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Limo MP*

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(THIRD SESSION)

NATIONAL ASSEMBLY

DEPARTMENTAL COMMITTEE ON FINANCE AND NATIONAL PLANNING

REPORT ON THE ACQUISITION OF NATIONAL BANK OF KENYA BY KENYA
COMMERCIAL BANK GROUP PLC

*Approved by Tabby
~~W. O. Odingo~~
DONA 7/8/19*

CLERKS CHAMBERS
DIRECTORATE OF COMMITTEE SERVICES
PARLIAMENT BUILDINGS
NAIROBI
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AUGUST, 2019

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CHAIRPERSON'S FOREWORD

This report contains the Committee's proceedings on the consideration of the Statement by the Hon. Tom Odiege, M.P on the proposed acquisition of the National Bank of Kenya by the Kenya Commercial Bank Group PLC.

In carrying out the inquiry, the Committee held a total of seven (7) meetings where it met with the Board and Management of National Bank of Kenya (NBK), Competition Authority of Kenya (CAK), Central Bank of Kenya (CBK), Capital Markets Authority (CMA), the National Treasury, Privatization Authority and National Social Security Fund on diverse dates.

On behalf of the Departmental Committee on Finance and National Planning and pursuant to provisions of Standing Order 199 (6), it is my pleasant privilege and honour to present to this House on the inquiry on the proposed acquisition of the National Bank of Kenya by the Kenya Commercial Bank Group PLC.

The Committee is grateful to the Offices of the Speaker and the Clerk of the National Assembly for the logistical and technical support accorded to it during its sittings. The Committee wishes to thank all the stakeholders whose input was invaluable in arriving at the observations and recommendations.

Finally, I wish to express my appreciation to the Honorable Members of the Committee who made useful contributions towards the preparation and production of this report.

EXECUTIVE SUMMARY

On Thursday 2nd May, 2019 the Hon. Tom Odiege, M.P. requested for a statement from the Chairperson of the Departmental Committee on Finance and National Planning regarding the imminent acquisition of the National Bank of Kenya Limited (NBK) by Kenya Commercial Bank (KCB). The Committee was expected to inquire into and report on:-

- a) whether the acquisition is a merger or a takeover;
- b) whether NBK is properly and professionally valued to safeguard pensioners, employees and taxpayers' interests;
- c) whether the process of selecting KCB Group PLC was done competitively and in a transparent manner;
- d) whether the Government is creating a monopoly in the banking sector;
- e) outline the process used by the management of both banks to arrive at this deal; and whether this is the best option to revive and/or privatise the NBK; and,
- f) whether the management of both banks applied the law when engaging in the transaction.

In carrying out the inquiry, the Committee held meetings with the Board and Management of National Bank of Kenya (NBK), Competition Authority of Kenya (CAK), Central Bank of Kenya (CBK), Capital Markets Authority (CMA), the National Treasury, Privatization Authority and National Social Security Fund.

Brief background on NBK

1. NBK was incorporated in 1968 with the main aim of helping Kenyans to take get access to credit and take control of their economy after independence. It was founded as an indigenous bank and was successful right from the beginning attracting a loyal clientele of local customers and it became the dominant bank in the public sector.
2. In 1994, the Government reduced its shareholding by 34% (forty million shares) through an Initial Public Offer it became a publicly listed company on the Nairobi Securities Exchange (NSE). The Government subsequently did a secondary IPO and further reduced its shares by another forty (40) million shares resulting into shareholdings as follows NSSF (48. %), National Treasury (22.5%) and the General Public (29.4%).
3. By way of a loan agreement between the National Treasury and NBK entered into in 2003, it was agreed that the Government would be issued with four hundred thousand (400,000) preference

shares following advancement of loan facility amounting to KSh. 2 billion. At the point of issuance of loan the value of each preference share was KSh. 5000. This amount was to cover a loan of KSh. 2 billion. At that time, ordinary shares traded at KSh. 13.35 per share.

4. The bank enjoyed considerable competitiveness until 1996 when the institution started experiencing turbulent times characterised by no growth and declining profits arising out of the non-performing loans (NPLs).
5. NBK challenges of liquidity crisis and a large portfolio of bad debts adversely affected its asset quality and thereby resulting to a serious loss of confidence from its customers in 1998. The unfortunate developments were largely because of mismanagement, political interference and a weak business model. The bank was also not changing in tandem with rapid changes in the banking industry leading to erosion of shareholder value.
6. As at 31st March, 2019 NBK had 48,987 ordinary shareholders with the top ten ordinary shareholders constituting about 75.14% of NBK's as follows:-
 - i. National Social Security Fund (NSSF) – 48.05%
 - ii. The Permanent Secretary, National Treasury – 22.5%
 - iii. Kenya Reinsurance Corporations Limited – 1.43%
 - iv. Best Investment Decisions Limited – 0.69%
 - v. Dizzyland Limited – 0.57%
 - vi. Stanbic Nominees Limited A/C NR5551514 – 0.55%
 - vii. Equity Nominee Ltd A/C – 0.4%
 - viii. NBK Client A/C – 0.3%
 - ix. Eng. Ephraim Mwangi Maina – 0.3%
 - x. Mr. George Muhia Mwaura – 0.3%
7. Some of the initiatives that have been pursued to mitigate NBK's challenges, particularly with respect to capital base include:-
 - i. In June 2007, the Government issued Non-Negotiable Treasury Bonds of KSh. 20 billion. The proceeds were used to cover the write-down of NBK's non-performing government related loans and advances and the non-performing commercial loan portfolio. Most of the bonds have been repaid and a balance of KSh. 6 billion is outstanding and due for repayment in 2020.

- ii. In 2013, a Rights Issue targeting to raise KSh. 13.2 billion was initiated but it was not concluded due to failure to obtain the requisite approvals.
 - iii. In March 2018, NBK's principal shareholders committed to inject KSh. 4.2 billion as subordinated debt (the National Treasury KSh. 1.3 billion and National Social Security Fund KSh. 2.9 billion). However, this commitment has not been fulfilled to date.
8. NBK has registered a declining financial performance over the period 2016 to-date as detailed below:-
- i. Core capital has declined from KSh. 10 billion as at 31st December, 2016 to KSh. 2 billion as at 31st March, 2019.
 - ii. Total asset base has declined from KSh. 115 billion as at 31st December, 2016 to KSh. 105 billion as at 31st March, 2019.
 - iii. The bank's core capital to total risk weighted assets declined from 11.3% as at 31st December, 2016 to 2.4% as at 31st March, 2019 below the statutory minimum of 10.5%.
 - iv. The bank's total capital to total risk weighted assets ratio declined from 11.9% as at December, 2016 to 3.8% as at 31st March, 2019 below the statutory minimum of 14.5%.
 - v. Core Capital to deposits ratio has declined 10.3 % in 2016 to 2.2% in 2019 against a minimum prudential requirement of 8%.
9. From the above analysis, NBK has violated provisions of the Banking Act particularly with respect to its capital. With the Core Capital to deposits ratio being below the minimum requirement (8%) the bank is unable to undertake deposit mobilization and lending.

1. CHAPTER ONE: PREFACE

1.1 ESTABLISHMENT OF THE COMMITTEE

1. The Departmental Committee on Finance & National Planning is one of the fifteen Departmental Committees of the National Assembly established under *Standing Order 216* whose mandates pursuant to the *Standing Order 216 (5)* are as follows:

- i. To investigate, inquire into, and report on all matters relating to the mandate, management, activities, administration, operations and estimates of the assigned ministries and departments;
- ii. To study the programme and policy objectives of Ministries and departments and the effectiveness of their implementation;
- iii. To study and review all the legislation referred to it;
- iv. To study, access and analyze the relative success of the Ministries and departments as measured by the results obtained as compared with their stated objectives;
- v. **To investigate and inquire into all matters relating to the assigned Ministries and departments as they may deem necessary, and as may be referred to them by the House;**
- vi. To vet and report on all appointments where the Constitution or any law requires the National Assembly to approve, except those under Standing Order No. 204 (Committee on appointments);
- vii. To examine treaties, agreements and conventions;
- viii. To make reports and recommendations to the House as often as possible, including recommendation of proposed legislation;
- ix. To consider reports of Commissions and Independent Offices submitted to the House pursuant to the provisions of Article 254 of the Constitution; and
- x. To examine any questions raised by Members on a matter within its mandate.

1.2 MANDATE OF THE COMMITTEE

2. In accordance with the Second Schedule of the Standing Orders, the Committee is mandated to consider, public finance, monetary policies, public debt, financial institutions (excluding those in securities exchange), investment and divestiture policies, pricing policies, banking, insurance, population revenue policies including taxation and national planning and development.

3. In executing its mandate, the Committee oversees the following government Ministries and departments;
 - a. The National Treasury and Ministry of Planning
 - b. Ministry of Devolution and ASAL
 - c. The Commission on Revenue Allocation
 - d. Office of the Controller of Budget
 - e. Salaries and Remuneration Commission

1.3 COMMITTEE MEMBERSHIP

4. The Departmental Committee on Finance and National Planning was constituted by the House in December, 2017 and comprises of the following Members:-
 1. The Hon. Joseph K. Limo, MP (**Chairperson**) – Kipkelion East Constituency – Jubilee Party
 2. The Hon. Isaac W. Ndirangu (**Vice-Chairperson**) – Roysambu Constituency – Jubilee Party
 3. The Hon. Jimmy O. Angwenyi, MP – Kitutu Chache North Constituency – Jubilee Party
 4. The Hon. Christopher Omulele, MP – Luanda Constituency – ODM Party
 5. The Hon. Dr. Enoch Kibunguchy, MP – Likuyani Constituency – FORD-K
 6. The Hon. Shakeel Shabbir Ahmed, MP – Kisumu Town East – Independent
 7. The Hon. Abdul Rahim Dawood, MP – North Imenti Constituency – Jubilee Party
 8. The Hon. Daniel E. Nanok, MP – Turkana West Constituency – Jubilee Party
 9. The Hon. Andrew A. Okuome, MP – Karachuonyo Constituency – ODM Party
 10. The Hon. David M. Mboni, MP – Kitui Rural Constituency – CCU Party
 11. The Hon. Francis K. Kimani, MP – Molo Constituency – Jubilee Party
 12. The Hon. Joseph M. Oyula, MP – Butula Constituency – ODM Party
 13. The Hon. Joshua C. Kandie, MP – Baringo Central Constituency – MCC Party
 14. The Hon. Lydia H. Mizighi, MP – Taita Taveta County – Jubilee Party
 15. The Hon. Mohamed A. Mohamed, MP – Nyali Constituency – Independent
 16. The Hon. Purity W. Ngirici, MP – Kirinyaga County – Jubilee Party
 17. The Hon. Samuel Atandi, MP – Alego Usonga Constituency – ODM Party
 18. The Hon. Stanley M. Muthama, MP – Lamu West Constituency – MCC Party
 19. The Hon. Edith Nyenze, MP – Kitui West Constituency – WDM-K

1.4 COMMITTEE SECRETARIAT

5. The Committee is facilitated by the following Secretariat:-

- | | | | |
|------|---------------------|---|--|
| i. | Ms. Leah W. Mwaura | - | Senior Clerk Assistant/Lead Clerk |
| ii. | Ms. Jennifer Ndeto | - | Principal Legal Counsel I |
| iii. | Ms. Laureen Wesonga | - | Clerk Assistant II |
| iv. | Mr. Josephat Motonu | - | Fiscal Analyst I |
| v. | Mr. Chelang'a Maiyo | - | Research Officer II |

2. CHAPTER TWO: SUBMISSION BY STAKEHOLDERS

2.1 NATIONAL BANK OF KENYA

The Managing Director, NBK appeared before the Committee on **Monday, 3rd June, 2019** to make his submission.

He replied to the concerns raised in the Statement as follows:- THAT-

6. Whether the acquisition is a merger or takeover

The offer received from KCB is a Take-Over Bid pursuant to the Capital Markets (Take-Overs and Mergers) Regulations, 2002. If all the NBK shareholders accept KCB's offer, then NBK will become a subsidiary of KCB and NBK will merge with KCB. In other words, the end product of the transaction contemplated by KCB is a merger through a Take-Over Bid.

7. Report on professional valuation of all assets and liabilities of NBK

Upon receipt of the Take-Over Document from KCB, the valuation of NBK's assets and liabilities will be completed to support the Board to make recommendations to the shareholders. The information will be provided to shareholders through a circular that will be prepared pursuant to the Take-Over Regulations.

8. Measures taken to safeguard the interests of employees, pensioners and taxpayers

Once the Take-Over Document is received from KCB after being approved by the Capital Markets Authority (CMA), it will give clarity on material terms of the transaction including KCB's proposal with regard to employees and pensioners. The proposal will be subject to compliance with applicable law and approval by the relevant regulatory authorities including the Competition Authority of Kenya (CAK).

In the circular issued to its shareholders, KCB stated that NBK will be initially operated as a stand-alone subsidiary of KCB Bank Kenya Limited. In this regard, NBK will continue to honour its obligations to its employees, pensioners, taxpayers and other stakeholders under the applicable law subject to any plan by KCB post implementation of the transaction.

9. Whether the process of selecting KCB was done competitively and in a transparent manner

The transaction was initiated by KCB as provided under the Take-Over Regulations. Under the said Regulations, any other bidder is free to make their own offer prior to the completion of the

process and will be taken as a competing bid. The Regulations allow a competing bid to be lodged at least ten business days before the expiry of the offer acceptance period.

10. Whether the Government is creating a monopoly in the market

The combined market share index for KCB and NBK has been in the region of 16.51% to 17.52% of the Kenyan banking sector which is significantly less than fifty percent of the Kenyan Banking Market. Therefore, the combined banks will not have a dominant market position and thus they do not create a monopoly. The CAK will also review the competition aspects of the transaction under the Competition Act.

11. Process used by management of both banks to arrive at this proposed acquisition and whether this is the best option to revive and/or privatize NBK

The duty of the Board and management of NBK is to relay KCB's intention to take over the bank to the shareholders and the public. Ultimately, the NBK shareholders have the discretion to accept or reject the offer following the recommendation of the Board.

12. Whether the management of both banks applied the law when engaging in the transaction

The offer by KCB is predicated on the Take-Over Regulations and NBK's responsibility is to respond in accordance with the same Take-Over Regulations. The current process is subject to the following approvals:-

- i. Shareholders' approval;
- ii. Regulatory approval under the Capital Markets Act;
- iii. Regulatory approval under the Banking Act;
- iv. Regulatory Approval under the Competition Act, 2012; and
- v. If applicable from the NSE

The relevant applications seeking for the different approvals will be prepared in due course i.e. once NBK has been served with the Take-Over Document by KCB.

2.2 COMPETITION AUTHORITY OF KENYA

13. The Competition Authority of Kenya appeared before the Committee on **Monday 3rd June, 2019**. The Director General was represented by his Officers who made the presentation by stating as follows: -

14. The Authority had not yet been formally notified by KCB and NBK about the proposed takeover. However, both KCB and NBK had kept the Authority abreast with regard to the roadmap to implement the merger. At that time, the proposed takeover was at the stakeholders' approval stage.
15. The two parties had shared the Notice of Intention to acquire all the ordinary shares of NBK with the Authority. The notice highlights that regulatory approvals including the Authority's are prerequisite to the implementation of the merger.
16. The Authority was awaiting formal notification that would be reviewed in accordance with the law. Additionally, in its assessment the Authority shall seek the views of other stakeholders such as CBK and CMA and the parties' competitors and the approval from the Authority shall not relieve the parties of any statutory requirements that they are supposed to observe to implement the merger.

2.3 CENTRAL BANK OF KENYA

17. The Governor, CBK appeared before the Committee on Tuesday, 4th June, 2019 and informed the Committee that:-
18. KCB Group had informed CBK of its intention to acquire all the ordinary shares of NBK by way of a share swap of one ordinary share of KCB for every ten ordinary shares of NBK. The acquisition of NBK is in line with KCB's strategy to:-
 - i. Strengthen its deposit base and lending capacity;
 - ii. Increase cost efficiencies due to economies of scale;
 - iii. Boost transactional revenue through leveraging on technology; and
 - iv. Competitively position the group in the rapidly evolving world of financial services.
19. NBK is currently facing several challenges including non-compliance with regulatory capital requirements and its business growth has been curtailed. The proposed acquisition would therefore turnaround NBK's fortunes and bring it into full compliance with the provisions of the Banking Act.
20. Section 9(1) of the Banking Act requires the proposed transaction to be approved by the Cabinet Secretary, National Treasury through the CBK. In addition, Section 13(4) of the Banking Act on transfer of significant shareholding requires CBK's approval for the transaction to take effect.

21. During their AGM held on Thursday, 30th May, 2019, KCB shareholders approved the proposal to acquire all the ordinary shares of NBK. NBK's AGM was scheduled for 14th June, 2019 where shareholders were expected to approve KCB's acquisition offer. It was expected that once NBK's shareholders approve the offer, KCB would submit the detailed application on the proposed transaction to CBK for the requisite approvals by the National Treasury and CBK.

Initiatives taken to mitigate NBK's challenges with respect to capital

22. In June 2007, the Government issued Non-Negotiable Treasury Bonds of KSh. 20 billion. The proceeds were used to cover the write-down of NBK's non-performing government related loans and advances and the non-performing commercial loan portfolio. Most of the bonds have been repaid and a balance of KSh. 6 billion is outstanding and due for repayment in 2020.

23. In 2013, a Rights Issue targeting to raise KSh. 13.2 billion was initiated but it was not concluded due to failure to obtain the requisite approvals.

24. In March 2018, NBK's principal shareholders committed to inject KSh. 4.2 billion as subordinated debt (the National Treasury KSh. 1.3 billion and National Social Security Fund KSh. 2.9 billion). However, this commitment has not been fulfilled to date.

Financial position of NBK and KCB Group

NBK has registered a declining financial performance over the period 2016 to-date as follows:-

25. Core capital has declined from KSh. 10 billion as at 31st December, 2016 to KSh. 2 billion as at 31st March, 2019.

26. Total asset base has declined from KSh. 115 billion as at 31st December, 2016 to KSh. 105 billion as at 31st March, 2019.

27. The bank's core capital to total risk weighted assets declined from 11.3% as at 31st December, 2016 to 2.4% as at 31st March, 2019 below the statutory minimum of 10.5%.

28. The bank's total capital to total risk weighted assets ratio declined from 11.9% as at December, 2016 to 3.8% as at 31st March, 2019 below the statutory minimum of 14.5%.

29. NBK therefore continues to violate provisions of the Banking Act particularly with respect to its capital ratios. The bank's capital base does not allow it to undertake further deposit mobilization and lending.
30. KCB Group continues to register a strong financial performance. This was their position as at 31st March, 2019:-
- i. Core capital was KSh. 110 billion above the statutory limit of KSh. 1 billion.
 - ii. Core capital to total risk weighted assets ratio was 18.6% above the statutory minimum of 10.5%.
 - iii. Total capital to total risk weighted assets ratio was 20% above the statutory minimum of 14.5%.
 - iv. Average liquidity ratio was 35.6% above the statutory minimum of 20%.
31. KCB's asset base is 7 times that of NBK while its core capital is 58 times that of NBK. KCB's capital base and liquidity position has sufficient buffers to accommodate NBK and still comply with regulatory requirements.
32. NBK is a medium sized bank with 82 branches in the country accounting for 2.5% of the banking sector market and serving a customer base of over 650,000. It also performs the role of tax collection agent on behalf of the government. NBK is therefore of systemic importance to the Kenyan Banking System and its turnaround is critical to the stability of the financial system. The receivership of NBK cannot therefore be contemplated at this point in light of the adverse contagion effect on the Kenyan banking sector.
33. The proposal by KCB presents an opportunity for the government and NSSF to consolidate their shareholding in the two institutions. More importantly, NBK stands to benefit from the superior governance and management capabilities of KCB and resolve its long standing challenges. In CBK's opinion, the proposal by KCB is the most appropriate and the only option at this time for NBK.

2.4 CAPITAL MARKETS AUTHORITY

34. The Chief Executive Officer (CEO) of the Authority appeared before the Committee on Monday, 20th June, 2019 and took the Committee through the process of take-over as provided in the Capital Markets Act and its attendant Regulations. He then responded as follows to the issues raised in the Statement, THAT:-

35. Whether the acquisition is a merger or a takeover

The acquisition is a take-over pursuant to the the Capital Markets (Take-Overs and Mergers) Regulations, 2002 where the KCB was intending to acquire 100 % shares of NBK.

36. Whether NBK was properly and professionally valued to safeguard pensioners, employees and taxpayers interests

Pursuant to Regulation 10 of the Take-over Regulations, NBK was expected to hire an independent adviser to undertake an independent review of the transaction and issue a fairness opinion for the sake of shareholders to assist them make an informed decision. The said Regulation require the board of directors of the offeree (NBK) to appoint an independent adviser on receipt of the offeror's statement in relation to the take-over offer. The independent adviser appointed should be an investment bank or stockbroker licensed by CMA.

37. Whether the process of selecting KCB was done competitively and in a transparent manner

A party is usually not aware of an offeror's intention to take them over until they are served with the Notice of Intention. The Board of the offeree (NBK) is required to issue a recommendation to its shareholders on whether they are in support of the takeover or not, however, the ultimate decision lies with the individual shareholder. Besides, any other party can make a competing offer at least five (5) days before the offer closes.

38. Whether the government is creating a monopoly in the banking sector

The takeover process was conditional on approval from CMA and CBK since the two entities are banks. In that particular case, CMA was working closely with other regulators to ensure any issues are addressed.

39. The process used by both banks to arrive at this deal and whether this is the best option to revive and/or privatize NBK

CMA was involved in the takeover process as stipulated by the law and as such all the concerns will be addressed before the approval was granted.

40. Whether the management of both banks applied the law when engaging in the transaction

The two banks had so far complied to the relevant Regulations as far as the takeover process was concerned.

2.5 THE NATIONAL TREASURY

41. The then Cabinet Secretary, Mr. Henry Rotich, E.G.H appeared before the Committee on Thursday, 27th June, 2019. The Cabinet Secretary gave the Committee a brief background of NBK before responding to the issues raised in the Statement. He responded to the specific issues as follows: -

42. Whether the acquisition is a merger or a takeover

The CS informed the meeting that the offer from KCB was a Take-Over Bid pursuant to the Capital Markets (Take-Overs and Mergers) regulations, 2002. Under the Regulations, any company listed on the Nairobi Securities Exchange could be a target of a Take-Over Bid. As such, the end product of the transaction contemplated by KCB was a Take-Over Bid resulting to a merger.

43. Whether there is any valuation done on NBK to ascertain its assets and liabilities

The CS stated that in accordance with the Take-Over Regulations, NBK was expected to appoint an expert to carry out a valuation for purposes of assisting the Board to make recommendations to the shareholders on whether the price offered by the offeror represented a fair market price.

44. NBK was in receipt of the Take-Over Document from KCB and the experts were working on the documents which would include the valuation aspect to be considered by the Board that will inform recommendations to the shareholders. Such information will be provided in a circular to shareholders which will be prepared pursuant to the Take-Over Regulations.

45. Measures put in place to safeguard the interests of the employees and the pensions' fund

The CS stated that according to KCB, the two organizations would continue to run as separate entities until the takeover and integration process is completed. KCB and NBK had jointly set up a project team comprising of staff from both entities to mitigate transitional risks and make the necessary preparations to enable smooth transition.

46. When approving mergers, CMA will consider among other things, the extent to which any proposed merger would affect employment of staff in both entities.

47. Whether this is the best option for reviving the bank

The CS informed the meeting that NBK had been having challenges in meeting its capital requirement that had had an effect in its core business. If this issue was not addressed it may lead to negative ramifications in the entire banking sector in the country. The proposed takeover by KCB therefore presented an opportunity to avert that risk of failure of NBK and indeed avert a potential banking sector crisis. It was in the interest of the shareholders and the government to support the acquisition. The proposed takeover by KCB was consistent with the overall financial sector strategy to create stronger banking institutions in the country.

2.6 NATIONAL SOCIAL SECURITY FUND

48. The National Social Security Fund led by Dr. Anthony Omerikwa Ag. Managing Trustee/CEO appeared before the Committee on **Monday, 1st July, 2019**. The CEO gave the Committee a brief background of NSSF and how the Fund invested in NBK. He stated that the Fund invested in NBK for purposes of generating investment returns to members in order to pay their dues upon retirement. NBK has however not paid dividends for five (5) years and the Auditor General has often questioned the Fund for holding a non-performing asset which necessitated the Board of Trustees to consider options for turnaround or exit. He responded to the specific issues as follows:

49. Whether the acquisition is a merger or a takeover

He stated that according to the notice of intention to acquire all the ordinary shares of NBK by KCB on 18th April, 2019 issued pursuant to Regulation 4(1) of the Capital Markets (Takeovers and Mergers) Regulations, 2002, it is a takeover of 100% of NBK Ordinary Shares.

50. Whether there is any valuation done on NBK to ascertain its assets and liabilities

Regulation 10 of the Capital Markets (Takeovers and Mergers) Regulations, 2002, a fairness opinion of KCB's offer, including whether the offer price is within a fair valuation of NBK will be carried out and it will be shared with the NBK shareholders.

51. Measures put in place to safeguard the interests of the employees and the pensions' fund

In compliance with the RBA Act, the Fund has engaged Fund Managers and investment Advisor in managing the Fund's investments. The issues of employees form part of the process that is ongoing.

52. Whether this is the best option for reviving the bank

This was the only option available in respect of reviving the fortunes of the bank.

2.7 BOARD OF DIRECTORS OF THE NATIONAL BANK

53. The Board of the National Bank of Kenya led by the Chairman, Mr. Mohamed A. Hassan appeared before the Committee on **Monday, 1st July, 2019.**

54. The Chairman informed the Committee that during the statutory audit of 2015, external auditors raised concerns to the Board regarding rebooking of non-performing loans, deposit mobilization activities, recognition of revenues on disposal of assets and provisioning for impairment of loans. The Board instituted forensic investigation and upon receipt of the report took immediate and decisive action in line with the company policies including disciplinary action and termination.

55. The Board notified the industry regulator and appropriate government agencies who carried out their own independent reviews and took action they deemed fit in line with the laws of Kenya. Some of the matters are still before courts. Subsequently, the Board took action to strengthen management by bringing in new talent through internal and external hires introducing independent oversight functions (Risk and Audit), revision of key policies and enhancement of capacity.

56. The issue of NBK has been lack of capital and having to operate below the capital ratios which has constrained business growth. Despite this fundamental limitation, the Board has managed to steer the Bank to improved profitability over the last three years while continuing to engage the shareholders on injection of additional capital.

He responded as follows to the questions raised in the letter:-

57. The total shareholder funds were KSh. 11B in 2016, KSh. 7.2B in 2017 and KSh. 7.2B in March, 2019. The reduction was in 2015/2016 as a result of correction of provisioning for loan impairment in compliance with IAS 39. During the same period the qualifying core capital was KSh. 10B in 2016, KSh. 3.5B in 2017 and KSh. 2B in March 2019. The reduction arises from compliance with prudential guidelines on depreciation of collaterals on non-performing loans (NPLs) by way of establishment of a statutory loan reserve. As of Dec. 2018, the bank held a statutory loan reserve of KSh. 3.6B while this is part of shareholder funds it is excluded from capital for regulatory purposes. The Board and Management has implemented several actions to accelerate recovery of the NPLs and unlock the reserves.
58. NBK received a Notice of Intention or Interest from KCB. KCB made an offer to the NBK shareholders. These processes are regulated by the Take-Over Regulations and once served on the Offeree, the duty of the Board of Management of the Offeree is to relay the same information to their shareholders and the public. The NBK shareholders have the discretion to accept or reject the Offer following the Board's recommendation.
59. The bank's challenges arise from undercapitalization not from poor management. The bank has strong liquidity at 20% above regulatory minimums but with capital ratios below the regulatory minimum. The bank has grown its customer base in the last three years after overcoming a challenging stabilization period in 2016. Since then, various innovations have been launched including mobile app, diaspora, mVisa, mobile loan, agriculture, SME, internet banking among others. The bank has won several industry awards on innovation and customer service which is a positive affirmation of the successes in the various initiatives put in place to turnaround the bank.
60. The banking industry has faced cyber and credit default risk, to mitigate this the bank has invested in new processing technology, enhanced credit and risk management processes and human capital enabling effective management.
61. The Board initiated a rights issue which received Board and shareholder approval at the EGM but it was not successful since they failed to obtain regulatory approvals from CMA. The Board has continued to engage key stakeholders regarding additional capital injection in form of Tier I and Tier II capital resulting to receipt of formal commitments by the principal shareholders to inject Tier II capital KSh 4.2B together with a long term capital solution.

62. The Board received formal commitments from principal shareholders on provision of capital during financial years 2017 and 2018. In the same period, the Board has engaged various strategies to generate capital organically by driving business growth through innovation, service and diversification, accelerated recovery of NPLs, cost management and disposal of non-core assets.

63. Impact of the disposal of non-core assets on the banks capital base and outline how the funds realized were expended

The bank realized proceeds of KSh. 759M from the sale of non-core assets which contributed KSh. 501M to core capital unlocking writing of new loans and deposits worth KSh. 4B and KSh. 6B respectively. The reduction in non-core assets also reduced the level of non-compliance to regulatory guidelines on investment in non-core assets.

64. The performance of the Board vis-à-vis the reduced capital growth of the bank and the ability of the Board to offer strategic direction as well as identification of risks that have put NBK in its current position

After the stallation of the rights issue, the Board continued to engage key stakeholders to inject Tier I & II capital. They also strengthened management, established an independent risk and audit function, enhanced governance and revised key policies to embed robust risk management and control environment. Resultantly, the bank was restored to profitability with profit before tax of KSh. 80M in 2016, KSh. 785M in 2017 and KSh. 456M in 2018 despite the limitation of capital and challenging operating environment.

3. CHAPTER THREE: REPORT ON INDEPENDENT VALUATION

65. By the time the Committee was concluding its investigations, NBK had received the independent report from the Standard Investment Bank.
66. Pursuant to Regulation 10 of the Capital Markets (Take Overs and Mergers) Regulation, 2002, the Board of the offeree (NBK) appointed Standard Investment Bank as the independent transaction advisor. The transaction advisor was expected to prepare a fairness opinion on the financial adequacy of the offer by KCB, for use by the Board of Directors of NBK and subsequent transmittal to the shareholders of the NBK.
67. The transaction advisor conducted the valuation utilising the methodologies: the Dividend Discount Method(DDM), the Net Assets Value (NAV) Multiples Method and Historical Trading Prices as summarised below:-
- i. **Dividend Discount Method (DDM):** the DDM valuation approach returned a share fair value of KSh 5.41 with a high of KSh 9.27 and a low of KSh 2.38. the assumptions used include a terminal Book Value multiple of 1.2x and a target cost of equity of 14.5%.
 - ii. **Net Assets Value (NAV) Multiples Method:** the Price to Book Value Method returned a share value of KSh 6.62.
 - iii. **Historical Share Trading Prices Method:** the historical share trading prices analysis returned a share value of KSh 5.01 on which a premium of 30% was loaded resulting in a share value of KSh 6.51.
68. Utilising a combination of the DDM, Net Assets Value Multiples and Trading Price, the Fair Value of the Bank has been determined as provided in the table below:-

Valuation Method (all figures in KSh)	Valuation	Weight	Weighted value
DDM	7,973,156,292	40%	3,189,262,517
NAV Multiples	9,756,431,544	30%	2,926,929,463

Trading Prices	9,598,736,956	30%	2,879,621,087
Fair Value			8,995,813,067
Proforma number of shares issued			1,473,781,200
Price per share (Fair Value)			6.10
Price per share High			6.62
Price per share Low			5.41

69. The above values are subject to the assumptions used. Utilising a combination of the above valuation methods, the Fair Value is calculated at KSh. 9 billion representing a share value of KSh. 6.10 with a low and high share value of KSh. 5.41 and KSh. 6.62 respectively. Ultimately, fair value is the price at which property would change hands between a willing buyer and a willing seller and both having full/reasonable knowledge of the relevant facts and market conditions.
70. A transaction is considered to be responsive if it falls within the low and high bands of valuation. Furthermore, from an investor's point of view the income approaches and more importantly the discounted cash flow (DCF) are considered to be the most responsive valuation methods because they reflect what the investor will derive from the business.
71. In the case of the KCB Take-Over Bid, the Offer price is about KSh. 3.801 per share which is significantly below the share fair value of KSh. 6.10. Based on the valuation analysis, the indicative exchange ratio proposed of one (1) ordinary share of KCB for every ten (10) ordinary shares of NBK may not be adequate. Given that NBK is operating below the required capital level which exposes the company to considerable risk of regulatory action.
72. However, there aren't any competing bids which makes it difficult to comment on the best obtainable price from the market. Furthermore, as advised to shareholders previously, although NBK remains a strong bank, it requires more capital to meet the regulatory capital and grow its

business which capital can be provided by KCB. In the circumstances and on prudence grounds, the Board recommended the Offer to the shareholders.

4. CHAPTER FOUR: SUMMARY OF FINDINGS

Issues raised by the Statement

73. From the hearings undertaken by the Committee and submissions by various stakeholders the Committee wishes to report as follows:-
74. The offer received from KCB is a Take-Over Bid pursuant to the Capital Markets (Take-Overs and Mergers) Regulations, 2002. The offer made by KCB is for the acquisition of 100% of the NBK Shares including the shares to be issued following the conversion of the non-cumulative preference shares. The consideration for the acquisition is to be satisfied in whole by way of a share swap of one (1) KCB share for every ten (10) NBK Shares (The swap Ratio). If all the NBK shareholders accept KCB's offer, then NBK will become a standalone subsidiary of KCB and thereafter NBK will merge with KCB within a period of two (2) years. In other words, the end product of the transaction contemplated by KCB is a merger through a Take-Over Bid. If acceptance of 75% of the Offer Shares are received, and subject to approval from the CMA, the Offer Shares will be de-listed from the NSE.
75. From the offer document in respect of the takeover scheme submitted by KCB (offeror) to NBK (offeree), the Committee learnt that the consideration of the acquisition was to be satisfied in whole by way of share swap of one (1) KCB share for every ten (10) NBK shares. The swap ratio was determined by the following factors:-
- i. The value of KCB's volume Weighted Average Price of one KCB share on the NSE for the 180 days up to and including 16th April, 2019 i.e. the date before the KCB Board approval of the proposed offer.
 - ii. The value of NBK's Volume Weighted Average Price (VWAP) of one NBK Share on the NSE for the 180 days up to and including 16th April, 2019 (the date before the KCB Board approval of the proposed Offer).

- iii. A discount of 30% to the value of NBK's 180 day VWAP up to and including 16th April, 2019 (the date before the KCB Group Board approval of the proposed Offer) of one NBK Share on the NSE to factor the need to recapitalize the business.
- iv. The Offer values the issued ordinary share capital of NBK at KSh. 1,287,707,341. After conversion NBK's cumulative preference shares into ordinary shares, the Offer values the issued ordinary shares of NBK at KSh. 5,601,842,341.
- v. Additional historical information on the performance of both KCB and NBK Shares on the NSE prior to the Offer.

76. Pursuant to the Capital Markets (Take Overs and Mergers) Regulations, 2002 NBK appointed Standard Investment Bank (SIB) as the independent advisor who prepared a fairness opinion assessing the financial adequacy of the share swap offer. The opinion rendered by SIB is expected to guide the shareholders in making the decision.

77. SIB considered several approaches in determining the true value and pricing. The approaches included the Dividend Discount Method (DDM), the Relative Valuation Approach, the Asset Based Approach (Net Assets Value (NAV) Multiples Method) and Historical Trading Prices. Utilising a combination of the DDM, Net Assets Value Multiples and Trading Price, the Fair Value of the Bank was determined at KSh. 9 billion compared to the offer bid given by KCB of KSh. 6 billion. The fair share price was valued at KSh. 6.1 compared to KSh. 3.801 given by KCB.

78. In the circular issued to its shareholders, KCB stated that NBK will be initially operated as a stand-alone subsidiary of KCB Bank Kenya Limited. In this regard, NBK will continue to honour its obligations to its employees, pensioners, taxpayers and other stakeholders under the applicable law subject to any plan by KCB post implementation of the transaction.

79. The transaction was initiated by KCB as provided under the Take-Over Regulations. KCB announced the proposed intention to take over NBK on 19th April, 2019 by way of press notice. Under the said Regulations, any other bidder is free to make their own offer prior to the completion of the process and will be taken as a competing bid. The Regulations allow a competing bid to be lodged at least ten business days before the expiry of the offer acceptance

period. In this case, the period is expected to be between 6th August to 17th September, 2019 where any other party can offer a competing bid.

80. The combined market share index for KCB and NBK has been in the region of 16.51% to 17.52% of the Kenyan banking sector which is significantly less than fifty percent of the Kenyan Banking Market. Therefore, the combined banks will not have a dominant market position and thus they do not create a monopoly. The CAK will also review the competition aspects of the transaction under the Competition Act.
81. The duty of the Board and management of NBK is to relay KCB's intention to take over the bank to the shareholders and the public. Ultimately, the NBK shareholders have the discretion to accept or reject the offer following the recommendation of the Board.
82. The offer by KCB is predicated on the Take-Over Regulations and NBK's responsibility is to respond in accordance with the same Take-Over Regulations. The current process is subject to the following approvals:-
 - i. Shareholders' approval;
 - ii. Regulatory approval under the Capital Markets Act;
 - iii. Regulatory approval under the Banking Act;
 - iv. Regulatory Approval under the Competition Act, 2012; and
 - v. If applicable from the NSE
83. The relevant applications seeking for the different approvals will be prepared in due course i.e. once NBK has been served with the Take-Over Document by KCB.

4. CHAPTER FOUR: OBSERVATIONS

In considering the Statement, the Committee made the following observations, THAT:-

84. The principal shareholders of NBK are the National Treasury (22.5%) and National Social Security Fund (48.05%) making total shareholding of 70.55%.
85. NBK is a strong bank with 86 branches across the country. The main challenge facing the bank is core capital to Total Risk Weighted Asset ratio (2.4%) which is below the minimum statutory requirement of 10.5%. In addition, the total capital to Total Risk Weighted Asset ratio is at 3.8% against a statutory requirement of 14.5%. In terms of core capital to deposit ratio, the Bank is operating at 2.2 % against a minimum prudential limit of 8.0 %. The current scenario has curtailed the bank from lending and also taking in more deposits. As far as liquidity ratios are concerned NBK is performing well at 40.4 % as compared to KCB which is at 35.6%.
86. KCB gave an offer bid per share price of KSh 3.801 and the total value of NBK at KSh. 6 billion against an independent valuation of per share price of KSh. 6.1 and a total value of KSh 9 billion. Therefore, the offer given by KCB does not reflect the fair value of NBK.
87. There was no competing bid by the time the Committee was concluding the investigation.
88. NBK is the principal collector of revenue on behalf of Kenya Revenue Authority hence it's a strategic institution of Government.

5. CHAPTER FIVE: RECOMMENDATIONS

After considering the submissions by the stakeholders, the Committee recommended that:-

89. The principal shareholders i.e the National Treasury and National Social Security Fund **SHOULD NOT ACCEPT** the offer by KCB on the acquisition of 100% shares of NBK. This is primarily to safeguard the interests of workers, taxpayers, staff of NBK, the minority shareholders and other stakeholders.
90. The National Treasury should seek alternative ways of funding NBK to ensure that the bank is compliant with the Banking Act capital ratios so as to continue lending and taking in more deposits.
91. The National Bank should pursue the Rights Issue way in order to raise enough capital.

SIGNED  DATE *7/8/2019*

THE HON. JOSEPH LIMO, MP

CHAIRPERSON

DEPARTMENTAL COMMITTEE ON FINANCE AND NATIONAL PLANNING

REPUBLIC OF KENYA



NATIONAL ASSEMBLY

DEPARTMENTAL COMMITTEE ON FINANCE & NATIONAL PLANNING
ADOPTION SCHEDULE FOR THE REPORT ON THE CONSIDERATION OF THE
STATEMENT BY HON. TOM ODIEGE, M.P. ON THE ACQUISITION OF NATIONAL BANK
OF KENYA BY KENYA COMMERCIAL BANK

DATE: 7TH JULY, 2019

NAME	SIGNATURE
1. HON. JOSEPH K. LIMO, MP – CHAIRMAN	
2. HON. ISAAC W. NDIRANGU – VICE-CHAIRMAN	
3. HON. JIMMY O. ANGWENYI, MGH, MP	
4. HON. CHRISTOPHER OMULELE, MP	
5. HON. ENOCH KIBUNGUCHY, MP	
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