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KENYA; AN ACTION PLAN FOR CAPITAL MARKET DEVELOPMENT AND CAPITAL MOBILIZATION

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FORWARD

The Sessional Paper No. 1 of 1986 clearly states the intentions of the Government concerning development of the economy. The IFC/Central Bank of Kenya's, Report and Recommendations on the Development of the Money and Capital Markets in Kenya of October, 1984, details the key issues for consideration. This paper will emphasize and, to an extent, prioritize certain major points.

KEY INGREDIENT TO CAPITAL MOBILIZATION

Because already heavy commitments of members of the cabinet preclude continuous, detailed deliberation by them on the issues involved, authority, not unlike that granted to a small number of people in the drought-created crisis of 1984, should be vested in a carefully selected group, The Capital Market Development Authority (CMDA). A commitment by appropriate members of the cabinet to champion the recommendations of the CMDA in presentations to the President and Parliament is essential to assure mobilization of savings into productive enterprises to a degree sufficient to achieve desired levels of productivity and standard-of-living.

I. INTRODUCTION

A. Role of The Capital Market

The primary responsibility of government is to improve the standard of living, the real income per capita, of the people. This can only be accomplished by increasing productivity which, in turn, requires mobilization of savings into investment in plant, equipment and technology as opposed to investment in non-productive real estate or worse yet, flight of capital. And, without a favorable climate for domestic capital, it is impossible to attract capital from abroad. A vibrant capital market is essential to the well-being of a productive economy.

B. Key Positive Aspects of Kenya for Capital Mobilization

1. Government-Private Sector Dialogue

Both through establishment of the Joint Industrial Commercial Consultive Committee and the preparation of Sessional Paper No. 1 of 1986, the government has shown a desire, uncommon in many countries, to carry on a continuing policy dialogue with the private sector. The Sessional Paper clearly states a recognition that government can not develop a country without progress in the private sector, and the private sector can not prosper without a favorable political and economic climate.

2. <u>Sound Accounting</u>

Kenya, unlike many developing countries, is gifted with a sound accounting profession and the capability of attaining an audit of integrity which meets international accounting standards.

3. <u>High Level of Savings and Institutional Investors</u>

A high level of savings, with concurrent development of major institutional investors in the form of insurance companies and retirement/provident funds, provides a ready source of capital for long-term investment. Further, the institutions assure a degree of liquidity in the securities market for individual investors.

C. NEED FOR AN ACTION PLAN

The terms of reference of the Government's Committee on Investment Policy (COIP) clearly mandate a program for action:

> "1. Study recent trends in private investment, domestic and foreign.
>
> 2. Assess investment climate with particular attention to impact of government polices and procedures.
>
> 3. Recommend changes in government policies & procedures which will improve investment climate and which will stimulate a rise in private investment that is consistent with economic strategy presented in <u>Sessional Paper No. 1 of 1986</u> . . ."

Chapter 3 of the Sessional Paper concludes, "The Government will provide a supportive environment and will work actively with the private sector to help develop a financial system that is conducive to more rapid economic growth."

There appears to be agreement as to the objectives but necessary policy changes to achieve these objectives often involve risks. The government has shown political courage in the past, both through the removal of the capital gains tax and the relaxation of a number of price controls. To further capital mobilization, the government--the Ministries of Finance and Planning and the Central Bank specifically--must move beyond the Sessional Paper. And, since demands on cabinet members' time preclude their continual heavy involvement, adequate authority must be delegated to a designated entity to assure priority being given to consideration of the major prerequisites for capital market development.

II. CAPITAL MARKET DEVELOPMENT AUTHORITY

Both the Sessional Paper and the detailed IFC/Central Bank Report and Recommendations on the Development of the Money and Capital Markets in Kenya (October, 1984) recommended the creation of a Capital Markets Development Authority (CMDA), a logical first step to improving capital mobilization. As recommended in the IFC/Central Bank report, the CMDA should include senior representatives of concerned government agencies but should be heavily weighted with representatives from the private sector informed on the needs for capital mobilization (underwriters, brokers, institutional investors, public company executives, accountants and practicing corporate lawyers). As a working group, it should be kept small for efficiency purposes.

The terms of reference for the CDMA should be to activate capital mobilization through sponsorship of capital market development, with the further responsibility of insuring protection of the general public's interest as the market develops, as stated in Sessional Paper No. 1. The first order of business should be to review the recommendations of the IFC/Central Bank report, establish priorities (in order of importance, not ease) and set a time frame for action on each. Technical assistance in the form of individuals with experience in capital mobilization in other developing countries probably will be available through A.I.D.

It would also be useful, early in the CMDA's deliberation, to have a delegation visit securities markets to which Kenya could relate, such as Brazil, Singapore and Malaysia. The delegation should be balanced between government and private sector representatives (for dialogue) and the trip well planned in advance with an in-country authority on capital markets as the host.

III. ISSUES TO BE ADDRESSED BY THE CAPITAL MARKETS DEVELOPMENT AUTHORITY

Capital markets and capital mobilization cannot be legislated into being. Incentives are necessary to entice private businesses, both foreign-owned and domestic, to accept outsiders as minority shareholders; to encourage the general public to purchase shares and bonds, and to stimulate the middleman (ie. the underwriter and stock broker) to educate potential investors and promote the process of bringing buyers and sellers together. These incentives provide the catalyst for capital market development.

A. Incentives and Disincentives to Companies "Going Public"

The lack of supply of securities available for purchase is clearly the current obstacle in Kenya and thus, an early priority to be addressed. There presently exists no advantage to "going public". Incentives are needed to encourage companies to undertake public offerings as opposed to private placements with a few individuals.

By limiting the number of shares purchased per individual and utilizing the banking system to effect distribution to the most remote provinces of the country (such as was accomplished in the Barclays underwriting), availability of attractive investments for the small, indigenous investcrs can be assured.

1. <u>Tax Incentives</u>

A significant tax reduction for companies "going public" with an even bigger one if 50% of the shares are distributed can be a major incentive, but <u>only if there is equality of tax treatment between public and private companies.</u> Certainly, as recommended in the IFC/Central Bank report, a company with wide ownership should be required to have audits by accountants qualified as members of the Institute, who meet standards of qualification, practice and independence acceptable to the Stock Exchange and the Capital Market Development Authority. But, the tax-reduction incentive will be of little value if a major private competitor is declaring and paying taxes on only a fraction of its true earnings. The government should require all companies receiving bank credit over a certain amount to have annual audits, utilizing international standards. Audit integrity for tax purposes would, in all likelihood,also benefit the government by more than making up any temporary loss in tax revenues resulting from tax-rate reductions and other recommended incentives, as well as reducing illegal flight of capital through manipulation of corporate records.

2. <u>Pricing</u>

A process which enables the issuer to receive a price which reflects the success and profitability of his company is essential to a meaningful flow of attractive equities to the investing public. The government, through the Capital Issues Committee (CIC), is presently playing a major role in the pricing of issues in a effort to protect the unsophisticated buying public. Actually, the government is placing itself at risk by so doing since it may be considered to be "recommending" the issue at that price. More importantly, as stated in the IFC/Central Bank report, the interference, through CIC, in the pricing of new public issues has negatively affected the willingness of companies to go public. Prices of all equity and debt security issues should be set by negotiations between the issuer and his underwriter(s) (in whose interest it is to see the issue "go public" at as low a price as possible). The present shortage of supply of securities on the market may cause the prices on the market to rise to levels which could place the uneducated buying public just as much at risk as would an overpriced new issue. Further, the underwriters are not going to place themselves at risk by agreeing to a price which would eliminate demand on the part of the sophisticated institutional investors.

Thus, institutions provide a safeguard for less sophisticated individual investors. Korea's capital market growth rapidly accelerated in 1973-74 when the Ministry of Finance liberalized the pricing process in that country.

3. Premiums of Issues in Blocked Accounts

Again, as mentioned in the IFC/Central Bank report, the requirement that when a foreign shareholder sells shares locally, any premium above original cost must be placed in a blocked account for five years and invested in low-yielding government bonds is clearly an impediment to some of the best candidates selling shares, and futher impedes new foreign investment. The best protection for the government against excessive repatriation of funds is making sure the political and economic climate in Kenya is conducive to private investment.

4. Private Placements

Certainly an enterprise should have freedom of choice between a private placement and a public issue when raising funds, but the wide-spread belief that private placement with influential individuals can help business activities is a disincentive to "going public."

5. <u>Restriction of Bank Credit</u>

Too often, short-term bank credit is being used to finance long-term capital needs. The government, through the Central Bank, might consider setting credit standards for bank lending.

6. <u>Tax-Free Interest on Bonds of Public Companies</u>

Only approximately four corporate debt securities are currently on the market. One reason for this is the difficulty such instruments have competing with tax-free housing bonds. An additional incentive to encourage companies to accept public shareholders would be to allow interest on their newly issued bonds to be tax-free <u>after</u> "going public" with common stock, thus, reducing the cost of raising long-term funds through debt issues.

7. <u>Removal of Red Tape</u>

The Sessional Paper acknowledges that investment approval procedures are cumbersome and time-consuming. The Capital Market Development Authority must make sure that the process of public offering approval is as efficient and least burdensome as possible.

B. Incentives to Attract Stock Investors

Kenya has an extremely high level of savings, both through individuals and institutions. Demand for sound investments presently outstrips supply. The fact that Barclays Bank stock rose 150% in 10 months after it became public clearly demonstrates an ability and willingness of the public to invest in sound investments. However, as incentives are set in place to increase supply, an appropriate set of incentives will be necessary to insure that demand keeps pace.

1. Comparative Yield

In a country such as Kenya where most investors are yield conscious and do not think in terms of total return (income plus appreciation), it is particularly important that dividends not be placed at a comparative disadvantage to the tax-free interest earned on postal savings and housing bonds. To further capital mobilization, interest on corporate bonds and dividends on stock should have at least as favorable tax treatment. The Sessional Paper states that the tax reform study will address taxes relating to interest payments, corporate profits and dividends and the IFC/Central Bank report recommends that securities should be put on the same footing as postal savings and housing bonds, or the tax preference should be removed. Again, increased tax revenues arising from requiring both private and public companies with bank borrowings above a certain level to have audits with international credibility will more than offset any temporary revenue loss.

2. Taxes

By removing the capital-gains tax, the government has demonstrated its interest in stimulating capital markets. The intercorporate-dividend tax which applies at the corporate rate unless a 12.5% ownership threshold is achieved should also be removed.

3. Investment Trusts

Investment Trusts provide the same advantages to small investors as those available to institutions and large individual investors; namely, diversification, careful selection of a securities portfolio by professional management and continuous supervision thereof. Capital mobilization for investment in productive enterprise can be stimulated further by providing tax incentives for investing in specialized investment trusts dedicated to investments in specific industries the government is anxious to develop (such as agribusiness). In the late 1960's, Brazil created such specialized "157 Funds". Anyone investing in this medium for a minimum of three years could reduce their taxes by a percentage of their investment. This program was a major factor in Brazil's capital mobilization through the introduction of its citizens to the advantages of stock ownership. Such a program in Kenya, however, should await the stimulation of the supply of securities available.

4. <u>Favorable Investment Experience -- Divestiture</u>

Nothing attracts new investors more than hearing from a friend of a favorable investment experience. Conversely, word of an unfavorable investment has a negative effect. It is extremely important, therefore, that in the early stages of equity-market growth, shares of well-established companies with favorable earnings trends and proven managements become available to new investors rather than the government encouraging issuance of shares in start-up (and risky) organizations.

<u>Divestiture</u> - Kenya has a limited number of companies of significant size with proven management and favorable earnings trends. A number of these are owned by the government directly or through institutions such as ICDC. Privatization would set an example for others and be a major stimulus to capital mobilization both by increasing supply and providing attractive investments. The Government controls the banking and insurance industries. Therefore, no need exists to own operational companies in these areas. Jamaica, a poorer

country with far smaller savings and less of a capital market than Kenya, privatized its largest bank. It overcame the potential criticism of "giving away the jewel of the land" by limiting size of purchase per investor and distributing shares to small investors in all provinces of the country through the banking system. ICDC is supposed to function in a developmental mode -- revolving its capital through sale of successful portfolio companies and reinvesting in newer enterprises of significant promise. Yet the executive director of ICDC believes he is being judged by his ability to balance losses of portfolio companies in difficulty with earnings of successful ones. Far greater impact on national development will be accomplished if the Ministry of Finance assures the Executive Director he will be judged by the degree to which he aids capital mobilization through making the shares of successful portfolio companies available to the public, with the full understanding that some "sick" portfolio companies may have to be liquidated (with resultant capital reduction). Proceeds from sales should be invested in specific industrial areas the government is anxious to develop. Further, capital injections may be necessary from time to time because of the developmental nature of the activity.

5. <u>Regulatory Climate</u>

An appropriate and effective regulatory climate to protect the interest of the investing public builds investor's confidence. This eventually will become a major on-going function of the CMDA. It should be recognized, however, that rules and regulations are of no value without adequate staff to ensure enforcement. It is essential that future annual budgets of the CMDA provide for an effective audit team to prevent "free riding" (retention by underwriters for their own account of new issues in great demand), "insider trading" (acting on non-public information) and other abuses which would place the general-public investor at a disadvantage.

C. <u>Incentives for the Underwriter, the Distributor and the Stock Broker</u>

The greatest protection for the investing public is not government rules and regulations, but the quality of individuals attracted to the investment banking and brokerage community. Such individuals are ultimately responsible for the growth of the capital market through the education of potential investors and the promotion of ownership of securities. Profitability attracts effective people to a profession, but the profitability must not be a result of taking unfair advantage of the public (ie. "free riding" and "insider trading").

Currently underwriting fees and commission are set in Kenya by the industry itself. Perhaps minimum fees should be mandated to preclude predatory competition in an embryonic industry, with final fee-setting left to negotiation between the issuers and the underwriters and determination of commission changes remaining with the Exchange. To ensure sufficient profitability to further stimulate vitality in the "stock exchange" community, brokers should be encouraged to act as dealers as well and to band together for the purpose of serving as underwriters. The wide branch networks of government-owned banks make them indispensible as distributors, both for underwritings and investment trust shares. To encourage growth of a private sector investment-banking community, however, government-owned banks, as well as ICDC, should not compete as underwriters.

IV. THE STOCK EXCHANGE

A securities market provides the liquidity, without which potential investors would not be interested in purchasing shares of ownership. The "Stock Exchange" of Kenya presently consists of six brokerage firms who act on a purely agency basis, notifying clients whenever blocks of stock become available at attractive prices. Their present rules preclude advertising. This policy should be modified. Individual firms should be promoting seminars to educate the public as to sound investment principles. (Educational activities will also raise the visibility and improve the image of the Stock Exchange members.) Seminars on investments are aggressively promoted in the U.S. and have been a major factor in attracting new investors. It is suggested that as stock and bond activity increases, consideration be given to inviting an individual well-versed in securities educational programs (possibly under A.I.D. technical assistance) to work with the brokers for a few days.

Before Exchange members take steps to modify the internal functioning of the "Exchange" in anticipation of greater activity, there should be exposure to securities markets in more advanced developing countries. Participation in the CMDA survey trip recommended earlier will afford the opportunity to explore various ways of providing liquidity through efficient market operations.

V. CONCLUSIONS

The Capital Market Development Authority must be a mixed public/private sector group dedicated to converting the intentions expressed in Sessional Paper No. 1 of 1986 concerning capital market development into reality through timely decisions, in a prioritized manner, on issues raised in the IFC/Central Bank of Kenya report of 1984. The CMDA must resist the temptation to delay action in the hope of obtaining all the facts as well as putting off action until the entire plan is complete. The authors of the most rapidly developing economies have not afforded themselves that luxury. Decisions should be based on estimated risk/reward ratios with program adjustments being made as the capital market expands.

Economies are developed through people, and people need incentives. The incentives (and removal of disincentives) emphasized in this paper have proven effective in furthering capital mobilization in such developing countries as Singapore, Korea, Taiwan, Malaysia and Brazil. Consideration of similar incentives by the Government of Kenya is merited.

Once the government has demonstrated a commitment to an action program for capital market development, A.I.D. would be hard pressed to find a project where technical assistance could be more productive. The end product of capital market development is an increasing standard of living resulting from increased productivity as savings are mobilized and invested in productive assets.