Silent Risks in Banking Today
africappractice Financial Services Sector Report

Perspectives and experiences of Kenyan bank leadership on silent risks affecting their business operations.

14th July 2016
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1. Background

On 14th July 2016, africapractice convened a financial services breakfast to discuss the non-financial risks affecting banking institutions. The breakfast forum attended by fund managers, regulators, non-executive board members and senior management of banking institutions brought to the fore some of the turbulence experienced by the sector over the last 12 months.

It also provided a platform for the different stakeholders to discuss better ways of managing the increasingly prominent “Silent risks” facing the sector to restore investor confidence. Our objective was to create a platform for the sector leaders to engage on pertinent issues and possible actions.

The discussion took the form of a presentation by africapractice on silent risks and panel engagement which offered a first-hand account on how different players perceived the present financial sector turbulence.

Key issues discussed:

- Defining silent risk and articulating present day strategic and operating factors that continue to influence the way companies operate and impact profitability
- Accountability and how companies can better integrate silent risk management across organizational functions
- Culture and how it influences organizational performance
- The need to proactively and constantly engage sector stakeholders
2. africapractice perspective on silent risks in banking

Lately, there has been aggressive competition in bank service offerings as a result of saturation in the industry to service a demanding but levelling off customer growth. There is also decreased public confidence on the financial sector, disruption and enablement by technology on the sector’s service and product offerings. There is also more stringent application of the regulatory framework by Central Bank of Kenya and more scrutiny by Kenya Revenue Authority, as well as political interest in the operations of the sector.

africapractice defines silent risks as the non-financial aspects of the business that have a bearing on the business and which, if not addressed, have a significant impact on the company’s reputation, competitiveness, and profitability.

The silent risks recently experienced in the banking sector have been as a result of failure to take into consideration the broader operating context, both external and internal, which includes changing needs, expectations and behaviours of other stakeholders, changing technology, competitive dynamics, government regulations and other forces of change. The sector must weigh these risks in its strategy and operational consideration as potential disruptors for business, which, if left unchecked, can translate into millions of shillings lost in equity value, operational expense and opportunity cost.

From the financial services roundtable, the panelists agreed that most of the silent risks inferred had become quite loud. Positive posting on banks’ profitability, growth and return on equity, made it easy to overlook the other systemic risks.

As one of the most advanced service industries in Kenya, the banking sector is more prone to the silent risks than other financial service subsectors.

*As africapractice, we see the silent risks in banking as falling in four key categories:*
**Competition** - As a risk, competition speaks to how the bank maintains its unique value proposition to attract the right clientele and deliver profits. Its competitive advantage should enable it to deal with threats such as competitive rivalry, potential of product/service substitution and influx of new entrants. Understanding how to do business in Africa’s diversified economies and accepting the possible need to constantly revise the business model, especially for international companies, is a key differentiator.

**Regulation** - The regulatory environment for banking in Kenya has become more stringent with the Central Bank of Kenya calling for increased levels of disclosures, changes and improvements on corporate governance, tenure of bank directors and loan book performance. Further, adoption of Basel accords and a Finance Bill (2016) proposing a shore up of core capital requirements are all examples of recent developments in the market that profile certain regulation as a silent risk for business. Changes in the local landscape are leading to the biggest regulatory change that the banking industry has seen in decades. It is one important, albeit gradual, component of a suite of related reforms that are changing banking, regulation, supervision and the relationship between banks and the regulator.

Corporate governance has not been highly placed in the market but its enforcement is slowly becoming mandatory. Internal regulation will have to improve considerably as stringent international standards become more and more applicable in the local market based on mandatory disclosures in transactions with developed countries. This brings to light the different internal and external stakeholders that have to be understood and managed if this is to succeed.

**Transformation** - With the increased regulation and competition, companies are having to look at different ways to remain relevant and competitive. The ripple effects that we are starting to see and that have been experienced in other markets that have gone through similar experiences include increased mergers and acquisitions, expansion of the client base, supplementary service offerings, efforts to better understand local, regional and international markets and increased efficiency among others.

All these efforts come along with major operational, reputational and/or financial risks. One example is the demand by customers for banks to be mobile, close to an expanding financially included population and more accessible on technology platforms. The demand has enforced innovation disruption to the Kenyan banking sector who must comply or are left with the risk of business marginalization.

**Reputation** - Banking is a business of trust. Over the last 12 months banks have struggled with loss in customer confidence, attributed to the collapse of three banking institutions in nine months. This has spread over to not only the affected banks but also to the whole industry. Organizations are having to better understand the different internal and external players and find ways to manage their perceptions and buy into their narrative. We have also seen the impact of modern technology that includes social media and how fast information is disseminated, tech-savvy employees causing increase in cybercrime among others.
3. Perspectives from the session - Issues Analysis

Who owns risk?

It sits with all parties and stakeholders – Internally right from management, board, shareholders, staff to even the most junior level and External players including media, the regulator and auditors.

Directors are faced with the responsibility to set the tone but implementation and enforcement cuts across different parties. This brings to question the frequency of vetting of senior management by the regulator – should it remain a one off at recruitment? What about having the right structures to acquire the right talent and have continuous investment in key processes and capabilities?

In sharing their experiences and perspectives, the attending executives offered the following insights on the challenges currently facing the industry and how they serve as silent risks:

<table>
<thead>
<tr>
<th>Exposure to Silent risks</th>
<th>Understanding the operating environment</th>
<th>Internal accountability</th>
<th>Culture as a propagator of silent risk</th>
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<tbody>
<tr>
<td>• Banks have traditionally placed importance on credit and liquidity risks but performed poorly in managing conduct risk</td>
<td>• There is a lack of concrete and proactive understanding of macro factors that would potentially have impact on the sector and organization, beyond economic factors.</td>
<td>• The banking industry, above others, is most prone to systemic risks and this creates the importance for all players to independently play their parts in managing their company risks.</td>
<td>• Management teams are under pressure to deliver returns to shareholders who push for competitive profits. This creates room for manipulation of the figures so as to deliver the expected returns.</td>
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<td>• Boards are often overwhelmed by the information presented to them at once for review during board committee or board management sessions, which might result in some being overlooked and necessary oversight not undertaken.</td>
<td>• Stakeholders involved are diverse and come with different expectations which result in blame games.</td>
<td>• There are weak structures put in place to hold people accountable for conduct risk</td>
<td>• Bank management do not like to be asked the tough questions by the board members</td>
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<td>• Bank management are often not challenged by their company boards and put to task to explain their presentations. There lacks a store keeper on the board to keep track of information presented by management.</td>
<td>• A speak up policy is often not effective where the bank management are owners of institutions</td>
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4. Perspectives from the session - Way Forward

Accountability:

1. The responsibility on risk mitigation and management should sit with all parties. The board is tasked with setting the tone for risk appetite and creating the guiding policies for risk mitigation. Management is responsible for ensuring the risk mitigation plans are implemented according to the guiding policies.

2. Board members should adopt a more proactive approach in reviewing the presentations by management. They should be able to ask “What If” questions as stress testing, not to undermine the management but to prepare for the unexpected.

3. Shareholders should be able to routinely question the long term sustainability of business cases presented by the bank management, routinely challenging the presentations beyond numbers, to include governance and compliance.

4. The board should regularly conduct independent audit reports to ascertain validity of the presentations provided by management. This is possible where the board directly contracts third party auditors who act independent of bank internal audit in scrutinizing the bank’s risk positions.
Culture:

1. Banks need to rethink board appointments. It is not enough to have a prominent personality on the board. Banks should also consider prior experience on boards and industry competence.

2. Banks should regularly conduct stress tests of existing risk frameworks even when going through positive performance periods.

3. While the board sets the tone for a positive culture through policy, bank management should be willing to infuse a culture of collective responsibility in addressing conduct risk.

4. There is need to introduce a voluntary, incentivised and non-punitive speak up policy in banking institutions, supported by proper risk mitigation frameworks that protect and address the reported risk cases, to encourage reporting of fraud within the institutions.

5. The risk assessment department should be separate from the audit department to avoid conflict of roles.

6. Banks need to focus on driving sustainable growth and earnings by building long term systems such as capacity building to the second and third levels of bank leadership to encourage an ownership culture beyond the top leadership.

7. Regulators and sector associations need to be proactive in inspiring good conduct. This can be through the formulation of a conduct policy which sets a minimum level of appropriate business conduct in the sector.

Sustainable Business:

1. Invest in long term solutions that result in sustainable businesses and systems that outlive the current management. A long term strategy is paramount for a clear common objective and plan for the growth of the organisation.

2. Understanding your operating environment assists to pre-empt and navigate pressures such as political forces and other non-commercial trends. It is easier to align objectives by understanding the intersect between various stakeholders.

3. Building organizational competency and capacity beyond 1st tier management and boards assists in embedding the risk management culture at all levels.
5. africapractice in the financial services industry

At africapractice, we help our clients to identify the silent risks in their business horizon and adequately plan for these, to mitigate reputational and operational risk. We work with clients to help them understand complex political and commercial dynamics and manage challenging relationships with demanding and critical audiences such as regulators, capital markets, the new age customers, suppliers and media.

Our operations are based on the principal of Shared Advantage™ which aims to align the interests of the private sector, public sector and civil society through a process and dialogue that is free from coercion to secure mutual benefits through improved performance and competitive gain, thereby engendering a relationship of mutual dependency in the achievement of key objectives. We work to align the interests of the private sector, shareholders, boards, the regulator, public sector, media and other stakeholders.

The africapractice value proposition for financial services:

We help you to identify, build and nurture privileged and influential relationship with your regulators and other stakeholders, based on our understanding of the policy and regulatory environment and ability to bring together key players in the sector to help shape best practice and enable you to stay ahead of potentially game changing disruptions and manage unforeseen risks.

We work with you to cultivate a strong corporate image that optimizes intrinsic company value (driven by profitability, quality of products and services, good governance) and enhances extrinsic value (derived from impact on the community, influence on economy/country/continent, environmental impact) leveraging our long term sectoral and geographic experience in Africa to build, maintain and sustain your investor, customer and employee relationships, sales, reputation and good will.

We help you to understand the market better using our diversified team of multi skilled professionals to identify underdeveloped commercial, financial and operational opportunities and to develop evidence based strategy, structural, financial and positioning interventions to drive growth and keep ahead of competition.

We support you to identify and adapt to changing trends and market dynamics, whether they be transactional, structural or financial. Our corporate finance team’s track record of support for African institutions delivers the capital solutions needed to achieve change, while our strategy and communications teams ensure a strong market reception, and minimum disruption during execution.
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