right CX strategy** by identifying and deploying the right initiatives and tools and ensuring that the focus is on customer experiences, not just internal operations improvement or digitising existing products and delivery channels.
2. **Seek continuous customer feedback** to drive the overall CX strategy. The mechanisms to collect customer feedback really matter, as do effective and timely responses to feedback. Customer expectations should form the core of a bank's CX strategy.

3. **Deliver a true omni-channel experience.** Interactions and experiences across all channels must be seamless so that customers can engage with you when, where and how they want to. Convenience and ease-of-use are important, but remember that personalisation and connection become more important as the value or emotional resonance of a transaction rises, such as in the case of mortgage services.
4. **Leverage data and analytics to gain insight** and inform decision-making. The vast amounts of data generated by banks can be mined to derive insights that will drive innovation and business improvements, improve trust and loyalty amongst customers and develop highly personalised and context-driven customer experiences. Once you know how to engage, reward and communicate with each customer, it becomes much easier to cross-sell and up-sell services.
5. **Go digital** to streamline simple, repetitive tasks. Banking customers are demanding increasingly digital services and will look for the best self-service solution to meet their needs. Millennials and Generation Y are not burdened with the lifelong sense of brand loyalty common amongst their baby boomer predecessors.

The future of banking requires a complete business transformation, with customer centricity at its heart. Banks need to transition from traditional product-centric business to digital institutions that live and breathe a customer- and technology-driven philosophy. Key processes such as customer onboarding must move from the branch to the web, through conversational channels. Social media-driven chat bots, for example, can address many of the areas that were managed previously by human customer service representatives. Account servicing, likewise, can deliver a more personalised experience by leveraging artificial intelligence. Card processing, loan management, compliance and risk management and customer servicing and support will all benefit from digital enablers.

For successful enterprise-wide transformation, leaders in the banking sector should address possible challenges upfront such as weak change management and the fear of risk. Transformation initiatives should be supported by the Board, driven by Chief Executive Officers and owned by all staff. Many employees value the opportunity to experiment and try new things.

To unleash their creativity, some banks have invested in ‘sandboxes’ and internal fintech units to build and test the commercial viability of new concepts. Whereas hiring skilled resources can help to create a more innovative culture, existing staff can also be retrained to take up new roles. Working with an experienced innovation advisor can also help to improve outcomes and the likelihood of success.

Digital transformation will require banks to adapt to disruptive technology and innovations, to leverage data insightfully in decision-making and to move with the speed and agility of innovative startups. The banks that succeed in this transformation will experience growth and savings through increased products per customer, revenues per customer, retention and reduced costs.

INDUSTRY PERSPECTIVE:

Theobald Sabi,
Managing Director,
NBC Bank

What is the role of customer service, in banks of the future? Can a customer experience be just as powerful at a branchless bank compared to an in-person interaction?

In Tanzania, currently almost all banks provide digital channels but cash-based transactions are still cheaper for customers; in general, customers also still prefer to transact bank business at branches, service centres and agency bank locations. A generational shift is likely to change this behaviour, as would government promotion of digital channels such as by accepting only digital forms of payment.

It is only in cities or towns where digital banking channels are commonly used. Digital channels will continue to grow in relevance and usage, but revenue from these channels is not yet significant.

Although the volume of transactions is high, internet penetration is still very low with less than 12% of the population having access to smart phones and less than 6% of the population transacting through the internet. This will change as smart phones become more affordable for more people and the cost of data comes down; the rate of change also depends on the speed of urbanisation.

Mobile money has thrived amongst a segment of customers who are very sensitive to the cost of banking services, as well as customers who benefit from the convenience of sending and receiving small amounts in a cheaper way.

Even though there is increasing competition for customer transactions, we expect no consolidation between banks and telecommunications companies due to regulations by the central bank.

Patrick Mweheire,
Chief Executive,
Stanbic Bank Uganda and
Chairman, Uganda Bankers
Association

Customers want to be banked 24/7, wherever they are and at whatever time. They interact with Amazon and Facebook, and want a similar, seamless experience with their primary bank.

The inspiring thing about Amazon is that rather than to trying to predict what the competition is doing, they focus relentlessly on their customers. If that's your focus, you will never fail. Because the customer will constantly tell you what they want and how they want to interact with you and if you just focus on that, you will gain market share and you will gain revenue. Obsessing about the customer is really the ultimate goal.

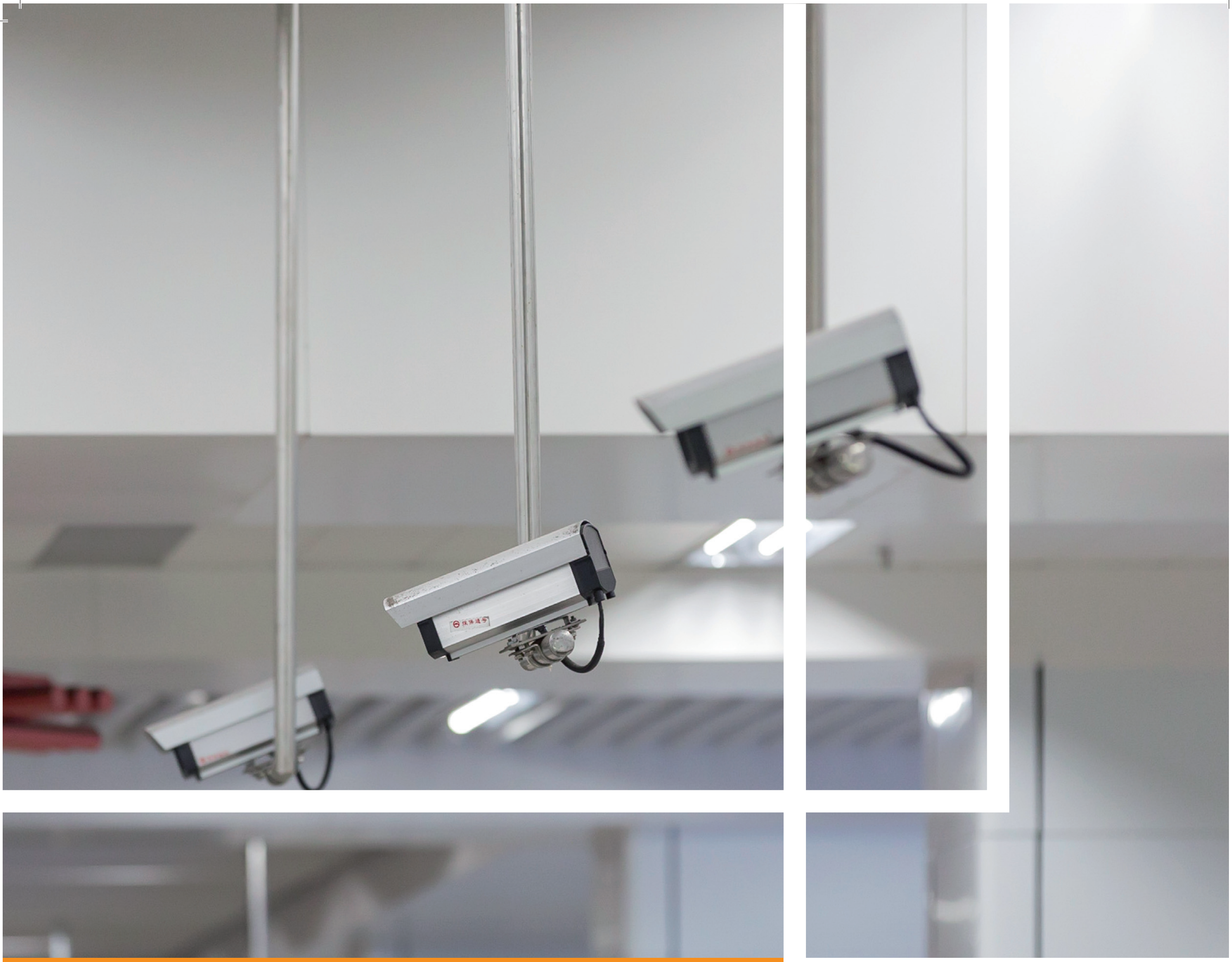
The future of banking will be achieved when customers do not have to visit a branch for us to serve them seamlessly and we simply provide a platform for them to serve themselves.

For example, we have rolled out new bulk note ATMs which can count UGX 50 million in 30 seconds and issue a receipt. They are also available 24/7. In Kikuubo for instance, almost 80% of our deposits come in through these bulk ATMs and some of our customers will queue to use these ATMS even when the banking hall is not busy.

Another example is school fees collection, a process that was characterized by very long queues for our customers and massive costs to our business including staff overtime and cash in transit costs.

When we migrated school fees collection from the banking hall to a mobile money platform, we turned around a loss-making service to become a profitable one.

About five years ago, over-the-counter transactions accounted for 75% of Stanbic's transactions – now it's less than 30%. We launched agency banking three months ago and it now accounts for 15% of our transaction volume.



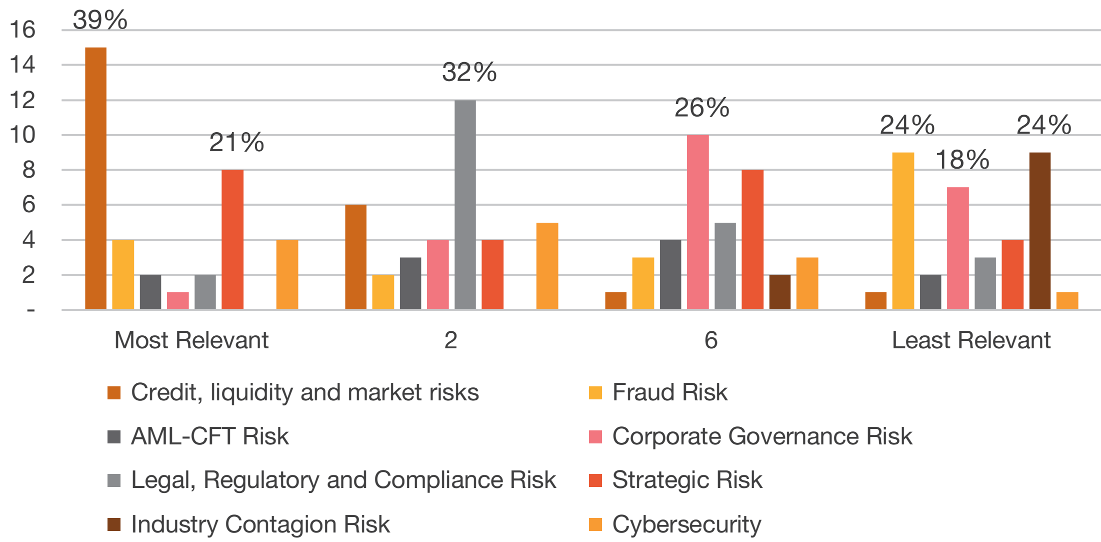
Risk management perspectives: Most relevant risks for banks today

A total of almost 40% of survey respondents ranked credit, liquidity and market risks first amongst risks to their bank/group, on a scale of 1 – 8. Strategic risk was also ranked first by 21% of respondents.

Legal, regulatory and compliance risk was ranked second in importance by 32% of respondents. Thereafter, survey responses were more evenly distributed amongst risks ranked of less importance; corporate governance risk was ranked sixth by 26% of respondents and two-thirds of respondents ranked fraud, corporate governance and industry contagion as risks of least importance.

Survey results mirror market trends. Each of the top three risks are discussed in more detail below.

FIGURE 11: Risks ranked by strategic relevance



Credit, liquidity and market risks

Credit risk is arguably the most significant risk in the banking industry. An ever-present risk, credit risk is the top-ranked risk in our 2017 survey.

We asked survey respondents in another question to identify the top contributors to credit deterioration in the industry. Their responses tell us a great deal about the operating environment in the East Africa region.

TABLE 3: Contributors to credit deterioration

CONTRIBUTOR	PERCENTAGE OF RESPONDENTS
Economic Slowdown	56%
Poor credit underwriting	28%
Delay by government to pay large contractors	25%
Over-exposure in certain sectors	22%
Diversion of funds by borrowers	22%
Fraud	14%

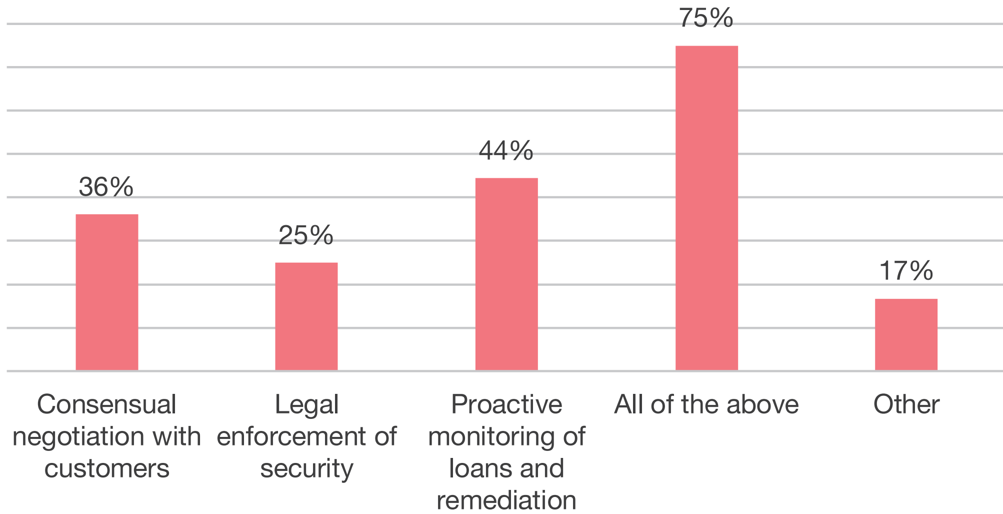
Although the average GDP growth in 2017 for East Africa was 5.9% according to the African Development Bank, there was a slowdown in Kenya due to the extended electioneering period in 2017 and a slight slowdown in Tanzania, whereas there was an uptick in Uganda and Rwanda.

The recovery from the 2016 drought helped to support underlying economic growth as did Foreign Direct Investment and investment in infrastructure supported by bonds.

Monetary policy in all four countries helped to support foreign exchange reserves and stable inflation and currencies.

Credit risk is also attributed to the levels of non-performing loans (NPL) due to high levels of government debt, a challenging economic environment and high interest rates. Generally, banks in the East Africa region are implementing several measures at the same time to alleviate credit deterioration.

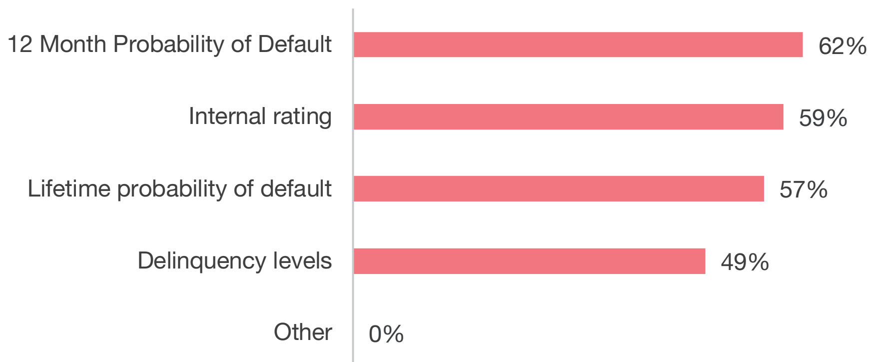
FIGURE 12: Top measure to alleviate credit deterioration



Our survey shows that 83% of respondents use a combination of internal and external resources to monitor and remediate NPL whereas 17% use internal resources only.

Banks use a combination of measures to assess the increase in credit risk for their main products. The implementation of the IFRS 9 expected credit loss model changes banks' forward-looking assumptions, how they provision for credit impairments and the segmentation of their credit portfolios (such as retail vs. corporate, secured vs unsecured, etc.), and affects functions within their organisations that manage risk, as discussed later in this report.

FIGURE 13: Top measure to alleviate credit deterioration



Corporate governance risk

Corporate governance was ranked relatively low amongst risks, due to the high levels of awareness and compliance observed by the majority of respondents.

Considering the following statements, most respondents indicated that they are 'very confident' or 'totally confident' of the following:

- Your firm has a strong governance culture (81%)
- Ethical leadership and integrity are embedded in your firm's culture and can be clearly demonstrated (78%)
- Individual members of your board act with sufficient independence in their decision making and challenge each other (75%)
- Board members and management always seek to avoid or manage conflicts of interest and act in the best interests of shareholders (76%)
- Board members clearly understand their directors' duties under the Companies Act 2015 (or applicable legislation where the jurisdiction is not Kenya) (86%)
- Board members clearly understand their obligations under relevant regulatory corporate governance guidelines (89%)

INDUSTRY PERSPECTIVE:

Dr Diane Karusisi,
CEO,
Bank of Kigali

How can banks prepare adequately for the challenges associated with regulatory change?

In my view, one of the unknown factors in the banking industry over the next ten years is regulation and how regulations will adjust to market disruptions. For example, regulation will determine whether banking services can be delivered by other service providers like FinTechs or telecommunications companies.

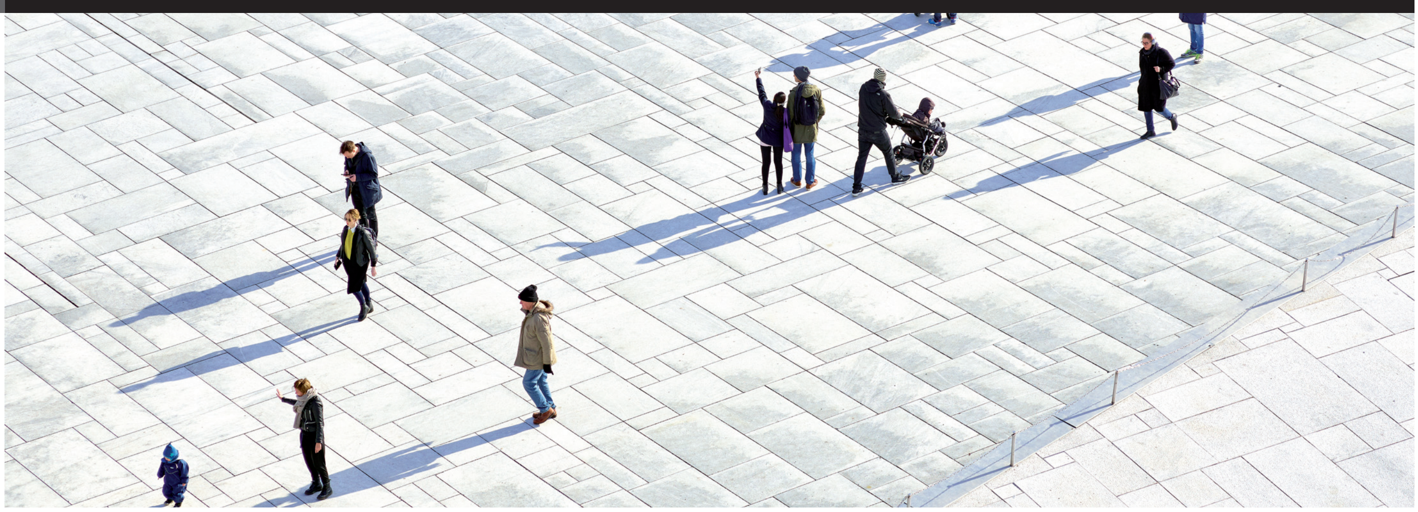
In Rwanda, regulators have put in place new requirements and a revised banking law to reflect the technological changes in financial services. In 2018, the National Bank of Rwanda released new cybersecurity regulations requiring penetration testing, preventing data from being stored in the cloud and mandating two-factor identification where possible in addition to a whole host of other requirements.

Overall, the cost of compliance with regulations like these in addition to higher capital requirements will make consolidation more likely than fragmentation in the industry in Rwanda.

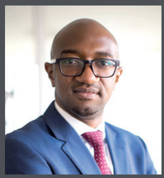
As the FinTech sector matures and starts to compete directly with banks, we can expect that regulators will also adjust to keep pace with their technological advancements. It would be unfair to subject only banks and not FinTech competitors to stringent supervisions. Regulators could face challenges related to privacy and tech-enabled financial manipulation and so certainly it would be preferable to discourage certain behaviours through regulation.

Given the complexity of regulatory and industry dynamics, there will always be diverging approaches in some areas.

However, Rwanda is in a unique position because of its vibrant and development-driven economy which allows more of a focus on synergies and avenues for quickly addressing misalignments. In addition to engaging regulators, industry players also design new business processes with regulatory change in mind.



PwC POINT OF VIEW:



Cletus Kiyuga
Partner
PwC Tanzania
cletus.kiyuga@pwc.com

Dennis Musau
Senior Manager
PwC Kenya
dennis.musau@pwc.com

Perspectives on risk management

First and foremost, banking is an industry of trust and maintaining that trust requires that banks rigorously manage risk. If customers sense that their bank is 'unsecure', they tend to withdraw funds in panic and you end up with a 'bank run', and in some instances, the bank may collapse. Does Greece 2015 ring a bell? Front of mind for any risk practitioner must therefore pivot around protecting the bank against this ultimate risk.

Overall, the risks that banks must continually think about can be categorised into two broad categories: traditional and emerging risks. Whereas traditional risks like credit, liquidity, market and operational risks have well-established control procedures, emerging risks like cybersecurity, regulatory compliance, financial crime, reputational, concentration and geopolitical risks continue to evolve and in most instances pose even greater threats than the traditional risks.

Addressing emerging risks is not just a matter of following documented policy, but being agile and thinking ahead of the pack – "What could go wrong?" The underlying assumptions and thinking must evolve with time, as the threats change. To achieve this, risk practitioners need to be fast learners, equipped with the right skills, data and tools to make the right risk-sensitive decisions. Rather than waiting for an incident to occur, risk practitioners must predict and derive insights, and support their businesses to anticipate the risks of tomorrow. After all, perpetrators of financial crimes are not resting on their laurels, either.

In the context of all of these traditional and emerging risks, CEOs and other banking executives must still execute their strategies. With market dynamics such as the interest rate capping regime currently enforced in Kenya, shifts in strategy to address the inevitable reduction in interest margins could in themselves introduce new risks. Rolling out or enhancing internet and mobile banking platforms is all very well and good, but then cybersecurity and money laundering risks enter the arena in lock-step.

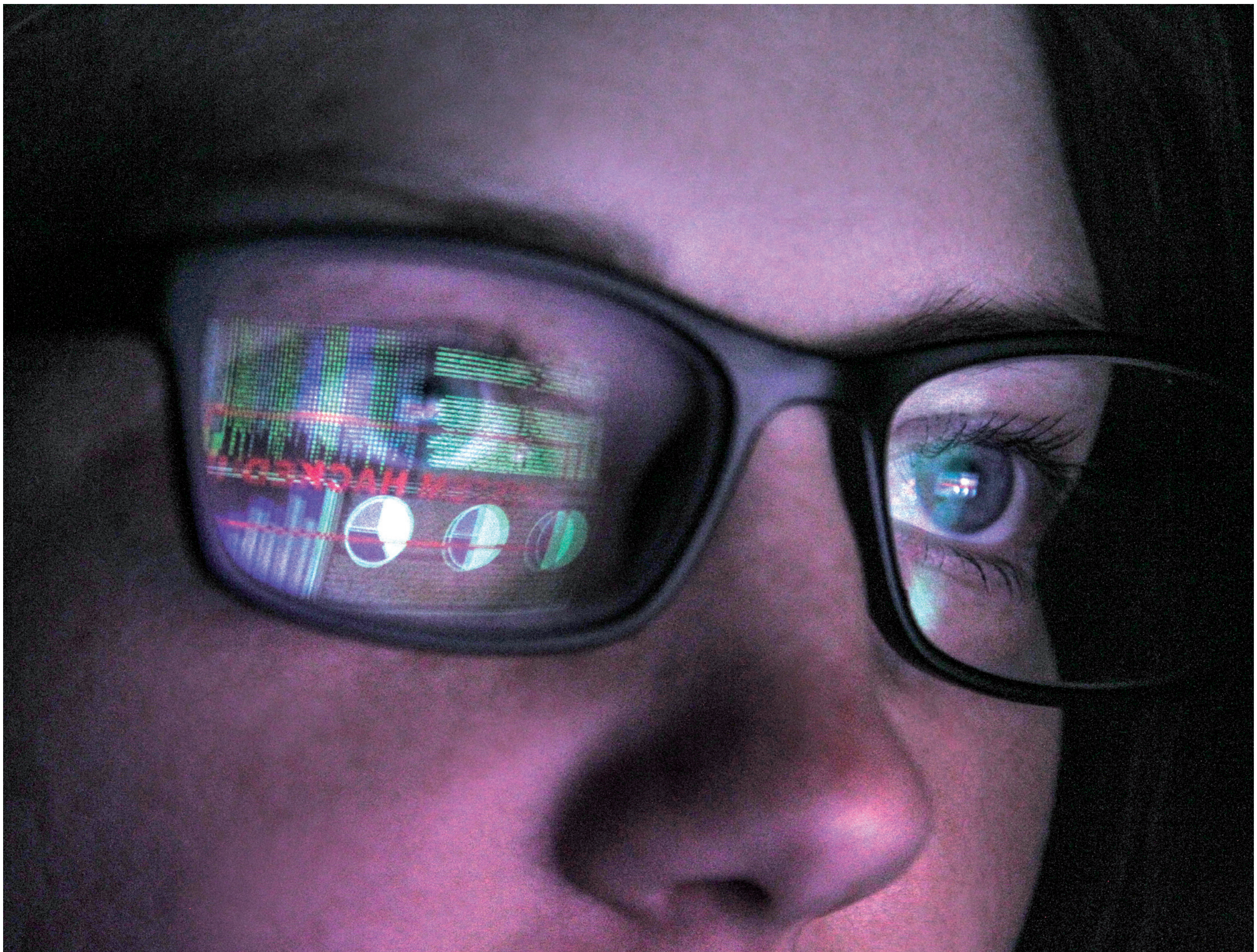
These risks can undermine a strategy of 'digital agility' quite quickly. Similarly, an economic slowdown can cause credit deterioration, which can be managed partly through tightened internal processes governing credit scoring. But that assumes the 'credit taps' were not inordinately open before the credit downturn season kicked in.

There is a long-standing question as to where risk management should sit and how risk management teams should interface within the defined the three lines of defence. It is becoming increasingly clear that risk management is no longer a department or a gatekeeper; instead, it's a business partner.

Whereas previously, risk management would be asked to review a new mobile and internet banking platform before launch and sign it off, now risk management is meant to be involved in the concept from the outset and embedded as part of the process.

As such, as banks consider their strategies, they need to incorporate their risk management strategies comprehensively. Traditionally, credit risk was the work of the credit department and liquidity was the work of Treasury, but emerging risks require a more holistic, comprehensive framework and approach to risk management.

'Know your customer' (KYC) is a well-known and established principle in banking and indeed other financial services enterprises. What about Know Your Employee (KYE)? Even the strongest controls, systems and processes and the most trust-worthy corporate culture can suffer from a failure of risk management.



PwC POINT OF VIEW:

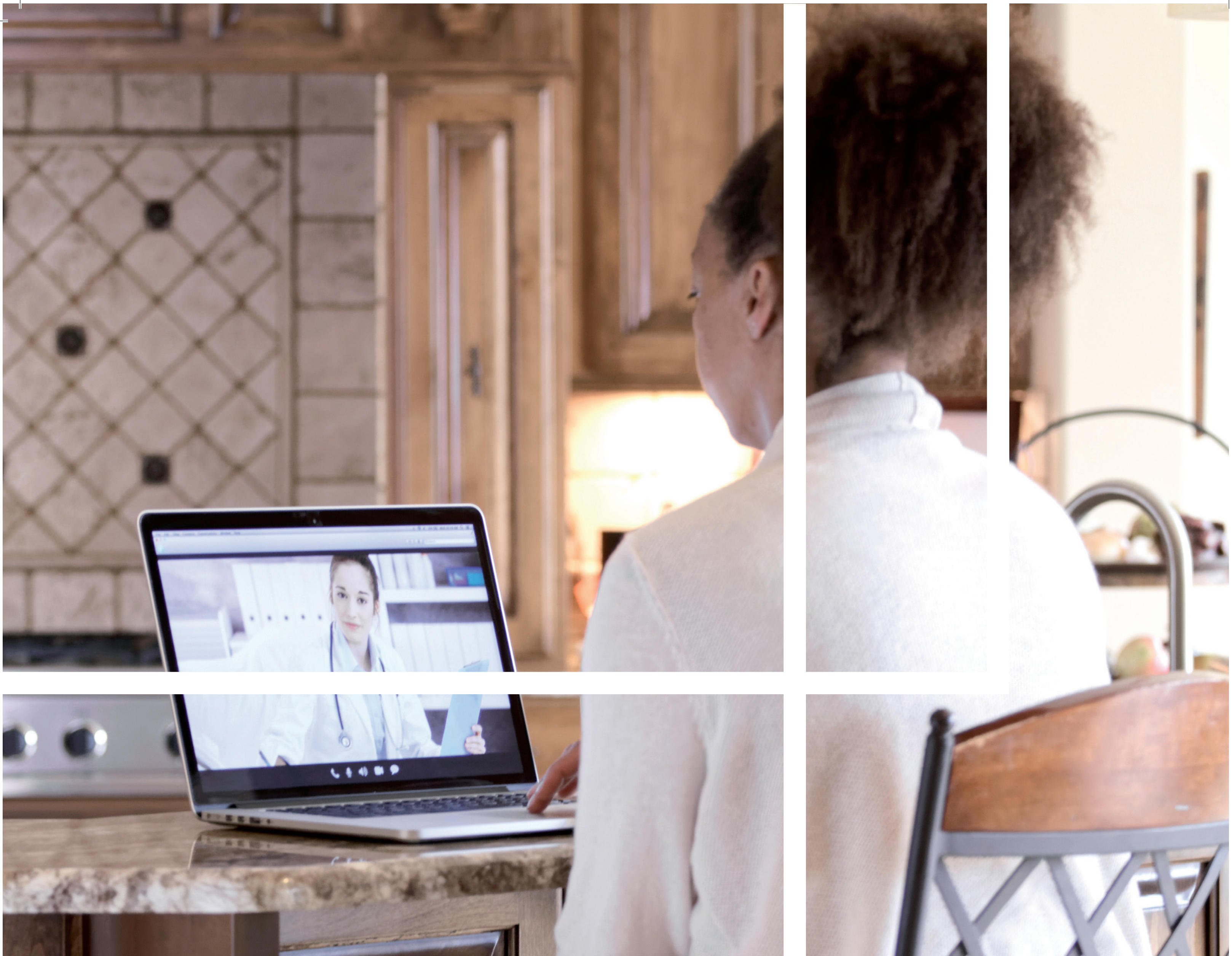
But culture and a sense of ownership and responsibility are the real keys to effective risk management. Anyone representing a bank needs to be aligned with the bank's moral compass. However, this is not always the case especially since banks have increasingly built controls to protect external attacks, the fraudsters have switched tact. They now collude with staff and third party suppliers to perpetrate fraud.

Do you know your employees well enough to detect a compromised database administrator, cleaner or teller? Does your bank reward integrity? In fact, do your performance management processes across the bank sufficiently incorporate risk management as KPIs?

Looking outward, successful risk management will also require more collaboration between banks and regulators. Perpetrators usually try one bank, and then another, until they are successful. Collaboration, in whatever form and within established regulatory frameworks, could help to stop these attacks in the first instance. At the end of the day, better collaboration would spell success for regulators, banks and customers alike: collaboration would help mitigate risk and manage and monitor compliance.

In the end, risk management is not an event or a role of 'that' team; it's an attitude and a culture that needs to permeate through the organisation and beyond.

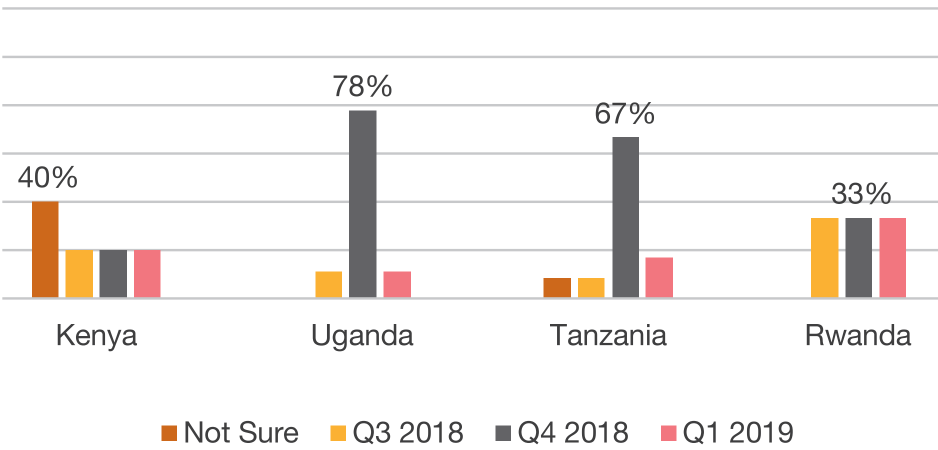
Risk management must be aligned to the enterprise strategy and must evolve with time to deal with the existing risks, and more importantly, the risks of the future. Risk is not a 'business prevention unit' it's a business protection and enablement function!



Impact of adoption of IFRS 9

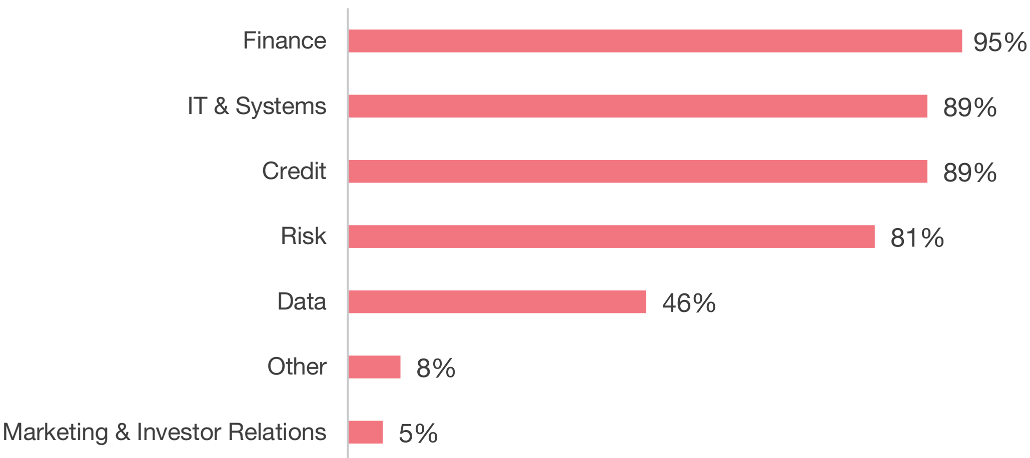
Considering the significant changes presented by the adoption of IFRS 9: Financial Instruments, which came into effect on 1 January 2018, it is perhaps of little surprise that 45% of our survey respondents have ranked this issue first amongst the most challenging external developments over the last 12 – 18 months.

FIGURE 14: IFRS 9 compliance readiness



IFRS 9 requires the input of many different operational functions within banks, particularly Finance, IT, Credit and Risk functions.

FIGURE 15: Operational functions involved in IFRS 9 projects



The expected loss model introduced by IFRS 9 is a significant shift from the incurred loss model that was applicable in the previous standard, IAS 39, and is at the centre of the numerous challenges that banks have had to overcome.

The new IFRS 9 impairment model was developed due to criticism of the IAS 39 incurred loss model following the 2008 financial crisis. IAS 39 was regarded as resulting in banks recognising losses too little and too late. Banks themselves often said that the IAS 39 model prevented them from recognising losses they were anticipating but had not yet incurred. The IASB therefore sought to develop a new model based on Expected Credit Losses which is more forward-looking.

Whilst the idea of an expected, as opposed to incurred, model might be straightforward, the final standard is highly complex both in terms of requirements and the practical implementation challenges.

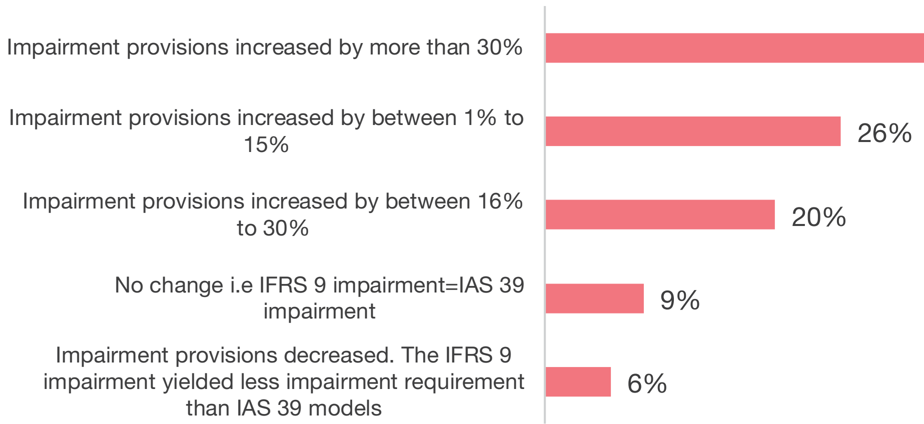
Some of the specific challenges include: availability and incorporation of forward-looking information, availability and quality of historical data, model building, business impact assessment, determination of significant increase in credit risk and availability of necessary skills.

Most foreign banks have leveraged off centralised approaches adopted by their parent companies towards implementation of the standard.

Local banks, however, had more challenges in implementing the standard, including gearing up internal capacity/skills, capital and investment in necessary technology.

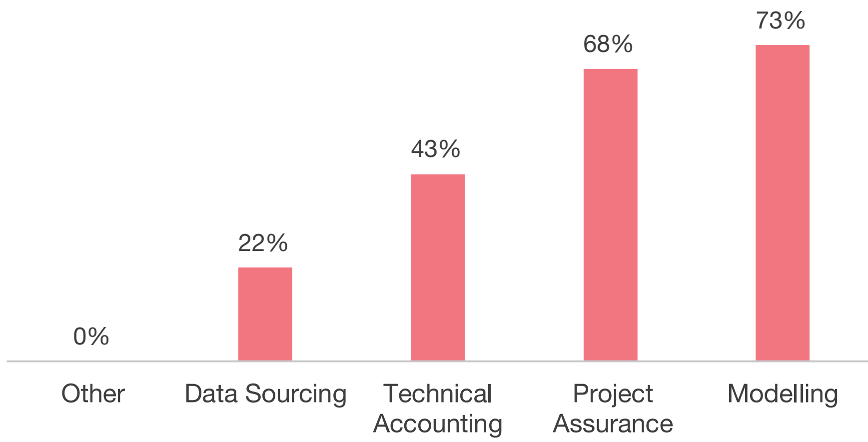
Amongst respondents to our survey, 86% said that they experienced an increase of some sort in their impairment.

FIGURE 16: Implementation of IFRS 9 on credit impairment provisions



Asked about how they have involved external consultants on their IFRS 9 projects, banks are focused on project assurance and modelling, with many also engaging consultants to help with technical accounting.

FIGURE 17: IFRS 9 project management

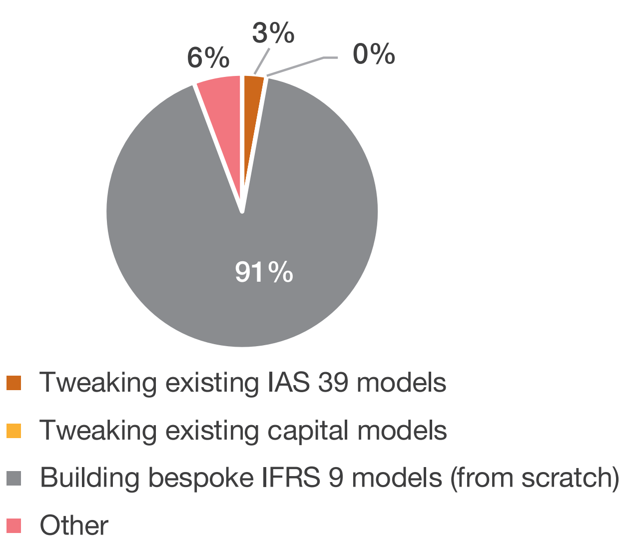


Effective implementation of IFRS 9 for entities like banks with significant exposure to credit risk is through the use of models to estimate impairment losses.

Unlike IAS 39, the models to be used under IFRS 9 are complicated owing to the various enhancements introduced.

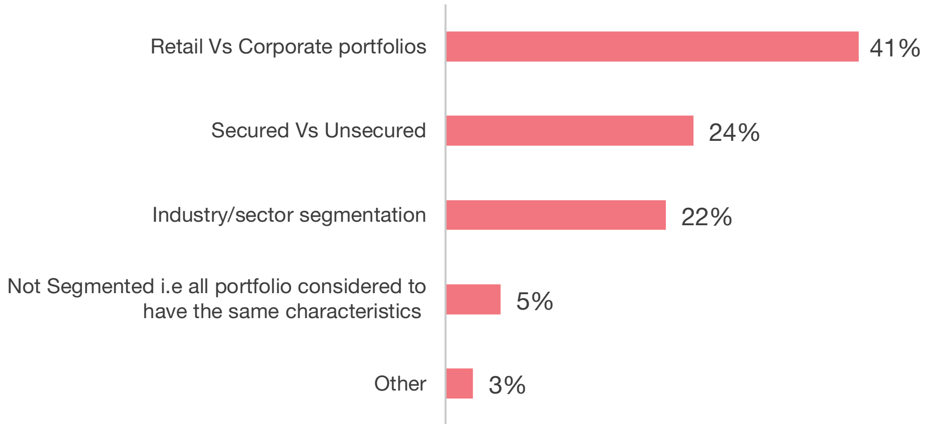
Model building is a complex matter that often requires the services of external consultants such as actuaries and other professional advisors. Yet 91% of respondents are building IFRS 9 models from scratch.

FIGURE 18: Approaches to IFRS 9 modelling



This process is particularly complicated for banks with significantly varied loan portfolios. In response, banks have segmented their loan portfolios specifically for the purpose of expected credit loss modelling. Only 5% of respondents have not segmented their portfolios at all.

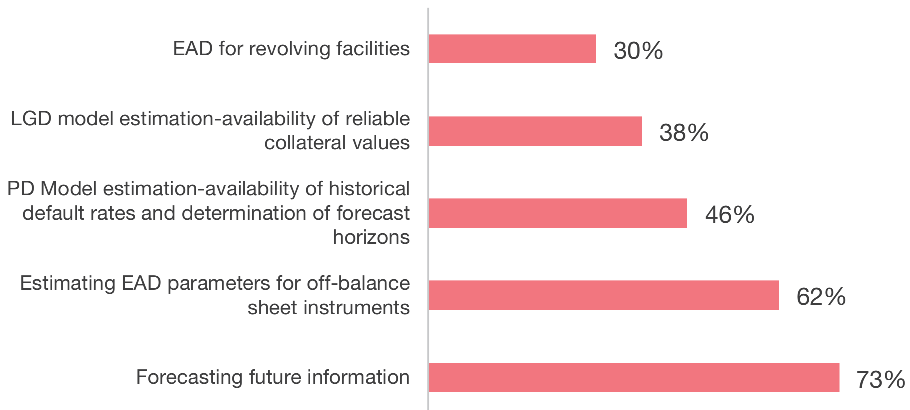
FIGURE 19: Credit portfolio segmentation



A number of banks have found that their management information systems have not been designed in a way to allow for easy and efficient collation and analysis of the required information. In many instances, there is a need for additional investment in smarter and more robust technology. Another common challenge noted was that relevant information was maintained in silos which further complicates the analysis process.

A key activity that we expect banks to prioritise this year is the streamlining of data extraction/collection so that the models can be run more readily.

FIGURE 20: ECL modelling challenges



Another challenge to the implementation of the standard is obtaining forward-looking information.

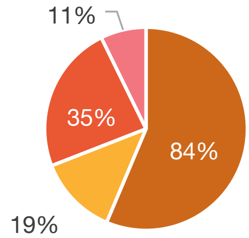
The use of forward-looking information to determine the impairment loss is an important part of the new approach and sets it apart from the IAS 39 incurred loss model.

This forward-looking information is that which is determined as reasonably able to predict future credit losses and includes macro-economic information on the country's GDP, inflation, unemployment rate, government borrowing and commodity prices, amongst other factors.

Reliability of this information is key to the assessment of future credit losses as this will help in determining how much and when expected losses should be reported.

The foremost challenge faced in this regard relates to the disparities in sources of data. Should banks make use of public information such as that provided by central banks and relevant ministries, or should they rely on third party sources like Moody's, S&P and Bloomberg? The answer is not always clear, and the data does not always compare.

FIGURE 21: Forward looking assumptions



- Scenario Modelling analysis
- Regulator-provided scenarios (based on recent market statistics)
- Internal scenarios developed (eg via internal Economics team)
- Other

INDUSTRY PERSPECTIVE:

Abdulmajid Mussa Nsekela,
Managing Director,
CRDB Bank

As we approach the end of Q4 for reporting IFRS 9 compliant results, what have you learned so far?

For CRDB Bank, IFRS 9 instruments have brought about significant changes to the accounting of impairment and measurement of expected credit losses.

This has resulted in an increase in provisions and a decline in bottom-line profit, as at the end of the 2018 financial year.

This realisation has driven us to a considered conclusion that the benefits of IFRS 9 far outweigh the cost.

This is because we have witnessed tremendous improvements in transparency, comparability, cost of capital and market liquidity.

I believe that adopting the IFRS 9 in full will guarantee greater benefits to financial institutions, especially if the standards are not varied in the local versions.

Theobald Sabi,
Managing Director,
NBC Bank

IFRS 9 requires that banks anticipate future losses and necessitates complex, forward-looking models and data analytics to derive assumptions for these models. How well prepared is your bank, in terms of the data and expertise required?

NBC has gone through a rigorous process for IFRS 9 implementation with the help of ABSA and group procurement. The model was done by an independent consultant and verified by PwC at a group level. Training of staff was appropriately done and PwC reviewed the roll out of the model as well. The governance element for the model is robust.

The only area to improve is to start living the standard and bring it to life in practice such as by being aware of the implications when negotiating various deals with customers, etc.

Currently the models are manual and there are no plans to automate as there are still a few nuances to be dealt with. As far as IFRS 9 is concerned, models will remain models and updates should always be made when there are changes in circumstances.

PwC POINT OF VIEW:

Moses Nyabanda
Partner
PwC Rwanda
moses.o.nyabanda@pwc.com

Gauri Shah
Associate Director
PwC Kenya
gauri.shah@pwc.com

Perspectives on IFRS 9

The first year of IFRS 9 compliance came to a close on 31 December 2018. For banks, compliance with IFRS 9 has been and continues to be a journey. Building the models to support IFRS 9 compliance certainly took time and effort, but the biggest challenge for many banks was getting good, clean data. Some banks have had to use rudimentary assumptions because the data simply did not exist. In 2019 and beyond, the focus has to be on collecting real data and streamlining the data extraction process.

On this journey, there can be a strong temptation to jump immediately into systemisation in the hope that it will streamline the end-to-end IFRS 9 process. In our experience, whilst moving to the right system should definitely be the ultimate goal, you shouldn't rush into it.

Our advice is to spend the time better understanding the IFRS 9 models that have been developed, enhancing them with richer data and running them more regularly with a wider internal team working on them. That way, when you are ready to move to a system based solution, your teams are able to scope the exact specifications required and test and understand that the solution is working as it should.

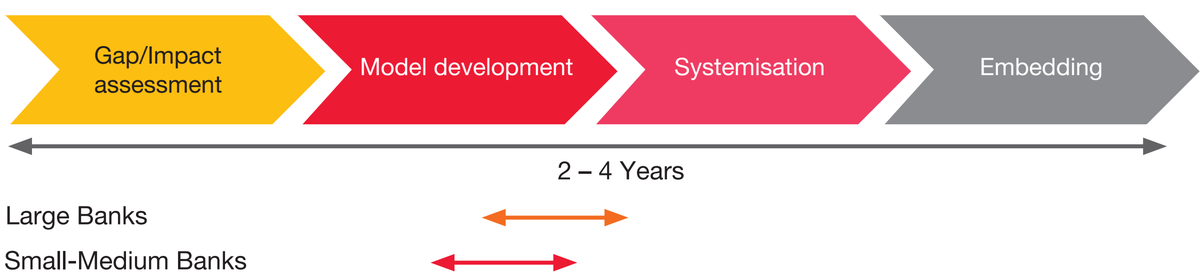
forward. In a nutshell, IFRS 9 compliance must move out of the project phase and towards business-as-usual.

In-house capacity is a challenge to business-as-usual and it became starkly evident when banks were running their 2018 year-end numbers for their auditors. Additionally, many banks have not spent enough time on disclosures and thinking through the messages that they want to communicate.

On the upside, IFRS 9 has brought about more discipline in terms of risk assessment and helped banks to derive powerful and insightful information from their businesses. IFRS 9's credit impairment requirements compel banks to anticipate what is likely to happen over the lifetime of a loan, and the very fact that this is an explicit requirement gives banks better indicators to manage their businesses.

Calculating expected credit losses requires information that is relevant to the management of credit risk. Because every loan or receivable has at least some probability of defaulting in the future, every loan or receivable has an expected credit loss associated with it – from the moment of its origination or acquisition. Expected credit loss therefore is a measure of the asset's credit risk.

Typical IFRS 9 Journey



Banks also need to set up strong model governance and model validation frameworks. They need clear policies regarding how regularly the models will be updated, who 'owns' them and how the models will be validated. The Board needs to be comfortable, not just because consultants have helped to usher the bank through the project phase but also comfortable that their internal teams can now move

Banks should be looking to integrate accounting and credit risk management systems and processes rather than treating the calculation like an independent accounting exercise. Most banks still have a lot of work to do improving their models, systemising data collection, and spreading knowledge to broader teams beyond finance and credit.

The question of how a bank is affected by IFRS 9 has a complicated answer: ‘it depends’. Every bank has to go through the process of re-evaluating their accounting policies, financial statement note disclosures and other areas affected by the new requirements, and making appropriate changes to their accounting systems and internal controls.

Lastly, there is the thorny issue of implementing the standard to other financial assets that are not measured at fair value through profit or loss. Clients have had challenges as to what probabilities of default should be assigned and 2019 provides an opportunity for banks to develop internal rating mechanisms for such counter parties in the event external information is not available. This also gives room for reflection as where to place investments in particular if the counter party ratings are not favourable.

If they embrace IFRS 9 in the true spirit of the standard’s intent, banks will gain better insights into their businesses and significantly enhance their credit management and monitoring processes.

The insights derived from IFRS 9 compliance will help banks to anticipate and plan, in line with fast-paced changes in customer behaviour and the marketplace overall.

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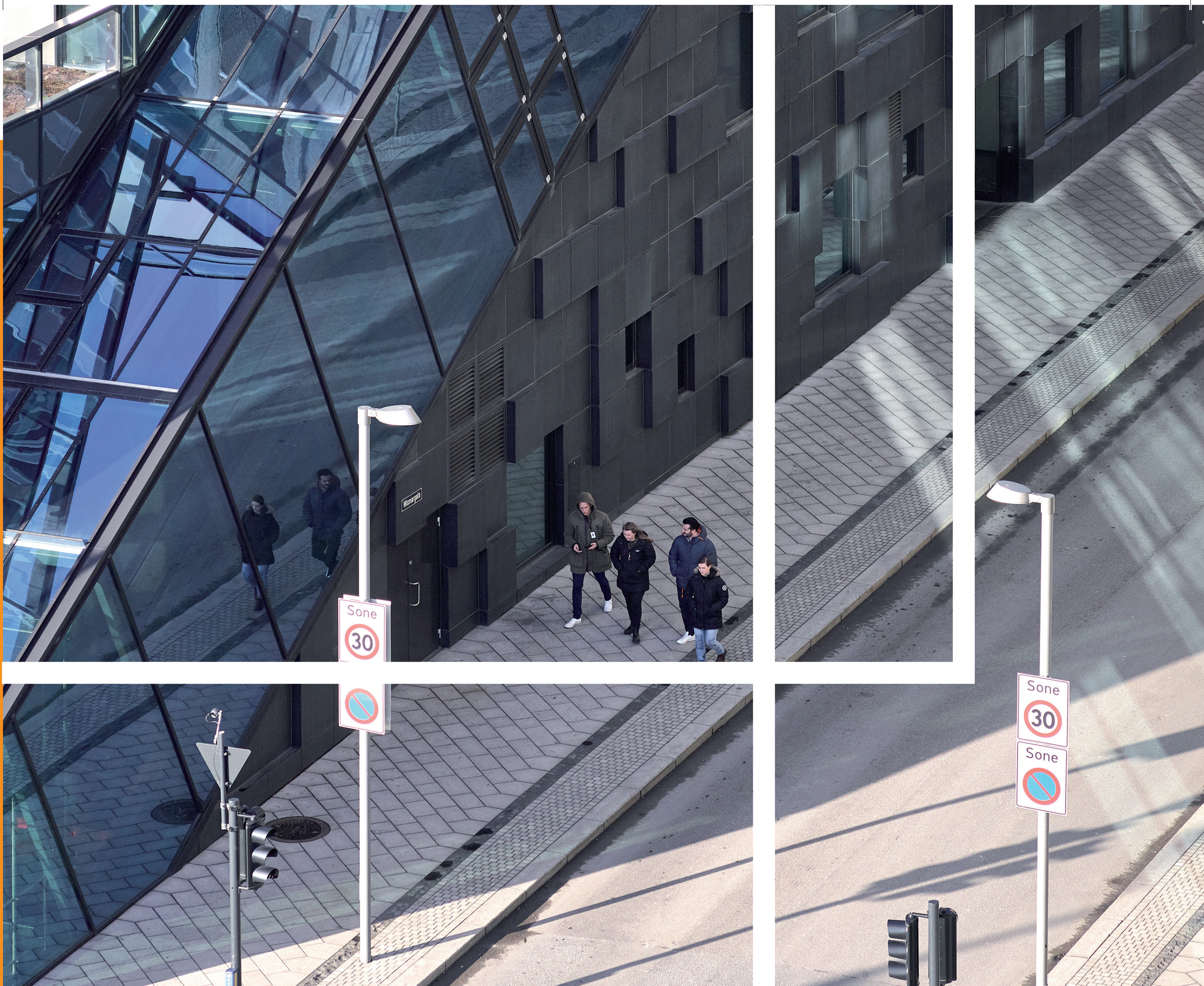
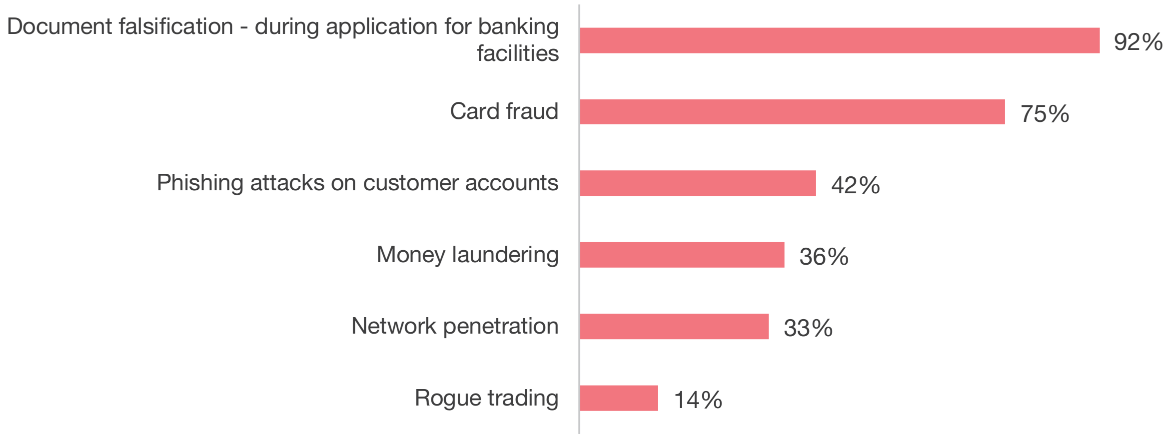
There can be a strong temptation to jump immediately into systemisation in the hope that it will streamline the end-to-end IFRS 9 process



Financial crime

Financial crime remains a significant challenge for respondents to our survey. Many forms of fraud are committed through the use of technology, and so whilst 30% of respondents believe that technological evolution will shape their businesses' futures in the next five to ten years (a higher percentage than amongst other macroeconomic trends), there are risks inherent in that evolution as well as opportunities.

FIGURE 22: Fraud in the East Africa region

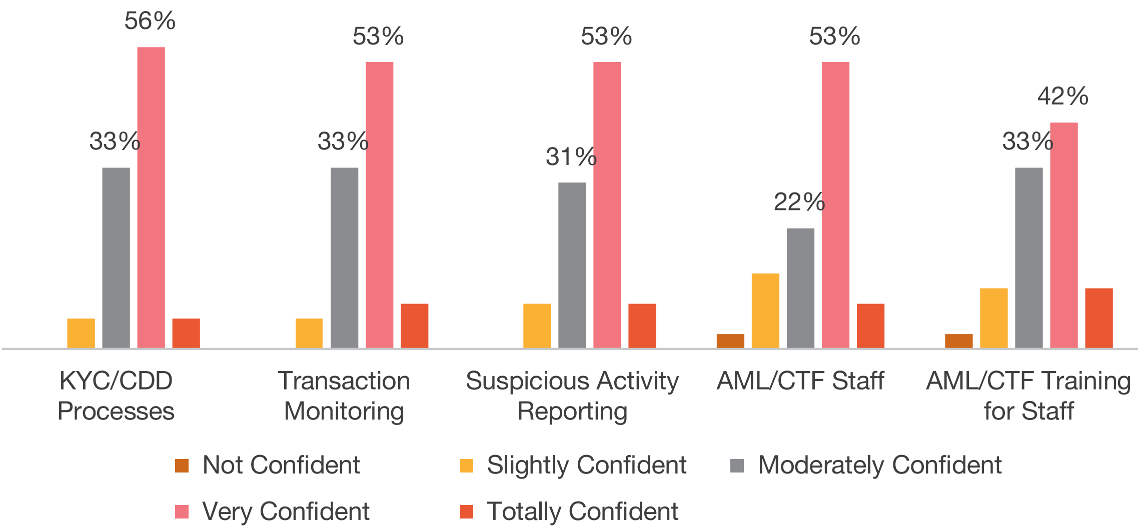


Amongst measures that banks have taken to detect and deter financial crime, by far the most effective has been the monitoring of suspicious transactions using technology, ranked first by 68% of respondents. Information and insights shared by fellow financial institutions and regulators ranked second and third most effective by 26% of respondents respectively. Rotation of personnel was seen to be the least effective.

FIGURE 23: Effective measure to detect and deter financial crime

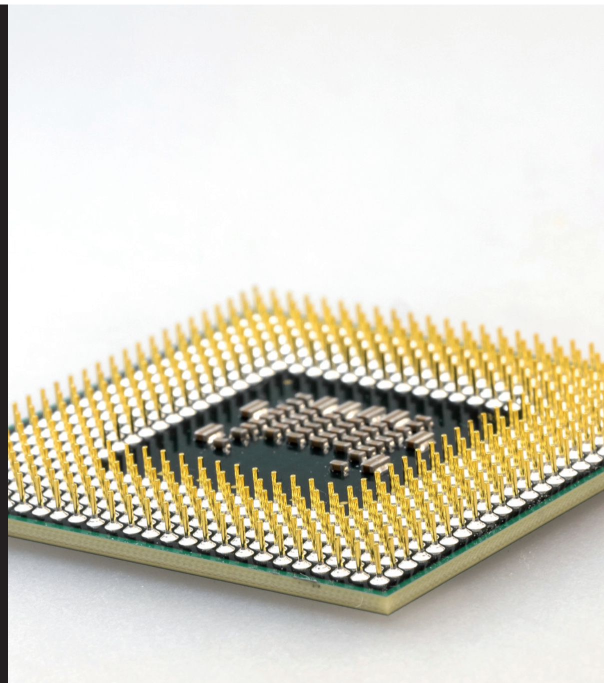
Anti-money laundering and Counter Terrorism Financing (AML-CFT) has become a major focus area for regulators and banks; banks have come under increasing scrutiny for non-compliance. Most survey respondents identified Know Your Customer/ Customer Due Diligence (KYC/CDD), transaction monitoring, suspicious activity reporting, AML/CTF dedicated staff and AML/CTF training for staff as areas where they are very confident or moderately confident.

FIGURE 24: On a scale of 1 (not confident) to 5 (totally confident), how confident are you regarding your bank's:



INDUSTRY PERSPECTIVE:

Dr James Mwangi,
CEO,
Equity Group Holdings Plc



How are banks managing the risks associated with emerging technology, cybersecurity and technology fraud?

Actually, what is increasingly risky is social engineering risk whereby customers are taken advantage of.

The divide between digital natives and others is a huge challenge. Digital natives are taking advantage of the less digitised in society; the playing field is level in the sense that increasingly everyone has access to similar platforms, but not everyone is similarly advanced technologically.

Another risk is that technology is evolving so fast that banks are not able to deploy and extract the value of their investments before they need to re-invest again. Another risk is taste. We are now dealing with a youthful banking population driven by taste and fashion, not brand loyalty.

The cost of their shifting loyalty is borne almost exclusively by the service provider whereas the cost of maintaining customer loyalty is very high.

Finally, there is risk associated with a deeply interconnected global financial system. Boundaries that used to protect people from economic shocks and cycles no longer exist.

INDUSTRY PERSPECTIVE:

Dr Diane Karusisi,
CEO,
Bank of Kigali

Do you think that banks in Rwanda treat cybersecurity as the business risk that it is? What has Bank of Kigali done to manage this risk?

Awareness of cyber risks is picking up steam at a crucial time when attackers are becoming more dangerously sophisticated. Banks are making the necessary investments in infrastructure and we discuss cybersecurity more frequently in our boardrooms. Recent regulation mandates banks to establish a board committee for IT that will also oversee the implementation of cybersecurity-related policies and procedures. We are also mandated to conduct an annual penetration test by external auditors which helps us to focus on continuously improving our cyber threat management and vulnerability identification.

Banks have traditionally managed only industry specific risks like credit, liquidity and operational risks. We are increasingly aware, however, that the risk landscape has changed. New innovations come with new associated risks. Our approach has been to work with stakeholders, auditors and the regulator as well as to involve external consultants to review our risk landscape and make recommendations.

However, it is still a challenge to sensitise clients and staff on the risks posed by cyber attacks and to find personnel with the skills and expertise needed. There is certainly a gap in the local market for IT security experts; at Bank of Kigali, we are investing in training and professional certifications to build the capacity of our employees.

Information sharing between competing banks can be difficult and so instead, we share information with the regulator who compiles a database of cybercriminals and shares this widely within the industry. More work remains to be done to encourage collaboration and the industry as a whole should constantly update systems and data pools to improve the quality of information that could be used to anticipate potential attacks before they occur.

Abdulmajid Mussa Nsekela,
Managing Director,
CRDB Bank

Do you think that banks treat cybersecurity as the business risk that it is?

Banks, world over, are at the centre of enterprise cybersecurity. By the very nature of their businesses, banks store enormous amounts of cash and consumer data, which makes them a top target for hackers. Obviously, the threat of financial losses, regulatory consequences, and reputational damage have compelled many of them to innovate and accelerate the field of cybersecurity.

Banks do treat cybersecurity with the utmost regard but, of course, there's m0re that can be done in terms of preparedness (surveillance) and building capacity (responsiveness) to deal with cyber threats. The nature of cybersecurity points to constantly evolving threats, which require constant upgrades, and proactive surveillance. Gladly, most of the vendors providing Information and Communication Technologies (ICTs) have are actively providing back-end support, especially with regard to early warning systems/ detection of threats such as malware, hacking attempts and other forms of security breaches such as data mining.

Today, as a result of shifting consumer attitudes and a resultant cashless culture, banks are heavily investing mobile and web-based services to facilitate payments and transfers. It is not in doubt that these applications have brought about new vulnerabilities, which every banker must be alert to.

PwC POINT OF VIEW:

John Kamau
Associate Director
PwC Kenya
john.kamau@pwc.com

Joseph Githaiga
Associate Director
PwC Kenya
joseph.githaiga@pwc.com

Perspectives on management of AML/CFT risk

Anti-money Laundering and Countering Financing of Terrorism (AML/CFT) is a topical global issue and therefore the legislative and regulatory changes that we are seeing locally are part of a much wider global effort. In this context, banks in East Africa need to stop treating AML/CFT like an inconvenience or a cost centre and instead see it as an opportunity to improve their systems and compliance—even to a point where their AML/CFT framework become a competitive advantage.

The banks that get their AML right, i.e., those that take a risk-based approach and truly understand their risks, should still be able to transact for most customers without undue delays. Segmenting customers, collecting appropriate data and implementing the right systems and processes will help to identify and report suspicious transactions more accurately, saving time and money.

Historically, East African governments have passed laws and issued guidance on AML/CFT but it was not until about 2013 that we began to see more deliberate efforts requiring banks to report suspicious transactions and review their processes. Fines and criminal prosecutions have become more frequent and significant, and consequently banks have beefed up their programmes to detect suspicious transactions.

In cases where we have seen significant fines, banks have been assessed as having not implemented appropriate systems or their staff were not trained well enough, or the banks became aware of suspicious transactions and did not report them within the required time frame, or they did not collect or submit the right documentation.

Whereas international banks have generally had policies and systems in place to manage AML/CFT due to group-level requirements, local banks have only begun recently to make these investments. As they make the investments, the local banks are having to contend with challenges such as transaction monitoring systems that return false positive results in the hundreds. Gaps in policies and procedures have also meant that in some cases, even for those transactions that are actually suspicious, the required supporting documentation is unavailable or incomplete.

All banks need to invest internally in the right systems and ensure that the data captured is appropriate. Even a very expensive transactions monitoring system will not identify suspicious transactions adequately if the data it relies on is incomplete, inaccurate or non-existent.

For example, a system might track the age of a customer and compare it to a typical risk profile and pattern of transactions. An 18 year-old transacting in amounts greater than USD 10,000 would probably be considered suspicious, but if the data does not include the customer's date of birth then the system will not flag those transactions.

It is also important to reinforce the three lines of defence at a bank: first, the bank staff members conducting transactions must be well-trained and facilitated. Second, banks need to invest in their compliance/risk functions and help their people to do their work better. Third, internal audit must do its part.

From a corporate governance perspective, it is worrisome that many banks have not invested in an independent risk department. Banks need enough people to manage AML/CFT-related risks and processes and they also need the right people.

Corporate culture plays a big role, but the focus for many banks has been on new products and aggressive growth targets. Now, after the fact, they are having to ask themselves whether certain customers are actually worth having.

From an AML/CFT perspective, banks should gather the right data, process it through appropriate systems, implement the three lines of defence and related internal processes, and report suspicious transactions in good time. For the banks that do this well, AML/CFT compliance should not impede their growth ambitions overmuch.

Conclusion

Much is changing in the banking industry in East Africa - with regulation, technology, changing customer expectations, greater competition and consolidation all presenting challenges and opportunities alike.

Our survey makes clear that banks need to get ahead of these changing circumstances and to make hard choices about which customers to serve, how to win and what to offer.

They need to build and grow their organisations around the customer, as well as simplify and structurally reduce costs. They need to be agile, innovative and adaptable in order to execute effectively - and deal with uncertainty as the future unfolds.

Each bank's unique response will depend on its current position, aspirations for the future, desired customer focus, organisational capabilities, brand promise, regulatory situation and capital constraints. In any case, it is clear from our survey and in-depth interviews that staying the same is not an option.

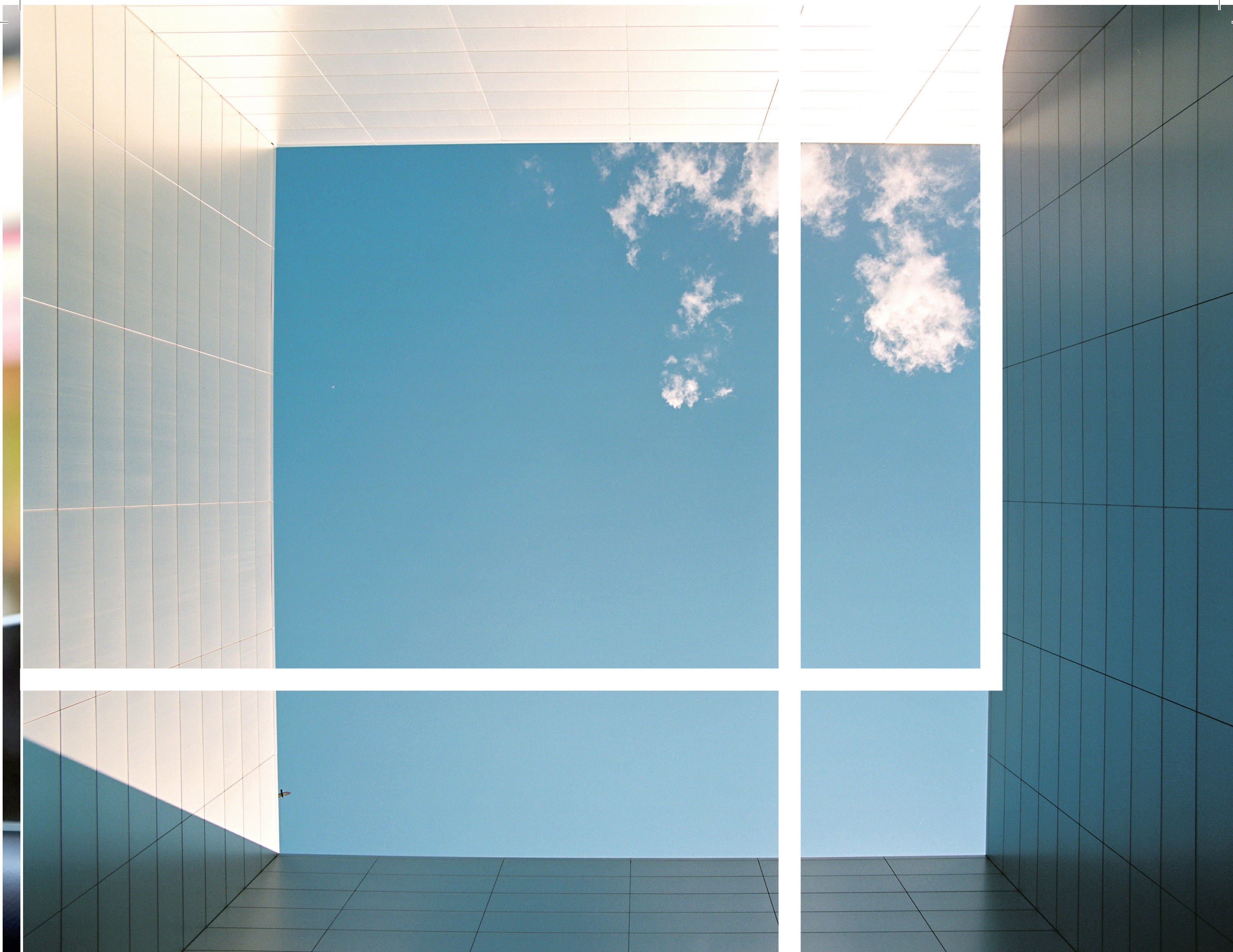
We hope that this publication has been thought-provoking and insightful as you consider both your own bank's strategy to thrive and the tactical actions that you need to take today.

About the survey

PwC's East Africa Banking Survey was completed by 49 respondents from Kenya, Rwanda, Tanzania and Uganda from August – November, 2018.

Not all survey questions were compulsory and so in some cases, the number of responses varies per question.

We would like to thank all of our survey respondents for taking the time to complete the survey. Their responses remain confidential.



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