

The POINT



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Stock Taking For Kenya's Equity Markets

The Nairobi Stock Exchange (NSE) has been a prominent facility within Kenya's capital market infrastructure since financial sector liberalisation commenced in 1993. In order to review the performance and regulatory challenges facing the NSE and the Capital Markets Authority, the Institute of Economic Affairs held a public forum on the 29th February 2002. The forum was addressed by Mr. Kibuga Kareithi (*Chief Executive, Nairobi Stock Exchange*) and Mr. James Murigu (*Managing Director, Suntra Stocks Ltd.*). The Points presents a synthesis of the dialogue.

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Introduction

The Nairobi Stock Exchange (NSE) has grown since it was established as an avenue for the mobilization of resources for investments and as an alternative means for acquiring capital for a corporations that wish to list on the market. Through its establishment, many foreign and Kenyan investors have taken advantage of the facility as a provider of investment opportunities. By virtue of the early establishment, the NSE has been one of the pre-eminent bourses in the eastern and central African region. For this reason, when government commenced the formal liberalization within the economy, attention focused on the institutions that would play an increasingly prominent role in the economy.

Financial regulation in independent Kenya started with the establishment of the Central Bank of Kenya (CBK) in 1966 as the

regulator of the banking industry. Insurance companies were initially regulated by the treasury and the Kenya Re-Insurance Company before the formal appointment of the Commissioner of Insurance in 1987. The stock exchange was regulated, the Capital Issues Committee in the treasury and was only replaced by the Capital Markets Authority in 1990. The Retirement Benefits Authority (RBA) was also formed and charged with the regulation of the retirement benefits industry as replacement for treasury in 1997.

Over time, the country established regulatory institutions and moved away from the regulatory roles that were performed by the treasury. These changes in the regulatory environment and institutions show that the country has a short regulatory history and further that government is adopting a new regulatory model to go with the liberalization.

When Kenya properly commenced



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liberalization in 1993, it was stated in policy proclamations that the financial services sector would be among the first to undergo reforms. This decision was informed by the realisation of the centrality of the financial services sector within the overall plan for economic growth. Liberalization exposed the fact that the equity markets required a new policy and regulatory dispensation because the structure of the economy was definitely changing. Principal among these changes was that the government expected to begin to divest from the ownership of banking institutions.

The Issues

Ü *Regulatory gap*

In taking a glance of the regulatory structure, a number of challenges arise that these need to be addressed before the exchange can respond to the changes taking place within the economy. The present regulatory regime has resulted in the duplication and overlapping roles in various sub-sectors of the financial services industry. For instance, both the Retirement Benefits Authority and the Capital Markets Authority regulate the fund managers for pensions funds. This means that issues of compliance are necessarily complicated because each of the individual regulators has specific regulatory goals. In addition, compliance with such a diverse set of regulatory provisions may lead to increased costs of compliance because of the possibility that the requirements may be in conflict with one another. More fundamentally however, the existing situation fails to agree with the basic requirement that regulatory provisions should be simple and flexible.

Ü *Increased compliance cost*

An extension of the argument presented above reveals that the overlap in the duties of regulatory agencies does result in increased costs of compliance. In turn, these imposed costs are eventually borne by the whole industry since they are passed over to consumers of those services. Therefore, while economic regulation is supposed to improve efficiency in markets, the present case demonstrates that it has caused some distortions by the substantial increments in the costs of compliance.

Ü *Control orientation*

The operations of capital markets often require the regulatory agency to facilitate the disclosure

of relevant information for the purposes of reducing asymmetries of information in sensitive markets. For this reason, it is an established principle of regulatory policy that the regulatory agency should be a facilitator of the sector for which it has been established. Whereas the preamble section of the Capital Markets Authority Act (*Cap 485A*) of Kenya's laws states that the purpose of the statute is to promote and facilitate the development of an orderly, fair and efficient capital market in Kenya, the administrative set up and applicable rules have a control effect. This state of affairs has implications for the capital markets because control oriented regulation may subvert market incentives that are more efficient.

Ü *Under developed infrastructure*

Even though the NSE has been institutionalised for a long time, Kenya's capital markets infrastructure has not been sufficiently developed. At the same time, the different sub-sectors within the larger financial services sector have developed separately. For this reason, the equity markets, the banking, the capital markets and the insurance industry are subject to stand-alone regulations administered by different regulatory agencies. The existence of these separate regulatory agencies within the financial services sector is evidence not only of a highly fragmented sector, but also proof of the duplication and overlap in the functions of the regulatory agencies.

Ü *Limited range of instruments*

Besides the main regulatory and policy challenges detailed above, the development path of Kenya's capital markets has been constrained by the increasing resort to informal financial activity in the economy. This directly means that the existing frameworks are not entirely appropriate for the character of financing that a significant portion of the population requires. As a result, the stock exchange cannot register wider acceptance and increased turnover in trade because it does not lend itself to tap into the informal systems of financing and trading. This situation then means that options for deepening the capital markets must begin to reconsider the large informal sector and adopt systems that would be applicable to this section.

Consequences of Regulatory Fragmentation

Ü *Imbalanced growth*

Among the main consequences of the overlap of institutions and fragmented regulation is that there is apparent imbalance in growth of the related sub-sectors. For instance, since financial sector regulations commenced, the foreign exchange trading bureaus have grown considerably while the equally important mortgages sub-sector has not had any benefits from the process of liberalization and policy changes. In addition, the disarticulated regulation merely shows that the fact that the separate sub-sectors are mutually reinforcing is not taken into account by the policy and regulations.

Ü *Primitive structure*

Kenya's capital markets are not sophisticated and this may be explained by the fact that economic liberalization has been extensive but incomplete. Market growth in the NSE has suffered since 1999. The initial growth soon after the establishment of the Capital Markets Authority could be attributed to the liberalization of the economy in general and the subsequent privatisation of firms such as the Kenya Commercial Bank and the National Bank of Kenya. Using the rise of other support institutions such as investment banks, stock brokerage firms and investment advisors, it is noticeable that only the stock brokerage and investment advisory services have grown appreciably. That an essential service such as investment banking is represented by a single registered firm does indirectly indicate that the market has not attained a high level of sophistication.

Ü *Limited trading instruments*

There has been a dearth of new instruments for trading at the NSE. Since the Capital Markets Authority took over the direct regulation of the exchange, there have been only a small number of instruments besides equities that were introduced. Apart from commercial papers that were introduced by a few companies, there have been few other innovative products. This is not necessarily because of lack of demand for additional products but rather that the regulatory regime does not allow for their rise and growth. Mutual funds and financial hedging products are taking too long to take root largely for this

reason. This factor ties in with poor sub-sectoral growth and affects the entire financial services sector because the scope for the expansion of foreign investments is highly limited by the instruments available for trading and the institutions that should facilitate transactions.

Ü *Frequency of non-compliance*

Any fragmented and inadequate policy environment substantially increases defaults and incidents of non-compliance by industry players. Since the regulatory agencies were instituted at different times and yet have overlapping jurisdictions, industry players experience compliance problems. In turn, the number of violations of the regulations are far above the expected average because of the burden of compliance with the regulations for each regulatory agency. It is also quite possible that the processes may be in conflict with one another hence may attract penalties from the regulatory agencies and further complicate compliance.

“In turn, the number of violations of the regulations are far above the expected average because of the burden of compliance with the regulations for each regulatory agency”

Key Drivers of Policy Reform

Globally, scholars identify challenges that drive in the structure and form of the financial services sector. While these changes are numerous and varied in complexity, they can be compressed under four main heads. These factors are therefore leading to regulatory pressures in other developing countries with moderately established or incipient markets.

a. *Globalisation*

As economies of the world begin to engage in more open trading with one another, opportunities for investment across national borders are also being exploited. As investors identify and proceed to make the investments, large volumes of funds are moved across borders quite rapidly. This movement of capital is so rapid and very dependent on correct information regarding the markets to which they are directed. For a developing country therefore, this situation may lead to a substantial investment boost for the equity markets and other opportunities that may exist in the financial services sector. The ease with which large volumes of funds are transferred also causes larger and regular payments imbalances because the funds do not always flow in equal volumes or in the same

direction.

More importantly, globalisation has created greater potential for financial instability for smaller and unsophisticated markets. This instability is more probable because governments have less influence on the direction in which funds will be moved. Sometimes investors will move funds into a country at the same time as they withdraw from another market. In essence, globalisation has transferred the decisions to individual investors whose actions have exposed the vulnerability of smaller capital markets. Government ability to intervene in the event of a financial crisis must be qualitatively improved because traditional interventions do not suffice. The key regulatory issue therefore is to reform the regulatory authority to facilitate increased investment while ensuring market stability.

b. Information and Communication Technology

Developments in the Information and Communication Technology (ICT) have had positive impact on the economy generally. One of the chief effects is that it has not only become easier to generate knowledge, but more importantly distribution and accessing of information is much easier. These benefits have also spilled into the financial markets by reducing information asymmetry for market players. Because the level of market asymmetry correlates with overall efficiency of that market, the reduction in information asymmetry necessarily leads to more efficient markets. At the same time, efficient markets favour real markets over intermediaries that add to the cost of transactions through their intermediation.

Market players at all levels in the financial services sector are taking advantage of information and communications technology not only to raise the efficiency of services, but also to cut down on the cost transactions. On this score, Kenya's stock exchange faces a serious competitive threat because the transaction period is typically a *12-day cycle*. This implies that Kenya's capital markets are still quite rudimentary and entail the added risk and cost of a longer period for completion of transactions. However, this situation will invariably change with the introduction of the proposals by the Capital Markets Authority to introduce a central depository system that would facilitate faster

clearance of trades and thereby reduce transaction costs. Regulatory policy within the financial markets in Kenya must therefore focus on the fact of increasing disintermediation in all financial markets and further that the market is assuming a leaner form where information analysis and the speed of transactions confer real advantages.

c. Demographic changes

The main demographic transition that is affecting financial markets in developed countries comes from the fact that there is a greater absolute number and proportion of older citizens in these countries than ever before. Individuals who have retired need higher rates of return on their savings and investment managers are compelled to consider investments that yield higher rates of return. On the other hand, the pursuit of higher rates of return for savings means that managers must assume comparatively higher risks. In order to ensure the expected rates of return, the professional investors often have to focus beyond a single country where the investment opportunities may not be as competitive.

Most savings and investments are institutionalised within mutual funds and into capital markets. This marks, a clear transition away from the savings deposited with banks that often offer lower returns. The response to the rise in volume of funds for investment is that institutions make most investment decisions. While these institutions may take different forms and sizes, they are the main players in terms of ownership of assets and financial instruments.

The demographic changes in the developed world are not the same as those evident in Kenya. However, there is the obvious need to recognise that international investors will consider Kenya's equity market against international benchmarks such as regulatory efficacy. It is conceivable that these investors will seek the high returns that their populations require and will be willing to invest only in sufficiently open markets that allow them to repatriate profits easily with few regulatory barriers. This situation necessarily places the NSE in vicious competition with other emerging equity markets in terms of robustness and diversity of tradable instruments.

d. Role of governments

For a long time, governments all over the world have had substantial and direct interest in the domestic economies with the effect that public sector presence was considerable. However, the cost of most of this government involvement has become indefensible. The requirement for fiscal rectitude on the part of governments is partly driving these governments towards privatisation of publicly owned businesses. Such disposal of publicly owned corporations means that the level of government participation in the economy is reducing in addition to the fact that the privatisation is dependent on the maturity of financial markets.

Regulatory policy has had to change by virtue of the exit by most governments from the financial services sector generally and the expanded role of private enterprises in most economies. This has seen the rise of reform in the regulatory frameworks of developing and developed countries in response to market developments. Regulatory policy has recognised the conglomeration of institutions and sought to reduce the amount of regulations to which institutions must adhere. Readjustments in the financial services regulation and industry is tending towards sectoral best practices that are proven to be efficient and most effective. As such, there is growing acceptance of international standardisation for the assessment of the quality of the services available in various markets.

In considering what roles Kenya's financial services sector should play, it must be recognised that the drivers of change are present in Kenya to various degrees. Regulatory and sectoral policy must consider factors beyond the immediate environment and attempt to moderate the adverse effects that these factors acting together or individually may have on the country and the region. At the same time, these drivers of change may confer some advantages that may be exploited to grow the financial services sector in Kenya.

Some Myths about Stock Markets

It is essential to question the commonly stated or implied assumption that capital markets automatically serve to mobilise domestic savings for investments. This may be a safe assumption

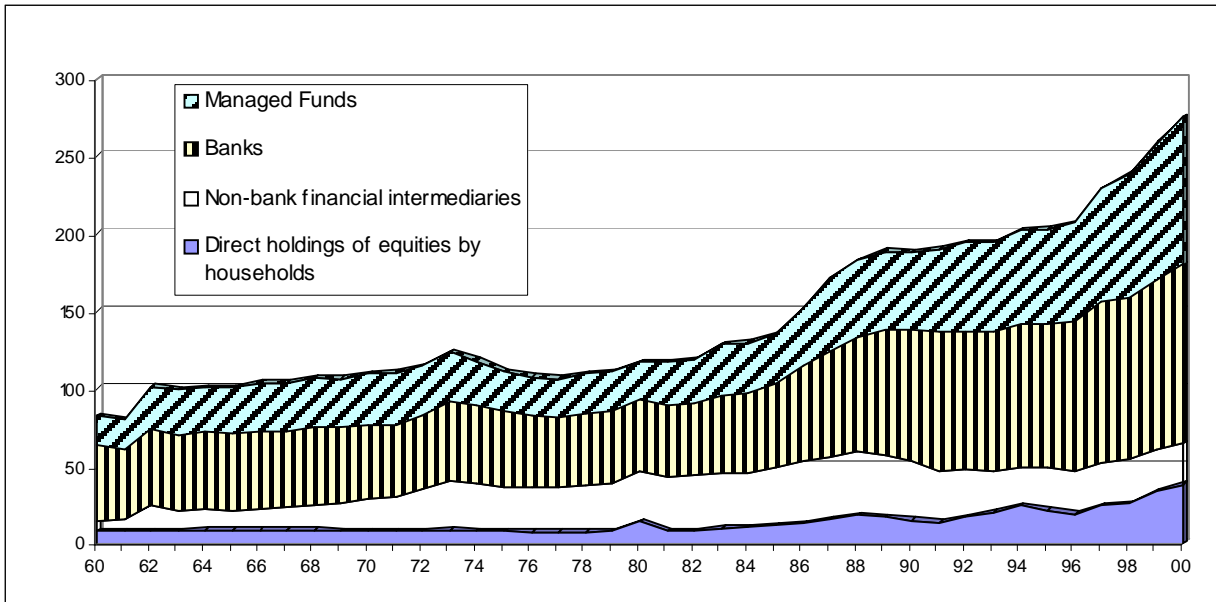
in a developed country context. However, the fundamental consideration for an individual or corporation is the issue of return on capital. Where the return on capital is not sufficient, then it should not be expected that the logic of investment through the capital markets would convince people with savings to opt for investment through the stock markets. For Kenya's case, the existing stock exchange does not only exhibit an absence of some instruments that Kenyans would wish to invest in but it is also structurally inappropriate for some activities.

Secondly, the literature regarding equity markets reinforce the assumption and myth that the capital markets are a guaranteed and efficient engine for financial and economic growth. Evidence in Kenya shows that this claim ought to be re-examined because on the average, only select corporations listed in the NSE have an above average performance. Instead, the listing of a corporation in the equity markets also exposes a firm to far more public scrutiny than is the case for privately held corporations. For this reason, it is important to consider that the growth throughout the economy will determine largely what the listed corporations will earn as income. Unless the other economic fundamentals are sound, a stock exchange on its own is unlikely to lead to much growth for any developing country.

Thirdly, financial sector policies are often constructed with the underlying assumption that stock markets mobilise funds for long-term growth. Objective studies reveal that in terms of priority as a source of financing for corporations and business entities, the stock market as an isolated institution comes last in the pecking order. Essentially therefore, the stock exchanges are in competition with other financial market institutions and often the ranks poorly. Considered globally, the stock exchange is generally proven not to be as efficient a market for the growth of savings invested. Instead, the stock market is more often used by fairly affluent as a for wealth holding in liquid and diversified portfolios.

The fourth myth that is often carried over from experience in the more developed stock

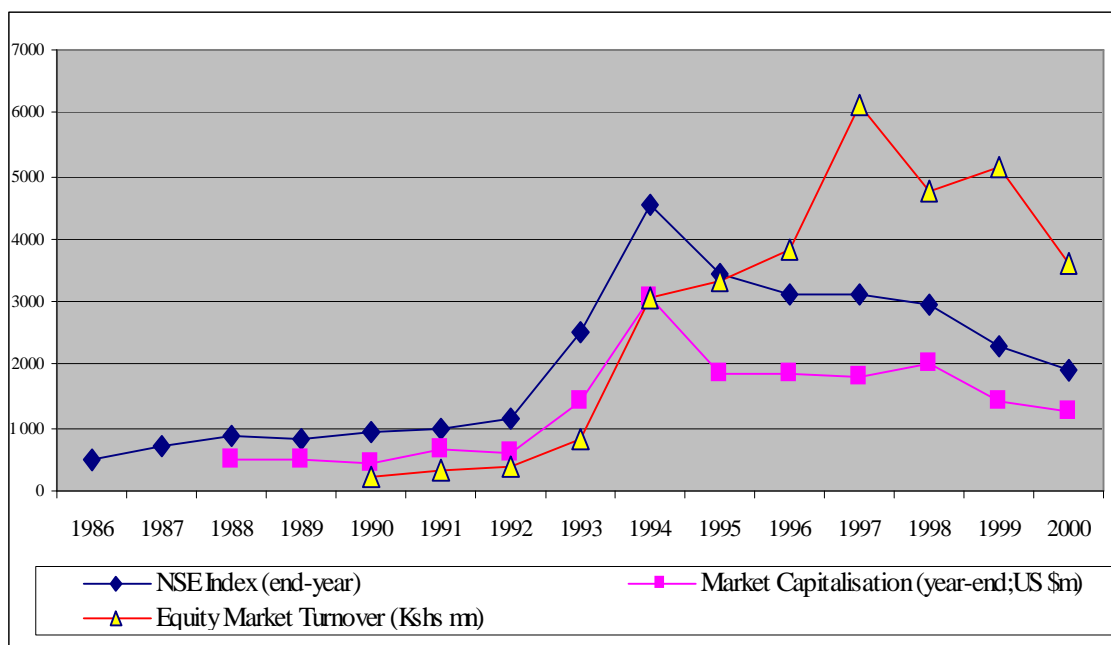
Figure 1: Holdings of Financial Assets - Main Components (% of GDP)



Source: Prof. Harper—Presentation to Association of Financial Analysts—East Africa

Figure 1 above demonstrates that over time, financial assets are moving towards managed funds. This aptly confirms that disintermediation is becoming the norm in the entire financial services sector

Figure 2: Various Equity Market Indicators (1986 - 2000)



Source: Kibuga Kareithi (2002)

exchanges is that it is possible to quickly mobilise small savings to be invested in the equity markets. This assertion also requires cautious consideration because income levels in most developing countries do condition people to consider savings as a form of insurance and not necessarily as an investment. Due to this factor, most people consciously consider the risk of savings in a conventional bank far more convenient than the returns that may result from the investment in the financial instruments available in stock markets.

Savings deposits therefore qualify as a form of insurance because they are merely set aside for convenient withdrawal. Impliedly, equity holdings are not entirely appropriate for the mobilization of the savings of the greater part of the populations living in developing countries generally and Kenya in particular. As a result, the income levels in Kenya impose a natural and formidable barrier to the expected growth of the stock exchange especially if the instruments available are predicated on a sophisticated market and investors.

Policy and Regulatory Lessons

It is evident that the regulatory reforms taking place in the world and the attendant changes in the structure of capital markets require that Kenya should review the policies governing the financial services sector as a whole. However, it is also necessary to critically consider the Kenyan economic context in decisions about the expected structures and roles of the financial services sector. It is therefore appropriate to reconsider whether the common assumptions about the role of capital markets can be generalised to all countries or whether developing countries whose citizens are still preoccupied with agriculture activities should think differently about capital markets. The resolution of such a question is fundamental to the direction that capital markets may take.

Ü *Listing licensing requirements*

Listing requirements for the NSE impose great costs for corporations that consider initial issues. This has led to the present situation where there are a limited number of fairly large issues. Given that the value of the shares at the stock exchange

is presently shrinking, there is need to reform the policy to attract many smaller corporations that will invigorate the stock exchange. It may therefore be realised that the reduction in the cost of issues will result in more corporations opting to list through the stock exchange. Apart from the reduction in the cost of listing for individual companies, the financial sector policy must recognise that listing at the stock exchange can only be aided by the separation of ownership and control of corporations. Also, requirements for the licensing fee for merchant banking is so high and unrealistic that it creates a significant barrier to entry into the market. Many brokers and interested merchant bankers rightly contend that the fee of 200 million Kenya Shillings is unrelated to the ability of applicants to competently perform the functions of merchant banking.

Ü *Commodities exchange*

Considering that the main occupation for most Kenyans is agriculture, it is important for the stock exchange to consider the establishment of commodities markets and an agricultural products exchange. The establishment of such a market would attract more activity because of the wide availability of agricultural products of various kinds. Policy must therefore bridge the gap in the financing and marketing for agricultural products and risks by establishing a market for trading these products and risks. This is a sure way of deepening activities at the exchange as it serves as an appropriate market for the main activity in which Kenyans are involved. In order to also ensure that policies in various sectors are compatible with one another, the relevant policies governing agricultural products should take cognisance and promote the rise of grain and commodity markets to expand the market for the products and to introduce new options for financing and accessing markets.

Ü *New instruments*

Because Kenya is a small economy comprised of a large informal sector, the financial services sector policy should be particularly geared to facilitating the development of products such as collective investment vehicles. In addition, the establishment of an over the counter market for non-listed shares and small companies ought to be supported. To its credit, the regulatory agency

(Capital Markets Authority) has been considering the publication of regulations to allow for the operation of collective investment schemes. Present policies in the capital markets require an expansion in scope to cover far more sophisticated instruments such as venture capital where they may be required. The expansion of the scope of instruments available in Kenya's stock exchange and the capital markets will provide an answer towards the next phase of growth.

Ü *Consolidated regulatory agency*

Due to the demonstrated convergence in the segments within the financial services sector, the prime policy question must be a reform that recognises the trends. The country must begin to have a far broader view of the entire sector. The present distortions in the market are mainly due to a fragmented regulatory regime. It is therefore imperative that regulatory reform should focus on the prompt establishment of a comprehensive financial services regulatory agency. This will invariably require that the regulatory institutions presently in charge of the insurance industry, retirement benefits and pensions, the equity markets and banking institutions be rationalised under a single authority. In order to facilitate this movement, it will be necessary to amend the laws that presently dictate the operation of these sub-sectors and establish a single financial services license as applies in Australia. An important principle in the regulatory policy should be that government regulation of banking institutions should be limited to the institutions that take deposits. This is especially important because there is obvious need to protect depositors only since institutions that give credit are assuming the risk of lending and need not be regulated for that function. However, government may need to recognise that savings

and credit cooperatives are an essential part of Kenya's financial services sector and have grown tremendously as an alternative to banking institutions.

Conclusion

Consolidation of the financial sector policy and regulatory practise will have added advantages such as ease of regulation, cost savings and facilitate balanced growth between the sub-sectors. In addition, it is expected that the new structure will place a greater premium on corporate governance to detect problems facing listed corporations before any de-listing is necessary. Already the Capital Markets Authority is in the final stages of the setting up of an electronic central depository system to aid in the speed of transactions at the exchange. There is scope for building on this as an initial step towards the leadership in establishing the connectedness within east Africa and eventually in the rest of the continent. The main policy lesson is that the convergence taking place in the financial services sector makes the fragmented regulatory structure imprudent and harmful to the sector. 6

A Comprehensive Report of the meeting is available from IEA offices.

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