# 2018

# ANNUAL REPORT

## AND FINANCIAL STATEMENTS


EXPERIENCE THE ULTIMATE

VICTORIA

COMMERCIAL BANK

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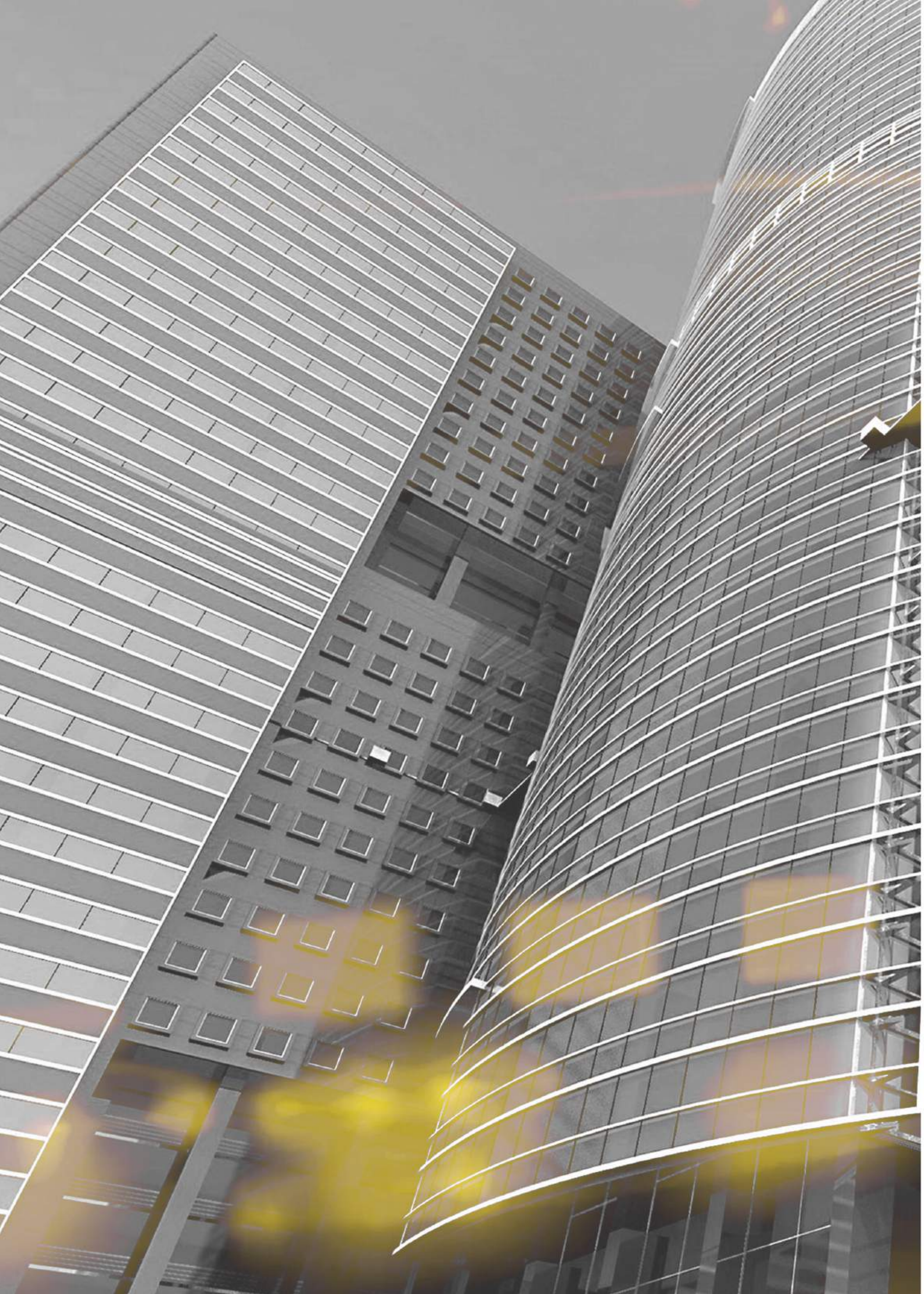

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# 2018

## ANNUAL REPORT

AND FINANCIAL STATEMENTS

SECTION ONE

# CORPORATE INFORMATION

## REGISTERED OFFICE

Victoria Towers, Mezzanine Floor
Kilimanjaro Avenue, Upper Hill
PO Box 41114- 00100, Nairobi

## AUDITOR

PricewaterhouseCoopers, Certified Public Accountants
PwC Tower, Waiyaki Way/Chiromo Road, Westlands
Nairobi, Kenya
PO Box 43963-00100, Nairobi

## PRINCIPAL CORRESPONDENTS

| | |
|---|---|
| Standard Chartered Bank | New York |
| Standard Chartered Bank | London |
| Standard Chartered Bank | Frankfurt |
| Standard Chartered Bank | Tokyo |
| Axis Bank Limited | India |
| Crown Agents Bank | London |

## MAIN LAWYERS

Taibjee and Bhalla Advocates LLP
Ashitiva and Company Advocates LLP
Raffman, Dhanji, Elms and Virdee Advocates
Njoroge Regeru & Company Advocates

## BOARD OF DIRECTORS

Ketaki Sheth*
CHAIR OF THE BOARD

Yogesh K Pattni Ph.D*
CHIEF EXECUTIVE OFFICER

Kanji D Pattni

Sylvano O Kola

Mukesh S Shah
VACANT UPON DEMISE ON 2 DECEMBER 2018

Mahesh P Acharya
APPOINTED 15 MARCH 2018

## COMPANY SECRETARY

Kaplan & Stratton
Williamson House
4th Ngong Avenue
P.O. Box 40111-00100
Nairobi

*BRITISH

## PRINCIPAL OFFICERS

Yogesh K Pattni Ph.D*
CHIEF EXECUTIVE OFFICER

Manish L Parmar
DIRECTOR - BUSINESS DEVELOPMENT

Nitin H Jethwa
DIRECTOR - OPERATIONS

Dharmesh M Vaya
GENERAL MANAGER

Azmina Pattni
HEAD OF LIABILITIES RELATIONSHIPS

Hezron Kamau
HEAD OF FINANCE

Mitesh Chouhan
HEAD OF CREDIT ADMINISTRATION

Alpesh C Parmar
SENIOR MANAGER, TREASURY

Fiddelice Otwani
HUMAN RESOURCES MANAGER

Daniel Kabuku
INTERNAL AUDITOR

Nasibo Abdullahi
HEAD OF COMPLIANCE

Meeraj Shah
HEAD OF RISK

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## CORPORATE GOVERNANCE STATEMENT

Corporate governance involves the way the business and affairs of an institution are governed by its board and senior management and provides the structure through which the objectives of the institution are set, and the means of attaining those objectives and monitoring performance are determined.

These structures are aimed at maintaining and increasing shareholder value simultaneously with the satisfaction of other stakeholders in the context of the institution's corporate mission.

Victoria Commercial Bank Limited is keen on ensuring the adoption of good corporate governance.

## BOARD OF DIRECTORS

The Board of Directors is composed of the Chairperson of the Board, non-executive directors, Independent non-executive directors and executive director who is the Chief Executive Officer. The directors have extensive business and professional experience applied in the management of the Bank. The Board meets regularly to review the Bank's performance against business plans in addition to formulating and implementing strategy as well as discharge its duties relating to the corporate accountability and associated risks in terms of management, assurance and reporting.

The Central Bank of Kenya Prudential Guidelines require that appointment of all directors must be approved by Central Bank, a requirement that the Bank has complied with since inception.

The Board has delegated authority for the conduct of the day to day business to the Management. However, the Board retains ultimate responsibility for establishing and maintaining the Bank's overall internal control of financial, operational and compliance issues.

The Board has four main functional committees (Audit, Credit, Nomination and Remuneration, and Risk Management) which meet at least on quarterly basis with the main functions outlined below. These are supported by Management committees charged with implementing various decisions of the Board.

All the Directors are committed to act honestly and in the best interests of the Bank. The Board also ensures that the Directors' personal interests do not conflict with their duty to the Bank and to all the stakeholders.

The following are the board and management committees of Victoria Commercial Bank Limited with brief description of their key role, composition and membership as well as the frequency of the meetings.

## BOARD AUDIT COMMITTEE (BAC)

This Committee provides independent oversight of the bank's financial reporting and internal control system, ensure checks and balances within the Bank are in place and recommends remedial actions regularly.

The committee comprises of three non- executive directors. In addition, the Chairperson of the Committee can invite members to attend meetings as may be necessary.

The external and internal auditors of the Bank shall have free access to the Audit Committee. The Auditors can request the Chairperson of the Committee to convene a meeting to consider any matter that the auditors believe should be brought to the attention of directors or shareholders.

The BAC is chaired by an independent non-executive director and meets once every quarter as per its terms of reference.

## BOARD RISK MANAGEMENT COMMITTEE (BRMC)

This Committee assists the board of directors in the discharge of its duties relating to the corporate accountability and associated risks in terms of management, assurance and reporting. The responsibility to ensure quality, integrity and reliability of the Bank's risk management is delegated to the BRMC.

The committee comprises of three non- executive directors. In addition, the Chairperson of the Committee can invite members to attend meetings as may be necessary.

The Risk and Compliance Function of the Bank has free access to the BRMC.

The BRMC is chaired by an independent non-executive director and meets once every quarter as per its terms of reference.

## BOARD CREDIT COMMITTEE (BCC)

This Committee assists the board of directors in reviewing and overseeing the overall lending of the Bank. The committee also monitors and reviews the quality of the Bank's portfolio and ensures adequate levels of loan loss provisions are maintained. The BCC deliberates and considers loan applications beyond the discretionary limits of the Credit Risk Management Committee.

The Committee comprises of two non-executive directors and the Chief Executive Officer, who is an executive director.

The BCC is chaired by an independent non-executive director and meets once every quarter as per its terms of reference. In addition, the Chairperson of the Committee can invite members to attend meetings as may be necessary.

## BOARD NOMINATION AND REMUNERATION COMMITTEE (BNRC)

The objective of this Committee is to assist the Board undertake structured assessment of candidates for membership of the Board and senior executives as well as regular review of structure, size and composition of the board and make recommendations on any adjustments deemed necessary.

The Committee also oversees the compensation system's design and operation in line with clearly defined remuneration principles. The Committee comprises of three non-executive directors and the Chief Executive Officer, who is an executive director.

The BNRC is chaired by an independent non-executive director and meets at least twice every year as per its terms of reference.

## EXECUTIVE COMMITTEE (EXCO)

This committee is the link between the Board and the management of the Bank. It assists the Chief Executive Officer in implementing operational plans, the annual budget and periodic review of the Bank's overall strategies.

The Committee comprises of the senior management of the Bank.

The Committee is chaired by the Chief Executive Officer of the Bank and meets at a minimum of twice per month unless otherwise notified by the Chairperson to the committee.

## RISK MANAGEMENT AND COMPLIANCE COMMITTEE

This Committee assists the board risk management Committee in the discharge of its duties relating to the corporate accountability and associated risks in terms of management, assurance and reporting.

The Committee is chaired by the Risk Manager and members include all the line managers and a representative of the senior management team. In addition, the chair person can invite other members of the Bank as may be necessary.

The Committee meets once every quarter as per its terms of reference.

## ASSETS AND LIABILITIES COMMITTEE (ALCO)

ALCO is responsible for monitoring and managing the assets and liabilities of the Bank. This includes managing interest rate movements, liquidity, treasury risk management, cost of funds/margins, reviewing and monitoring bank deposit base, foreign exchange exposure and capital adequacy. The Committee also recommends appropriate steps with regards the areas above in line with the CBK/Risk Management guidelines.

The Committee comprises mainly of the executive team and is chaired by the Head of Treasury.

The Committee meets at a minimum once a month as per its terms of reference.

## CREDIT RISK MANAGEMENT COMMITTEE

The objectives of the Credit Risk Management Committee are to review, oversee, decline and approve the credit facilities in line with the lending policy set by the Board Credit Committee.
The committee also deals with the day to day management of loans and advances as well as off- balance sheet facilities in accordance with the Credit Policies of the Bank.
The committee is chaired by the General Manager in charge of credit. Other members are the senior management team,

relationship managers, credit Manager, legal Officer and the committee secretary. The committee reports to the Board Credit Committee.

The Committee meets on monthly basis as per its terms of reference.

## ICT STEERING COMMITTEE

ICT Committee's responsibilities include directing the investigation and development of ICT requirements; developing long-term strategies and plans for ICT services; recommending and implementing approved systems, policies and strategies; recommending and approving hardware and software changes; ensuring accurate management information is available on a timely and reliable manner and that appropriate security arrangements are in place including information security.

The Committee is chaired by Chief Executive Officer and membership consists of representatives from senior management, the IT function, Credit Manager, Operations Officer as well as the Project Manager. The Committee meets once every three months as per its terms of reference.

## ALTENATIVE DISPUTE RESOLUTION COMMITTEE (ADRC)

The committee has a general responsibility for establishing and maintaining systems of alternative dispute resolution, including provisions for both dispute mediation and dispute arbitration. It also provides efficient and effective mechanisms for handling complaints relating to our provision of financial products and services. The mandate extends to ensuring there is prudent management of customer complaints by the Bank on timely basis.

## INSIDER LENDING

The Bank complies with the requirements of Prudential guidelines and the Banking Act with regards to insider lending.

## CODE OF CONDUCT

The bank adheres to the banking code of ethics which requires all employees to conduct business with high integrity. The code of conduct ensures that all actions are in the overall best interests of the Bank and reflects commitment to maintaining the highest standards of integrity, ethical behaviour and compliance with all applicable internal and external laws and regulations.

All the Bank's Directors and employees adhere to the principles of the Code of Conduct in all of their dealings on behalf of the Bank.

## CONFLICT OF INTEREST

Persons empowered with decision-making authority such as the directors and management are required to exercise care to avoid situations that may give rise to a conflict of interest. The Bank has adopted code of conduct and ethics to ensure potential conflicts can be identified and managed appropriately.

## RELATIONSHIP WITH SHAREHOLDERS

The shareholders' role is to appoint the Board of Directors and independent auditors. This role is extended to holding the board accountable and responsible for efficient and effective governance of the Bank for mutual good of the various stakeholders.

## ANTI-BRIBERY AND CORRUPTION POSITION

The Bank has a zero tolerance attitude to bribery and corruption and is fully committed to maintaining ethical behavior in its relationships with its various stakeholders.

## BOARD OF DIRECTORS EVALUATION

The Board, on an annual basis, carries out a self-assessment of its members. Each board member evaluates fellow board members as well as the Chairperson of the Board. An evaluation of the performance of the Chief Executive Officer during the period under review is also carried out.

## ATTENDANCE AT BOARD MEETINGS - 2018

| Name | Jan 23 | Mar 1 | Mar 19 | Apr 26 | May 31 | Jun 27 | Jul 27 | Sep 27 | Oct 29 | Nov 20 |
|---|---|---|---|---|---|---|---|---|---|---|
| Ketaki Sheth<br>CHAIR OF THE BOARD | P | P | P | P | P | P | P | P | P | P |
| Yogesh K Pattni<br>CHIEF EXECUTIVE OFFICER | P | P | P | P | P | P | P | P | P | P |
| KD Pattni | P | P | P | P | P | AP | P | P | P | P |
| S O Kola | P | P | P | P | P | P | P | P | P | P |
| Mukesh Shah<br>(VACANT UPON DEMISE ON 2.12.18) | P | P | P | P | P | AP | AP | AP | P | AP |
| Mahesh P Acharya<br>(APPOINTED 15.03.18) | | | P | AP | P | P | P | P | P | P |

P Present A Absent AP Absent with Apology

The assessment is broad based and encompasses all aspects of management of the business and particularly the contribution of each board member. Effectiveness, participation, attendance and co-operation amongst directors also form part of the basis of the assessment. Mix of skills and experiences of each director are taken into consideration. All directors and the Chairperson of the Board will continue making these assessments on an annual basis.

## INTERNAL CONTROLS

The Board is committed to managing risk and to controlling the business and financial activities of the Bank in a manner which enables it to maximize profitable business opportunities, avoid or reduce risks which can cause loss or reputational damage and ensure compliance with applicable laws and regulations.

## GOING CONCERN

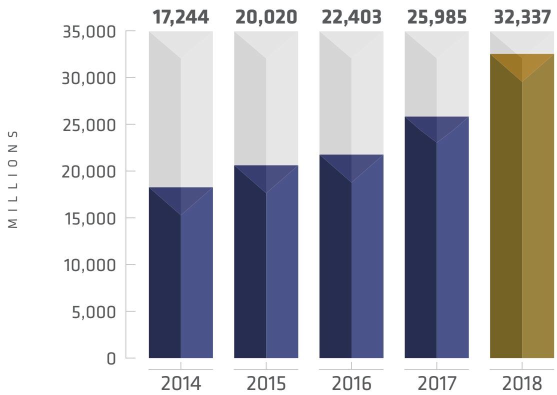
The Board is satisfied that the Bank has adequate resources to continue in business for the foreseeable future. For this reason, it continues to adopt the going concern basis when preparing the financial statements and carrying out its business objectives in pursuit of the Bank's vision and strategic goals.


287782
265672
237835
225562
217763
207746
189457

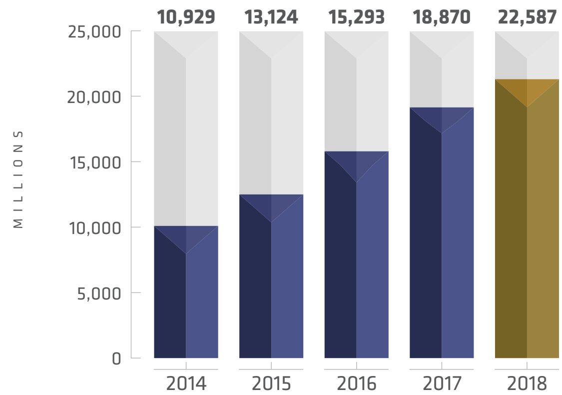
# FIVE-YEAR FINANCIAL REVIEW

| | 2014 Shs'000 | 2015 Shs'000 | 2016 Shs'000 | 2017 Shs'000 | 2018 Shs'000 |
|---|---|---|---|---|---|
| **BALANCE SHEET** | | | | | |
| **Assets** | | | | | |
| Government securities | 2,399,880 | 2,823,790 | 2,993,604 | 2,586,695 | 3,814,317 |
| Loans and advances to customers | 10,979,238 | 13,124,420 | 15,292,829 | 18,870,101 | 22,586,671 |
| Property and equipment | 185,373 | 235,466 | 192,350 | 174,508 | 213,341 |
| Other assets | 3,679,601 | 3,836,396 | 3,924,698 | 4,353,856 | 5,722,626 |
| **Total assets** | **17,244,092** | **20,020,072** | **22,403,481** | **25,985,160** | **32,336,955** |
| **Liabilities** | | | | | |
| Customer deposits | 12,288,662 | 14,024,406 | 15,695,947 | 18,677,388 | 23,764,638 |
| Long term borrowings | 1,387,418 | 1,305,428 | 1,519,870 | 1,382,370 | 1,940,093 |
| Other liabilities | 692,464 | 1,178,729 | 127,627 | 313,509 | 669,326 |
| **Total liabilities** | **14,368,544** | **16,508,563** | **17,343,444** | **20,373,267** | **26,374,057** |
| **Shareholder's funds** | **2,875,548** | **3,511,509** | **5,060,037** | **5,611,893** | **5,962,898** |
| **Total equity and liabilities** | **17,244,092** | **20,020,072** | **22,403,481** | **25,985,160** | **32,336,955** |
| **INCOME STATEMENT** | | | | | |
| Interest income | 1,797,221 | 2,447,904 | 2,541,003 | 2,711,691 | 3,198,776 |
| Interest expense | (902,899) | (1,325,394) | (1,302,865) | (1,274,363) | (1,698,639) |
| **Net interest income** | **894,322** | **1,122,510** | **1,238,138** | **1,437,328** | **1,500,137** |
| Non- funded income | 162,403 | 127,994 | 177,878 | 205,697 | 221,181 |
| **Operating income** | **1,056,725** | **1,250,504** | **1,416,016** | **1,643,025** | **1,721,318** |
| Credit impairment charge | (10,982) | (20,026) | (12,032) | (35,321) | (371,204) |
| Other operating expenses | (410,858) | (553,537) | (607,571) | (758,505) | (785,019) |
| **Profit before income tax and exceptional items** | **634,885** | **676,941** | **796,413** | **849,199** | **565,095** |
| Exceptional items | - | 242,161 | - | - | - |
| **Profit before tax after exceptional items** | **634,885** | **919,102** | **796,413** | **849,199** | **565,095** |
| Income tax expense | (170,540) | (205,302) | (204,018) | (232,022) | (128,091) |
| **Profit for the year** | **464,345** | **713,800** | **592,395** | **617,177** | **437,004** |
| **PERFORMANCE RATIOS** | | | | | |
| Earnings per share (Shs) | 14.36 | 21.69 | 18.6 | 14.72 | 10.42 |
| Dividend Per share (Shs) | 5.00 | 3.00 | 3.00 | 3.50 | 2.53 |
| Return on average shareholder's funds | 23.70% | 28.78% | 20.84% | 15.91% | 9.76% |
| Return on average assets | 4.11% | 4.93% | 3.75% | 3.51% | 1.94% |
| Non performing loans to total loans and advances | 0% | 0% | 0% | 0.09% | 3.08% |
| Net advances to customer deposits (%) | 89.34% | 93.58% | 97.43% | 101.03% | 95.04% |

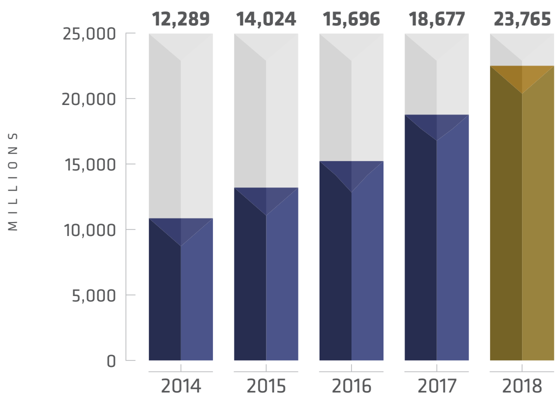
## TOTAL ASSETS



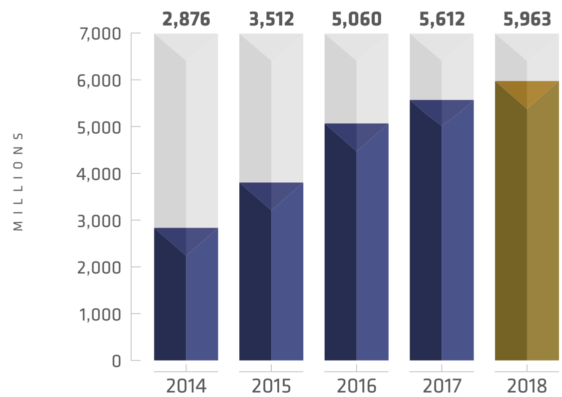

## LOANS AND ADVANCES



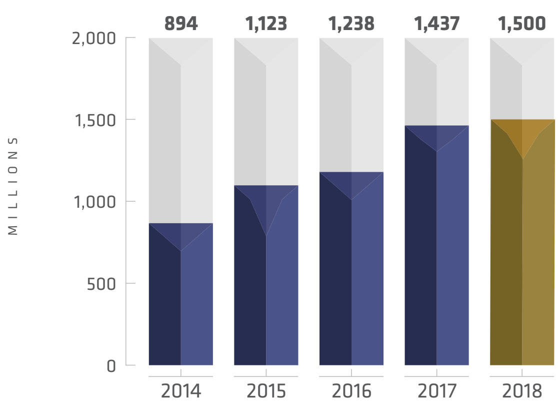

## CUSTOMER DEPOSITS



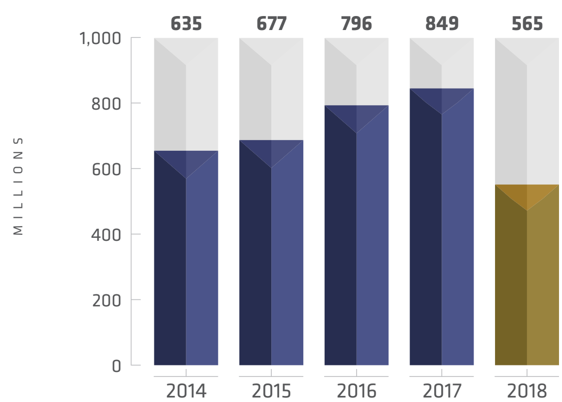

## SHAREHOLDERS' EQUITY




## NET INTEREST INCOME

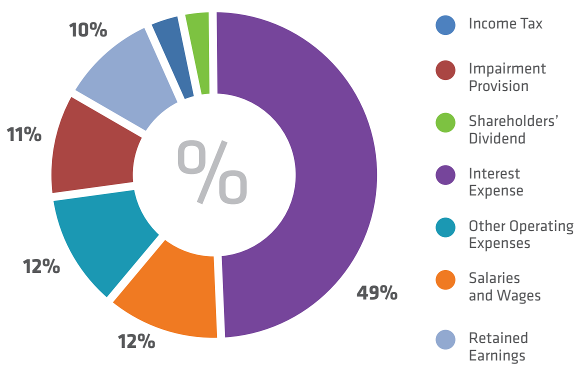



## PROFIT BEFORE TAX

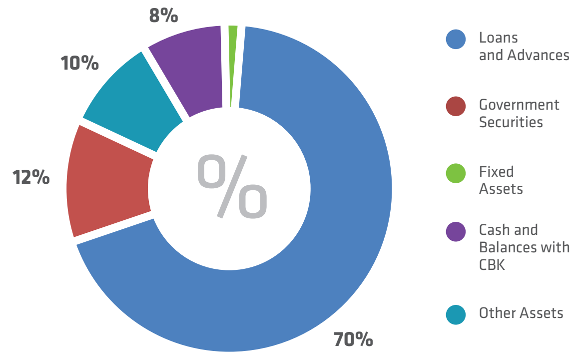



*2015 PBT excludes gains on sale of associate

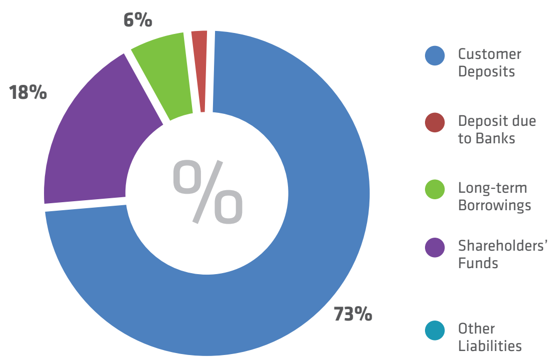
### UTILIZATION OF INCOME - 2018



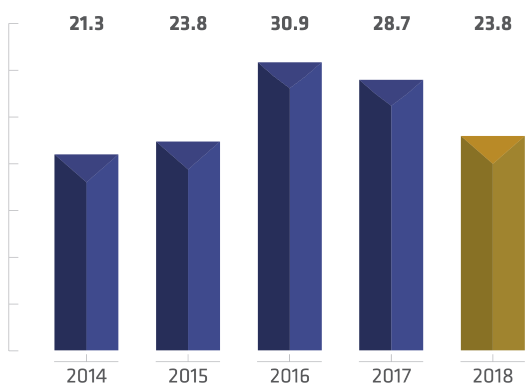

### COMPOSITION OF ASSETS - 2018



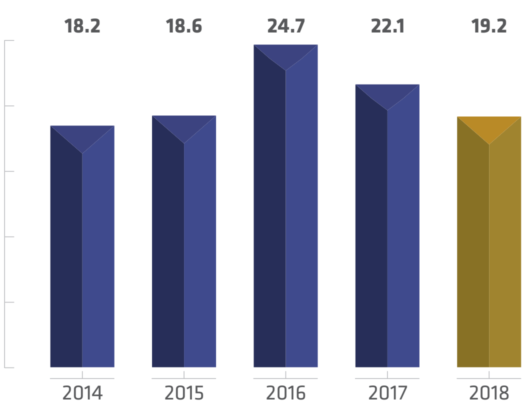

### COMPOSITION OF LIABILITIES - 2018



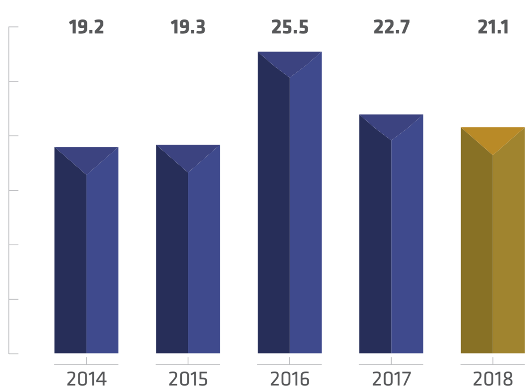

### CORE CAPITAL TO DEPOSITS RATIO (%)




### CORE CAPITAL TO TOTAL RISK WEIGHTED ASSETS (%)




### TOTAL CAPITAL TO TOTAL RISK WEIGHTED ASSETS (%)



# DIRECTOR'S REPORT

The Directors submit their report together with the Audited Financial Statements of Victoria Commercial Bank Limited (the "Bank") for the year ended 31 December 2018.

## PRINCIPAL ACTIVITIES

The principal activities of the Company and the Bank is provision of retail and corporate banking services.

## DIVIDEND

The net profit for the year of Shs 437,004,000 (2017: Shs 617,177,000) has been added to retained earnings. During the year, the Bank paid an interim dividend of Shs 106,071,000 (2017: Shs 146,737,000). The directors do not recommend payment of a final dividend. (2017: Nil)

## BUSINESS REVIEW

The Bank is engaged in the business of banking and the provision of related services and is licensed under the Banking Act.

A detailed performance review is set out on pages 19 to 21.

## DIRECTORS

| | |
|---|---|
| Ketaki Sheth | Chair of the Board |
| Yogesh K Pattni PhD | Chief Executive Officer |
| Kanji D. Pattni | Non- Executive Director |
| Sylvano O. Kola | Non- Executive Director |
| Mukesh S. Shah | Non- Executive Director<br>*(Became Vacant upon his demise on 2 December 2018)* |
| Mahesh P Acharya | Non- Executive Director<br>*(Appointed 15 March 2018)* |

## STATEMENT AS TO DISCLOSURES TO THE BANK'S AUDITOR

With respect to each director at the time this report was approved;

(a) there is, so far as the director is aware, no relevant audit information of which the Bank's auditor is unaware; and
(b) the director has taken all the steps that the director ought to have taken as a director so as to be aware of any relevant audit information and to establish that the Bank's auditor is aware of that information.

## TERMS OF APPOINTMENT OF THE AUDITOR

PricewaterhouseCoopers continue in office in accordance with the Company's Articles of Association and Section 719 of the Kenyan Companies Act, 2018. The directors monitor the effectiveness, objectivity and independence of the auditor. The directors also approve the annual audit engagement contract which sets out the terms of the auditor's appointment and the related fees.

**By order of the Board**

**Company Secretary**

## STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Kenyan Companies Act 2015 requires the directors to prepare financial statements for each financial year which give a true and fair view of the financial position of the Bank as at the end of the financial year and of its profit or loss for the year then ended. The directors are responsible for ensuring that the Bank keeps proper accounting records that are sufficient to show and explain the transactions of the Bank; disclose with reasonable accuracy at any time the financial position of the Bank; and that enables them to prepare financial statements of the Bank that comply with prescribed financial reporting standards and the requirements of the Kenyan Companies Act 2015. They are also responsible for safeguarding the assets of the Bank and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors accept responsibility for the preparation and presentation of these financial statements in accordance with International Financial Reporting Standards and in the manner required by the Kenyan Companies Act 2015. They also accept responsibility for:

i. Designing, implementing and maintaining internal control as they determine necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error;

ii. Selecting suitable accounting policies and then apply them consistently; and

iii. Making judgements and accounting estimates that are reasonable in the circumstances.

Having made an assessment of the Bank's ability to continue as a going concern, the directors are not aware of any material uncertainties related to events or conditions that may cast doubt upon the Bank's ability to continue as a going concern.

The directors acknowledge that the independent audit of the financial statements does not relieve them of their responsibilities.

Approved by the board of directors on 26 February 2019 and signed on its behalf by:

**Ketaki Sheth**
*Chair of the Board*

**Kanji D Pattni**
*Director*

## REPORT OF THE INDEPENDENT AUDITOR TO THE SHAREHOLDERS OF VICTORIA COMMERCIAL BANK LIMITED

**Report on the audit of the financial statements**

*Opinion*

We have audited the accompanying financial statements of Victoria Commercial Bank Limited (the "Bank") set out on pages 28 to 76 which comprise the statement of financial position at 31 December 2018 and the statements of profit or loss, other comprehensive income, changes in equity and cash flows for the year then ended and the notes to the financial statements, which include a summary of significant accounting policies.

In our opinion, the financial statements give a true and fair view of the financial position of Victoria Commercial Bank Limited at 31 December 2018 and of its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act, 2015.

*Basis for opinion*

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Kenya, and we have fulfilled our ethical responsibilities in accordance with these requirements and the IESBA Code.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

*Other information*

The other information comprises the information included in the annual report other than the financial statements and our auditor's report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed on the other information, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

PricewaterhouseCoopers CPA. PwC Tower, Waiyaki Way / Chiromo Road, Westlands
PO Box 43963 - 00100 Nairobi, Kenya
T: +254 (20)285 5000 F: +254 (20)285 285 5001 *www.pwc.com/ke*

Partners: E Kerich B Kimacia M Mugasa A Murage F Muriu P Ngahu R Njoroge S O Norbert's B Okundi K Saiti

*Responsibilities of the directors for the financial statements*

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act, 2015 and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Bank or to cease operations, or have no realistic alternative but to do so.

*Auditor's responsibilities for the audit of the financial statements*

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

**Report on other matters prescribed by the Kenyan Companies Act, 2015**

In our opinion, the information given in the report of the directors on page 22 is consistent with the financial statements.

**Certified Public Accountants**
*Nairobi, 13 March 2019*

**CPA Kang'e Saiti**, Practising Certificate No. 1652
Signing Partner responsible for the independent audit

SECTION TWO

2018

# ANNUAL REPORT

AND FINANCIAL STATEMENTS

# FINANCIAL STATEMENTS

| | Notes | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|---|
| **STATEMENT OF PROFIT AND LOSS** | | | |
| Interest income | 5 | 3,198,776 | 2,711,691 |
| Interest expense | 6 | (1,698,639) | (1,274,363) |
| **Net interest income** | | **1,500,137** | **1,437,328** |
| Credit impairment charge | 14 | (371,204) | (35,321) |
| **Net interest income after credit impairment charge** | | **1,128,933** | **1,402,007** |
| Fee and commission income | | 153,263 | 148,983 |
| Fee and commission expense | | (28,981) | (30,543) |
| Net fee and commission income | | 124,282 | 118,440 |
| Foreign exchange income | | 47,572 | 29,587 |
| Other income | | 35,771 | 44,637 |
| **Non funded income** | | **207,625** | **192,664** |
| **Net operating income** | | **1,336,558** | **1,594,671** |
| Operating expenses | | (785,019) | (758,505) |
| Profit from operations | | 551,539 | 836,166 |
| Share of profit from associates | 9 | 13,556 | 13,033 |
| **Profit before income tax** | | **565,095** | **849,199** |
| Income tax expense | 10 | (128,091) | (232,022) |
| **Profit for the year** | | **437,004** | **617,177** |
| **Earnings per share (Shs per share)** | | | |
| Basic | 11 | 10.42 | 14.72 |
| Diluted | 11 | 10.02 | 14.11 |

| | Notes | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|---|
| **STATEMENT OF OTHER COMPREHENSIVE INCOME** | | | |
| Profit for the year | | 437,004 | 617,177 |
| **Other comprehensive income:** | | | |
| *Items that may be subsequently reclassified to profit or loss* | | | |
| Fair value gain on available for sale investments | 15 | 55,787 | 42,897 |
| Release of revaluation reserve on disposal of fixed income security | | - | (10,700) |
| | | 55,787 | 32,197 |
| Deferred tax on fair valuation of available for sale investments | 18 | (16,736) | (9,659) |
| Other comprehensive income for the year, net of tax | | 39,051 | 22,538 |
| **Total comprehensive income for the year** | | **476,055** | **639,715** |

## STATEMENT OF FINANCIAL POSITION

| | Notes | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and balances with Central Bank of Kenya | 13 | 2,640,188 | 1,748,562 |
| Investment securities: | | | |
| - Fair Value Through OCI | 15 | 2,501,698 | 1,619,958 |
| - At Amortised Cost | 15 | 1,767,275 | 1,429,704 |
| Deposits and balances due from banking institutions | 22 | 1,704,805 | 1,542,152 |
| Loans and advances to customers | 14 | 22,586,671 | 18,870,101 |
| Investment in associate | 9 | 310,620 | 297,064 |
| Property and equipment | 16 | 213,341 | 174,508 |
| Intangible assets | 17 | 33,034 | 26,186 |
| Current income tax | | 14,961 | - |
| Deferred income tax | 18 | 131,502 | 15,435 |
| Other assets | 19 | 432,860 | 261,490 |
| **Total assets** | | **32,336,955** | **25,985,160** |
| **LIABILITIES** | | | |
| Customer deposits | 20 | 23,764,638 | 18,677,388 |
| Deposits and balances due to banking institutions | 21 | 573,987 | 208,812 |
| Long term borrowings | 23 | 1,940,093 | 1,382,370 |
| Other liabilities | 24 | 95,339 | 97,976 |
| Current income tax | | - | 6,721 |
| **Total liabilities** | | **26,374,057** | **20,373,267** |
| **EQUITY** | | | |
| Share capital | 25 | 838,494 | 838,494 |
| Share premium | 25 | 1,321,289 | 1,321,289 |
| Fair value reserve | | 30,815 | (8,236) |
| Revaluation reserve | | 137,000 | 137,000 |
| Regulatory reserve | | - | 120,000 |
| Retained earnings | | 3,635,300 | 3,203,346 |
| **Shareholders' equity** | | **5,962,898** | **5,611,893** |
| **Total equity and liabilities** | | **32,336,955** | **25,985,160** |

The financial statements on pages 28 to 76 were approved for issue by the Board of Directors on 26 February 2019 and signed on its behalf by:

**Ketaki Sheth**
*Chair of the Board*

**Kanji D Pattni**
*Director*

## STATEMENT OF CHANGES IN EQUITY

| | Notes | Share Capital Shs '000 | Share Premium Shs '000 | Fair Value Reserve Shs '000 | Revaluation Reserve Shs '000 | Regulatory Reserve Shs '000 | Retained Earnings Shs '000 | Total Shs '000 |
|---|---|---|---|---|---|---|---|---|
| **Year ended 31 December 2017** | | | | | | | | |
| At 1 January 2017 | | 829,162 | 1,271,743 | (30,774) | 137,000 | 105,000 | 2,747,906 | 5,060,037 |
| Profit for the year | | - | - | - | - | - | 617,177 | 617,177 |
| Other comprehensive income, net of tax | | - | - | 22,538 | - | - | - | 22,538 |
| **Total comprehensive income for the year** | | **-** | **-** | **22,538** | **-** | **-** | **617,177** | **639,715** |
| Transfer to regulatory reserve | 26 | - | - | - | - | 15,000 | (15,000) | - |
| **Transactions with owners** | | | | | | | | |
| Issue of new shares | 25 | 9,332 | 51,330 | - | - | - | - | 60,662 |
| Interim Dividend | 12 | - | - | - | - | - | (146,737) | (146,737) |
| Cost of issuing new shares | | - | (1,784) | - | - | - | - | (1,784) |
| **At 31 December 2017** | | **838,494** | **1,321,289** | **(8,236)** | **137,000** | **120,000** | **3,203,346** | **5,611,893** |
| **Year ended 31 December 2018** | | | | | | | | |
| At 1 January 2018 | | 838,494 | 1,321,289 | (8,236) | 137,000 | 120,000 | 3,203,346 | 5,611,893 |
| Change on initial application of IFRS 9 | 14 | - | - | - | - | - | (18,979) | (18,979) |
| Profit for the year | | - | - | - | - | - | 437,004 | 437,004 |
| Other comprehensive income, net of tax | | - | - | 39,051 | - | - | - | 39,051 |
| **Total comprehensive income for the year** | | **-** | **-** | **39,051** | **-** | **-** | **437,004** | **476,055** |
| Transfer from regulatory reserve | 26 | - | - | - | - | (120,000) | 120,000 | - |
| **Transactions with owners** | | | | | | | | |
| Interim dividend paid | 12 | - | - | - | - | - | (106,071) | (106,071) |
| **At 31 December 2018** | | **838,494** | **1,321,289** | **30,815** | **137,000** | **-** | **3,635,300** | **5,962,898** |

## STATEMENT OF CASH FLOWS

| | Notes | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Interest receipts | | 3,141,091 | 2,683,302 |
| Interest payments | | (1,686,720) | (1,192,199) |
| Net fee and commission receipts | | 124,282 | 135,509 |
| Foreign exchange income receipts | | 47,572 | 29,587 |
| Other Income received | | 28,525 | 7,504 |
| Payments to employees and suppliers | | (726,315) | (715,550) |
| Income tax paid | | (274,441) | (243,813) |
| Cash flows from operating activities before changes in operating assets and liabilities | | 653,994 | 704,340 |
| Changes in operating assets and liabilities: | | | |
| - loans and advances | | (4,038,941) | (3,584,203) |
| - cash reserve requirement | | (213,132) | (179,244) |
| - other assets | | (175,104) | (76,544) |
| - customer deposits | | 5,064,030 | 2,899,277 |
| - other liabilities | | (2,638) | (22,500) |
| **Net cash generated from/ (used in) operating activities** | | **1,288,209** | **(258,874)** |
| **Cash flows from investing activities** | | | |
| Purchase of property and equipment | 16 | (88,043) | (19,167) |
| Purchase of intangible assets | 17 | (16,294) | (8,170) |
| Purchase of investment securities | | (1,175,051) | (102,544) |
| Proceeds from sale of investment securities | | 8,252 | 454,129 |
| Proceeds from sale of property and equipment | | 2,010 | 11,400 |
| Dividend received | | 5,236 | - |
| **Net cash (utilised in)/ generated from investing activities** | | **(1,263,890)** | **335,648** |
| **Cash flows from financing activities** | | | |
| Borrowings during the year | | 922,899 | 71,312 |
| Interim dividend paid | 12 | (106,071) | (146,737) |
| Proceeds from issue of new shares | 25 | - | 60,662 |
| Cost related to issue of new shares | | - | (1,784) |
| **Net cash generated from /(used in) from financing activities** | | **816,828** | **(16,547)** |
| Net increase in cash and cash equivalents | | 841,147 | 60,227 |
| **Cash and cash equivalents at start of year** | | **2,332,396** | **2,272,169** |
| **Cash and cash equivalents at end of year** | 28 | **3,173,543** | **2,332,396** |

**Notes**

**1. General information**

Victoria Commercial Bank Limited (the "Bank") is a company domiciled in Kenya. The registered address of the Bank is:

Mezzanine Floor, Victoria Towers
Kilimanjaro Avenue, Upper Hill
PO Box 41114
00100 Nairobi

**2. Summary of significant accounting policies**

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

**2.1 Basis of preparation**
The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS).

*(a) Basis of measurement*
The measurement basis used is the historical cost basis except where otherwise stated in the accounting policies below.

For those assets and liabilities measured at fair value, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When measuring the fair value of an asset or a liability, the Bank uses market observable data as far as possible. If the fair value of an asset or a liability is not directly observable, it is estimated by the Bank using valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs (e.g. by use of the market comparable approach that reflects recent transaction prices for similar items or discounted cash flow analysis). Inputs used are consistent with the characteristics of the asset / liability that market participants would take into account.

Fair values are categorised into three levels of fair value hierarchy based on the degree to which the inputs to the measurements are observable and the significance of the inputs to the fair value measurement in its entirety:

- Level 1 fair value measurements are derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 fair value measurements are derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Transfers between levels of the fair value hierarchy are recognised by the Bank at the end of the reporting period during which the change occurred.

*(b) Use of estimates*
The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Bank's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in note 3.

*(c) Changes in accounting policies and disclosures*

*(i) New and amended standards adopted by the Bank*

*IFRS 9 - Financial instruments*

The Bank has adopted IFRS 9 as issued by the IASB in July 2014 with a date of transition of 1 January 2018, which resulted in changes in accounting policies and adjustments to the amounts previously recognised in the financial statements. The Bank did not early adopt any of IFRS 9 in previous periods.

As permitted by the transitional provisions of IFRS 9, the Bank elected not to restate comparative figures. Any adjustments to the carrying amounts of financial assets and financial liabilities at the date of transition were recognised in the opening retained earnings and other reserves of the current period.

Consequently, for notes disclosures, the consequential amendments to IFRS 7 disclosures have also only been applied to the current period. The comparative period notes disclosures repeat those disclosures made in the year.

The adoption of IFRS 9 has resulted in changes in our accounting policies for recognition, classification and measurement of financial assets and financial liabilities and impairment of financial assets. IFRS 9 also significantly amends other standards dealing with financial instruments as IFRS 7 'Financial Instruments: Disclosures'.

Set out below are disclosures relating to the impact of the adoption of IFRS 9 on the Bank. Further details of the specific IFRS 9 accounting policies applied in the current period (as well as the previous IAS 39 accounting policies applied in the comparative period) are described in more detail in note 2.4

**i) Classification and measurement of financial instruments**

The following table shows the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Bank's financial assets as at 1 January 2018.

| | Original Classification under IAS 39 | New Classification under IFRS 9 | Original Carrying amount under IAS 39 Shs'000 | New Carrying Amount Under IFRS 9 Shs'000 |
|---|---|---|---|---|
| **FINANCIAL ASSETS** | | | | |
| **ASSETS** | | | | |
| Cash and balances due to financial institutions | Loans and receivables | Amortised cost | 3,290,714 | 3,290,687 |
| Investment securities: | | | | |
| - Investment securities held at fair value through OCI | AFS | FVOCI | 1,619,958 | 1,617,882 |
| - Investment securities held to maturity (amortised cost) | HTM | Amortised cost | 1,429,704 | 1,428,288 |
| Loans and advances to customers | Loans and receivables | Amortised cost | 18,870,101 | 18,846,507 |
| Other assets (financial) | Loans and receivables | Amortised cost | 297,064 | 297,064 |
| **Total Financial Assets** | | | **25,507,541** | **25,480,428** |

**ii) Reconciliation of statement of financial position balances from IAS 39 to IFRS 9**

The Bank performed a detailed analysis of its business models and managing financial assets as well as their cash flow characteristics. The following table reconciles the carrying amount of financial assets from their previous measurement category in accordance with IAS 39 to their new measurement categories upon transition to IFRS 9 on 1 January 2018.

| | IAS 39 carrying amount 31 December 2017 | Reclassifications | Remeasurements | IFRS 9 carrying amount 1 January 2018 |
|---|---|---|---|---|
| | Shs'000 | Shs'000 | Shs'000 | Shs'000 |
| **FINANCIAL ASSETS** | | | | |
| **Amortised cost:** | | | | |
| Cash and balances with CBK | 1,748,562 | - | (15) | 1,748,547 |
| Amounts due from banking institutions | 1,542,152 | - | (12) | 1,542,140 |
| Loans and advances to customers | 18,870,101 | - | (23,594) | 18,846,507 |
| Investment securities | 1,429,704 | - | (1,416) | 1,428,288 |
| Other assets | 297,064 | - | - | 297,064 |
| **Total financial assets measured at amortised cost** | **23,887,583** | **-** | **(25,037)** | **23,862,546** |
| **Fair value through other comprehensive income (FVOCI)** | | | | |
| Available for sale financial assets | 1,619,958 | - | (2,076) | 1,617,882 |
| **Total financial assets measured at FVOCI** | **1,619,958** | **-** | **(2,076)** | **1,617,882** |
| **Total financial assets** | **25,507,541** | **-** | **(27,113)** | **25,480,428** |

The total re-measurement loss for the Bank as at 1 January 2018 was Shs 18,979,310 (net of deferred income tax) and was recognised in opening retained earnings at 1 January 2018.

**iii) Reconciliation of impairment allowance balances from IAS 39 to IFRS 9**

The following table reconciles the prior year's closing impairment allowance measured in accordance with the IAS 39 incurred loss model to the new impairment allowance measured in accordance with the IFRS 9 expected loss model at 1 January 2018.

| | Credit Loss allowance under IAS 39 | Reclassifications | Remeasurements | Credit loss allowance under IFRS 9 |
|---|---|---|---|---|
| | Shs'000 | Shs'000 | Shs'000 | Shs'000 |
| **FINANCIAL ASSETS** | | | | |
| **Amortised cost:** | | | | |
| Cash and balances with CBK | - | - | (15) | (15) |
| Amounts due from banking institutions | - | - | (12) | (12) |
| Loans and advances to customers | (92,527) | - | (16,113) | (108,640) |
| Loan commitments and financial guarantee contracts | - | - | (7,481) | (7,481) |
| Investment securities | - | - | (1,416) | (1,416) |
| **Total financial assets measured at amortised cost** | **(92,527)** | **-** | **(25,037)** | **(117,564)** |
| **Fair value through other comprehensive income (FVOCI)** | | | | |
| Available for sale financial assets | - | - | (2,076) | (2,076) |
| **Total financial assets measured at FVOCI** | **-** | **-** | **(2,076)** | **(2,076)** |
| **Total financial assets** | **(92,527)** | **-** | **(27,113)** | **(119,640)** |

*IFRS 15 Revenue form contracts with customers*

This standard became effective on 1 January 2018 and replaced the existing revenue standards and their related interpretations. The standard set out the requirements for recognising revenue that applies to all contracts with customers (except for contracts that are within the scope of the standards on leases, insurance contracts or financial instruments). The core principle of the standard is that revenue recognised reflects the consideration to which the company expects to be entitled in exchange for the transfer of promised goods or services to the customer. The standard incorporates a five step analysis to determine the amount and timing of revenue recognition. The standard however does not apply to revenue associated with financial instruments, and therefore does not impact the majority of the Bank's revenue streams. The Bank identified and reviewed the contracts with customers that are within the scope of this standard and concluded that the adoption of IFRS 15 did not materially impact the Bank's revenue recognition models and there were no material transition adjustments required.

*ii) New and revised standards and interpretations that have been issued but are not yet effective*

The Bank has not applied any new or revised standards and interpretations that have been published but are not yet effective for the year beginning 1 January 2018. The Bank's assessment of the impact of these new standards and interpretations is as follows:

*IFRS 16 Leases*

The new standard, effective for annual periods beginning on or after 1st January 2019, introduces a new lessee accounting model, and will require a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee will be required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

Application of IFRS 16 in 2019 will require right-of-use assets and lease liabilities to be recognised in respect of most operating leases where the Company is the lessee. The total undiscounted value of unexpired leases at 31 December 2018 was Shs 53,414,705. Based on the Directors' preliminary assessment, right of use assets of Shs 40,990,341 and lease liabilities of Shs 40,990,341 will be recognised at 1 January 2019.

**2.2 Foreign currency translation**

*(a) Functional and presentation currency*

Items included in the financial statements are measured using the currency of the primary economic environment in which the entity operates ('the Functional Currency'). The financial statements are presented in Kenya shillings, which is the Bank's presentation currency.

*(b) Transactions and balances*

Foreign currency transactions are translated into the Functional Currency using the exchange rates prevailing at the dates of the transactions or valuation where items are re-measured.

Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except for differences arising on translation of non-monetary financial assets carried at fair value through other comprehensive income, which are recognised in other comprehensive income.

Foreign exchange gains and losses that relate to borrowings and cash and cash equivalents are presented in the income statement within "finance income or costs". All other foreign exchange gains and losses are presented in the statement of profit or loss for the year within "other gains/losses-net".

Translation differences on non-monetary financial assets and liabilities such as equities held at fair value through profit or loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets, such as equities classified as available for sale, are included in other comprehensive income.

**2.3 Financial instruments**

**2.3.1 Financial assets and liabilities**

**Measurement methods**

*Amortised cost and effective interest rate*

The amortised cost is the amount at which the financial asset of financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and, for financial assets, adjusted for any loss allowances.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset (i.e. its amortised cost before any impairment allowance) or to the amortised cost of a financial liability. The calculation does not consider expected credit losses and includes transaction costs, premiums or discounts and fees paid or received that are integral to the effective interest rate, such as origination fees. For purchased or originated credit-impaired financial assets – assets that are credit-impaired at initial recognition, the Bank calculates the credit adjusted effective interest rate, which is calculated based on the amortised cost of the financial asset instead of its gross carrying amount and incorporates the impact of expected credit losses in estimated future cash flows.

When the Bank revises the estimates of future cash flows, the carrying amount of the respective financial asset or financial liability is adjusted to reflect the new estimate discounted using the original effective interest rate. Any changes are recognised in the profit or loss account.

*Interest income*
Interest income and interest expense on interest bearing financial instruments is calculated by applying the effective interest rate to the gross carrying amount, except for:

a) Purchased or originated credit impaired (POCI) financial assets, for which the original credit-adjusted effective interest rate is applied to the amortised cost of the financial asset; and

b) Financial assets that are not "POCI" but have subsequently become credit-impaired, for which interest revenue is calculated by applying the effective interest rate to their amortised cost (i.e.net of the expected credit loss provision) in subsequent reporting periods.

*Initial recognition and measurement*
Financial assets and financial liabilities are recognised when the entity becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognised on trade-date, the date which the Bank commits to purchase or sell the asset. At initial recognition, the Bank measures a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through the profit or loss, transaction costs that are incremental and directly attributable to the acquisition or issue of the financial asset or financial liability, such fees and commissions. Transaction costs of financial assets and financial liabilities are carried at fair value through profit or loss are expensed in profit or loss. Immediately after the initial recognition, an expected credit loss allowance (ECL) is recognised for the financial assets measured at amortised cost and investments in debt instruments measured at FVOCI, which results in an accounting loss being recognised in profit or loss when an asset is newly originated.

When the fair value of financial assets and liabilities differs from the transaction price on initial recognition, the entity recognises the difference as follows:

a) When the fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. Level 1 input) or based on a valuation technique that uses only data from observable markets, the difference is recognised as a gain or loss.

b) In all other cases, the difference is deferred and the timing of recognition of deferred day one profit or loss is determined individually. It is either amortised over the life of the instrument, deferred until the instrument's fair value can be determined using market observable inputs, or realised through settlement.

**Financial assets**

*i) Classification and subsequent measurement*
From January 2018, the Bank has applied IFRS 9 and classifies its financial assets in the following measurement categories:

- Fair value through profit or loss (FVPL)
- Fair value through other comprehensive income (FVOCI)
- Amortised cost

*Debt instruments*
Debt instruments are those instruments that meet the definition of a financial liability from the issuer's perspective, such as loans, government and corporate bonds and trade receivables purchased from clients in factoring arrangements without recourse. Classification and subsequent measurement of debt instruments depend on:

i) the Bank's business model for managing the asset and the cash flow characteristics of the asset;

Based on these factors, the Bank classifies its debt instruments into one of the following three measurement categories:

- Amortised cost: assets that are held for collection of contractual cash flows where those cash flows represent solely payments of principal and interest (SPPI), and that are not designated at FVPL, are measured at amortised cost. The carrying amount of these assets are adjusted by any expected credit loss allowance. Interest income from financial assets is included in "interest and similar income" using the effective interest rate method.

- Fair value through other comprehensive income (FVOCI): Financial assets that are held for collection of contractual cash flows and for selling the assets, where the assets' cash flows represent solely payments of principal and interest, and that are not designated at FVPL, are measured through other comprehensive income (FVOCI). Movements in the carrying amount are taken through OCI, except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses on instrument's amortised cost which are recognised in profit or loss. When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss and recognised in "Net investment income" using the effective interest rate method.

- Fair value through the profit or loss: Assets that do not meet the criteria for amortised cost or FVOCI are measured at fair value through profit or loss. A gain or loss on a debt investment that is subsequently measured at fair value through profit or loss and is not part of a hedging relationship is recognised in profit or loss and presented within "Net trading income" in the period in which it arises, unless it arises from debt instruments that were designated at fair value or which are not held for trading, in which case they are presented separately in "Net investment income".

*Business model:* The business model reflects how the Bank manages the assets in order to generate cash flows. That is, whether the Bank's objective is solely to collect the contractual cash flows from the assets or is to collect both the contractual cash flows and cash flows arising from sale of assets. If neither of these is applicable (e.g. financial assets are held for trading purposes), then the financial assets are classified as part of "other" business model and measured at FVPL. Factors considered by the Bank in determining the business model for a Bank of assets include past experience on how cash flows for these assets were collected, how the asset's performance is evaluated and reported by key management personnel, how risks are assessed and managed and how managers are compensated. For example, the liquidity portfolio of assets is held by the Bank as part of liquidity management and is generally classified with the hold to collect and sell business model. Securities held for trading are held principally for the purpose of selling in the near term or are part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. These securities are classified in the "other" business model and measured at FVPL .

*SPPI:* Where the business model is to hold assets to collect contractual cash flows or to collect contractual cash flows and sell, the Bank assesses whether the financial instruments' cash flows represents solely payments of principal and interest (the "SPPI test"). In making this assessment, the Bank considers whether the contractual cash flows are consistent with a basic lending arrangement i.e. interest includes only consideration for the time value of money, credit risk and a profit margin that is consistent with a basic lending arrangement. Where the contractual terms introduce exposure to risk or volatility that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

Financial assets with embedded derivatives are considered in their entirety when determining whether their cash flows are solely payment of principal and interest.

The Bank reclassifies debt investments when and only when its business model for managing those assets changes. The reclassification takes place from the start of the first reporting period following the change. The changes are expected to be very infrequent and none occurred during the year.

*ii) Impairment*

The Bank assesses on a forward-looking basis the expected credit losses ("ECL") associated with its debt instrument assets carried at amortised cost and FVOCI and with the exposure arising from loan commitments and financial guarantee contracts. The Bank recognises a loss allowance for such losses at each reporting date. The measurement of ECL reflects:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money; and
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

*iii) Modification of loans*

The Bank sometimes renegotiates or otherwise modifies the contractual cash flows of loans to customers. When this happens, the Bank assesses whether or not the new terms are substantially different to the original terms. The Bank does this by considering, among others, the following factors:

- If the borrower is in financial difficulty, whether the modification merely reduces the contractual cash flows to amounts the borrower is expected to be able to pay.
- Whether any substantial new terms are introduced, such as a profit share/equity based return that substantially affects the risk profile of the loan.
- Significant extension of the loan term when the borrower is not in financial difficulty.
- Significant change is interest rate
- Change in the currency of the loan
- Insertion of collateral, other security or credit enhancement that significantly affect the credit risk associated with the loan.

If the terms are substantially different, the Bank derecognises the original financial asset and recognises a "new" asset at fair value and recalculates a new effective interest rate for the asset. The date of renegotiation is consequently considered to be the date of initial recognition for impairment calculation purposes including for the purpose of determining whether a significant credit risk has occurred.

However, the Bank also assesses whether the new financial asset recognised is deemed to be credit impaired at initial recognition, especially in circumstances where the renegotiation was driven by the debtor being unable to make the originally agreed payments. Differences in the carrying amount are also recognised in profit or loss as a gain or loss on derecognition.

If the terms are not substantially different, the renegotiation or modification does not result in derecognition, and the Bank recalculates the gross carrying amount based on the revised cash flows of the financial asset and recognises a modification gain or loss in profit or loss. The new gross carrying amount is recalculated by discounting the modified cash flows at the original effective interest rate of credit-adjusted effective interest rate for POCI financial assets.

*iv) Derecognition other than on a modification*

Financial assets, or a portion thereof, are derecognised when the contractual rights to receive the cash flows from the assets have expired, or when they have been transferred and either (i) the Bank transfers substantially all the risks and rewards of ownership, or (ii) the Bank neither transfers nor retains substantially all the risks and rewards of ownership and the Bank has not retained control.

The Bank enters into transactions where it retains the contractual rights to receive cash flows from assets but assumes a contractual obligation to pay those cash flows to other entities and transfers substantially all of the risks and rewards. These transactions are accounted for as "pass through" transfers that result in derecognition of the Bank:

(i) Has no obligation to make payments unless it collects equivalent amounts from the assets
(ii) Is prohibited from selling or pledging the assets; and
(iii) Has an obligation to remit any cash it collects from assets without material delays

Collateral (shares and bonds) furnished by the Bank under standard repurchase agreements and securities lending and borrowings transactions are not derecognised because the Bank retains substantially all the risks and rewards on the basis of predetermined repurchase price, and the criteria for derecognition are therefore not met. This also applies to certain securitisation transactions in which the Bank retains a subordinated residual interest.

**Financial liabilities**

*i) Classification and subsequent measurement*

In both the current period and prior period, financial liabilities are classified as subsequently measured at amortised cost, except for:

- Financial liabilities at fair value through profit or loss such as derivatives, financial liabilities held for trading (e.g. short positions in the trading booking) and other financial liabilities designated as such at initial recognition. Gains or losses on financial liabilities designated at fair value through profit or loss are presented partially in other comprehensive income (the amount of change in the fair values of the financial liability that is attributable to changes in the credit risk of that liability) and partially profit or loss (the remaining amount of change in the fair value of the liability);

- Financial liabilities arising from the transfer of financial assets which did not qualify for derecognition, whereby a financial liability is recognised for the consideration received for the transfer. In subsequent periods, the Bank recognises any expense incurred on the financial liability; and

- Financial guarantee contracts and loan commitments

Financial liabilities are derecognised when they are extinguished (i.e. when the obligation specified in the contract is discharged, cancelled or expires).

The exchange between the Bank and its original lenders of debt instruments with substantially different terms, as well as substantial modification of the terms of the existing financial liabilities, are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. In addition, other qualitative factors, such as the currency that the instrument is denominated in, changes in the type of interest rate, new conversion features attached to the instrument and change in covenants are also taken into consideration.

If the exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange of modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

**Offsetting financial assets and financial liabilities**

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

### 2.4 Cash and cash equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short term highly liquid investments with original maturities of three months or less. Funds restricted for a period of more than three months on origination and cash reserve deposits with the Central Bank of Kenya are excluded from cash and cash equivalents. Cash and cash equivalents are carried at amortised cost.

### 2.5 Intangible assets - software

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised over their estimated useful lives of 5 years.

Costs associated with maintaining computer software programmes are recognised as an expense as incurred.

### 2.6 Property and equipment

Property and equipment are stated at historical cost less depreciation.

Depreciation is calculated on the straight line basis to allocate their cost less their residual values over their estimated useful lives, as follows:

| | |
|---|---|
| • Office premises | 50 years |
| • Office improvements | 8 years |
| • Furniture, fittings and equipment | 8 years |
| • Motor vehicles | 4 years |
| • Computer equipment | 3-4 years |

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. The Bank assesses at each reporting date whether there is any indication that any item of property and equipment is impaired. If any such indication exists, the Bank estimates the recoverable amount of the relevant assets. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are Banked at the lowest levels for which there are separately identifiable cash flows (cash-generating units).

Gains and losses on disposal of property and equipment are determined by reference to their carrying amount and are taken into account in determining profit.

**2.7 Impairment of non – financial assets**

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). The impairment test also can be performed on a single asset when the fair value less cost to sell or the value in use can be determined reliably. Non-financial assets that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

**2.8 Employee benefits**

*(a) Retirement benefit obligations*

The Bank operates a defined contribution scheme for its employees. A defined contribution plan is a retirement benefit plan under which the Bank pays fixed contributions into a separate entity. The Bank has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods. The assets of the scheme are held in separate trustee administered fund, which is funded from contributions from both the Bank and employees.

The Bank also contributes to the statutory National Social Security Fund. This is a defined contribution pension scheme registered under the National Social Security Act. The Bank's obligations under the scheme are limited to specific obligations legislated from time to time and are currently limited to a maximum of Shs 200 per month per employee. The Bank contributions in respect of retirement benefit schemes are charged to profit or loss in the year to which they relate.

**2.9 Income tax expense**

The tax expense for the period comprises current and deferred income tax. Tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity. In this case, the tax is also recognised in other comprehensive income or directly in equity respectively.

*(a) Current income tax*

Current income tax is the amount of income tax payable on the taxable profit for the year determined in accordance with the Kenyan Income Tax Act.

*(b) Deferred income tax*

Deferred income tax is recognised, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. However, deferred tax liabilities are not recognised if they arise from the initial recognition of goodwill; deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the reporting date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current income tax assets against current income tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the same entity or different taxable entities where there is an intention to settle the balances on a net basis.

**2.10 Leases**

Leases are divided into finance leases and operating leases.

*i) Operating lease*

Leases in which a significant portion of the risks and rewards of ownership are retained by another party, the lessor, are classified as operating leases. Payments, including pre-payments, made under operating leases (net of any incentives received from the lessor) are charged to profit or loss on a straight-line basis over the period of the lease.

The total payments made under operating leases are charged to 'other operating expenses' on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

*ii) Finance lease*

Leases of assets where the Bank has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalised at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments.

Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in deposits from banks or deposits from customers depending on the counter party. The interest element of the finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

The leases entered into by the Bank are primarily operating leases.

**2.11 Dividend payable**

Dividends on ordinary shares are charged to equity in the period in which they are declared.

**2.12 Share capital**

Ordinary shares are classified as 'share capital' in equity. Any premium received over and above the par value of the shares is classified as 'share premium' in equity.

**2.13 Interest income and expense**

Interest income and expense for all interest-bearing financial instruments, except for those classified as held for trading or designated at fair value through profit or loss, are recognised within 'interest income' or 'interest expense' in the income statement account using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest that was used to discount the future cash flows for the purpose of measuring the impairment loss.

**2.14 Fee and commission income**

Fees and commissions are generally recognised on an accrual basis when the service has been provided. Loan commitment fees for advances are credited to income upon first utilisation of the facility and are charged on an annual basis.

**2.15 Dividend income**

Dividends are recognised in profit or loss when the Bank's right to receive payment is established.

**2.16 Acceptances and letters of credit**

Acceptances and letters of credit are accounted for as off-balance sheet transactions and disclosed as contingent liabilities.

**2.17 Investment in associates**

The investment in the associates is accounted for using the equity method. It is initially recorded at cost and the carrying amount is increased or decreased to recognise the Bank's share of the profits or losses of the investee after the acquisition date. Distributions received from the investee reduce the carrying amount of the investment.

On disposal of the investment, the difference between the net disposal proceeds and the carrying amount is charged or credited to the profit or loss.

**2.18 Derivative financial instruments**

Derivatives, which comprise solely forward foreign exchange contracts, are initially recognised at fair value on the date the derivative contract is entered into and are subsequently measured at fair value. The fair value is determined using forward exchange market rates at the balance sheet date or appropriate pricing models. The derivatives do not qualify for hedge accounting. Changes in the fair value of derivatives are recognised immediately in the statement of profit or loss.

**3. Critical accounting estimates and judgements in applying accounting policies**

The preparation of financial statements requires the use of accounting estimates which, by definition, will seldom equal the actual results. The directors also need to exercise judgment in applying the Bank's accounting policies.

All estimates and assumptions required in conformity with IFRS are best estimates undertaken in accordance with the applicable standard. Estimates and judgements are evaluated on a continuous basis, and are based on past experience and other factors, including expectations with regard to future events.

This note provides an overview of the areas that involve a higher degree of judgment or complexity, and major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment within the next financial year. Detailed information about each of these estimates and judgements is included in the related notes together with information about the basis of calculation for each affected line item in the financial statements.

**Measurement of expected credit losses**

The measurement of the expected credit loss allowance for financial assets measured at amortised cost and FVOCI is an area that requires the use of complex models and significant assumptions about future economic conditions and credit behaviour (e.g. the likelihood of customers defaulting and the resulting losses).

A number of significant judgements are also required in applying the accounting requirement
for measuring ECL, such as:

- Determining criteria for significant increase in credit risk;
- Choosing the appropriate models and assumptions for the measurement of ECL;
- Establishing the number and relative weightings of forward-looking scenarios for each type of product/market and the associated ECL;
- Establishing groups of similar financial assets for the purposes of measuring ECL;
- Determining the relevant period of exposure to credit risk when measuring ECL for credit cards and revolving credit facilities; and
- Determining the appropriate business models and assessing the "solely payments of principal and interest (SPPI)" requirements for financial assets.

**4. Financial risk management**

The Bank's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk, cash flow interest rate risk and price risk), credit risk and liquidity risk. Those activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. Taking risk is core to the Bank's business, and the financial risks are an inevitable consequence of being in business. The Bank's aim is therefore to achieve an appropriate balance between risk and return and minimise potential adverse effects on its financial performance.

Risk management is carried out by the Risk and Compliance unit under policies approved by the Board Risk Management Committee (BRMC). Assets and Liability Committee (ALCO) identifies, evaluates and hedges financial risks in close cooperation with the operating units. The Board provides written principles for overall risk management, as well as written policies covering specific areas such as foreign exchange risk, interest rate risk, credit risk, use of derivative and non-derivative financial instruments.

**4.1 Credit risk**

The Bank takes on exposure to credit risk, which is the risk that a counterparty will cause a financial loss to the Bank by failing to pay amounts in full when due. Credit risk is the most important risk for the Bank's business: management therefore carefully manages the exposure to credit risk. Credit exposures arise principally in lending and investment activities. There is also credit risk in off-balance sheet financial instruments, such as loan commitments. Credit risk management and control is centralised in the Credit Risk Management Committee, which reports regularly to the Board Credit Committee (BCC).

The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to industry segments. Such risks are monitored on a revolving basis and are subject to annual or more frequent review. Limits on the level of credit risk by industry sector are approved regularly by the BCC.

The exposure to any one borrower including banks is further restricted by sub-limits covering on- and off-balance sheet exposures and daily delivery risk limits in relation to trading items such as forward foreign exchange contracts. Actual exposures against limits are monitored daily.

Exposure to credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations and by changing lending limits where appropriate. Exposure to credit risk is also managed in part by obtaining collateral equal or above the loan advanced.

**Loans and advances (including loan commitments and guarantees)**

The estimation of credit exposure is complex and requires the use of models, as the value of a product varies with changes in market variables, expected cash flows and the passage of time. The assessment of credit risk of a portfolio of assets entails further estimations as to the likelihood of defaults occurring, of the associated loss ratios and of default correlations between counterparties.

The Bank has developed models to support the quantification of the credit risk. These rating and scoring models are in use for all key credit portfolios and form the basis for measuring default risks. In measuring credit risk of loans and advances at a counterparty level, the Bank considers three components: (i) the 'Probability of Default' (PD) by the client or counterparty on its contractual obligations; (ii) current exposures to the counterparty and its likely future development, from which the Bank derive the 'Exposure at Default' (EAD); and (iii) the likely recovery ratio on the defaulted obligations (the 'Loss Given Default') (LGD). The models are reviewed regularly to monitor their robustness relative to actual performance and amended as necessary to optimise their effectiveness.

**4.1.1 Credit risk measurement**

The estimation of credit exposure is complex and requires the use of models, as the value of a product varies with changes in market variables, expected cash flows and the passage of time. The assessment of credit risk of a portfolio of assets entails further estimations as to the likelihood of defaults occurring, of the associated loss ratios and of default correlations between counterparties.

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(EAD); and (iii) the likely recovery ratio on the defaulted obligations (the 'Loss Given Default') (LGD). The models are reviewed regularly to monitor their robustness relative to actual performance and amended as necessary to optimise their effectiveness.

**Credit risk grading**

The Bank has developed an internal credit risk grading system that reflect its assessment of the probability of defaults of individual counterparties. The Bank uses internal rating models tailored to the various categories of counterparty. Borrower and loan specific information collected at the time of application (such as disposable income, the level of collateral for retail exposures, and turnover and industry type for wholesale exposures) is fed into this rating model. This is supplemented with external data such as credit bureau scoring information on individual borrowers. In addition, the models enable expert judgment from the Credit Risk Officer to be fed into the final internal credit rating for each exposure. This allows for the considerations which may not be captured as part of the other data input into the model.

The following are additional considerations for each type of portfolio held by the Bank:

*Retail*
After the date of initial recognition, for retail business, the payment behaviour of the borrower is monitored on a periodic basis to develop a behavioural score. Any other know information about the borrower, which impacts their creditworthiness – such as unemployment and previous delinquency history – is also incorporated into the behavioural score. This score is mapped to a PD.

*Corporate*
For wholesale business, the rating is determined at the borrower level. A relationship manager will incorporate any updated or new information/credit assessments into the credit system on an ongoing basis. In addition, the relationship manager will also update information about the creditworthiness of the borrower every year from sources such as public financial statements. This will determine the updated internal credit rating and PD.

For debt securities in the treasury portfolio, external rating agency credit grades are used. These published grades are continuously monitored and updated. The PDs associated with each grade are determined based on realised default rates over the prior 12 months, as published by the rating agency.

Treasury
For debt securities in the treasury portfolio, external rating agency credit grades are used. These published grades are continuously monitored and updated. The PDs associated with each grade are determined based on realised default rates over the prior 12 months, as published by the rating agency.

**4.1.2 Expected credit loss measurement**

IFRS 9 outlines a "three-stage" model for impairment based on changes in credit quality since initial recognition as summarised below:

- A financial instrument that is not credit impaired at initial recognition is classified in "Stage 1" and has its credit risk continuously monitored by the Bank.
- If a significant increase in credit risk ("SICR" since initial recognition is identified, the financial instrument is moved to "Stage 2" but is not yet deemed to be credit impaired.
- If the financial instrument is credit-impaired, the financial instrument is then moved to "Stage 3.
- Financial instruments in Stage 1 have their ECL measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Instruments in Stage 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis.

- A pervasive concept in measuring ECL in accordance with IFRS 9 is that it should consider forward- looking information.
- Purchased or originated credit-impaired financial assets are those financial assets that are credit-impaired on initial recognition. Their ECL is always measured on a lifetime basis (Stage 3)

The key judgements and assumptions adopted by the Bank in addressing the requirements of the Standard are as follows:

**4.1.2.1 Significant increase in credit risk**

The Bank considers a financial instrument to have experienced a significant increase in credit risk when one or more of the following quantitative, qualitative or backstop criteria have been met:

Quantitative criteria

The standard also sets out a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. The Bank has adopted the default standard definition of 30 days past due to determine the significant increase in credit risk.

*Qualitative criteria*

The Bank considers a significant increase in credit risk in their portfolio if the borrower is on the watch list and/or the instrument meets one or more of the following criteria:

- Significant increase in credit spread
- Significant adverse changes in business, financial and/or economic conditions in which the borrower operates
- Actual or expected forbearance or restructuring
- Actual or expected significant adverse change in operating results of the borrower
- Significant change in collateral value (secured facilities only) which is expected to increase risk of default
- Early signs of cash flows/liquidity problems such as delay in servicing of trade creditors/loans.

The assessment of SICR incorporates forward-looking information and is performed at the counterparty level and on a periodic basis. The criteria used to identify SICR are monitored and reviewed periodically for appropriateness by the independent credit team.

**4.1.2.2 Definition of default and credit-impaired assets**

The Bank defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets one or more of the following criteria:

*Qualitative criteria*

The borrower meets unlikeliness to pay criteria, which indicates the borrower is in significant financial difficulty. These are instances where:

- The borrower is in long-term forbearance
- The borrower is deceased
- The borrower is insolvent or becoming probable that the borrower will enter bankruptcy
- The borrower is in breach of financial covenants
- An active market for that financial asset has disappeared because of financial difficulties
- Concessions have been made by the lender relating to the borrower’s financial difficulty
- Financial assets are purchased or originated at a deep discount that reflects the incurred credit losses

The above criteria have been applied to all financial instruments held by the Bank and are consistent with the definition of default used for internal credit risk management purposes. The default definition has been applied consistently to model the Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD) throughout the Group’s expected loss calculations.

An instrument is considered to no longer be in default (i.e. to have cured) when it no longer meets any of the default criteria for a consecutive period of six months. This period of six months has been determined based on an analysis which considers the likelihood of a financial instrument returning to default status after cure using different possible cure definitions.

The expected credit loss (ECL) is measured on either a 12-month (12M) or Lifetime basis depending on whether a significant increase in credit risk has occurred since initial recognition or whether an asset is considered to be credit impaired. Expected credit losses are the discounted product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows:

- The PD represents the likelihood of a borrower defaulting on its financial obligation, either over the next 12 months (12M PD), or over the remaining lifetime (Lifetime

PD) of the obligation.

- EAD is based on the amounts the Bank expects to be owed at the time of default, over the next 12 months (12M EAD) or over the remaining lifetime (Lifetime EAD).

LGD represents the Bank's expectations of the extent of loss on a defaulted exposure. LGD varies by type of counterparty, type of seniority of claim and availability of collateral or other credit support. LGD is calculated on a 12-month or lifetime basis, where 12 month LGD is the percentage of loss expected to be made if the default occurs over the next 12 months and lifetime LGD is the percentage of loss expected to be made if the default occurs over the remaining expected lifetime of the loan.

**4.1.2.3 Measuring expected credit loss – inputs, assumptions and estimation techniques**

Forward-looking economic information is also included in determining the 12-month and lifetime PD, EAD and LGD. These assumptions vary by product type.

**4.1.2.4 Forward-looking information incorporated in the ECL models**

The assessment of SICR and the calculation of ECL both incorporate forward-looking information. The Bank has performed historical analysis and identified the key economic variables impacting credit risk and expected credit losses for each portfolio. These economic variables and their associated impact on PD, EAD and LGD vary by financial instrument.

The most significant period-end assumptions used for the ECL estimate as at 31 December 2018 are as follows:

**Macro-Economic Variable**

| | | Weighting | | |
|---|---|---|---|---|
| | | Base | Upside | Downside |
| | Coeficient | 90% | 5% | 5% |
| Deposit Rate | (0.2098) | 8% | 9.29% | 6.72% |
| Savings Rates | 0.0808 | 5.75% | 8.00% | 3.50% |
| GDP Ratio | 0.4095 | 5.77% | 6.43% | 5.12% |
| Housing Price Index | (0.2969) | 0.13% | 0.98% | 0.72% |
| Constant | (0.0038) | - | - | - |

Other forward-looking considerations not otherwise incorporated within the above scenarios, such as the impact of any regulatory, legislative or political changes, have been considered, but are not deemed to have a material impact on therefore no adjustment has been made to the ECL for such factors. This is reviewed and monitored for appropriateness on a quarterly basis.

**Sensitivity analysis**

Set out below are the changes to the ECL at 31 December 2018 that would result from reasonably possible changes in the Bank's macro economic overlays and the probability weightings from actual assumptions used in the Bank's economic variable assumptions.

The impact of a 5% increase/decrease in macro-economic overlays will lead to the following change in expected credit loss;

| | Base | Upside | Downside |
|---|---|---|---|
| | Shs '000 | Shs '000 | Shs '000 |
| 5% Change | 2,237 | 5,597 | -1,123 |

**4.1.3 Credit risk exposure**

| Maximum exposure to credit risk before collateral held | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Balances with Central Bank of Kenya (Note 13) | 2,528,443 | 1,660,897 |
| Deposits and balances due from banking institutions (Note 22 | 1,704,805 | 1,542,151 |
| Loans and advances to customers (Note 14) | 22,586,671 | 18,870,101 |
| Government and other securities held to maturity (Note 15) | 1,767,275 | 1,429,704 |
| Available for sale investment securities (Note 15) | 2,501,698 | 1,619,958 |
| Other assets | 260,791 | 225,435 |
| Credit risk exposures relating to off-balance sheet items: | | |
| - Acceptances and letters of credit | 2,246,636 | 2,060,767 |
| - Guarantee and performance bonds | 983,292 | 697,218 |
| - Commitments to lend | 3,477,194 | 2,681,861 |
| | **38,056,805** | **30,788,092** |

The above table represents a worst case scenario of credit risk exposure to the Bank at 31 December 2018 and 2017, without taking account of any collateral held or other credit enhancements attached. For on-balance sheet assets, the exposures set out above are based on carrying amounts as reported in the balance sheet.

Loans and advances to customers and off-balance sheet items are secured by collateral in form of charges over land and buildings and/or plant and machinery or corporate guarantees and other collateral acceptable by the Kenyan law. However, there are loans and advances to corporate customers and individuals that are unsecured. Before disbursing any unsecured loan, the Bank undertakes stringent credit risk assessment.

Management is confident in its ability to continue to control and sustain minimal exposure of credit risk to the Bank resulting from both its loan and advances portfolio and debt securities based on the following:

- the Bank exercises stringent controls over the granting of new loans
- 97% of the loans and advances portfolio are neither past due nor impaired
- 94% of investments securities at amortised cost are government securities.

**Financial assets that are past due or impaired**

The Bank aligns the classification of assets that are past due or impaired in line with the Central Bank of Kenya prudential guidelines. In determining the classification of an account, performance is the primary consideration. Classification of an account reflects judgement about the risk of default and loss associated with the credit facility.

Accounts are classified into five categories as follows:

| CBK PG/04 Guidelines | Days past due | IFRS 9 Stage allocation |
|---|---|---|
| Normal | 0-30 | 1 |
| Watch | 31-90 | 2 |
| Substandard | 91-180 | 3 |
| Doubtful | 181-365 | 3 |
| Loss | Over 365 or considered uncollectible | 3 |

Loans and advances less than 30 days past due date are not considered to be impaired unless other information is available to indicate otherwise.

Loans and advances are summarised as follows:

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Stage 1: Neither past due nor impaired | 22,082,600 | 18,812,593 |
| Stage 2: Past due but not impaired | 336,578 | 180,215 |
| Stage 3: Impaired | 696,424 | 15,159 |
| **Gross** | **23,115,602** | **19,007,967** |
| Staff loan adjustment | (41,606) | (45,339) |
| Less: allowance for impairment (Note 14) | (487,325) | (92,527) |
| **Net loans and advances** | **22,586,671** | **18,870,101** |

No other financial assets are either past due or impaired

*Write-off policy*

The Bank writes off a loan balance when the credit department determines that the loans are uncollectible. This determination is reached after considering information such as the occurrence of significant changes in the borrower's financial position such that the borrower can no longer pay the obligation or that proceeds from collateral have failed to cover the entire facility outstanding. For smaller balance standardised loans, write-off decisions are generally based on a product specific past due default history.

*Collateral on loans and advances*

The Bank routinely obtains collateral and security to mitigate credit risk. The Bank ensures that any collateral held is sufficiently liquid, legally effective, enforceable and regularly reassessed.

Before attaching value to collateral, business holding approved collateral must ensure that they are legally perfected devoid of any encumbrances. Security structures and legal covenants are subject to regular review, to ensure that they remain fit for purpose and remain consistent with accepted local market practice.

The principal collateral types held by the Bank for loans and advances are:

- Mortgages over residential properties.
- Charges over business assets such as premises, inventory and accounts receivable.
- Charges over financial instruments such as debt securities and equities.

Valuation of collateral taken will be within agreed parameters and will be conservative in value. The valuation is performed only on origination or in the course of enforcement actions. Collateral for impaired loans is reviewed regularly to ensure that it is still enforceable and that the impairment allowance remains appropriate given the current valuation.

The Bank will consider all relevant factors, including local market conditions and practices, before any collateral is realized.

| | 2018<br>Shs'000 | 2017<br>Shs'000 |
|---|---|---|
| **Stage 1: Against neither past nor impaired:** | | |
| Property | 14,590,928 | 14,732,187 |
| Other* | 16,050,748 | 15,133,403 |
| **Stage 2: Against past due but not impaired:** | | |
| Property | 339,800 | 184,920 |
| **Stage 3: Against individually impaired:** | | |
| Property | 500,000 | 30,000 |
| Other | - | - |

*Other includes log books, cash cover, machinery, debentures and directors' guarantees

### 4.2 Concentrations of risk

Economic sector risk concentrations within the customer loan and deposit portfolios were as follows:

| | Loans and advances % | Credit Commitments % |
|---|---|---|
| **At 31 December 2018** | | |
| **CORPORATE** | | |
| Manufacturing | 28% | 30% |
| Wholesale and Retail trade | 21% | 38% |
| Transport and Communication | 2% | 2% |
| Business services | 3% | 3% |
| Agriculture | 5% | 2% |
| Building & Construction | 8% | 4% |
| Real estate | 16% | 9% |
| Others | 11% | 2% |
| **RETAIL** | | |
| Personal & Households | 6% | 10% |
| | **100%** | **100%** |
| **At 31 December 2017** | | |
| **CORPORATE** | | |
| Manufacturing | 26% | 17% |
| Wholesale and Retail trade | 21% | 6% |
| Transport and Communication | 2% | 38% |
| Business services | 3% | 7% |
| Agriculture | 5% | 2% |
| Building & Construction | 8% | 7% |
| Real estate | 23% | 7% |
| Others | 7% | 5% |
| **RETAIL** | | |
| Personal & Households | 5% | 11% |
| | **100%** | **100%** |

**Customer deposits**

| | 2018 | 2017 |
|---|---|---|
| Insurance companies | 1% | 1% |
| Private enterprises | 33% | 35% |
| Commercial banks | 0% | 0% |
| Individuals | 62% | 56% |
| Non – residents | 1% | 1% |
| Non-profit organisations | 1% | 3% |
| Others | 2% | 4% |
| | **100%** | **100%** |

**4.3 Liquidity risk**

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities as they fall due and to replace funds when they are withdrawn.

The Bank is exposed to daily calls on its available cash resources from overnight deposits, current accounts, maturing deposits, and calls on cash settled contingencies. The Bank does not maintain cash resources to meet all of these needs as experience shows that a minimum level of reinvestment of maturing funds can be predicted with a high level of certainty. The Central Bank of Kenya requires that the Bank maintain a cash reserve ratio computed as 5.25% of customer deposits of the preceding month. In addition, the Board and Assets and liabilities Committee (ALCO) closely monitors the limits on the minimum proportion of maturing funds available to meet such calls and on the minimum level of inter-bank and other borrowing facilities that should be in place to cover withdrawals at unexpected levels of demand. The Treasury department monitors liquidity ratios on a daily basis. The table below details the reported ratios of net liquidity assets to deposits from customer during the year:

| | **2018 %** | **2017 %** |
|---|---|---|
| At close of the year | 31.10 | 28.60 |
| Average for the period | 31.26 | 30.30 |
| Maximum for the period | 40.90 | 36.90 |
| Minimum for the period | 26.60 | 25.10 |

The Bank at all times complies with the regulatory minimum liquidity ratio of 20%.

The table below presents the undiscounted cash flows payable by the Bank under financial liabilities by remaining contractual maturities at the balance sheet date. All figures are in Thousands of Kenya Shillings.

**At 31 December 2018**

| | **Up to 1 month** | **1-3 years** | **3-6 years** | **6-12 years** | **Over 1 year** | **Total** |
|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | |
| Customer deposits | 7,426,014 | 11,802,618 | 2,987,356 | 1,790,943 | 11,105 | 24,018,036 |
| Deposits and balances due to banking institutions | - | 58,355 | 516,139 | - | - | 574,494 |
| Long term borrowings | - | 483,408 | - | - | 2,136,169 | 2,619,577 |
| Other financial liabilities | 95,338 | - | - | - | - | 95,338 |
| **Total financial liabilities (contractual maturity) dates** | **7,521,352** | **12,344,381** | **3,503,495** | **1,790,943** | **2,147,274** | **27,307,445** |

**At 31 December 2017**

| | **Up to 1 month** | **1-3 years** | **3-6 years** | **6-12 years** | **Over 1 year** | **Total** |
|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | |
| Customer deposits | 5,405,929 | 10,128,853 | 2,879,170 | 604,358 | 178 | 19,018,488 |
| Deposits and balances due to banking institutions | - | - | 211,045 | - | - | 211,045 |
| Long term borrowings | - | 966,212 | - | - | 517,553 | 1,483,765 |
| Other financial liabilities | 104,697 | - | - | - | - | 104,697 |
| **Total financial liabilities (contractual maturity) dates** | **5,510,626** | **11,095,065** | **3,090,215** | **604,358** | **517,731** | **20,817,995** |

### 4.4 Market risk

Market risk is the risk that changes in market prices, which include currency exchange rates and interest rates, will affect the fair value or future cash flows of a financial instrument. Market risk arises from open positions in interest rates and foreign currencies, both of which are exposed to general and specific market movements and changes in the level of volatility. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while optimising the return on risk. Overall responsibility for managing market risk rests with the Assets and Liabilities Committee (ALCO). The Treasury department is responsible for the development of detailed risk management policies (subject to review and approval by ALCO) and for the day to day implementation of those policies.

### Currency risk

The Bank takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Board sets limits on the level of exposure by currency and in total for both overnight and intra-day positions, which are monitored daily.

The table below summarises the Bank's exposure to foreign currency exchange rate risk at 31 December. Included in the table are the Bank 's financial instruments, categorised by currency (all amounts expressed in thousands of Kenya Shillings):

**At 31 December 2018**

| | USD | GBP | Euro | Other | Total |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances with Central Bank of Kenya | 225,135 | 63,790 | 13,447 | 33 | 302,405 |
| Deposits and balances due from banking institutions | 827,813 | 502,298 | 62,367 | 4,493 | 1,396,971 |
| Loans and advances to customers | 3,030,843 | 256,789 | 664,215 | - | 3,951,847 |
| Investment securities | 418,894 | - | - | - | 418,894 |
| Other assets | 119 | - | 856 | - | 975 |
| **Total assets** | **4,502,804** | **822,877** | **740,885** | **4,526** | **6,071,092** |
| | | | | | |
| **Liabilities** | | | | | |
| Customer deposits | 2,515,416 | 915,570 | 80,225 | - | 3,511,211 |
| Deposits and balances due to banking institutions | 515,744 | - | 58,243 | - | 573,987 |
| Long term borrowings | 1,462,144 | - | 477,949 | - | 1,940,093 |
| Other liabilities | 2,689 | 1 | 5 | - | 2,695 |
| **Total liabilities** | **4,495,993** | **915,571** | **616,422** | **-** | **6,027,986** |
| **Net on-balance sheet position** | **6,811** | **(92,694)** | **124,463** | **4,526** | **43,106** |
| **Net off-balance sheet position** | **8,051** | **114,014** | **(130,128)** | **-** | **(11,423)** |
| **Overall open position** | **14,862** | **21,320** | **(5,665)** | **4,526** | **31,683** |
| | | | | | |
| **At 31 December 2017** | | | | | |
| Total assets | 2,329,764 | 448,569 | 815,506 | 1,439 | 3,595,278 |
| Total liabilities | 2,381,152 | 399,667 | 840,700 | - | 3,621,519 |
| **Net on-balance sheet position** | **(51,388)** | **48,902** | **(25,194)** | **1,439** | **(26,241)** |
| **Net off-balance sheet position** | **69,965** | **(34,785)** | **2,466** | **-** | **37,646** |
| **Overall open position** | **18,577** | **14,117** | **(22,728)** | **1,439** | **11,405** |

The net off-balance sheet position represents the off balance sheet facilities that were held by the Bank.

**Currency risk sensitivity analysis**

The table below shows the impact on post tax profit of 10% appreciation or depreciation of the shilling against other major currencies (all amounts expressed in thousands of Kenya Shillings):

| | Currency carrying amount | Appreciation by 10% | Depreciation by 10% |
|---|---|---|---|
| **At 31 December 2018** | | | |
| **Assets** | | | |
| Cash and balances with Central Bank of Kenya | 302,405 | (30,241) | 30,241 |
| Deposits and balances due from banking institutions | 1,397,971 | (139,797) | 139,797 |
| Loans and advances to customers | 3,951,847 | (395,185) | 395,185 |
| Investment securities | 418,894 | (41,889) | 41,889 |
| Other assets | 975 | (97) | 97 |
| **Total assets** | **6,072,092** | **(607,209)** | **607,209** |
| **Liabilities** | | | |
| Customer deposits | 3,511,211 | 351,121 | (351,121) |
| Deposits and balances due to banking institutions | 573,987 | 57,399 | (57,399) |
| Long term borrowings | 1,940,093 | 194,009 | (194,009) |
| Other liabilities | 2,695 | 270 | (270) |
| **Total liabilities** | **6,027,986** | **602,799** | **(602,799)** |
| Total (decrease) / increase | | 4,410 | (4,410) |
| Tax charge 30% | | (1,323) | 1,323 |
| **Impact on profits** | **-** | **3,087** | **(3,087)** |

At 31 December 2018, if the Shilling had weakened/strengthened hypothetically by 10% against the foreign currencies in which the Bank had exposures, with all other variables held constant, post-tax profit for the year would have been higher/lower by Shs 3,087,000 (2017: Shs 1,836,000 ).

### Interest rate risk

The Bank takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on both its fair value and cash flow risks. Interest margins may increase as a result of such changes but may reduce or create losses in the event that unexpected movements arise. Management sets limits on the level of mismatch of interest rate re-pricing that may be undertaken, which is monitored daily.

The table below summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's assets and liabilities at carrying amounts, categorised by the earlier of contractual re-pricing or maturity dates. The Bank does not bear an interest rate risk on off balance sheet items. All figures are in thousands of Kenya Shillings.

**At 31 December 2018**

| | Up to 1 month | 1-3 years | 3-6 years | 6-12 years | Over 1 year | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank of Kenya | - | - | - | - | - | 2,640,188 | 2,640,188 |
| Investment securities: | | | | | | | |
| - Fair Value through OCI | - | - | - | - | 2,156,920 | 344,778 | 2,501,698 |
| - At Amortised Cost | - | - | 602,897 | 183,156 | 981,222 | - | 1,767,275 |
| Deposits and balances due from banking institutions | 519,398 | - | - | - | - | 1,185,407 | 1,704,805 |
| Loans and advances to customers | 2,669,173 | 1,641,369 | 2,610,742 | 4,201,007 | 11,464,380 | - | 22,586,671 |
| Investments in associates | - | - | - | - | - | 310,620 | 310,620 |
| Property and equipment | - | - | - | - | - | 213,341 | 213,341 |
| Intangible assets | - | - | - | - | - | 33,034 | 33,034 |
| Tax Incemetax | - | - | - | - | - | 14,961 | 14,961 |
| Deferred income tax asset | | | | | | 131,502 | 131,502 |
| Other assets | - | - | - | - | - | 432,860 | 432,860 |
| **Total assets** | **3,188,571** | **1,641,369** | **3,213,639** | **4,384,163** | **14,602,522** | **5,306,691** | **32,336,955** |
| **Liabilities & Shareholders' Funds** | | | | | | | |
| Customer deposits | 8,979,665 | 7,422,549 | 2,885,638 | 1,673,093 | 10,165 | 2,793,528 | 23,764,638 |
| Deposit and Balances due from Banking Institutions | 58,243 | - | 515,744 | - | - | - | 573,987 |
| Long term borrowings | 47,075 | 451,287 | - | - | 1,441,731 | - | 1,940,093 |
| Current income tax | - | - | - | - | - | - | - |
| Other liabilities | - | - | - | - | - | 95,339 | 95,339 |
| Shareholders' funds | - | - | - | - | - | 5,962,898 | 5,962,898 |
| **Total liabilities & shareholders' funds** | **9,084,983** | **7,873,836** | **3,401,382** | **1,673,093** | **1,451,896** | **8,851,765** | **32,336,955** |
| **Interest sensitivity gap** | **(5,896,412)** | **(6,232,467)** | **(187,743)** | **2,711,070** | **13,150,626** | **(3,545,074)** | **-** |

**At 31 December 2017**

| | Up to 1 month | 1-3 years | 3-6 years | 6-12 years | Over 1 year | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| **Total assets** | **2,113,411** | **991,699** | **2,527,723** | **4,031,119** | **12,547,120** | **3,774,088** | **25,985,160** |
| **Total liabilities** | **(6,642,945)** | **(7,413,652)** | **(2,975,027)** | **(571,411)** | **(675,685)** | **(7,706,440)** | **(25,985,160)** |
| **Interest sensitivity gap** | **(4,529,534)** | **(6,421,953)** | **(447,304)** | **(3,459,708)** | **11,871,435** | **(3,932,352)** | - |

**Interest rates risk sensitivity analysis**

The Bank monitors the impact of risks associated with fluctuations of interest rates. The table below indicate the impact of a hypothetical 100basis points increase or decrease in interest rates on the Bank's financial assets and liabilities:

| | | At 31 December 2018 | |
|---|---|---|---|
| | Carrying Amounts | Increase by 1% | Decrease by 1% |
| **Assets** | | | |
| Cash and balances with Central Bank of Kenya | 2,640,188 | - | - |
| Investment securities : | | | |
| - Fair Value Through OCI | 2,501,698 | - | - |
| - At Amortised Cost | 1,767,275 | - | - |
| Deposits and balances due from banking institutions | 1,704,805 | - | - |
| Loans and advances to customers | 22,586,671 | 225,867 | (225,867) |
| Investment in associate | 310,620 | - | - |
| Property and equipment | 213,341 | - | - |
| Intangible assets | 33,034 | - | - |
| Tax recoverable | 14,961 | - | - |
| Deferred income tax | 131,502 | - | - |
| Other assets | 432,860 | - | - |
| **Liabilities & Equity** | | | |
| Customer deposits | 20,971,110 | (209,711) | 209,711 |
| Customer deposits zero rate | 2,793,528 | - | - |
| Deposits and balances due to banking institutions | 573,987 | - | - |
| Long term borrowings | 920,512 | - | - |
| Longterm Borrowing at Variable Rate | 1,019,581 | (10,196) | 10,196 |
| Other liabilities | 95,339 | | |
| Shareholders' equity | 5,962,898 | - | - |
| **Net interest income increase /(decrease)** | | **5,960** | **(5,960)** |
| **Tax charge at 30 %** | | **(1,788)** | **1,788** |
| **Impact on post tax profit** | | **4,172** | **4,172** |

At 31 December 2018, assuming all other variables remain constant an increase/decrease of 100 basis point on interest rates would have resulted in an increase/decrease in post-tax profit of Shs 4,172,000 (2017: Shs 5,601,000).

The effective interest rates by major currency for monetary financial instruments at 31 December 2018 and 2017 were in the following ranges:

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | In Shs | In Other Currencies | In Shs | In Other Currencies |
| **Assets** | | | | |
| Government securities | 11.66% | - | 11.86% | - |
| Deposits and balances due from banking institutions | 6.50% | - | 8.28% | - |
| Loans and advances to customers | 12.98% | 8.41% | 13.93% | 7.69% |
| Other investment securities | - | 5.00% | - | 5.00% |
| **Liabilities** | | | | |
| Customer deposits | 7.65% | 1.75% | 8.60% | 2.22% |
| Deposits and balances due to banking institutions | - | 5.27% | - | 4.50% |
| Long term borrowings | - | 7.26% | - | 5.94% |

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of the Bank. It is unusual for banks assets and liabilities ever to be completely matched since business transacted is often of uncertain terms and of different types. An unmatched position potentially enhances profitability, but can also increase the risk of losses.

The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature, are important factors in assessing the liquidity of the Bank and its exposure to changes in interest rates and exchange rates.

**4.5 Fair values of financial assets and liabilities**

Effective 1 January 2009, the Bank adopted the amendment to IFRS 7 for financial instruments that are measured in the balance sheet at fair value, this requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1);
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2); and
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3).

The following table presents the Bank's assets that are measured at fair value at 31 December. There were no liabilities measured at fair value through profit and loss for the same period (2017: Nil)

| | Level 1 Shs'000 | Level 2 Shs'000 | Level 3 Shs'000 | Total Balance Shs'000 |
|---|---|---|---|---|
| **As at 31 December 2018** | | | | |
| **Assets** | | | | |
| Fair Value Through OCI | | | | |
| - Debt investments | 2,157,926 | - | 245,224 | 2,403,150 |
| - Equity investments | 100,726 | - | - | 100,726 |
| - Impairment Charge | (1,006) | - | (1,172) | (2,178) |
| **Total Assets** | **2,257,646** | **-** | **244,052** | **2,501,698** |
| | | | | |
| **As at 31 December 2017** | | | | |
| **Assets** | | | | |
| Available for sale financial assets | | | | |
| – Debt investments | 1,269,728 | - | 248,134 | 1,517,862 |
| | 102,096 | - | - | 102,096 |
| **Total assets** | **1,371,824** | **-** | **248,134** | **1,619,958** |

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry Bank, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the Bank is the current bid price. These instruments are included in level 1. Instruments included in level 1 comprise primarily foreign corporate bonds and Nairobi Securities Exchange ("NSE") equity investments classified as available for sale.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in level 2.

If one or more of the significant inputs is not based on observable market data, the instrument is included in level 3.

Specific valuation techniques used to value financial instruments include:

• Quoted market prices or dealer quotes for similar instruments
• The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.
• The fair value of forward foreign exchange contracts is determined using forward exchange rates at the balance sheet date, with the resulting value discounted back to present value.
• Other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

The movement in level 3 during the year are in respect of forex gains.

The fair value of investment securities at amortised cost listed at NSE as at 31 December 2018 is estimated at Shs 1,475,430,000 (2017: Shs 1,245,420,000) compared to their carrying value of Shs 1,445,420,000 (2017: Shs1,237,009,000). The fair value through OCI investment securities are carried at fair value in the Bank's books. The fair values of the Bank's other financial assets and liabilities approximate the respective carrying amounts, due to the generally short periods to contractual repricing or maturity dates as set out above. Fair values are based on discounted cash flows using a discount rate based upon the borrowing rate that directors expect would be available to the Bank at the balance sheet date.

**4.6 Capital management**

The Bank's objectives when managing capital, which is a broader concept than the 'equity' on the balance sheets, are:

• to comply with the capital requirements set by the Central Bank of Kenya;
• to safeguard the Bank's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders;
• to maintain a strong capital base to support the development of its business.

Capital adequacy and use of regulatory capital are monitored regularly by management, employing techniques based on the guidelines developed by the Basel Committee, as implemented by the Central Bank of Kenya for supervisory purposes. The required information is filed with the Central Bank of Kenya monthly.

The Central Bank of Kenya requires each bank to: (a) hold the minimum level of regulatory capital of Shs1 billion; (b) maintain a ratio of total regulatory capital to the risk-weighted assets plus risk-weighted off-balance sheet assets (the 'Basel ratio') at or above the required minimum of 10.50%; (c) maintain core capital of not less than 8% of total deposit liabilities; and (d) maintain total capital of not less than 14.50% of risk-weighted assets plus risk-weighted off-balance sheet items.

The Bank's total regulatory capital is divided into two tiers:

•Tier 1 capital (core capital): share capital, share premium, plus retained earnings.

•Tier 2 capital (supplementary capital): 25% (subject to prior approval) of revaluation reserves, subordinated debt not exceeding 50% of Tier 1 capital and hybrid capital instruments. Qualifying Tier 2 capital is limited to 100% of Tier 1 capital.

The risk weighted assets are measured by means of a hierarchy of four risk weights classified according to the nature of – and reflecting an estimate of the credit risk associated with – each asset and counterparty. A similar treatment is adopted for off-balance sheet exposure, with some adjustments to reflect the more contingent nature of the potential losses.

**Introduction of Basel II principles in the measurement and assessment of Capital Adequacy Ratios (CARs)**

Kenyan banks computed the CARs based on Basel I methodology i.e. restricted to credit risk measurement of assets only. In the revised guideline effective from 2015, some principles of Basel II measurement of capital adequacy have been introduced. This will require Kenyan banks to also take into account capital charges for:

a. Operational risk –using the Basic Indicator Approach
b. Market risk - both specific and general market risks to be calculated using the standardized management approach.

The table below summarises the composition of regulatory capital and the ratios of the Bank at 31 December

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Tier 1 capital | 5,663,581 | 5,363,129 |
| Tier 1 + Tier 2 capital | 6,207,062 | 5,517,379 |
| Risk-weighted assets | | |
| Adjusted credit risk weighted assets | 25,231,830 | 20,722,546 |
| Total market risk weighted assets equivalent | 1,205,320 | 697,160 |
| Total risk weighted assets equivalent for operation risk | 2,987,724 | 2,844,816 |
| **Total risk-weighted assets** | **29,424,874** | **24,264,522** |
| | | |
| Basel ratio | | |
| Core capital to risk – weighted assets (CBK minimum –10.5%) | 19.2% | 22.10% |
| Total capital to risk– weighted assets (CBK minimum- 14.50%) | 21.1% | 22.70% |
| Core Capital to deposits (CBK minimum – 8 %) | 23.8% | 28.70% |

## 5. Interest income

| | | |
|---|---|---|
| Loans and advances to customers | 2,580,428 | 2,180,414 |
| Government securities | 368,481 | 319,034 |
| Cash and short term funds | 33,157 | 43,387 |
| Other investments | 9,445 | 15,840 |
| Loan fee and Commission Income | 207,265 | 153,016 |
| | **3,198,776** | **2,711,691** |

## 6. Interest expense

| | | |
|---|---|---|
| Fixed deposit accounts | 1,255,477 | 930,127 |
| Current and demand deposits | 286,045 | 244,562 |
| Deposits and balances due to banking institutions | 181 | 3 |
| Borrowings | 156,936 | 99,671 |
| | **1,698,639** | **1,274,363** |

## 7. Expenses by nature

The following items are included within operating expenses

| | | |
|---|---|---|
| Employee benefits (Note 8): | | |
| - Key management | 148,906 | 138,330 |
| - Other employees | 261,148 | 241,129 |
| Depreciation of property and equipment (Note 16) | 49,209 | 34,972 |
| Amortisation of intangible assets (Note 17) | 9,446 | 8,088 |
| Auditor's remuneration (inclusive of value added tax) | 4,500 | 4,375 |

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **8. Employee benefits** | | |
| The following items are included within employee benefits expense: | | |
| Retirement benefit costs: | | |
| - National Social Security Fund | 185 | 165 |
| - Employer Pension Contribution | 19,388 | 16,554 |

**9. Investment in associates**

| | | |
|---|---|---|
| At start of year | 297,064 | 284,031 |
| Share of profit for the year, net of tax | 13,556 | 13,033 |
| **At end of year** | **310,620** | **297,064** |

The Bank owns 24.52% share capital of Victoria Towers Limited. Victoria Towers Limited's profit after tax for 2018 attributable to the owners of the parent was Shs 55,285,527 (2017: Shs 52,774,365). The Bank accounts for its share of associates profit equivalent to its shareholding.

The summarised financial information in respect of the associate is set out below;

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Total assets | 2,385,281 | 2,149,416 |
| Total liabilities | (1,114,913) | (934,360) |
| **Net assets** | **1,270,368** | **1,215,056** |
| Less: Non-controlling interest | (3,564) | (3,537) |
| Net Assets – Equity holders of the Parent | 1,266,804 | 1,211,519 |
| Bank's share of net assets of Victoria Towers Limited | 310,620 | 297,064 |
| Total revenue | 109,289 | 105,267 |
| Profit for the year | 55,286 | 52,774 |
| Bank's share of profit for the year | 13,556 | 12,940 |
| Under/Over provision of prior year share of profit | - | 93 |
| **Total Bank's share of profit** | **13,556** | **13,033** |

| 10. Income tax expense | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Current income tax | 252,760 | 243,382 |
| Deferred income tax (Note 18) | (124,669) | (11,360) |
| | **128,091** | **232,022** |

The tax on the Bank's profit before income tax differs from the theoretical amount that would arise using the statutory income tax rate as follows:

| | | |
|---|---|---|
| Profit before income tax | 565,095 | 849,199 |
| Tax calculated at the statutory income tax rate of 30% (2017: 30%) | 169,528 | 254,760 |
| Tax effect of: | | |
| - Income not subject to tax | (66,835) | (41,477) |
| - Expenses not deductible for tax purposes | 25,398 | 18,739 |
| **Income tax expense** | **128,091** | **232,022** |

### 11. Earnings per Share

Basic earnings per share are calculated on the profit attributable to shareholders of Shs 437,004,000 (2017: Shs 617,177,000) and on the weighted average number of ordinary shares outstanding during the year.

| | | |
|---|---|---|
| Net profit attributable to shareholders (Shs thousands) | 437,004 | 617,177 |
| Weighted average number of ordinary shares in issue (thousands) | 41,925 | 41,925 |
| Basic earnings per share (Shs) | 10.42 | 14.72 |

The Bank issued a debt instrument that has an option to convert into equity (Note 23). The dilutive earnings per share is Shs 10.02 (2017: Shs 14.11).

### 12. Dividends per share

During the year, the Bank paid an interim dividend of Shs 2.53 per share amounting to a total of Shs 106,070,000 (2017:146,737,000). Payment of dividends is subject to withholding tax at a rate of 5% for resident and 10% for non-resident shareholders.

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|

### 13. Cash and balances with Central Bank of Kenya

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Cash in hand | 111,745 | 87,665 |
| Balances with Central Bank of Kenya | 2,528,443 | 1,660,897 |
| | **2,640,188** | **1,748,562** |

The Expected Credit Loss on the above balances is not material and no adjustment has been made to the cash and balances with CBK.

### 14. Loans and advances to customers

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Overdrafts | 10,098,252 | 6,654,704 |
| Loans | 11,033,887 | 11,060,490 |
| Advances under Finance Lease agreements | 1,896,412 | 1,226,283 |
| Credit cards | 87,051 | 66,490 |
| **Gross loans and advances** | **23,115,602** | **19,007,967** |
| - Staff loan adjustment | (41,606) | (45,339) |
| Less: Provision for impairment of loans and advances | | |
| - Stage 1 | 46,302 | 75,021 |
| - Stage 2 | 101 | 1,979 |
| - Stage 3 | 440,922 | 15,527 |
| | **(487,325)** | **(92,527)** |
| **Net loans and advances** | **22,586,671** | **18,870,101** |

**i) Loans and advances to customers at amortised cost**

| | Stage 1 Shs'000 | Stage 2 Shs'000 | Stage 3 Shs'000 | Stage 4 Shs'000 |
|---|---|---|---|---|
| **Gross carrying amount as at 31 December 2017** | **18,812,593** | **180,215** | **15,159** | **19,007,967** |
| Restatement on adoption of IFRS 9 | | | | |
| **Gross carrying amount as at 1 January 2018** | **18,812,593** | **180,215** | **15,159** | **19,007,967** |
| Changes in the gross carrying amount | | | | |
| - Transfer from stage 1 to stage 2 | (852,787) | 852,787 | - | - |
| - Transfer from stage 1 to stage 3 | - | - | - | - |
| - Transfer from stage 2 to stage 3 | - | (696,424) | 696,424 | - |
| - Transfer from stage 3 to stage 2 | - | - | - | - |
| - Transfer from stage 2 to stage 1 | - | - | - | - |
| - Write-offs | | | | |
| New financial assets originated or purchased | 4,122,794 | - | - | 4,122,794 |
| Financial assets that have been derecognised | - | - | (15,159) | (15,159) |
| **Gross carrying amount as at 31 December 2018** | **22,082,600** | **336,578** | **696,424** | **23,115,602** |

**ii) Provisions – Loans and advances to customers**

| | Stage 1 Shs'000 | Stage 2 Shs'000 | Stage 3 Shs'000 | Stage 4 Shs'000 |
|---|---|---|---|---|
| Provisions as at 31 December 2017 | 75,021 | 1,979 | 15,527 | 92,527 |
| Change on adoption of IFRS 9 | 23,594 | - | - | 23,594 |
| **Provisions as at 1 January 2018** | **98,615** | **1,979** | **15,527** | **116,121** |
| Charge to profit or loss | | | | |
| - Transfer from stage 1 to stage 2 | - | - | - | - |
| - Transfer from stage 1 to stage 3 | - | - | - | - |
| - Transfer from stage 2 to stage 3 | - | (1,878) | 435,065 | 433,187 |
| - Transfer from stage 3 to stage 2 | - | - | - | - |
| - Transfer from stage 2 to stage 1 | - | - | - | - |
| - Write-offs | - | - | (9,670) | (9,670) |
| New financial assets originated or purchased | (52,313) | - | - | (52,313) |
| **Provisions as at 31 December 2018** | **46,302** | **101** | **440,922** | **487,325** |

Movements in provisions for impairment of loans and advances are as follows:

| | Stage 1 Shs'000 | Stage 2 Shs'000 | Stage 3 Shs'000 | Total Shs'000 |
|---|---|---|---|---|
| **Year ended 31 December 2018** | | | | |
| At 1 January 2018 | 98,615 | 1,979 | 15,527 | 116,121 |
| Write-off in the year | - | - | (9,670) | (9,670) |
| (Decrease)/ Increase in impairment provision | (52,313) | (1,878) | 435,065 | 380,874 |
| **At 31 December 2018** | **46,302** | **101** | **440,922** | **487,325** |
| **Charge/(credit) to profit or loss** | | | | |
| (Decrease)/ Increase in impairment provision | (52,313) | (1,878) | 435,065 | 380,874 |
| Write-off in the year | - | - | (9,670) | (9,670) |
| | **(52,313)** | **(1,878)** | **425,395** | **371,204** |

All impaired loans are written down to their estimated recoverable amount. The aggregate carrying amount of impaired loans at 31 December 2018 was Shs 696,424,000 (2017: Shs 16,855,000).

**iii) Provisions restatement on adoption of IFRS 9**

| | Shs'000 |
|---|---|
| Opening adjustment | |
| - Loans and advances | 23,594 |
| - Other financial assets | 3,519 |
| **Total** | **27,113** |
| Deferred income tax | (8,134) |
| **Net amounts adjusted through opening retained earnings** | **18,979** |

The loans and advances to customers include finance lease receivables, which may be analysed as follows:

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **Net investment in finance leases:** | | |
| Not later than 1 year | 14,546 | 51,499 |
| Later than 1 year and not later than 5 years | 1,766,732 | 1,009,002 |
| Later than 5 years | 115,134 | 165,782 |
| | **1,896,412** | **1,226,283** |

There were no individually assessed provisions for finance lease receivable as at 31 December 2018 (2017: Nil).

## 15. Investment securities

| | 2018<br>Shs'000 | 2017<br>Shs'000 |
|---|---|---|
| **Fair Value Through OCI** | | |
| Government securities | 2,157,926 | 1,269,728 |
| Foreign securities | 279,073 | 282,522 |
| Other local investments | 66,877 | 67,708 |
| Impairment Charge | (2,178) | - |
| **Total securities available for sale** | **2,501,698** | **1,619,958** |
| **At Amortised Cost** | | |
| Government securities | | |
| - Maturing within 91 days of the date of acquisition | - | - |
| - Maturing after 91 days of the date of acquisition | 1,658,031 | 1,316,967 |
| Local corporate bond and investments | 6,049 | 12,100 |
| Foreign investments | 104,291 | 100,637 |
| Impairment Charge | (1,096) | - |
| Total securities held to maturity | 1,767,275 | 1,429,704 |
| **Total investment securities** | **4,268,973** | **3,049,662** |

The Bank invests in government securities, corporate infrastructure bonds, placements with financial and other institutions Banks as well as various offshore funds. These investments have been classified as either held to Fair Value Through Profit or Loss (FVTPL), Amortised Cost and Fair Value through Other Comprehensive Income (FVTOCI).

**The movement in investments is shown below:**

| | Value at 01/01/2018 Shs '000 | Purchases at cost Shs '000 | Disposals /Maturities Shs '000 | Premium/ Discount Shs '000 | Unearned Interest Shs '000 | Interest Receivable Shs '000 | Impairment Charge Shs '000 | Forex Gains/Losses Shs '000 | Gain in fair Value Shs '000 | Value at 31/12/2018 Shs '000 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Fair Value Through OCI** | | | | | | | | | | |
| Government securities | 1,269,728 | 5,128,300 | (4,295,889) | - | - | - | (1,006) | - | 55,787 | 2,156,920 |
| Foreign securities | 282,522 | - | - | - | - | - | (1,032) | (3,449) | - | 278,041 |
| Other local investments | 67,708 | - | - | - | - | - | (140) | (831) | - | 66,737 |
| | **1,619,958** | **5,128,300** | **(4,295,889)** | **-** | **-** | **-** | **(2,178)** | **(4,280)** | **55,787** | **2,501,698** |
| **At Amortised Cost** | | | | | | | | | | |
| Government securities: | | | | | | | | | | |
| - Maturing within 91 days of the date of acquisition | - | - | - | - | - | - | - | - | - | - |
| - Maturing after 91 days of the date of acquisition | 1,316,967 | 498,000 | (210,756) | 38,748 | (4,528) | 19,600 | (634) | - | - | 1,657,397 |
| Local corporate bond investments | 12,100 | - | (6,175) | - | - | 124 | | - | - | 6,049 |
| Foreign investments | 100,637 | 4,955 | (2,147) | - | - | 2,197 | (462) | (1,351) | - | 103,829 |
| | **1,429,704** | **502,955** | **(219,078)** | **38,748** | **(4,528)** | **21,921** | **(1,096)** | **(1,351)** | **-** | **1,767,275** |
| **Total investment securities** | **3,049,662** | **5,631,255** | **(4,514,967)** | **38,748** | **(4,528)** | **21,921** | **(3,274)** | **(5,631)** | **55,787** | **4,268,973** |

## 16. Property and equipment

| | Office Premises Shs.'000 | Office Improvements Shs.'000 | Furniture fittings & Equipment Shs.'000 | Motor Vehicles Shs.'000 | Total Shs.'000 |
|---|---|---|---|---|---|
| **At 1 January 2017** | | | | | |
| Cost | 77,246 | 72,633 | 152,905 | 62,532 | 365,316 |
| Accumulated depreciation | (22,202) | (30,918) | (84,976) | (34,870) | (172,966) |
| **Net book amount** | **55,044** | **41,715** | **67,929** | **27,662** | **192,350** |
| | | | | | |
| **Year ended 31 December 2017** | | | | | |
| Opening net book amount | 55,044 | 41,715 | 67,929 | 27,662 | 192,350 |
| Additions | - | 327 | 3,308 | 15,532 | 19,167 |
| Net book value of assets disposed | - | - | - | (2,037) | (2,037) |
| Depreciation charge | (1,545) | (6,517) | (17,897) | (9,013) | (34,972) |
| **Closing net book amount** | **53,499** | **35,525** | **53,340** | **32,144** | **174,508** |
| | | | | | |
| **At 31 December 2017** | | | | | |
| Cost | 77,246 | 72,961 | 155,616 | 58,569 | 364,392 |
| Accumulated depreciation | (23,747) | (37,436) | (102,276) | (26,425) | (189,884) |
| **Net book amount** | **53,499** | **35,525** | **53,340** | **32,144** | **174,508** |
| | | | | | |
| **Year ended 31 December 2018** | | | | | |
| Opening net book amount | 53,499 | 35,525 | 53,340 | 32,144 | 174,508 |
| Additions | - | 31,205 | 27,800 | 29,038 | 88,043 |
| Depreciation charge | (1,545) | (8,228) | (21,213) | (18,224) | (49,210) |
| **Closing net book amount** | **51,954** | **58,502** | **59,927** | **42,958** | **213,341** |
| | | | | | |
| **At 31 December 2018** | | | | | |
| Cost | 77,246 | 104,166 | 183,416 | 82,498 | 447,326 |
| Accumulated depreciation | (25,292) | (45,664) | (123,489) | (39,540) | (233,985) |
| **Net book amount** | **51,954** | **58,502** | **59,927** | **42,958** | **213,341** |

Included in office premises are costs related to the floor owned by the Bank at Victoria Towers and the parking bays at the premises. The remaining floors of Victoria Towers are owned by Victoria Towers Limited, an associate of the Bank (Note 9).

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **17. Intangible assets** | | |
| Opening net book amount | 26,186 | 26,104 |
| Additions | 16,294 | 8,170 |
| Amortisation charge | (9,446) | (8,088) |
| **Closing net book amount** | **33,034** | **26,186** |
| Cost | 158,407 | 142,113 |
| Accumulated amortisation | (125,373) | (115,927) |
| **Closing net book amount** | **33,034** | **26,186** |

**18. Deferred income tax**

Deferred income tax is calculated using the enacted income tax rate of 30% (2013: 30%).

The movement on the deferred income tax account is as follows:

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| At start of year | 15,435 | 13,734 |
| Change on initial application of IFRS 9 | 8,134 | - |
| Credit to profit or loss (Note 10) | 124,669 | 11,360 |
| Charge to other comprehensive income | (16,736) | (9,659) |
| **At end of year** | **131,502** | **15,435** |

The deferred income tax asset, deferred income tax charge/(credit) in the income statement is attributable to the following items:

| | 1.1.2018 Shs '000 | Initial adoption of IFRS 9 Shs '000 | (Charged)/ credited to P&L Shs '000 | Charge to OCI Shs '000 | 31.12.2018 Shs '000 |
|---|---|---|---|---|---|
| **Year ended 31 December 2018** | | | | | |
| Provisions for impairment | 28,185 | 8,134 | 123,434 | - | 159,753 |
| Excess of accounting depreciation over tax allowance | (1,299) | | 1,235 | - | (64) |
| Fair value gains on available for sale investments | (11,451) | | - | (16,736) | (28,187) |
| **Deferred income tax asset** | **15,435** | **8,134** | **124,669** | **(16,736)** | **131,502** |

| | 1.1.2017 Shs.'000 | (Charged)/ credited to P&L Shs.'000 | Charge to OCI Shs.'000 | 31.12.2017 Shs.'000 |
|---|---|---|---|---|
| **Year ended 31 December 2017** | | | | |
| Provisions for impairment | 17,100 | 11,085 | - | 28,185 |
| Excess of accounting depreciation over tax allowance | (1,574) | 275 | - | (1,299) |
| Fair value gains on available for sale investments | (1,792) | - | (9,659) | (11,451) |
| **Deferred income tax asset** | **13,734** | **11,360** | **(9,659)** | **15,435** |

## 19. Other assets

| | 2018 Shs.'000 | 2017 Shs.'000 |
|---|---|---|
| Local and upcountry cheques for clearing or collection | 238,632 | 109,983 |
| Other debtors | 22,159 | 70,113 |
| Prepayments | 130,463 | 36,055 |
| Staff loan benefit | 41,606 | 45,339 |
| | **432,860** | **261,490** |

## 20. Customer deposits

| | 2018 Shs.'000 | 2017 Shs.'000 |
|---|---|---|
| Current and demand deposits | 2,793,528 | 1,987,485 |
| Savings accounts | 4,632,493 | 3,416,073 |
| Fixed deposit accounts | 16,338,617 | 13,273,830 |
| | **23,764,638** | **18,677,388** |

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **21. Deposits and balances due to banking institutions** | | |
| Balances due to banks | 573,987 | 208,812 |
| | | |
| **22. Deposits and balances due from banking institutions** | | |
| Overnight lending | 300,054 | 900,613 |
| Current account balances with other banks | 1,185,406 | 641,539 |
| Placements with other banks | 219,345 | - |
| | **1,704,805** | **1,542,152** |

The bank calculated the expected credit loss on deposits due from other Bank and the amount was not material and therefore no adjustment was made.

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **23. Long term borrowings** | | |
| At start of year | 1,382,370 | 1,519,870 |
| Additions | 1,018,461 | 120,800 |
| Payments during the year | (478,330) | (275, 628) |
| Accrued interest | 17,592 | 17,328 |
| **At end of year** | **1,940,093** | **1,382,370** |

The Bank's long term borrowings includes :

**I. Subordinated Debt`**

USD 5 million unsecured facility raised from Swedfund International AB in April 2018, with a tenure of 7years. This facility bears interest at rates referenced to the 3 months Libor. Outstanding principal Balance as at 31 December 2018 was USD 5million (2017: Nil).

**II. Senior Debt**

USD 5 Million raised from World Business Capital Inc.(WBC) in June 2018, with a tenure of 10 years . This facility bears interest at rates referenced to 3 months Libor. Outstanding principal balance as at 31 December 2018 was USD 5 million (2017: Nil).

**III. Other Borrowings**

• USD 4 Million unsecured 5 year term loans acquired in June 2016. The facility attracts interest rate referenced to 6 month Libor. Outstanding Principal Balance as at 31 December 2018 was USD 4million (2017: USD 4 million ) .As per the loan agreement, the lender has an option to convert either part, or the whole balance into equity at an agreed price-to-book multiple of 1.7 of the Bank's core capital and noncurrent assets valued at the market value as per the last unaudited financial statements of the Bank preceding the date of conversion. As at 31.12.2018, the Bank fair valued this borrowing and there was no significant difference between the fair value and the Book Value.

• USD 15 Million unsecured credit line from GCL Green Company Ltd Limited. The loan attracts a fixed rate of interest. Outstanding principal balance as at 31 December 2018 was USD 4,876,497 (2017: USD 6,812,485).

• USD 18 Million unsecured credit line from Cistenique Investment Fund BV. The facility bears a fixed rate of Interest. Outstanding principal balance as at 31 December 2018 was USD 200,000.00 (2017: USD 2,410,703).

**b) Compliance with debt covenants**

During the year under review, the Bank met all its loans repayment obligations. The Bank was in compliance with all financial covenants stipulated by both WBC and Swedfund.

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **24. Other liabilities** | | |
| Bankers cheques | 12,236 | 13,199 |
| Accrued expenses | 45,592 | 46,436 |
| Other | 37,511 | 38,341 |
| | **95,339** | **97,976** |

| | Number of Shares Shs'000 | Share Capital Shs'000 | Share Premium Shs'000 |
|---|---|---|---|
| **25. Share capital** | | | |
| Balance at 1 January 2017 | 41,458 | 829,162 | 1,271,743 |
| Issue of new shares | 467 | 9,332 | 51,330 |
| Cost related to issue of new shares | - | - | (1,784) |
| At 31 December 2017 | 41,925 | 838,494 | 1,321,289 |
| At 1 January 2018 | 41,925 | 838,494 | 1,321,289 |
| At 31 December 2018 | 41,925 | 838,494 | 1,321,289 |

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **26. Regulatory reserve** | | |
| At start of year | 120,000 | 105,000 |
| Transfer (to)/ from retained earnings | (120,000) | 15,000 |
| **At end of year** | **-** | **120,000** |

The regulatory reserve represents an appropriation from retained earnings to comply with the Central Bank of Kenya's Prudential Regulations. The balance in the reserve represents the excess of impairment provisions determined in accordance with the Prudential Regulations over the impairment provisions recognised in accordance with the Bank's accounting policy. The reserve is not distributable.

**27. Off balance sheet financial instruments, contingent liabilities and commitments**

In the ordinary course of business, the Bank conducts business involving guarantees, acceptances and performance bonds. These facilities are offset by corresponding obligations of third parties. In addition, there are other off-balance sheet financial instruments including forward contracts for the purchase and sale of foreign currencies, whose nominal amounts are not reflected in the balance sheet. At the year end, the contingent items were as follows:

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **Contingent liabilities** | | |
| Acceptances and letters of credit | 2,246,636 | 2,060,767 |
| Guarantees and performance bonds | 983,292 | 697,218 |
| | **3,229,928** | **2,757,985** |

**Nature of contingent liabilities**

Guarantees are generally written by a bank to support performance by a customer to third parties. The Bank will only be required to meet these obligations in the event of the customer's default.

Letters of credit commit the Bank to make payment to third parties, on production of documents, which are subsequently reimbursed by customers.

An acceptance is an undertaking by a bank to pay a bill of exchange drawn on a customer. The Bank expects most acceptances to be presented and reimbursement by the customer is almost immediate.

Forward foreign exchange contracts are commitments to either purchase or sell a designated financial instrument at a specified future date for a specified price and may be settled in cash or another financial asset. The fair values of the respective currency forwards are carried under other assets and other liabilities as appropriate.

| **Other Commitments** | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Undrawn formal stand-by facilities, credit lines and other commitments to lend | 3,477,194 | 2,681,861 |
| Foreign exchange forward contracts | 114,890 | 34,712 |
| Operating Lease | 53,415 | 42,049 |
| | **3,645,499** | **2,758,622** |

**Nature of commitments**

Commitments to lend are agreements to lend to a customer in future subject to certain conditions. Such commitments are normally made for a fixed period. The Bank may withdraw from its contractual obligation for the undrawn portion of agreed overdraft limits by giving reasonable notice to the customer.

**28. Analysis of cash and cash equivalents as shown in the cash flow statement**

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Cash and balances with Central Bank of Kenya (Note 13) | 2,640,188 | 1,748,562 |
| Less: Cash reserve requirement | (1,171,450) | (958,318) |
| Deposits and balances due from banking institutions (Note 22) | 1,704,805 | 1,542,152 |
| | **3,173,543** | **2,332,396** |

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than 91 days maturity from the date of acquisition including: cash and balances with central banks, treasury bills and other eligible bills, and amounts due from other banks. Cash and cash equivalents exclude the cash reserve requirement held with the Central Bank of Kenya.

Banks are required to maintain a prescribed minimum cash balance with the Central Bank of Kenya that is not available to finance the bank's day-to-day activities. The amount is determined as 5.25% (2017: 5.25%) of the average outstanding customer deposits over a cash reserve cycle period of one month.

**29. Assets Pledged as security**

The Bank has pledged assets in form of treasury bonds to secure certain trade finance and money market lines. The total assets pledged as at 31 December 2018 was Shs 500,000,000 (2017: Shs 500,000,000).

**30. Related party transactions**

The Bank is owned by a diverse group of shareholders and none of them holds a controlling interest.

A number of banking transactions are entered into with related parties in the normal course of business. These include loans, deposits and foreign currency transactions.

*(i) Loans and advances to related parties*

Advances to customers at 31 December 2018 include an amount of Shs 502,788,000 (2017: Shs 297,582,000 ) relating to loans to companies controlled by directors or their families, and/ or shareholders of the Bank and Bank employees.

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| At start of year | 297,582 | 238,957 |
| Additions | 238,631 | 92,591 |
| Payments during the year | (75,258) | (53,325) |
| Accrued interest | 41,833 | 19,359 |
| **At end of year** | **502,788** | **297,582** |

Out of Shs 502,788,000 that relates to lending to related parties, Shs 65,121,000 (2017:117,602,000) relates to employee loans. Employees loans are advanced at rates lower than commercial rates but equal or higher than the ruling fringe benefit tax rates. Loans to all other related parties are advanced at commercial rates.

Loans and advances to related parties are 100 % performing and fully secured. No impairment provision has been recognised on loans and advances to related parties during the year *(ii) Related party deposits*

At 31 December 2018, customer deposits include deposits due to staff, directors and shareholders or their associates amounting to Shs 712,528,000 (2017: Shs 879,410,000). These deposits attract rates of interest similar to all other deposits.

*(iii) Purchase of goods and services*

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Victoria Towers Limited - rent and service charge | 8,179 | 8,073 |
| Victoria Towers Limited – parking | 557 | 557 |
| | **8,736** | **8,630** |

*(iv) Key management compensation*

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| **Salaries and other short-term employee benefits** | **148,906** | **138,330** |

*(v) Directors' remuneration*

| | 2018 Shs'000 | 2017 Shs'000 |
|---|---|---|
| Fees for services as a director | 23,200 | 36,000 |
| Salaries (included in key management compensation above) | 71,316 | 65,495 |
| | **94,516** | **101,495** |

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# ANNUAL REPORT

AND FINANCIAL STATEMENTS

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UPPER HILL • WESTLANDS • INDUSTRIAL AREA • RUARAKA

**Victoria Commercial Bank**

HEAD OFFICE
Victoria Towers, Mezzanine Floor, Kilimanjaro Avenue
Upper Hill, Nairobi
+254 709 876 100
victoria@vicbank.com

www.victoriabank.co.ke