

A.I.D. EVALUATION SUMMARY - PART I

15N 10754 PD-ABL-982

1 REPORT FILLING SET THIS FORM HEAD THE ATTACHED INSTRUCTIONS
2 USE LETTER QUALITY TYPE NOT COPY MATERIAL

IDENTIFICATION DATA

A. Reporting A.I.D. Unit: Mission or AID/W Office: <u>USAID/Kenya/PEO</u> IES# _____		B. Was Evaluation Scheduled in Current FY Annual Evaluation Plan? Yes <input checked="" type="checkbox"/> Slipped <input type="checkbox"/> Agreed <input type="checkbox"/> Evaluation Plan Submission Date: FY ____ Q ____	C. Evaluation Timing Interim <input type="checkbox"/> Final <input checked="" type="checkbox"/> By Date: _____
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C. Activity or Activities Evaluated (List the following information for project(s) or program(s) evaluated. If not applicable list the end date of the evaluation report.)

Project No.	Project (Program Title)	First PROAG or Equivalent (FY)	Most Recent PACO (Mo/Yr)	Planned LOP Cost (000)	Amount Disbursed to Date (000)
615-0240	Structural Adjustment Assistance Program— Technical Assistance Program (SAAPTAP) (Capital Markets Authority) [CMA]	Aug. 1988	Mar, 1995	\$775,000	\$775,000

ACTIONS

E. Action Decisions Approved By Mission or AID/W Office Director		Name of Officer Responsible for Action	Date Action to be Completed
Action(s) Required			
1.	Business Plan for a Clearing and Settlements System	Chief Executive (CE)/CMA	3/95
2.	Improving CMA operating and accounting and internal control systems, and reviewing brokerage firms' operating and accounting systems	CE/CMA	3/95
3.	Study Tour to South East Asia	CE/CMA	3/95
4.	Hosting a Nairobi-based course on Capital Markets Development and Regulation	CE/CMA	3/95
5.	Increase Public Awareness through the CMA Information Center (procurement of literature)	CE/CMA	3/95
6.	Prepare a Calendar for issuing new regulations for the foreseeable future	CE/CMA	3/95
7.	Establish a Committee on Shareholder Complaints and a Compensation Fund	CE/CMA	6/95

(Attach extra sheet if necessary)

APPROVALS

F. Date Of Mission Or AID/W Office Review Of Evaluation: _____ (Month) _____ (Day) _____ (Year)

G. Approvals of Evaluation Summary And Action Decisions:

Name (Typed)	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer	Mission or AID/W Office Director
	PEO: Zack Ratemo	CMA: Paul K. Melly	PROG: Stephen Ndele	DIR: George Jones
Signature	<i>Zack Ratemo</i>	<i>Paul K. Melly</i>	<i>Stephen Ndele</i>	<i>George Jones</i>
Date	September 15, 1995	September 15, 1995	September 27, 1995	9/20/95

A B S T R A C T

H Evaluation Abstract (Do not exceed the space provided)

The purpose of the Capital Markets Authority component of the SAAPTAP project is "to finance long term technical advisors to the Ministry of Finance, and associated costs, to assist the Government of Kenya in the creation of a functional capital markets development authority as well as funding selected in country consultants."

Capital markets did not really exist in Kenya before the initiation of the component. There was neither a Securities Act nor a regulatory agency; the Nairobi Stock Exchange was a private association or club whose six members of long standing did not trade among themselves and it could not be termed a "stock market" in the accepted sense of that term.

Overall, it can be concluded that a reasonably well-formed and functioning, if still embryonic, capital market has been implemented in Kenya over a remarkably short period, and in a very adverse economic, financial and political context. That market is capable of sustained growth. It can also be concluded that the assistance provided by the component has been critical to both the quality and the timeliness of this development, which would likely have been placed in serious jeopardy if the assistance had not been available.

Capital markets center around three core institutions: The regulatory authority, stock exchange, and clearing and settlement facility. During the tenure of the USAID CMA project, two of these core institutions were built from the ground up in Kenya: Regulator (CMA) and stock exchange (NSE). The USAID-funded advisor to the CMA has played an important and fruitful role in these developments. Unfortunately, the deterioration of the relationship between the CMA and NSE made the advisor's position increasingly untenable, eventually forcing him to curtail and then stop his work with the exchange. It is doubtful whether the two institutions have matured sufficiently by now to be left to their own devices with confidence.

Key Recommendations:

- o Review of CMA Act and regulations
- o Review of CMA lines of authority, operations & accounting practices
- o Development of a Clearing and Settlements Process
- o Improve internal management of NSE
- o Increase public awareness of rules and regulations of the capital markets
- o Increase listing and trading on the exchange.
- o Not to financially subsidize the normal operations of the NSE
- o Defining and implementing "self-regulation" of NSE
- o Establishing a Complaints Committee & Compensation Fund in NSE
- o Provide Technical Assistance to CMA and NSE for above and for the development of additional regulations

Lessons Learned: Capital markets can be developed in most adverse economic, financial and political circumstances, with very little funding, although full development of the such markets will take many years.

C O S T S

I. Evaluation Costs

1. Evaluation Team		Contract Number OR TDY Person Days	Contract Cost OR TDY Cost (U.S. \$)	Source of Funds
Name	Affiliation			
Andre Saumier	KPMG	PLE-0025-Q-00- 3071-00 Delivery Order No. 1	\$41,087.78	SAAPTAP Project Funds 615-0240
G. Barasa	KPMG			
2. Mission/Office Professional Staff Person-Days (Estimate) <u>20</u>		3. Borrower/Grantee Professional Staff Person-Days (Estimate) <u>5</u>		

S U M M A R Y

J. Summary of Evaluation Findings, Conclusions and Recommendations (Try not to exceed the three (3) pages provided)
Address the following items:

- Purpose of evaluation and methodology used
- Purpose of activity(ies) evaluated
- Findings and conclusions (relate to questions)
- Principal recommendations
- Lessons learned

Mission or Office:

Date This Summary Prepared:

Title And Date Of Full Evaluation Report:

Purpose of the evaluation and the methodology used:

The purposes of the CMA evaluation were to:

1. Determine the impact of the assistance made under the project on the Capital Market in Kenya and its effect on the Kenyan economy including employment creation.
2. Assist USAID/Kenya to determine the best and useful way of extending any further assistance to the Capital Markets Authority and whether the assistance so far provided or any that might be contemplated can contribute to the private enterprise development objectives of USAID Kenya.
3. Analyze the capital market in Kenya. Analyze the economic and political context and identify issues/problems that impinge on or have influenced (i.e. facilitated and impeded) its growth. Recommend how these issues/problems can be dealt with.
4. Provide general lessons learned for USAID in how assistance to stock markets such as Kenya's may best be provided. Assess/critique such assistance as a vehicle for development aid.

The methodology used in the evaluation of this activity included a review of relevant documents and records such as the project paper, project agreement, progress/activity reports, agreements with consultants, etc; interview of key players such as CMA board and management staff, USAID Advisor to CMA, Government officials, NSE Brokers, experts from the business and commercial sector, etc; and observation of operations at the Nairobi Stock Exchange.

Purpose:

Capital markets play an important role in structural adjustment processes. Assistance to their development can be a legitimate and useful component of foreign assistance structural adjustment package. Such has been the case in Kenya, where the SAAPTAP (Structural Adjustment Assistance Program-Technical Assistance Project) had a "Capital Markets Authority" component, with a broad objective of assisting the development of capital markets in the country.

Capital markets did not really exist in Kenya before the initiation of the component. There was neither a Securities Act nor a regulatory agency; the Nairobi Stock Exchange was a private association or club whose six members of long standing did not trade among themselves and it could not be termed a "stock market" in the accepted sense of that term. There was also no clearing/settlement institution.

SAAPTAP was intended to provide technical assistance to strengthen the institutional framework and for planning and policy analysis necessary for the implementation of the Structural Adjustment Assistance Program (SAAP), which was a major country objective for Kenya. The purpose of the CMA component was spelled out to "finance long term technical advisors to the Ministry of Finance, and associated costs, to assist the Government of Kenya in the creation of a functional capital market development authority as well as funding selected in country consultants".

It should be noted that a key objective of any structural adjustment program (SAP) is to shrink the role of the State in economic development and to correspondingly expand the role of the private sector. Without the mechanism of a well functioning capital market, SAPs will not be able to proceed as smoothly or as effectively as they need to. Hence the need in Kenya to have a CMA component and project.

Main Findings and Conclusions:

Overall, it can be concluded that a reasonably well-formed and functioning, if still embryonic, capital market has been implemented in Kenya over a remarkably short period, and in a very adverse economic, financial and political context. That market should be capable of sustained growth. It can also be concluded that the assistance provided by the component has been critical to both the quality and the timeliness of the development, which would likely have been placed in serious jeopardy if the assistance had not been available.

USAID's Contribution: A reasonably well-formed capital market has been put in place. With some additions, a fairly favorable economic and market environment, and a modicum of care and advice, the Kenya capital market should grow quite nicely over the years, both in absolute terms and by comparison with its regional competition. Prior to project commencement, capital markets in Kenya were not effective; subsequently they were. The generally successful outcome of the project, for its part, has certainly and well contributed to the broader SAAP and country objectives.

Capital markets center around three core institutions: The regulatory authority, stock exchange, and clearing and settlement facility. During the tenure of the USAID CMA project, two of these core institutions were built from the ground up in Kenya: Regulator (CMA) and stock exchange (NSE).

The USAID-funded advisor to the CMA has played an important and fruitful role in these developments. The advisor had to convince the various actors to create a stock exchange more or less from nothing and then teach every one, regulator, stock exchange and brokers alike, how to make it work.

Unfortunately, the deterioration of the relationship between the CMA and NSE made the advisor's position increasingly untenable, eventually forcing him to curtail and then stop his work with the exchange. It remains that the training the advisor has been able to give and the market philosophy he has tried to impart, must still be merely "skin deep." They have been tested only slightly so far, although more so in the case of the NSE which passed through the market boom. It is doubtful whether the two institutions have matured sufficiently by now to be left to their own devices with confidence. It is likely that both would find the going very tough in policy terms as well as in technical and administrative matters.

In any case, there can be little doubt that the USAID assistance to the NSE was critical to getting it off the ground at an early date. Certainly the broker community was not of a mind to finance start up costs for a proposed stock exchange, without which they had been able to function for years. This contribution was therefore strategic and timely.

CMA: The CMA needed considerable outside expert assistance in at least four areas: Legal, regulatory, strategic and organizational. The project's long-term advisor helped to create and shape the CMA in these areas. However, it must also be noted that certain major projects of the CMA, such as its Information Center for users of the capital market, have not yet been implemented.

The regulatory output of the Authority has been at once impressive. The regulations go some way towards remedying the deficiencies of the Securities Act as analyzed in more detail in the body of the report. For example, the regulations are forthcoming on the organization and responsibilities of stock exchanges, which must neither distribute their profits nor restrict their membership. They also touch on most important issues directly affecting the capital markets: Stock exchanges, licensing of brokers

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and other intermediaries, investment advisers, primary market, off-exchange transactions, complaints and compensation.

However, the regulations remain silent on the clearing and settlement institution; have little to say on the primary market; do not clarify the decisional hierarchy which may exist among the Government, the Minister, the CMA, and other parties or groups as mentioned above; and have nothing to say on the important policy issues of the required initial and continuing capital of securities firms.

The general lines of authority in the regulation of capital markets also need to be resolved. The Securities Act fails to specify the hierarchy of responsibility which is to exist between the CMA and the Minister of Finance to which the CMA reports and answers. In other words, it is important for the CMA to know with precision the areas where it is "supreme" and may act without reference to the Minister.

The NSE The NSE has benefitted from USAID assistance for the establishment of its first physical facilities as well as for training and publicity purposes. USAID provided a long-term advisor who devoted most of his first 18 months to the Exchange. The NSEs restructuring from an association to a company called for the retraining more or less from zero of the complete capital markets industry as it then existed. The acid test of the success of the NSE transformation happened when the market took off in June 1993: The NSE and its members "held" and were able to cope. That is an accomplishment whose importance can hardly be overstated, and it provides the necessary foundations on which further developments can be built.

The NSE has now put together an ambitious expansion program, under which it is moving to large new facilities with a trading room capable of accommodating 100 traders and clerks and some 25 large trading boards, a public gallery and an auditorium, a dedicated clearing and settlement area, and adequate office space. Although the cost of this expansion will represent a financial challenge for the Exchange, there is no reason to believe that it should not be able to meet its budgets over time.

Government of Kenya Contribution: The Government of Kenya has kept its part of the legislative bargain in the strengthening of their capital markets through the passage of the Securities Act and the tabling of the recent amendments. Notably also, the CMA was constituted almost immediately after the Act was approved; the Chief Executive appointed in very short order, and the Authority was soon made modestly operational with initial office space, staff and budget. This is almost lightning-like speed in traditional terms. Moreover, considering the immense needs of the country and the extreme paucity of public resources, the CMA has been generously funded.

The Government also took a number of other steps designed to facilitate the expansion of the capital markets: Equalization of tax treatment for interest and dividend income; reduction of the withholding tax; removal of the stamp duty on exchange transactions; issue costs made deductible for companies; block funds freed; privatization of some state owned enterprises through the equity markets; strengthening of the quality of accounting information; and the issuance of administrative regulations under the Securities Act.

These are all important measures, implemented within a relatively brief period of time. What one might call the administrative "bargain" has thus been more than substantially honored. Still, there remains work to be done on legal and administrative issues regarding the capital market.

Capital Market Activities: The growth of the NSE over the last three years has been in some ways impressive. For instance, there are now some one billion shares outstanding from 50 listed companies with an average value of KShs 80 per share. The volume of trading has soared, albeit from a tiny base and still small in absolute terms. Also, the market index has climbed quite dramatically--it more than doubled in 1993 alone, and has almost tripled since June of last year. These figures are quite

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Page 5a.

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impressive considering that the activity occurred during a period of high inflation, a monetary devaluation, an epidemic of damaging financial scandals, record interest rates, a freeze on donor funds, and unpredictable shifts in macroeconomic policy. Nonetheless, it would be prudent to think of the NSE and of the capital markets institutional complex as still being in their infancy and in need of nurturing rather than on the verge of joining the ranks of strongly emerging markets such as Thailand or Indonesia.

The quality of trading on the NSE is another vital issue. It is immediately clear that the NSE is not, by any reasonable benchmark, an active stock exchange and therefore cannot claim to provide a liquid market with quality trading. To illustrate that point, one may note that there are at the moment more shares traded in one day on the Jakarta Stock Exchange than there were during all of last year on the NSE.

Obstacles to Growth

In regard to the **CMA**, it can correct some of the environmental obstacles to capital markets growth. CMA contributions can include the following: Creating and maintaining a level playing field; Attracting more listings; Strengthening clearing and settlement; Maintaining the quality and effectiveness of regulatory implementation; Educating the public and responsibility promoting the stock exchange; Dealing with the political environment.

In regard to the **NSE**, its obstacles to growth include: Clarifying the NSE's legal standing; Determining the structure of the NSE; Dealing with the effective absence of corporate finance/underwriting capability in existing securities firms; Market illiquidity; Improving clearing, settlement and registration (see CMA section). It should also be noted that both the CMA and the NSE could benefit from organizational evolution.

Key Recommendations:

1. Improve/Clarify the sections and/or dispositions of:

- Capital Markets Authority Act
- 1992 Ministerial Regulations
- 1992 Authority Rules

2. The Capital Market Authority

- structure itself more clearly in relation to its primary and secondary markets mandates
- bolster its capability for regulation of the primary market
- improve the time-frame for approval of IPOs and new issues
- work on the unit trust and investment fund problem
- mount a campaign in conjunction with NSE to attract companies to the market
- identify ways of promoting the development of underwriting and corporate finance capability
- define the major parameters for an effective clearing and settlement institution and for an improved share transfer/registration system
- prepare a discussion paper on major parameters for the SRO system
- implement an information program for the public on the specific role and mandates of the Authority
- create its Committee on Shareholders' Complaints
- prepare a discussion paper on the funding and functioning of the Investor Compensation Fund
- study modalities for the financial "autonomy" of the Authority
- establish an internal calendar of regulatory actions

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The Nairobi Stock Exchange

- structure itself more clearly in function of its three major rules
- introduce a "book" for each listed stock
- charge a transaction fee to members on each trade
- set a membership fee for joining the exchange, based on a clear formula
- consider the concept of "introducing" brokers ("remisiers")
- put in place an improved information and data program
- activate a program of public education in "investment practice"
- set up an Investors Complaints Committee of its Board
- improve the clearing/settlement process and work for the creation of a clearing/settlement entity
- look into ways of improving the share registration process
- mount a campaign and program to convince and help companies to become listed on the exchange
- encourage the creation of underwriting and corporate finance capability within existing securities firms

Positive Lessons Learned

- Capital markets can be developed in most adverse economic, financial and political circumstances. The process can be quite rapid, as it was in Kenya. An effective capital markets assistance program does not have to be particularly expensive or all-encompassing.
- Even embryonic and completely unstructured capital markets can play an effective role in the mobilization of savings and the allocation of capital. The transfer of knowledge and expertise is entirely feasible in the field of capital markets development.

Negative Lessons Learned

- The Kenyan experience has made it clear again that capital markets regulation is not an instantaneous process and that it requires time to unfold and take hold. A strong self-regulatory philosophy and practice will have to be nurtured until a "culture of compliance" has begun to take root.
- It has been confirmed that capital markets, particularly during their "emerging" phase, have a powerful political component which can either speed up progress, and bog it down. Local conflicts can slow progress considerably or even arrest it altogether.
- It has been shown again that clearing and settlement (along with other associated processes such as transfer and registration) is usually the forgotten "orphan" in capital markets development programs.

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ATTACHMENTS

K. Attachments (List attachments submitted with this Evaluation Summary: always attach copy of full evaluation report even if one was submitted earlier. Attach studies, surveys, etc. from "ongoing" evaluation if relevant to the evaluation report.)

Full Evaluation Report

COMMENTS

L. Comments By Mission, AID/W Office and Borrower/Grantee On Full Report

USAID Comments:

USAID concurs with the general findings and conclusions of the evaluation. The capital markets in Kenya have developed significantly and the USAID funded technical assistance was key to promoting this development. The intervention was an inexpensive and effective activity. The evaluation paid insufficient attention to immediate implementation issues, tensions between the Capital Markets Authority and the Nairobi Stock Exchange, and the role of the CMA and NSE in economic development. While the former issues seem to be resolving themselves, it is difficult for USAID/Kenya to determine the relative importance of capital market development, compared to other possible interventions, until the Private Sector Strategy is fully developed. Thus, while USAID concurs that additional long term technical assistance would be beneficial, USAID/Kenya is not able to commit to this type of assistance at this point. However, USAID will support the recommendations for feasible short term activities for the remainder of the life of project.

CMA Comments:

CMA notes the contents and issues raised in the Evaluation Report. The Authority will strive to implement the issues highlighted in the evaluation. The assistance from USAID has resulted in achievement of the critical aspect of institutional creation and strengthening which will go a long way in forming the basic foundation for further development of capital markets.

The Evaluation Report highlights some specific areas of weaknesses in the policies and existing structure of market institutions. CMA will continue to review the policies and the existing institutional framework with a view to creating a level playing field and promoting market development. In particular, and arising from the Evaluation Report, CMA wishes to undertake two key studies namely "Clearing and Settlements at NSE and Accounting and Operating Systems for Market Operators." In conjunction with NSE and other institutions like Central Banks, CMA will launch a public awareness program on capital markets investments. This strategy will encompass encouraging more companies to list on the Exchange. CMA will further strengthen the regulatory framework through a review of existing regulations and rules and with greater private sector participation.