The Development of Credit Markets in Kenya for Urban Infrastructure and Housing Finance

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Abstract: The objectives of this paper are to: 1) Evaluate the feasibility of immediate application of USAID guarantees to the current housing and infrastructure program, and 2) Explore the possibility of using USAID auspices to assist in developing an ongoing financial market to enhance housing and infrastructure development in Kenya. The report also reviews the capacity of various Kenyan financial institutitions, and analyzes the country's economic environment as it relates to developing capital markets.

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THE DEVELOPMENT OF CREDIT MARKETS IN KENYA FOR URBAN INFRASTRUCTURE AND HOUSING FINANCE

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EXECUTIVE SUMMARY

Objectives: The objectives of this paper are to:

(1). Evaluate the feasibility of immediate application of USAID guarantees to the current housing and infrastructure program, and

(2). Explore the possibility of using USAID auspices to assist in developing an ongoing financial market to enhance housing and infrastructure development in Kenya.

Need: The Ministry of Works, Housing and Physical Planning estimated in 1985 that the formal sector of the Kenyan economy produces an average of 6,000 to 8,000 housing units annually and that over 280,000 new units per year would be required to keep up with projected population growth and to replace deteriorating existing units.

This need and the need for ancillary infrastructure place a critical burden on the GoK to enhance available financing for housing and infrastructure. Bond finance is one option. However, this is made more difficult by the fact that Kenyan municipal governments may be characterized by:

- Poor collection of existing tax sources,
- Bookkeeping that most likely would be inadequate for public investors,
- An inconsistent history of repayment, and
- Little financial assistance from the central government.

Lending Institutions: Most lending for housing or infrastructure derives from three sources--commercial banks, insurance companies and housing finance institutions. Bank investments are generally from 3 months to one year in maturity; insurance companies 3-5 years; and housing finance institutions 10-20 years.

- Banks have wide latitude in investments but, in practice, tend to hold mostly GoK securities. The current liquidity requirement is 25%, which is nearly always met with holdings of government securities. To comply with the IMF restructuring agreement and to combat inflation, the expansion of new loans by the banking sector is limited to no greater than 12% per year.

- Insurance companies are required to invest 25% of their assets in Government Securities, securities of certain statutory bodies, securities issued by local authorities or those of prescribed organizations. They must invest at least 65% of their assets in the above securities along with mortgages property in Kenya, shares of companies quoted on the stock exchange, instruments of title to immovable property in Kenya, and loans on life assurance policies issued in Kenya. The result is that portfolios for insurers in Kenya are about 25% invested in GoK securities, 20% residential mortgages and 30% commercial mortgages.

- The Housing Finance Institutions make loans with the longest maturity in Kenya by rearranging deposits averaging about 3½ years duration into loans of 10 to 20 years duration. One category of Housing Finance Institution consists of limited liability companies, known as "Mortgage Finance Companies" which come under the direct regulation/supervision of the Central Bank of Kenya. The law stipulates that "Not less than 75% of all loans made by a Mortgage Finance Company shall be made for the purpose of acquisition, construction, development, improvement or alteration, by the borrower, or residential property in Kenya."

  The other category consists of mutually-owned building societies which are under the supervision of the Attorney General of Kenya and the Commissioner of Cooperatives. Mutually-owned societies are required to invest the same 75% of all loans in mortgage loans. At present the Building Societies Act limits loans to KShs 750,000 (US$ 32,895). There has been a general weakening of all but one mutually-owned society and a consolidation of other societies within the last few years.

The lack of deposit insurance is a problem for the mutually-owned building societies. Notably, under the Guarantee (Loans) Act of 1980 the GoK can attribute its guarantee to other governmental bodies and co-operative societies registered under the Co-operative Societies Act.

All Kenyan financial institutions suffer from the lack of a liquidity facility or secondary market for mortgages and other investments.

Borrowers: The largest borrower in Kenya is the GoK, having nearly KShs 14.6 billion (US$.64 billion) of long term debt and KShs 37.2 billion (US$ 1.632 billion) of short term debt. Government Sponsored Corporate Debt includes debt of Kenya Power and Lighting, and others. Bankers interviewed seemed to feel that the debt of these "high quality" parastatals was better than the GoK debt itself perhaps because of the revenue stream generated by such quasi-business entities.

Financial Intermediaries: There are few true financial intermediaries in Kenya.

- The Central Bank will only discount GoK bond's with less than 3 months to maturity.

- The short term CD's issued by Citibank Kenya and First American Bank of Kenya will be redeemed at par at any time and appear to be being traded at par. Without discounting, however, their significance as an intermediary is questionable.

- Some firms such as Minet Insurance, Housing Finance Company of Kenya and Dyer and Blair have contemplated making secondary markets for various instruments.

- The Nairobi Stock Exchange has existed since 1954 and grew to 70 companies by 1967. Since then, however, the exchange has shrunk in volume, capitalization and number of stocks listed primarily because of the growing dominance of government debt over this period.

Economic Environment: Four economic factors detract from the prospects of developing a capital market in Kenya in the short run:

(1) inflation (particularly relative to world inflation),
(2) high levels of Central Government spending and borrowing,
(3) negative real interest rates, and
(4) overall expectations of changes to come.

- The average *official* annual rate of inflation, as measured by the change in the consumer price index, declined slightly to 10.6% in December 1989 from 10.7% in December 1988. The official estimate of inflation today remains in the 11% range. However, unofficially, the inflation rate appears to be in the range of 18 to 20% rather than the official rate based upon a 1974 market basket of goods to produce a CPI.

- The central government is consuming significant resources and savings. As of June, 1990 the GoK has KShs 2.3 billion (US$ 100 million) of one year bonds outstanding, KShs 4.5 billion (US$ 197 million) of two year bonds and KShs 7.8 billion (US$ 342 million) of five year bonds--a total of KShs 14.6 billion (US$ 640 million)in a country with a Gross Domestic Product of about KShs 175 billion (US$ 7.7 billion), but one that produces a very small flow of available savings.

- Interest rates are managed by the GoK. For example, mortgage rates cannot exceed 19% annually, 250 basis points above the Treasury long term tender rate of 16½%. Stated rates can be deceiving, however. The 16½% rate, after allowing for a discounted purchase and semi-annual payment of debt, yields about 23% yearly. Also, the 18 or 19% charged on mortgages is comparable to 22 to 23% effective yield. The GoK has announced its intentions to decontrol interest rates by July 16, 1991.

- The common perception is that the controlled interest rate will continue to head higher until the managed rate is approximately equal to the market rate and that the GoK is adhering to the 1986 Sessional Paper which calls for deregulation leading to convertability of the Kenyan shilling. Thus, expectations of decontrol and higher yields force financial institutions into an extremely short maturity pattern.

Investment Alternatives: At this point it would appear that the highest expected annual return in Kenya is on commercial property (probably in the 30% range); GoK debt (real yields of 22-23%); bank deposits (about 17% for large depositors); and corporate equities (8 to 9%). Real rates, of course, would be the above estimated rates minus the expected 18 to 20% annual rate of inflation. Thus the return to holding cash is a negative 18 to 20%. Were it not for various regulations, transaction costs, risks, capital requirements, and expectations concerning future returns investors would invest their entire portfolios in commercial property. There must be some doubt, however, that commercial property can continue to provide the return that has come to be anticipated. Several persons interviewed indicated some fear that commercial property (in Nairobi) was being overbuilt.

Savings: The aggregate flow of savings and profits in the Kenyan economy appear to be substantial. The official savings rate is around 17%, but, because savings are calculated as a residual (income not spent) some portion of the calculation must be attributable to leakages from the formal sector to the informal sector as well as to savings supplied by the foreign donors. An appropriately constructed market instrument that meets the needs of the informal sector (i.e., being very liquid and unregistered) could draw savings and economic activity from the informal sector to the formal sector.

Investment Risks: Every investor and lender face a number of risks over time. Four important risk considerations are (1) interest rate risk, (2) purchasing power risk, (3) exchange rate risk, and (4) liquidity risk. Each risk is described, along with methods for reducing such risks, in the paper that follows.

- In a free market economy, investors can usually hedge their debt investments against equity investments to avoid interest rate risk. Generally, as stock prices escalate, bond prices fall. And, as is discussed in the body of this paper, a well developed and freely fluctuating capital market allows for warrants, puts, calls, swaps and other devices that can be used to limit losses. The Kenyan managed credit system effectively has removed any possibility of such a hedge and , thus, has reduced the attractiveness of credit instruments.

- The usual hedge against purchasing power risk, inflation, for a lender is a variable rate instrument. The only thing close to a viable index in Kenya is the Central Bank of Kenya ceiling rate (19%, as of June 1990) or the Treasury Bond rate plus two points (about 16½% plus 2%, or, 18½%). Because both rates are below market and subject to administrative control by the GoK, neither is satisfactory to the borrower or the lender.

- The local currency guarantee has the advantage of:

    (1) assisting to a greater extent in the development of local capital markets,
    (2) being consistent with the IMF restructuring agreement, and
    (3) alleviating the exchange rate burden from a developing country.

- Liquidity risk resulting from the lack of a secondary market or liquidity facility is the single most important limitation to the development of capital markets in Kenya. For all practical purposes there is no secondary market in Kenya.

Elements of a Municipal Market: In the US the fees of various parties to a bond issue contribute from 1 to 2½% of the issue size. Such services as underwriting, bond counsel, trustee, and insurance contribute significantly to the costs of issuance and would indicate that the size of an issue must be large enough to support such costs. Some costs could be offset with "arbitrage earnings". Arbitrage is the buying of a contract in one market and selling it in another. In the tax-exempt municipal market the term specifically refers to borrowing a tax-exempt rates and lending at taxable rates. The earnings could be considerable if this spread is large. However, there is some reason to believe that the spread is minimal.

Recent Developments: The Capital Markets Authority Act of 1989 established a Capital Markets Authority with the purpose of developing the Kenyan capital market with "particular emphasis on the removal of impediments to and the creation of incentives for longer term investments in productive enterprise; the creation, maintenance and regulation of a market in which securities can be issued and traded in an orderly, fair and efficient manner; and the protection of investor interests." The Authority is granted the power to purchase or otherwise acquire movable and immovable property; borrow and lend money; grant license to operate as a broker, dealer or investment advisor; to approve of unit trusts and mutual funds; and to formulate rules for exchanges, records and disclosure. However, three factors became apparent:

(1) Although there is great hope expressed by government officials for the work of the Authority there is considerable pessimism on the part of private businessmen.
(2) The Authorities first task is licensing and regulation rather than any particular plan to strengthen and lubricate the workings of the financial market.
(3) The main concentration is on the Nairobi Stock Exchange.

The 1990 Budget Message proposed several tax law changes designed to augment various components of the capital market:

(1) The message proposed elimination of double taxation on Unit Investment Trusts. A Unit Investment Trust is a fixed portfolio of securities sold to investors in trust "units", which represent fractional undivided ownership interests in the portfolio. Unit Trusts will be subject to withholding taxes of 15% on dividends and 10% on interest which will be final and not subject to corporate tax. The system could be used to package various loans (packaging reduces overall risk somewhat like an insurance fund), and sell them on an organized exchange as a "pass-through" security--that is, where principal and interest payments are passed from the borrower directly through to the investors.

(2) Various fees and expenses for public issues were reduced. Where dividend and interest income is received by tax exempt persons such as pension plans, the income will not be subject to withholding tax. Furthermore, stamp duties payable for retail share transactions quoted in the Nairobi Stock Exchange, both for individuals and institutional investors, are to be abolished. Finally, legal fees and other costs of public issues of shares, debentures and bonds will be made a deductible expense so as to promote such public issues.

Implications for the Local Currency Housing Guaranty: It appeared (as of June, 1990) that the spread between the mortgage rate and the local cost of funds was too narrow to make the LCHG program work. This was primarily due to the compression of all rates. There may have been institutions in Kenya with low average costs of funds, however, which would have viewed the safety of the LCHG as an adequate tradeoff against any investment alternative. Such institutions were not immediately evident however.

Financial observers contemplate that the constricted nature of credit market (its short term nature with a compression of rate structures) will ease over the next one to two years as the Kenyan government moves toward decontrol and convertability and the LCHG will become a viable and desirable, option. If positive interest rate spreads are achieved, and they undoubtedly will be if decontrol is accomplished, then there is no reason why a LCHG should not be utilized to raise local liquidity for shelter and infrastructure development.

Implications for the Development of a Municipal Credit Market: All evidence basically condenses to the conclusion that the development a public securities market suffers from:

(1) the poor credit of the potential borrowers,
(2) the lack of a secondary market for the securities, and
(3) the necessarily long maturity of debt.

- Several local governments warrant investigation as possible candidates for early entry into the market. The target communities would have to be evaluated on the basis of set criteria relating both to their own credit worthiness and the value of the project to be financed.

- Because the advent of a secondary market is necessary for long term debt issuance one of two course seems prudent (1) to issue only short term bridge financing similar to the so-called RAN (revenue anticipation note) in U.S. municipal markets (if such a need exists) for a period of one month to one year, or (2) investigate the possibility of supporting an emerging secondary market.

- Because costs of issuance can be substantial, an umbrella issue including the needs of several communities may be desirable. As noted, many costs are of a lump sum nature and would not increase with the size of the issue. Furthermore, the payment to the underwriter, the largest single cost in U.S. markets, presumes certain responsibilities including underwriting and making a secondary market. To the extent that such services are not included, the basic underwriting fee might reduce to a mere sales fee.

- It is possible that the bonds could trade on a revitalized Nairobi Stock Exchange. There is no *a priori* reason why such an exchange could not handle debt as well as equity. Municipal debt did trade on the exchange in prior years.

- Although there is reason to believe that the tax exemption makes little difference (poor collection and evasion, according to interviewees, make tax consideration less relevant) it would still be desirable to press for the designation (1) to maintain the option for the future, and (2) because it doesn't seem to do any harm (would only cost the government if, in fact, it were effective) and, as some financial institutions mentioned, will still subtract some amount, however small, from the overall required yield.

THE DEVELOPMENT OF CREDIT MARKETS IN KENYA FOR URBAN INFRASTRUCTURE AND HOUSING FINANCE

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ACRONYMS USED IN THIS PAPER

CD	Certificate of Deposit
CMA	Capital Markets Authority
EAC	East African Community
GDP	Gross Domestic Product
GIC	Guaranteed Investment Contract
GoK	Government of Kenya
HFCK	Housing Finance Company of Kenya
HG	Housing Guarantee
IMF	International Monetary Fund
KShs	Kenyan shillings
LCHG	Local Currency Housing Guarantee
LGLA	Local Government Loan Authority
LOC	Letter of Credit
MLG	Ministry of Local Government
NCC	Nairobi City Commission
NHC	National Housing Corporation
NSE	Nairobi Stock Exchange
NSSF	National Social Security Trust Fund
OS	Offering Statement
RAN	Revenue Anticipation Note
RHUDO	Regional Housing and Urban Development Office
RHUDO/ESA	Regional Housing and Urban Development Office for East and Southern Africa
SLK	Savings and Loan Kenya
UIT	Unit Investment Trust
USAID	US Agency for International Development
WB	World Bank

NOTE: Exchange Rate used in this paper is 22.8 KSh = US$1

THE DEVELOPMENT OF CREDIT MARKETS IN KENYA FOR URBAN INFRASTRUCTURE AND HOUSING FINANCE

I. BACKGROUND

A. PURPOSE OF THE STUDY

The purpose of this study has been to assess the prospects and methods for improving the ability of the Kenyan financial system to provide funds for infrastructure and housing and shelter for low and moderate income Kenyan families. More specifically, the project seeks to answer the following question: How might USAID's Regional Housing and Urban Development Office for East and Southern Africa (RHUDO/ESA) use the facilities at its disposal to accomplish this purpose?

The task falls into two categories:

First, evaluating the feasibility of immediate application of USAID guarantees to the current housing and infrastructure program; and

Second, exploring the possibility of using USAID auspices to assist in developing an ongoing financial market which might enhance housing and infrastructure development in Kenya.

The study concludes that there are steps that can be taken to assist in the development of a secondary market for housing and infrastructure bonds. Furthermore, the study concludes that a local currency housing guarantee, though not viable under the controlled interest rate conditions that existed during the period of study [late June, 1990], is a desirable method of stimulating local liquidity for shelter and infrastructure development when the financial environment is altered.

B. THE FINANCING ENVIRONMENT

1. The Housing and Infrastructure Program

Kenya's current population of 24 million is projected to grow over the next 15 years to over 40 million people by the year 2005. The total number of households during the same period will increase by over 3.6 million of which 1.3 million will be in urban areas. Thus, while 15% of the population currently reside in urban areas, 25% will reside in urban areas by 2005. In order to keep up with projected growth and to replace deteriorating existing housing units, over 280,000 new units per year are currently required throughout the country with over 59,000 of these in urban areas alone. By 2005, over 460,000 new units will be required annually, some 145,000 in the urban areas. In reality, formal sector housing has amounted to an average of only 6,000 to 8,000 units annually of which 3,000 to 4,000 units have been through public sector institutions and somewhat lesser amounts through the private sector. It is estimated that almost 22 billion shillings[1] (US$ .965 billion) per year will be required to meet the needs of Kenyan families by the end of the century.[2]

RHUDO/ESA has been active in Kenya since 1972. During the span of years since that time, emphasis has shifted from financing shelter provided by government agencies to working with private developers, financial institutions and the informal sector and, more recently, towards increased emphasis on infrastructure and urban development.

The U.S. Congress authorizes guarantee authority pursuant to section 223(e)2 of the Foreign Assistance Act of 1961.

> The Housing Guaranty program extends guarantees to US private investors who make loans to developing countries to assist them in formulating and executing sound housing and community development policies that meet the needs of lower income groups. Activities to be carried out will emphasize (1)sites and services and core housing projects providing home sites and shelter for poor families; (2) slum upgrading projects designed to conserve and improve existing shelter; (3) low-income shelter projects designed for demonstration or institution building purposes; and (4) project related community facilities and services. ...Borrowing authority ... is to replenish the Housing Guaranty reserve, depleted as a result of increased loan reschedulings." (US Budget for Fiscal Year 1991, p. A-418.)

Dollars may be raised from US institutions using the guarantee, denominated in dollars, to improve the quality of the loan. In turn, the dollars are provided to the government of Kenya which may take the dollar foreign exchange in exchange for a guarantee by the Government of Kenya (GoK) to US AID (the US government). The dollars may then be

[1] The June, 1990 official exchange rate is 22.8 Kenyan shillings to the U.S. dollar. The unofficial market rate appeared to be about 32 shillings to the dollar.

[2] From a statement by the Honorable Maina Wanjigi, Minister of Works, Housing and Physical Planning at the USAID/MOWHPP Seminar on Secondary Mortgage Markets, December 11, 1985.

used for unrestricted purposes in exchange for an equal amount of Kenyan Shillings that are on-lent to local institutions public or private, for the uses specified in the program agreement (less a fee of 1% of the dollar amount, which goes to the USAID trust fund).

For example, under the authorized private sector housing project the funds would be lent to the Housing Finance Company of Kenya, a parastatal, which will then provide take-out financing for privately developed projects. Under the Small Towns Shelter and Community Development project the GoK lent funds to the Local Government Loans Authority and the National Housing Corporation respectively for infrastructure and shelter in small towns.[3]

Three Housing Guaranty (HG) projects with an aggregate value of nearly $30 million have been implemented by the Nairobi City Commission. Another $30 million in authorized HG financing is currently available under the Private Sector Project and the associated Cooperative Housing Project, which will support privately produced and financed, low-cost shelter in cities and towns throughout the country.

Outside Nairobi, RHUDO/ESA's Secondary Towns HG program financed low-cost shelter in 11 towns, and the more recent Small Towns Shelter and Community Development Project has financed shelter and urban infrastructure in 26 small towns. These projects have provided $20 million in capital assistance. Technical assistance and training has focused on improving local government management and operations.

Repayment to the government of Kenya (and hence to the US private lenders) is a passthrough from the housing authority and local governments. If there is a default or restructuring, the guarantee of the government of Kenya, and eventually from the USAID trust fund comes into play.

In practice, USAID has borne the risk of restructuring international debt payments. Default risk and the exchange rate risk has been borne by the GoK.

2. Financing Infrastructure and Services: Own Resources

A poor record of tax collection, alternative sources of borrowing, the scant history of bond finance in Kenya, a faulty history of repayment and poor record keeping diminish the prospects for developing a local government bond market. Each is discussed below.

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[3] The loans have been 30 year loans, about 120 to 200 basis points (1.2 to 2 percentage points) above the U.S. Treasury bond rate (of similar maturity), and have had a 10 year grace period for repayment of principal. One half of one percent of each disbursement is remitted to USAID in US dollars in payment for the administrative costs locally.

a. Tax Collection: There 120 local jurisdictions in Kenya. Jurisdictions consist of either township councils, urban councils, municipalities and county councils in rural areas. All of Kenya that is open to population is within one, and only one jurisdiction. Of the four types, municipalities have the most power and would be the only governmental form legally and practically capable of issuing bonds. Otherwise, governments anticipate revenues from four sources:

- Taxes, so-called "rates", paid by property holders based upon the value of land (numerous attempts to change the system to a property tax based upon the value of improved property have been rejected by the Ministry of Local Government which does have the prerogative to initiate the change).

- Fees and charges for such services as water and refuse disposal. While water and electric parastatals must grant permission to applicant municipalities who wish to undertake alternate municipal water or electric services, the parastatals have announced a moratorium on any further permission.[4]

- An "urban service charge" which imposes a fee upon each business establishment for each worker employed in the jurisdiction ranging up to KShs 700 (US$ 30.70) per worker per year depending upon salary. The revenue source was first approved for the 1988 fiscal year so that the record of collection is unknown at this time. It is collected by the sale of a stamp which is affixed to the employee's employment record.

The record for collecting taxes and ratables appears questionable at best. For example, representatives in the Nairobi City Commission's (NCC's) Treasurer's Office indicated that the NCC anticipated revenues from the service charge of about Kshs 300 million (US$ 13.2) million per year--however collections to date indicate that the amount will be about Kshs 200 million (US$ 8.8 million) per year--only KShs 236 million (US$ 10.35 million) has been collected since December, 1988 when the tax was instituted. The prime reason for the reduced collection is a failure to print the stamp that was needed to evidence payment of the tax.

b. Alternative Loan Sources: Local governments do borrow, primarily through the means of overdrafts, from local banks for both bridge loans and mid-term financing (1 to 5 years). The rates are usually market rates and the additional costs associated with the loans appear to be small. Furthermore, it would appear that there are few, if any, defaults partially because of the close relationship between the local government and the institution but also because the Ministry of Local Government must approve of every borrowing.

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[4] Notably, it would appear that each of the fee and charge services could be candidates for privatization--they have their own income stream and some operate profitably. Nevertheless, privatization has been consistently rejected by the central government.

c. History of Bond Finance: There is little experience with a formal municipal bond market, but there is some. Prior to independence in 1963, larger local governments in Kenya issued debt that was traded on both the London Exchange and the Nairobi Stock Exchange. In fact, the Local Government Act still gives Nairobi the right to borrow on international markets. The last attempt at a public sale was in 1985 when the Nairobi City Commission sold KShs 250 million[5] of bonds for general purposes supported by the full faith and credit of the City of Nairobi. Because few other buyers came forward, the Government of Kenya placed almost the entire amount with the Kenya's National Social Security Trust Fund.

d. Defaults: The city of Nairobi is four years in arrearage on debt service payments to the fund, reasoning that the Government of Kenya owes the city considerably more in terms of payment in lieu of taxes on Government property than is owed by the city to the Government of Kenya. Nairobi is only one example of municipal debt default, but an important one. Besides being the nation's capital it holds about 1.5 million of Kenya's 24 million people. It is understandable that the market would be totally unresponsive to any borrowing by the NCC or any similar governmental unit. Though not completely of their own doing, Nairobi has not paid their debts in a timely manner and in most cases, not at all. Their tax structure appears to be inadequate to meet current needs, let alone debt service requirements--and the general attitude of retributory non-payment (they don't pay their debts because the central government has not paid them) adds an element of risk that would be unacceptable to a conventional credit market.[6]

e. Financial Record Keeping: Poor financial record keeping is another reason which the construction of a bond market for local government debt would be difficult. Audits from the Ministry of Local Government lag about one and one-half years behind the record year. There appears to be little agreement as to what constitutes an asset items, and there are few trained bookkeepers to post ledgers. Borrowing or lending without prospect of repayment does nothing to engender the establishment of credit and financial markets. Thus, the establishment of a market presumes the creation of underwriting standards which detail the nature and source of repayment, credit history, quality of management, propriety of bookkeeping, and economic prospects.

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[5] US$ 15.22 million at 1985's exchange rate of KSh 16.43 to US$1.

[6] For Nairobi and cities in similar situations, the creation of some bonding authority, possibly overlapping with other jurisdictions in a special district sort of arrangement, and with a dedicated payment source not otherwise encumbered or with ambiguous priority (possibly augmented by a guarantee from some source), has some possibility of favorable reception by the investment community. Payments due and receivable would have to be accounted for and placed in a directed program of repayment and collection. Accounts would have to be brought up to date and scrutinized by some third party.

3. Financing Infrastructure and Services: Central Government Resources

Besides their own resources, Kenyan local governments have received assistance from the Central Government in three ways:

- Direct loans from the Local Government Loan Authority under auspices of the Local Government Act, chapter 265 as revised in 1978; and the 1977 Guarantee Loan Act, chapter 461. as amended. However, rather than operating as a revolving fund as envisioned, the fund has basically become defunct because of the lack of repayments back into the fund. For whatever reason, the fund now operates solely to the extent that Treasury and international donors provide funds, and over the last several years the total amount has been declining. There is a proposal to reinvigorate the fund, which is currently being studied by the World Bank and others.

- Payments in lieu of rates from the Government of Kenya for properties used or leased from local government. The payments are expected to be made as an annual grant. In cases such as Nairobi, the amount of payment in lieu of taxes could be substantial. However, given the strict confines of budget and pressures imposed by World Bank borrowing limitations, local authorities have been unable to collect any significant amount from the Central Government since 1982, and it appears likely (as was stressed by representatives of both the Central Bank and the Ministry of Local Government) that the situation will continue as long as the IMF restructuring agreement is in place.

- Central government provision of facilities and services. Such items as roads, sewers, water facilities, telephones and electric facilities are often the responsibility of the Central Government or of the appropriate parastatal. Local governments are then left to finance such items as streets, lighting, parks and recreational space, health care facilities and clinics, central markets, bus stations and so forth.[7]

C. THE FINANCIAL SECTOR

Any financial market could be viewed as consisting of three components: lenders, borrowers, and intermediaries between the two.

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[7] In a response to a recent inquiry by the Kenyan Social Security Trust Fund as to the needs of the city which might be assisted by the surplus of the Fund, the Nairobi City Commission, responded that the major need were for road maintenance and refuse removal followed by low cost housing, social and recreational services, street lighting and health clinics and health centers. Other large urban areas appear to have similar needs.

- **Lenders.** Lenders buy investment instruments. Of course, they can only be demanders of investment instruments to the extent that they have funds which they do not wish to exchange for current consumption, that is, they must have savings. Such lenders can be:
  - (a) Institutional entities (such as insurance companies, mutual funds, pension funds, banks, underwriters, trusts or the like);
  - (b) Private individuals;
  - (c) Government entities.

- **Borrowers.** Borrowers sell investment instruments. While such suppliers of investment opportunities would have current needs, which exceed their current ability to meet those needs, they must calculate that they will have an ability to repay the principal of the borrowings plus any agreed upon interest payment from some future stream of income which may or may not be enhanced by the borrowing. They include:
  - (a) Central, state or regional and local governments;
  - (b) Private individuals; or
  - (c) Private companies and corporations.

- **Financial Intermediaries.** Intermediaries are institutions which match borrowers with lenders. Although these financial institutions intermediate between suppliers and demanders of funds, the impact is more than mere matching, however. In a truly functioning intermediary market, risk and maturity characteristics of debt can be transformed--variable debt can be transformed into fixed debt, short maturity borrowing can be transformed into long maturity lending, and high risk characteristics can be hedged. Such intermediation, requires a very deep market, that is, many borrowers and lenders with a myriad of objectives and financial circumstances.

1. Lenders in Financial Markets

Historically, if not currently, most lending for housing or infrastructure in Kenya derives from three sources--commercial banks, insurance companies and housing finance institutions (which includes so-called "building societies").[8]

a. Commercial Banks: There are 26 commercial banks in Kenya, of which 3 are government owned, 14 are branches of foreign banks, and nine are private domestic banks. The two largest banks in Kenya, in terms of deposits, are the Kenya Commercial Bank with deposit liabilities of KShs 14 billion (US$ 614 million) and the Barclays Bank of Kenya with deposit liabilities of KShs 9.5 billion (US$ 416 million) as of December 31, 1989. Banks generally indicated that their funds were placed in GoK securities and short term

[8] There are also 1,700 rural savings institutions, and five development banks; and a number of industry or interest specific co-operatives which generally funnel their funds to the three major institutional forms.

loans to match against the short term nature of their liabilities. In fact, their horizon was extremely short, concentrating on 3 months to 3 years. They showed little interest in participating in a loan program for housing finance institutions or local government capital investment, except to the extent that loans could be liquidated or somehow transformed into liquid investment instruments such as Unit Investment Trusts (discussed later) that would trade on some market.

Banks generally have wide latitude in investments although the current liquidity requirement is 25 percent. It might be met through a number of alternatives but because of the high relative yields of government securities the requirement is nearly always met with the holdings of such securities. Furthermore, as an anti-inflationary measure, and a measure agreed upon as a condition of the IMF restructuring agreement, banks are held to expansion of new loans of no greater than 12 percent per year.

The Banking Act of 1989 requires in section 19 that an institution shall maintain such minimum holding of liquid assets as the Central Bank may from time to time determine, and that "liquid assets" means all or any of the following:

(a) notes and coins which are legal tender in Kenya;
(b) balances held at the Central Bank;
(c) balances at other banks in Kenya after deducting balances owed to those other banks;
(d) balances at banks abroad withdrawable on demand or short notice and money at call abroad after deducting balances owed to banks abroad where the balances and money at call and short notice are denominated in convertible currencies;
(e) Kenya treasury bills and bonds of a maturity not exceeding ninety one days which are freely marketable and rediscountable at the Central Bank; and
(f) such other assets as the Central Bank may specify.

Commercial Banks in general are quite content to hold assets in the form of very liquid capital: either GoK debt or very short term loans.

b. Insurance Companies: In addition to commercial banks, there are numerous non-bank financial intermediaries, including 37 insurance companies (of which about 30 are brokers rather than portfolio managers).

Section 50 of the Insurance Act of 1987 prescribes the composition of assets of an insurance company. Insurance companies carrying on long-term business are required to invest 25 percent of their assets in any one or more of specified securities. These include Government securities, the securities of certain prescribed statutory bodies, securities issued by local authorities and those of prescribed organizations (prescribed by the Vice President and Minister for Finance).

The Insurance Act further indicates that insurance companies shall invest at least 65 percent of their assets in one or more of other specified investments, including the securities specified above along with mortgages and debentures on unencumbered[9] immovable property in Kenya, debenture preference shares or ordinary shares of companies quoted on the stock exchange, instruments of title to immovable property in Kenya, and loans on life assurance policies issued in Kenya.

In addition, the specified investments may include deposits in banks or financial institutions licensed under the Banking Act, provided that if an insurer is carrying on long term insurance business, such deposits in any one bank or financial institution shall not exceed five percent of the insurer's total assets. Further, if the insurer is carrying on general insurance business, such deposits in a bank or finance house shall not exceed 10 percent of the assets of the insurer. Generally, after investing 25 percent of their assets in the securities specified and a further 65 percent in other specified investments, insurance companies may invest the remaining 10 percent in such investments in Kenya at their discretion.

The result is fairly predictable portfolios for the six major ultimate insurers in Kenya--Jubilee, Apollo, Madison Insurance, Alico, Employee Benefit and Trustee, and Kenya National--about 25% in GoK securities, 20% residential mortgages and 30% commercial mortgages.

Jubilee Insurance Company Ltd. indicated it holds four types of assets in its portfolio:

(1) Real Estate: about 65 percent of the portfolio with returns as high as 23%. Real estate lending consists of residential mortgage lending (40%), and commercial mortgage lending (60%);
(2) GoK Bonds (2 to 5 year): the minimum amount required against long and short term liabilities totalling about 25 percent of the portfolio with an effective yield of about 23%;
(3) Deposits (6 mo. to 1 year): about 10 percent of the portfolio, and
(4) Quoted and Unquoted Stocks: only 1% of portfolio with a yield of 7-9%.

[9] There was some debate as to the meaning of "unencumbered" with the Insurance Company of East Africa taking the view that mortgaged property did not satisfy the definition of "unencumbered". Such an interpretation would seriously restrict mortgage investment by insurance companies.

Alico Kenya, a subsidiary of American Life Insurance Co. Ltd., which, in turn, is a member company of the American International Group, headquartered in Wilmington, Delaware (having about an 80 percent market share of life insurance underwriting in Kenya). has:

(1) GoK Bonds: about 35% of its assets yielding an average annual rate of 17 1/2 percent;
(2) Residential Mortgages and Other Loans: about 11 percent ranging from 17 days to seven years (the average duration is about 3 1/2 years);
(3) Commercial Mortgages: about 25 percent;
(4) Fixed Deposits: about 25 percent; and
(5) Equities: about 1 percent (although they have had very poor experience with equities).

c. **Housing Finance Institutions:** The lending institutions making loans with the longest maturity in Kenya are the Housing Finance Institutions which generally rearrange deposits averaging about 3½ years duration into loans of 10 to 20 years duration. Faced with the mandate to provide housing finance which generally has fixed intermediate to long terms, financed by deposits which tend to grow shorter when the economy weakens or is otherwise shaken, a mismatch of timing is always possible. The mismatch can cause problems as was evidenced by a serious credit crisis in 1986 which was abated with the assistance of the GoK and the Central Bank of Kenya.

There are two categories of housing finance institutions in Kenya. One category consists of limited liability companies, known as "mortgage finance companies", registered under the Companies Act and licensed under the Banking Act. They come under the direct regulation/supervision of the Central Bank of Kenya. For Mortgage Finance Companies, The Banking Act of 1989 stipulates in 15(2) "Not less than seventy-five percent of all loans made by a mortgage finance company shall be made for the purpose of acquisition, construction, development, improvement or alteration, by the borrower, or residential property in Kenya."

- The Housing Finance Company of Kenya (HFCK), with assets of KShs 2.8 billion (US$ 121.2 million) is currently owned 50-50 by the Commonwealth Development Corporation (CDC) and the GoK, but intends by the end of 1990 to make one-third of its ownership public. Mortgages constitute 76.1 percent of HFCK's assets.

- Savings and Loan Kenya with assets of KShs 1.24 billion (US$ 54.4 million) is one-fifth privately owned with the remaining ownership held by the GoK and has 85.8 percent of its assets invested in mortgages.

The other category of housing finance institutions consists of mutually-owned building societies which are registered under the Building Societies Act and licensed by the Registrar of Building Societies. Compared to the supervision provided by the Central Bank, the Office of the Registrar is purported to be poorly staffed and ineffective. The impetus behind the formation of this category of institution was twofold: (1) the Central Bank had closed-off the formation of new banks and non-bank financial institutions but the creation of new building societies was still open; and (2) there seemed to be a desire to utilize the building society vehicle as a way to generate funds to finance development activities on the part of the principals. While the Central Bank now provides for the review and examination of building societies, it is not empowered to enforce any actions against building societies which are not complying with the law; it can only recommend actions to be taken to the Registrar of Building Societies. At present the Building Societies Act limits loans to KShs 750,000 (US$ 32,895).

- East African Building Society, an old line institution, is the only substantial institution within this category with assets of KShs 2 billion (US$ 87.8 million). However, there were as many as 37 institutions in the category as late as 1987, of which 32 remain, but are largely moribund.
- About twenty failing institutions will be merged into a single building society, the Consolidated Bank Ltd., within the next few months with the hope that the merged capital will be sufficient to make the resulting institution a viable one.

There are two problems that preclude development of building societies as viable institutions:

(1) the lack of deposit insurance for mutually owned building societies, a unique problem as insurance is either provided or mandatory for other financial institutions, and
(2) the lack of a liquidity facility or secondary market for mortgages--the problem that all institutions in Kenya suffer from.

2. Borrowers in Financial Markets

The largest borrower in Kenya is the GoK, having nearly KShs 14.6 billion of long term debt and KShs 37.2 billion (US$ 1.632 billion)[10] of short term debt rolling over as of May, 1990. The GoK has net borrowings of KShs 13.45 billion (US$ 589.9 million) from the Central Bank and borrowings outstanding amounting to KShs 59.8 billion (US$ 2.62 billion) from foreign creditors (mainly the World Bank and other donors). Government stocks amounted to KShs 11.45 billion (US$ 502 million). Thus, total government debt outstanding

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[10] Including KShs 322 million (US$ 14.1 million) of Cereals and Sugar Finance Corporation (C&SFC) debt which is debt earmarked for finance of that industry.

amounts to around 60 percent of Gross Domestic Product. This is a proportion which would not be staggering if the Kenyan economy were assured of secular growth. The debt becomes more of a burden, however, in the absence of long-term economic growth.

Under the Guarantee (Loans) Act of 1980 the GoK can attribute its guarantee to other governmental bodies and co-operative societies registered under the Co-operative Societies Act. "The Government may, with the prior approval of the National Assembly, guarantee in such manner and upon such conditions as it may think fit the due performance of any covenants on the part of a local authority or a body corporate under the terms of any legal instrument to which such local authority or body corporate is a party."

Local Authorities and bodies corporate specifically granted the guarantee in the Act include: Land and Agriculture Bank of Kenya, Canning Crops Board, Settlement Fund Trustees, Pyrethrum Board of Kenya, East African Airways Corporation, Kenya Dairy Board, Uplands Bacon Factory Ltd., Kenya Meat Commission, Kenya Tea Development Authority, Lands Limited, Mombasa Pipelines Board, Museum Trustees of Kenya, Jockey Club of Kenya, United Kenya Club, Kenya Cultural Centre, City Council of Nairobi, East African Common Services Authority and the Kenyan Industrial Development Corporation. The privilege of the guarantee has also been granted to various Tea companies and three mutual Building Societies (otherwise private entities). Some of the guarantees, when made, were jointly shared by Uganda and Tanzania. The current status of such guarantees is uncertain, although still on paper the guarantee is enjoined by all three governments.

Government Sponsored Corporate Debt includes debt of Kenyan Water Supply, Kenya Bus Service, Kenya Electric, Kenya Development Corporation and others. It would appear that Water and Electric services issue revenue based debt on their own behalf and have the implicit guarantee of the GoK. Nevertheless, bankers seemed to feel that the debt of these "high quality" parastatals was better than the GoK debt itself because there is an identifiable stream of revenue, and often tangible property, to insure the lien.[11] Other parastatals, such as Kenya Airlines, have had some difficulty making payments and appear to have had contractual guarantees from the GoK in their borrowings from foreign governments or individuals.

The practice of GoK debt guarantees is addressed in the 1990 Budget Message by the Vice President and Minister for Finance:

> The last area I want to discuss under the heading of fiscal policy is the finances of State Corporations, or parastatals. This is also an area of public sector finance that is causing me great concern. There is now a widespread lack of financial control and discipline. For instance, it is not unusual that

[11] One local water company even turned water off to GoK buildings for lack of prompt payment.

parastatals engage in new investments while they are falling behind, or are even in default on their obligations to the Treasury. In addition, there is another equally disturbing development. The Government, as guarantor of external loans by parastatals, is increasingly being called upon to honor parastatal debts to foreign lenders. The Treasury is then forced to divert funds from budgeted purposes to meet these obligations. As a consequence, the Budget becomes distorted and the deficit remains too high. These developments are totally unacceptable. I want to make it quite clear that the Treasury will no longer honor such parastatal debt obligations without a thorough investigation of the circumstances behind the payment default. Indeed, I will insist that appropriate corrective measures are taken before assuming any obligation.[12]

Private individuals outside of business borrow for home purchases but seem to have little consumer debt outstanding. They do borrow for business purposes, however, as do companies and corporations. About 15% of the lending by commercial banks is to agricultural enterprise. The remainder, as discussed above, is to the GoK and for non-agricultural enterprise. Non-bank credit (credit extended by sources other than commercial banks grew by 16.5 percent in 1989 and by 20 percent in 1990. The general feeling is that the growth has been used to fuel commercial real estate building and purchases, however. In Kenya, according banks interviewed for this paper, a 60/40 Debt/Equity ratio is considered to be a reasonable degree of leverage--which shows a rather low level of borrowing.

3. Financial Intermediaries

There are few true financial intermediaries in Kenya. A commonly used indicator of formal sector financial depth is the ratio of broadly defined money[13] to gross domestic product. The more money required to support a given level of GDP, the less advanced are the financial institutions in the country in question. This is because the financial institutions are not in place to turn the existing money supply over rapidly--the turnover is slow. The US has a rate of about 12 percent; Mexico a rate of about 20 percent. In Kenya's case, the ratio was about 30.3 percent in 1989, compared with 32.1 in 1988, 36.0 percent in 1987 and 34.7 percent in 1986--not much change and relatively weak. The existing intermediaries in the formal market may be described by the following anecdotal and statistical information.

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[12] The Honorable Prof. G. Saitoti, Vice President and Minister for Finance; <u>Kenya Budget for the Fiscal Year 1990/1991</u>, June 7, 1990, p.8.

[13] The broadly defined money supply consists of demand deposits, time deposits, plus any recognized negotiable instruments such as certificates of deposit. The measure here is taken from the Annual Report of the Central Bank of Kenya.

- The Central Bank will discount a GoK bond which has less than 3 months remaining to maturity.

- The short term CD's issued by Citibank Kenya and First American Bank of Kenya appear to be being traded at par and will be repurchased at par by the respective institutions.

- The Post Office will buy and sell small denomination savings certificates for the Kenya Post Office Savings Bank (with deposits of KShs 1.45 billion--US$ 63.6 million).

- Some private firms such as Minet Insurance, Housing Finance Company of Kenya and Dyer and Blair have contemplated making secondary markets for various instruments.[14]

- The Nairobi Stock Exchange has existed since 1954. Underwriters exists but function only to match buyers with sellers rather than to underwrite new issues or make a secondary market for securities. The Nairobi Stock Exchange grew to 70 companies by 1967. Since then, however, partially as a result of the breakup of the East African Community, the exchange has shrunk in volume, capitalization and number of stocks listed. From 1973 to 1983 there was not a single new stock listed.

  As of June, 1990 there are 70 securities representing 57 companies listed on the Nairobi Stock Exchange. Two are under suspension and only 7 trade with any regularity. As much as 80% of the listed stocks have some GoK ownership and banks are the most active stocks. The minimum price asked is KShs 2, the maximum price asked is KShs 45 (for Barclay's Bank). The spread between asking and selling price is considerable, however, KShs 2 to 3, reflecting the very thin market. The volume is small--possibly 15 trades for each of the two days per week that the exchange operates. The number of shares traded during 1989 were 6,252,326 compared with 10,061,871 in 1988. The total capitalization is only KShs 420 million.

Three factors are expected to regenerate the NSE over the next five to ten years:

(1) First, the elimination of the capital gains tax in 1985. The tax was dropped from 35% in 1975 to 12 1/2 percent in 1980 to its current zero rate in 1985.

[14] Minet was instructed to stop its preparation by the Ministry of Finance because it was felt that such activity was contrary to the strict confines of the Insurance Act. Both HFCK and Dyer and Blair are continuing their plans--Dyer and Blair have, in fact, already bought and sold one lot of GoK bonds.

(2) Second, changes in tax law introduced in the 1990 Budget will presumably become effective, including the removal of a 1% consideration (transfer) tax; the elimination of the double taxation of dividends and interest (15% withheld only once) and similar relaxation for Unit Investment Trusts.

(3) Third, the encouragement of the GoK as evidenced by the creation of the Capital Market Authority, a government authority charged with encouraging and entering into certain financial agreement which might stimulate the development of capital markets. The CMA, its powers and responsibilities are discussed later in this paper.

There has been some encouragement from the oversubscribed of recent bank stock issues. The market will be further tested when the Housing Finance Company of Kenya goes public with 30 percent of its ownership in the near future.

It is important to note that throughout the Kenyan financial sector, because of the absence of well developed intermediate markets, lenders and borrowers must match the payment structure of their assets with those of their liabilities. Well developed financial intermediaries allow financial institutions to restructure their assets and liabilities in such a way that even short term liabilities can support long term assets. But without intermediaries, the maturity of assets must approximate the maturity of liabilities. Thus, the relative long term lending horizon of Kenya's insurance companies, for example, is predicated upon the long term nature of their liabilities. Large institutional portfolios are large enough, however, to use rollover as a way of adjusting for unforseen inflation.

D. THE ECONOMIC ENVIRONMENT

Four economic factors impact heavily upon the feasibility of achieving the objectives of this project: (1) inflation (particularly relative to world inflation), (2) Central Government spending and borrowing, (3) interest rates, and (4) overall expectations of changes to come. Financial variables impacted by these four factors, namely liquidity, savings, and specific interest rates are discussed later in this paper.

1. The Rate of Inflation

The average *official* annual rate of inflation, as measured by the change in the consumer price index (1974 base year) declined slightly to 10.6 percent in December 1989 from 10.7 percent in December 1988. The official estimate of inflation today remains in the 11 percent neighborhood. However, unofficially, the rate of inflation appears to be in the neighborhood of 18 to 20 percent annually rather than the official rate based upon a 1974 market basket of goods to produce a CPI.

The inflation is understandable. There has been a 22% increase (30% in 1988) in the money supply and a 15% devaluation of the Kenyan shilling in the last 3 months. The broadly based money supply, M2 (which includes all easily liquidated financial deposits besides just currency and demand deposits), expanded by 17.8 percent in 1989 compared with an increase of 8.3 percent in the previous year. Among the components of the money supply, demand deposits rose by 19.2 percent, quasi-money (nearly liquid funds such as savings accounts) by 18.6 percent and currency outside banks by 13.1 percent. The deficit in the trade account widened substantially during the first five months of 1989 to reach KShs 8.9 billion (US$ 390 million) compared with a deficit of KShs 5.9 billion (US$ 260 million) in a corresponding period of 1988. Imports grew by 27.2 percent during this five month period while exports registered only a modest increase.

There is evidence that the Central Bank intends to crack down on monetary growth and the expansion of domestic credit. In addition to expressing the desire in various interviews, the government has begun to enforce the 12 percent growth ceiling on outstanding loans to commercial banks as part of the IMF restructuring agreement by levying a penalty against infractions.

2. The Growth of the Central Government Budget

The budget is growing considerably, financed mainly by donor grants and loans, and domestic borrowing. Total government expenditure is estimated to have increased by 19.6 percent in 1989 above the 1987/88 level to KShs 47.6 billion (US$ 2.1 billion)--or 30 percent of Gross Domestic Product. Urban unemployment rates of 25 to 35 percent have occasioned some of the increase, but the increase is also to be found in the areas of defense and education.

The point is, however, that the central government is consuming significant resources and savings. At present the GoK has KShs 2.3 billion (US$ 100 million) of one year bonds outstanding, KShs 4.5 billion (US$ 197 million) of two year bonds and KShs 7.8 billion (US$ 342 million) of five year bonds--a total of KShs 14.6 billion (US$ 640 million)in a country with a Gross Domestic Product of about KShs 175 billion (US$ 7.675 billion), but one that produces a very small pool of available savings. The restriction on debt occasioned by the agreement with the IMF restricts the promulgation of greater debt but places a premium on other methods of finance and, in order to reduce annual expenditures, will force domestic rescheduling of payments from the GoK to local government and other interests.

3. The Level and Escalation of Interest Rates

Interest rates are ostensibly managed by the GoK. For example, mortgage rates cannot exceed 19 percent annually,[15] 250 basis points above the Treasury long term tender rate of 16½ percent. But, as will be discussed, because many institutions are required to buy Treasury debt, the tender offer essentially sets the market for 5 year debt at 16½ percent. Thus, the rates are "managed" if not "controlled". Of course, the exchange rate is set by Central Bank fiat--presently 22.8 Kenyan Shillings to the US dollar.

Stated rates can be deceiving, however. The 16½ percent rate, after allowing for a discounted purchase and semi-annual payment of debt, actually yields about 23 percent per year. Also, without changing the law, the GoK has tacitly let it be known that loan fees and points are allowable. These allow the effective rate to be comparable with other market rates. According to various sources, the 18 or 19 percent charged on home mortgages is comparable to a 22 to 23 percent effective yield.[16]

4. Expectations of Inflation and Interest Rate Changes

Based upon the interviews undertaken for this paper, banks are the shortest term lenders, institutions such as insurance companies come next, and specialized long term lenders, such as housing finance institutions in Kenya's case, lend the longest. What is surprising, however, is the short duration of the maturity spectrum. Banks are generally from 3 months to one year in maturity (they would lend for no more than 7 days if they could); insurance companies 3-5 years; and building societies 10-15 years. Everyone looks for liquidity.

For non-residential loans, long term lines of credit (callable after 1 or 2 years) fill the gap for long term credit for many purposes. In isolated circumstances--for the few excellent credits in Kenya--there are longer term loans (at rates adjusted according to the Central Bank ceilings)--even 15 to 20 years at around 19 percent annually.

The common perception is that the controlled interest rate will continue to head higher until the managed rate is approximately equal to the market rate--most persons interviewed for this study believe that the market rate (rather than the 16½ percent

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[15] The ceiling was changed in May from 18 percent. Most institutions have chosen to remain at 18 percent while adding fees to escalate the effective rate, presumably holding the base rate increase for a later date.

[16] Citibank Kenya has a yield curve which ranges from 12½ percent for 7-15 day money to 19½ percent for three year money. For short term bridge loans they have lent at a rate as high as 29 percent even though the normal market rate for bridge lending is about 23 percent.

managed rate) is around 20-25 percent. The general impression is that the GoK is adhering to the 1986 Sessional Paper Number 1 which calls for deregulation leading to convertability of the Kenyan shilling.[17] Most of the financial managers interviewed do not see the adjustment continuing long. In fact, several indicated their belief that the credit markets are going through a period of serious adjustment in Kenya and, within one to two years should have straightened themselves out. The key may be whether world rates will hold still while Kenya "catches up". Citibank Kenya, for one, expects a considerable slowdown in borrowing and anticipates that commercial real estate will be hard hit over the next year--especially in Nairobi.

Thus, the salient features of the current economic environment may be summarized as:

(1) Inflation is running at about 18 to 20 percent rather than the 11 percent that is reported.

(2) Short term (30 day) rates are around 13½ percent; stated one year rates are around 15 percent; 3 to 5 year stated rates are about 16½ percent; and 10 to 15 year mortgage rates are around 19 percent. Nevertheless, fees, discounts, and creative compounding make effective low risk yields from 16 percent for short term to around 23 to 25 percent for long term.

(3) Because of the expectation of continued managed interest rate and price increases, money past 3 years in maturity is only available at insurance companies and building societies (with evidence of some selectivity for non-residential real estate loans); lenders do not wish to have their money tied up in low yielding loans with interest rates moving up.

(4) The climate will probably change within one to two years as the Central Government and its relevant agencies (the Kenyan Central Bank and the Ministry of Finance) move towards deregulated rates and convertible currency. Many are convinced that they are moving with hesitancy and that the rate of inflation is putting the target further and further out of reach. Nevertheless, it is a stated goal and was reiterated by most every government official interviewed. More resourceful financial institutions seem to be awaiting completion of the task before launching new and innovative financial proposals.[18]

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[17] In early July 1990, the GoK announced that it was its intention to decontrol interest rates as of July 16, 1991.

[18] One banking official expressed his belief that interest rates would even fall after deregulation--occasioned by increased supply of loanable funds and innovative intermediation.

In sum, effective interest rates are high to cover high inflation and liquidity is held in short maturities occasioned by expectations of still higher interest rates.

Of course expectations regarding inflation and interest will be the primary influence on the form that investment and savings take. To a certain extent, the nature of investment is in the mind of the investor--the nature of his intentions. The behavior of an investor who buys for capital gain will differ from that person who purchases the same investment instrument for income purposes. Similarly, the ultimate behavior of a person who buys commercial property for speculative purposes will differ from one who buys the property for occupancy only. The three major types of investment are described in the following table:

- One form of investment instrument is cash. The rate of return on cash for a given time period is described by the rate of inflation over that same time period; and the expected rate of the return on cash is the negative of the expected rate of inflation.

- Another form of investment is the purchase of a real property asset which ascribes a capital gain or flow of income to the holder. To the extent that the return on this asset is greater than the appropriately measured rate of inflation, the return is a positive real return, to the extent that it is less than the rate of inflation it is a negative real return. In fact, Kenyan businessmen we spoke to have invested whatever excess income they have in real property assets--mainly commercial real estate.

- A third form of investment is a paper instrument, or contract which either bestows a promissory contract to pay a flow of income to the holder, or a contract of ownership which entitles the holder to a share of a revenue generating enterprise. The first of these is termed "debt" the second "equity", but either is under the general rubric of a "security". Needless to say, the greater the return on savings relative to cash the stronger will be the inducement to save, and the greater the return on one instrument relative to another the stronger will be the inducement to utilize the instrument with the greater return. In the US, it appears that stripped of all risk factors, investors demand, and suppliers are willing to pay, about 200 basis points above the expected rate of inflation per year to consummate a transaction. Thus, if the expected rate of inflation is 4% per year, the US market demands, discounting for any additional risk, a 6 % expected annual rate of return before a transaction would occur. A taxonomy of potential investment instruments would include: real assets including commercial property, cash, Government of Kenya securities, local government debt, corporate debt, corporate and parastatal equities, bank deposits, insurance shares, co-op shares, and pension and retirement.

At this point it would appear that the highest expected annual return in Kenya is on commercial property (probably in the neighborhood of 30 percent); Government of Kenya debt (real yields of 22-23 percent); bank deposits (about 17 percent for large depositors); and corporate equities (8 to 9 percent). Real rates, of course, would be the above estimated rates minus the expected 18 to 20 percent annual rate of inflation. Thus the return to holding cash is a negative 18 to 20 percent. Were it not for various regulations, transaction costs, risks, capital requirements, and expectations concerning future returns investors would invest their entire portfolios in commercial property.

5. Savings Available for Investing

The current level of investment by the buyers of investment instruments must be met in the future by a flow of savings equal to principal plus interest on the part of today's borrowers. The concern is more than an academic one in the sense that debt markets can only exist where current flow of savings is sufficient to purchase debt instruments and where the future flow of savings is expected to be sufficient to make the repayment.

Savings and profits in the Kenyan economy, in aggregate appear to be substantial. The official savings rate is around 17 percent--but a great deal of this derives from foreign donors and leakages from the formal sector to the informal sector[19]. The Vice President and Minister for Finance reported in his 1990 Budget Message that "...investment and savings were lower in 1989 than 1988. We invested 25.6% of GDP of which 34.4% was financed from abroad. This compares with an investment of 25.3% the previous year with an external component of some 32.1% in real terms. Gross Fixed Capital Formation grew by less than 2% in 1989, well below the 8.7% recorded in 1988, but this was not general since investment in the service sectors grew by 18.8% against contraction of just under 10% in 1988."

Nevertheless, there is anecdotal evidence that savings are available if instruments can be fashioned to coax the savings from the public, and if vehicles can be fashioned to channel the savings into investment.

- The Central Bank of Kenya reports that both bank and non-bank financial institutions are quite liquid having ratios of 26 and 28 percent respectively, above the 20 and 24 percent required. The non-bank sector was particularly liquid at year end, 1989 having shifted noticeably to GoK bills and bonds.

[19] Earnings and spending can only be counted in the formal sector of the economy. Savings are accounted for as a residual. That is, earnings (which can be counted) minus spending (which can be counted) equates to saving. But, if earnings flows from the formal to the informal sector, the amount is counted as savings even if it is spent because the spending cannot be accounted for.

- First American Bank was able to sell KShs 150 million at prices providing for a 13 to 17 percent yield (depending on 1 to 3 year maturities respectively) primarily to institutional investors, while Citibank, aiming at a less sophisticated private savings market sold KShs 20 million at around 13 1/2 percent. Insurance companies showed little interest (even little knowledge) of the securities. Each sold in denominations as low as KShs 100,000.

- One study indicated that 60 percent of the demand for Barclay's public offering was from outside Nairobi.

- Several persons interviewed noted that most share issues have been oversubscribed--and the bulk of this oversubscription is from private investors who otherwise must keep their savings in bank deposits, Treasury securities or cash. Barclay's, 1st American Bank, Kenyan Commercial Bank and Standard Chartered Bank have sold shares and had to limit the number of shares that could be purchased by individual investors. There is an appetite for equity investment.

Despite the concentration of economic activity in Nairobi, savings and liquidity exist outside the confines of Nairobi. Both Citibank and First American Bank have indicated that their CD's appear to be selling and being sold in Kenya's secondary cities and towns.

By far the single largest source of savings and long term funds is the National Social Security Trust Fund (NSSF). Since the NSSF was established in 1965 it has received contributions amounting to KShs 1.75 billion (US$ .077 billion) and has settled claims amounting to KShs 1.25 billion (US$ .055 billion). The fund receives an average of KShs 90 million (US$ 3.95 million) a month or KShs 1.1 billion (US$ .048 million) a year. As of December 31, 1989 its total membership consisted of 2,195 million individual contributing and non-contributing employees and 38,938 registered employers. The fund has KShs 22 million placed in both short and long term investments--KShs 6.3 billion (US$ .273 billion) in GoK bonds, about KShs 5.5 billion (US$ .241 billion) in GoK bills and KShs 2.8 billion (US$ .123 billion) in deposits at financial institutions. The remainder is invested in Government stock, Nairobi City Commission bonds, real estate and shares or equities. Approximately 25% of deposit liabilities of the Housing Finance Company of Kenya derive from the NSSF.

But, with respect to overall savings there are three questions to be confronted in the case of Kenya:

- How can existing savings be shifted from investment in either real assets or other forms of paper into the public securities market;

- How can funds be shifted from current consumption to savings and hence increase the pool of savings to be invested; and

- How can funds be drawn from the informal market, which might not be accessible to a formal securities market, to the public securities market?

These markets provide the credit and savings mobilization functions for a major portion of Kenya's economy. An appropriately constructed market instrument that meets the needs of the informal sector stands some chance of drawing savings and economic activity from the informal sector to the formal sector.

The requisite action would seem to be to remove the inhibitions from a well functioning financial market, inhibitions which preclude the appropriate signals from reaching the demander and suppliers of savings. Such factors include:

- Cultural unfamiliarity with sophisticated secondary markets
- Government controlled interest rate ceilings or managed interest rates
- Exchange rate controls
- Credit allocation including mandatory governmental debt purchase requirements or reserve requirements
- Tax policies which discriminate against savings or other investment activities
- Lack of anonymity of the investor (fear of governmental intrusion).[20]

Of course, it must be recognized that some policies have been implemented for other reasons and their alteration will necessarily result in exacerbation of other problems even though they may facilitate the development of a secondary financial market. The elimination of exchange rate controls might be one such policy that exacerbate certain trade problems even though it might enhance the mobility of funds and expedite the development of the secondary market.

By definition no data exists to confirm the fact that the informal economy possibly appropriates a sizable proportion of the savings, but conventional wisdom in Kenya seems to indicate that it is the case.[21]

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[20] Mr. Jaffer, Chairman and Chief Executive of the Jubilee Insurance Company Limited, suggests that the main drawback to the development of a secondary market is the lack of anonymity.

[21] It is important to note that the persons we have discussed these issues with are part of the formal economy although I did meet on an informal basis with Mr. Hammad, a local proprietor and active participant in the local Muslim financial establishment.

II. DEVELOPMENT OF FINANCIAL INSTRUMENTS AND MARKETS

A. CHARACTERISTICS OF INVESTMENT INSTRUMENTS

Persons voluntarily invest in an asset because of the anticipated return on their investment. Characteristics of an investment instrument which will influence the eventual total return either directly or indirectly are listed below:

Maturity	The maturity of the instrument or more generally, the time schedule by which interest and principal payments are made,
Variability	Whether the instrument is related to fixed or floating interest rates and, if floating, the nature of the index,
Pledge	The nature of the repayment pledge--the source of the repayment,
Credit	The quality of the credit, including the history of credit and the prognosis for repayment,
Tax	The tax treatment, (including issues of compliance, avoidance and evasion),
Registration ...	Whether the instrument is a bearer or registered type of instrument,
Liquidity	The nature and quality of underwriting and the ability to anticipate a secondary market,
Guarantee	The existence of any guarantee of timely repayment of interest and/or principal,
Arbitrage	Arbitrage restrictions placed upon the borrower,
Encumbrance	Any fees or encumbrances attached to the instrument--(one encumbrance might be in the nature of a call, for instance),
Legal Status	The legal ability of the debt to fulfill certain categories of Kenyan law: (a) tax exemption, (b) count as reserve holdings, (c) to provide arbitrage earnings to the issuer;

The contract between a supplier of funds and the demander of funds must provide:

(1) Stated dates and amounts of repayment,

(2) The nature of recourse if the borrower is delinquent or in default on repayment, and

(3) For enforcement of the contract by the legal system in a timely and predictable manner.

To the extent that the legal system and institutions surrounding a market are unable to provide assurance of such perfection then the rates required by all three parties to the transaction may be prohibitive and the volume of such a bond market would be small or nonexistent. Lien covenants seem to be enforceable in Kenya although the seeming casual regard for debt obligations of the Nairobi City Commission and others raises questions regarding the will to enforce.

Certain events could occur which would impact the return but cannot be directly treated in the investment contract--these are items of risk.

B. CONSIDERATIONS OF RISK

Clearly risk increases with the duration to maturity. That is, the more time that lapses between the time the money is lent and the time it is repaid the greater the risk of some adverse occurrence. Presumably both the demander and supplier of the investment instrument have made an assessment of the inherent risks prior to authorization of the contract and have demanded and agreed to pay the appropriate risk premiums.

Risk factors may be grouped under the following categories:

Interest Rate Risk--Because the price of a bond is inversely related to the market interest rate, any change in the market rate will cause the bond's value in the market to fluctuate inversely as well.

Purchasing Power Risk--To the extent that the rate of inflation is greater between the time the loan contract is negotiated and time of repayment than is anticipated at the time the contract is negotiated, then the bond holder incurs a loss of purchasing power.

Market Risk--The secondary market reflects macro-economic factors apart from the general credit worthiness and yield of the debt security. The bond holder could suffer a capital loss (or gain) if circumstances impact the secondary market adversely.

Exchange Rate Risk--Transactions denominated in currency different from that facilitate local purchases run the risk of adverse shifts in the exchange rate.

Liquidity Risk--Bonds tend to trade in somewhat segmented markets where some bonds, despite yield and creditworthiness characteristics, may develop a reduced secondary market and may be forced to offer significant premiums to maintain liquidity.

Default Risk--The nature and quality of credit underlying any given debt issue varies considerably depending upon the nature of the credit pledge. There is always risk of default.

Issue-specific Risks--Debt instruments can be complex in their structure. Yield calculations take cognizance of the rate at which various payments must be reinvested, or must assume that certain call provisions will or will not be exercised by the issuer. Thus, the purchaser assumes some risk that features of the bond will adversely impact the yield.

1. Interest Rate Risk

In the same manner that unforseen interest rate changes can cause a reduction in the market value of a bond, the same factor can be used in a diversified portfolio to protect against loss. For example, in a free market economy investors can usually hedge their debt investments against equity investments. Because

(1) the price of a bond is inversely related to the market yield[22] ,
(2) interest rates most always reflect the anticipated rate of inflation, and

[22] Bonds are sold at a premium or discount from their par value depending on the market rate of interest compared to the stated (or "book") rate stated by the bond indenture. If the bond pledges to repay a debt at a certain interest rate, and is not subject to adjustment, then a rise in market rates above that rate will cause the seller of that fixed rate bond to have to induce a buyer to buy by cutting the price of the bond thus raising the effective yield on that bond. On the other hand, if the market rate is below the stated price on the bond the seller can demand a higher price for his bond because its interest payments are higher than the buyer could get in the market at the present time.

(3) stock market prices tend to be directly related to the rate of inflation--

given a broad enough investment in equities (say with a mutual fund) one can reduce their exposure to a fall in bond prices[23]. In a centrally managed credit market, where interest rates are controlled, but equity prices are not, such hedges are not available and conservative investors loose an important tool in limiting their losses. The Kenyan managed credit system, while removing some interest rate risk, removes the possibility of such a hedge and thus reduces the attractiveness of more comprehensive credit portfolios by large investors.

2. Purchasing Power Risk

Purchasing power risk is not inherent with equities for the fact that equity payments are not fixed but presumably fluctuate in some relation to the rate of inflation. Thus in a situation where potential investors have difficulty assessing the risk of inflation, equity markets are relatively more desirable than fixed income markets.

The usual hedge against inflation for a lender is some instrument which will adjust automatically to changes in market conditions, a variable rate loan. Ideally a variable rate instrument is based upon an index which:

(1) Allows for the re-computation of interest payments at stated intervals known in advance,
(2) Assures the borrower that the periodic rate will be known, published or constructed at the stated intervals,
(3) Is neutral in the sense that it does not by its construction favor the borrower or the lender, and
(4) Can be constructed from market determined information that can be publicly known and calculated. [24]

Although any or all of these rules could conceivably be violated it would surely be at the expense of reduced demand and volume. But, a variable rate can mean two different things in Kenya:

First, it can mean a loan repayable at rates which are periodically indexed to some known index--such as Treasury rates or the rate ceilings promulgated by the Bank of Kenya. But this method suffers in three respects: (1) both rates are administered

[23] Of course, at the same time that the investor limits his downside risk he limits his potential gain.

[24] Such as the index of Treasury yields, or the Federal Reserve Board's Home Mortgage Index (even subdivided by region) in the United States.

rather than market determined--Treasury rates are derived from rather mandatory purchases at stated tender rates and the ceiling rates are contrived to be in accordance with other national objectives; and (2) the rates are published irregularly and, thus, cannot be counted on for adjustment at consistent intervals.[25]

Second, the concept of variable rate can simply mean bonds which are rolled over or "renegotiated". The rollover rates are based upon market rates at the time of renegotiation. The renegotiation may be required by some "renewal" provision of the original contract, but the essence is still a balloon payment rolled over at new market rates. Such an arrangement is less satisfactory to borrowers in the sense that the principal becomes due and payable if an appropriate renegotiated rate cannot be agreed upon by the lender.[26]

The only close to a viable index is the Central Bank of Kenya ceiling rate[27] or the Treasury Bond rate plus two points[28]. Because both rates are below market and subject to administrative control by the GoK, neither is satisfactory to the borrower or the lender.

3. Market Risk

The expectations regarding the Kenyan economy are fairly uniform and are spelled out previously--few people anticipate lower inflation rates or lower interest rates in the short to medium term. The July 6, 1990 announcement by the GoK of its intent to decontrol interest rates by July 16, 1991 confirmed the expectations of most financial analysts. Although it is an indication that the Ministry of Finance and Bank of Kenya believe current rates to be only marginally below market, there remains some skepticism that the target will, in fact, be reached.

4. Exchange Rate Risk

An important constraint to continued use of USAID Housing (dollar) Guarantee funds by developing country borrowers for lower income infrastructure and shelter is its foreign exchange component. As noted, HG borrowings in US dollars as applied to long-term financing of local currency investments leave these countries fully exposed to the

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[25] Alico, Kenya's largest insurance firm indicated they did hold loans with maturities up to three year indexed to the Bank of Kenya ceilings.

[26] Citibank, Kenya, for one, sees this type of variable rate bond as the only type that they would take into portfolio--otherwise the inflation risk is too great.

[27] 19% in July of 1990.

[28] About 16½ percent plus two percent, or, 18½ percent in July of 1990.

exchange risk involved. Four possible solutions to reduce this risk to the eventual contractor are listed below:

- To require a host government guarantee, as is the case under the existing HG program. This runs up against a country's overall limits on foreign debt service and ceilings if it is under World Bank restrictions (such as Kenya). Furthermore, it only passes on the exchange rate risk to the central government, an entity which, although best positioned, is unlikely to be well positioned to bear such risk.

- Similar to the above is a currency and interest rate swap where a housing authority borrows US dollars under the USAID guarantee, swaps the dollars for local currency with the central bank, the central bank invests in a dollar denominated investment (possibly a guaranteed investment contract, GIC), and the housing authority ensures that its mortgage contracts are sufficient to unwind the swap (i.e., buy back the dollars at the end of the loan maturity). There are two problems with such an arrangement, however: First, there is the risk that the mortgage terms will be insufficient to redeem the dollars, and, second, the central bank is denied free use of the dollars over the investment period.

- To let the ultimate borrower himself meet this risk through some form of indexation of local currency borrowings. This works only to the extent that the mortgaged asset's appreciation corresponds to or exceeds the currency's depreciation, with the further proviso that the borrower's income also keeps pace with his increased payment obligations--conditions which can seldom be presumed to be met. Furthermore, as will be noted, an appropriate index is difficult to find or construct in a managed system such as that of Kenya.

- The last option is to raise the loans locally, in local currency, and provide the USAID guarantee in terms of the local currency. Thus, the local currency housing guarantee proposal (LCHG) differs from the dollar guarantee program only in respect to the fact that the guarantee is denominated in terms of local currency. The exchange risk is essentially mooted although a modicum of risk would be borne by the US government were Kenyan currency to appreciate (an unlikely event). The USAID guarantee and default risk could be borne by the Gok, and to a secondary extent by USAID. Under current US law, however, lenders would have to be Kenyan offices of 100% US owned firms. Such a program has the advantage of:

(1) Removing all exchange risk from the host country which is presumably ill suited to bear such risk,

(2) Allowing for various options in the distribution of default risk, and

(3) Possibly stimulating domestic financial institutions more than would ultimate reliance on US based institutions (this impact would be enhanced considerably if US law were altered to allow domestic institutions rather than US owned institutions to originate the loan).

5. Liquidity Risk

In the US liquidity risk is usually associated with a particular incident such as a widely publicized default of a similarly structured bond or a down rating by one of the credit rating agencies of the issue or a similar issue.[29] In a country with a poorly developed or uneven secondary market, however, liquidity risk becomes a more ominous factor. The central bank of Kenya only provides an effective discount window for Treasuries, with maturities remaining of less than 90 days. And, although secondary traders of Treasury securities are required to notify the Central Bank of the change in registration it is seldom done, maintaining the required degree of anonymity.

There is evidence, according to Citibank Kenya and First American Bank of Kenya, that the bearer CD's are trading on an informal secondary market at par. In 1988, Minet Insurance Brokers established a subsidiary to provide investment advice and intermediary services but was told to discontinue the operation by the Ministry of Insurance because of an apparent conflict with the 1984 Insurance Act. Dyer & Blair, a Nairobi financial firm is preparing to offer a secondary market in GoK bonds, even to the extent of warehousing them (holding them for some period before selling) and otherwise matching buyers with sellers for a fee. Eventually they intend to take on other paper, perhaps Unit Investment Trust Certificates if this market develops. The Post office sells and buys (at par) small denomination, short maturity bills.

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[29] It should be pointed out that in the US market, the original underwriter of an issue is pledged by rules of the Municipal Securities Rulemaking Board, the Securities and Exchange Commission and the National Association of Securities Dealers to maintain a secondary market for bonds. The secondary market is to be "orderly" in the sense that prices (thus yields) should be adjusted slowly according to market supply and demand conditions. Of course, such order can only be established where the volume on the secondary market is sufficiently large and spread over sufficient time to permit gradual movement.

For all practical purposes, however, there is no secondary market in Kenya. Liquidity risk resulting from the lack of a secondary market or liquidity facility is the single most important limitation to the development of capital markets in Kenya.

6. Default Risk

Most persons interviewed indicated that default risk was exceedingly low in Kenya's private lending--probably because credit is, by necessity allocated to the most credit worthy clients. Underwriting standards seemed particularly stringent with the Building Societies where the major reason for loan rejection was a major disparity between the loan amount and the assessed value of the property. As has been noted, however, public lending is a different matter with considerable history of default and no apparent municipal insurance backing to backstop the default.

7. Issue-specific Risks

Without a secondary market there has been little creative development of more complex debt or equity instruments. In fact, until the market for bond instruments is more fully developed such ornaments as puts, calls, variable rates and so on would possibly do more to hinder the market than to enhance it.

C. DISTORTION CAUSED BY A MANAGED MARKET

The combination of private and public needs competing in a financial market with specified instruments and a variety of risks will create a myriad of interest rate structures which vary according to characteristic of the contract.

The relationship between maturity and yield for a given type of instrument is called the "yield curve". Generally a yield curve is upward sloped indicating that the longer the maturity, the greater yields are required to induce a lender to part with his savings. And, although there may be many factors affecting the shape of the yield curve, a fundamental one is the expectation of inflation. If lenders anticipate inflation, and interest rates to rise, for example, they will "go short", that is, try to keep as liquid as possible by keeping very liquid--bidding up the price on short term bonds relative to long term bonds--making the yield curve more steeply sloped by driving up the price (hence reducing the yield) of short term investments relative to long term investments. The opposite would hold if inflation and interest rates were expected to fall.

What exists in Kenya is a relatively flat yield curve, with official rates below the market rate and expectations of increasing rates. With capital restricted from expatriation[30] there is little to do but go for very short maturities at the highest safe rate possible. The result is a very restrictive market in Kenya where the two real choices are between "safe" GoK bonds, or somewhat risky but high yielding commercial real estate ventures.

D. SERVICES REQUIRED IN A DEBT MARKET AND THE COSTS OF ISSUANCE

As already discussed, the bond market consists of demanders, suppliers, and intermediaries which match the two. But, more specifically, there will have to be other actors in the market if the transaction is to be a successful one. Although there is no reason to anticipate that the institutions befitting Kenya will necessarily be those of the US, it is instructive to look at the nature of offering and pricing of a bond in the US municipal market.

- **Underwriter:** For a fee, the underwriter in most cases is expected to purchase the entire offering of the borrower (thus he "underwrites" the issue). The issue will be subdivided into shares of a denomination both consistent with law and convenient for the underwriter to resell.

  The underwriter earns two fees directly: (1) the management fee which compensates the underwriter for his assistance in structuring the transaction and providing market advice, and (2) the "takedown" which compensates the underwriter for both initial sales effort and his promise to assist in whatever manner is necessary in providing a smooth and certain secondary market for the bond. Although the outcome is the same, the management fee is usually stated as a lump-sum payment while the takedown is a percentage of the total size of the offering.

  The underwriter may also receive payment by means of a "discount"--that is, selling the bonds at a higher price than they pay the borrower for the bonds. Such a discount may be either intentional or unintentional on the part of the borrower but often constitutes a large portion of the payment to the underwriter.[31]

  There are underwriters in Kenya, but their activities have mainly been brokerage activities. When equities have been issued the underwriter has usually been the

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30 Even though the currency is blocked, a report of the Central Bank of Kenya indicates that there are KShs 1.3 billion (US$ .057 billion) circulating outside of Kenya, presumably used to purchase Kenyan commodities.

31 In the US the total fee paid the underwriter can range between $5 and $20 per $1,000 of bonds sold depending upon the complexity of the transaction and the strength of the market at the time the bonds are sold.

issuing bank (most recent and most successful issues have been commercial banks or insurance companies which have the capacity to serve as their own underwriters).

- **Bond Counsel:** Bond counsel provides two types of legal opinions. First, they opine that appropriate procedures have been followed according to relevant law. Second, if appropriate, they opine that the bonds have a recognized tax standing to the buyer of the bond (taxable or tax exempt, for instance).[32]

  Bond counsel may also be assigned to supervise the preparation of the "Offering Statement" (O.S. or prospectus) although he is assisted by the underwriter and borrower himself. Offering statements would include a strict definition of the use of the funds, a description of the borrowing entity including the governmental structure; method of repayment; economic circumstance and prospects; audited accounts; and history of past borrowings; and in general full disclosure of any prospect which might impact on the ability of the borrower to repay. The O.S. provides comfort to the borrower and in the U.S., bond counsel is asked to opine that the information so contained is complete and factual.[33] The preparation of an extensive OS has not been standard practice in Kenya but may be required to provide necessary comfort to potential investors.

- **Trustee:** The trustee is a disinterested third party institution with fiduciary responsibility for disbursement of funds and protecting the rights of the bondholder (including protecting the bondholder against interceding liens). To provide comfort to a lender, the Trustee must be perceived as fair and impartial and, of course, must operate for the life of the bond. Generally, the trustee employees separate counsel which is included in the Trustee's fee.[34] Private loan arrangements in Kenya utilize a trustee arrangement and it is probable that a Trustee with impeccable credentials would be required to provide the necessary comfort to investors in municipal issues as well.

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[32] In the US, Bond Counsel certifies that in their opinion the bonds are tax exempt under US Federal Tax Law. Bond Counsel thus has some liability if proved wrong under rulings of the Internal Revenue Service.

[33] In the US, Bond counsels fee is usually a flat fee ranging from $10,000 to $100,000 depending upon the size and complexity of the bond.

[34] In the U.S. the Trustee's fee is usually much less than that of bond counsel--perhaps $10,000 to $40,000 on even the largest issues. However, in the U.S. the role is seen as generally a pro forma activity where the Trustee acts only if roused by litigation threatened by a bond holder. Otherwise the roll can be a bookkeeping roll, tracking bondholders in the case of registered bonds (which are now mandated by U.S. law).

- **Miscellaneous expenses** are incurred including printing of both bonds and offering statements. The amounts are *de minimis* but must still be accounted for in total sizing of the bond issue. Included in this category are a variety of advisors and consultants which might include financial consultants as well as engineers[35]

  Also included might be payments to one or more "rating agencies". A rating agency is an independent evaluator of default risk. The evaluation is provided the potential investor without comment on other forms of risk. Such services are not presently provided in Kenya and the degree of comfort that such a service would provide would be dependent upon the current reputation and independence of the provider. It would seem that the nature of a bond market, particularly a municipal bond market, would have to be established and understood before the nuances of a rating agency would have any beneficial impact--a few successful issuances will have to precede the acceptance of a "rating agency".

- **Insurance and Letters of Credit:** To enhance the salability and quality of various borrowers the borrower may acquire insurance.[36] Another form of insurance is an Irrevocable Letter of Credit (LOC) from a highly rated bank (AAA)(most are Japanese banks). Insurance provides principal and interest payments for the duration of the bond and generally costs about 2 points (2 percent of the size of the issue) depending upon the degree of risk; while the LOC is purchased one year at a time (one years principal and interest payment) and generally costs about a quarter of a point (.25 percent of the size of the issue). The general feeling is that if a credit can make the first one or two interest payments the loan will be a good one and the insurance can be dropped--thus, the popularity of the LOC.

- **Capitalized Interest:** In many construction projects supported by revenue bonds, payments of interest are often required prior to the completion of the project and recoupment of revenue. In such cases, localities borrow additional amounts to make the initial payments. The practice is generally a very expensive one unless interest earned on the excess borrowing can offset interest paid.

- **Reserve Funds:** It is the general practice in the U.S. to include in the size of borrowing a reserve fund equal to about one years principal and interest payment. In the case of tax exempt bonds the rate paid on the bonds may be as much as 200 basis points below the rate that can be earned on non-tax-exempt investment,

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[35] Engineers are often required to provide comfort that costs of construction (if that is what is being financed) will not exceed the amount bonded, or that traffic on a toll road (for example) will be sufficient to provide the revenue forecast.

[36] In the US, for example, there are three major insurers AMBAC, MBIA and FGIC; all syndicates of underwriters and major insurance companies.

however. This arbitraging of reserve funds was leading to ever growing reserve funds but was curtailed by the 1982 Tax Act, and was eliminated entirely by the 1986 Tax Reform Act.

In the US the above elements generally constitute up to 2 1/2 percent of the issue size and are all additions to the principal when determining the size of the issue. It is impossible to know, at this time, what the similar services would cost in Kenya. The following element is a subtraction, however, and can be considerable under appropriate financial conditions.

- **Arbitrage:** In general, arbitrage is the buying of a contract in one market and selling it in another. In the tax-exempt municipal market the term refers to borrowing a tax-exempt rates and lending at taxable rates. Because the spread between the tax-exempt rate and the taxable rate can be high[37], the interest earned can be considerable and will, of course, be greater with the volume and duration of the amount arbitraged. The Ministry of Local Government indicates that earning arbitrage over some short period of time has been a practice which they approved in the past--the key, however, is having a spread between the borrowing rate and the rate of investment.

Thus, the total sizing of an issue relates to principal, expenses and timing of disbursements[38]. The point is, even without being able to identify persons or entities within Kenya who can serve these necessary functions, it is evident that there is some critical size of issue and/or some reduction in cost of issuance necessary before a municipal issue could be cost effective. One possibility is to wrap several municipal issues into one--a so-called "designated pool bond"--which would raise capital for several projects with a single bond issuance.

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[37] As high as 150 to 200 basis points in the U.S.. Prior to 1982 the practice of floating "arbitrage bonds" solely for the purpose of earning income was common among U.S. municipalities. Under terms of the 1986 Tax Reform Act the practice is illegal *per se* and greatly curtailed in practice.

[38] Roughly, to borrow a net $10 million for 20 years in the U.S. municipal market, a jurisdiction would anticipate a bond issue size of around $12 million--making a 10 percent market rate for necessary principal equal to about 11 percent annually.

E. RECENT DEVELOPMENTS

1. The Capital Markets Authority

In 1989 the Kenya Parliament established a Capital Markets Authority (CMA) with the expressed purpose of developing all aspects of the capital market with "particular emphasis on the removal of impediments to and the creation of incentives for longer term investments in productive enterprise; the creation, maintenance and regulation of a market in which securities can be issued and traded in an orderly, fair and efficient manner; the protection of investor interests; and the operation of a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligations." The Authority is granted the power to purchase or otherwise acquire movable and immovable property; borrow and lend money; grant licenses to operate as a broker, dealer or investment advisor; to approve of unit trusts and mutual funds; and to formulate rules for exchanges, records and disclosure. Funds for operation and compensation are to derive from license fees, fines and penalties, interest accruing to the fund, and other money granted by the Vice President and Minister for Finance.

The Authority has little staff at this time (July 1990). Mr. W.K.B. arap Chelashaw serves as Executive Director of the Authority which consists of: six individuals appointed by the Vice President and Minister for Finance, the Permanent Secretary to the Treasury, the Governor of the Central Bank of Kenya, and the Attorney General. A chairman will be appointed by the President on the recommendation of the Vice President and Minister of Finance.

Three factors were apparent from discussions held with individuals familiar with the operations of the Authority. First, although there is great hope expressed by government officials for the work of the Authority there is considerable pessimism on the part of private businessmen who do not yet see conditions conducive to the growth of financial markets and have seen no systematic plan of attack developed or being developed for strengthening financial markets. Second, according to spokespersons, the Authority's first task is licensing and regulation rather than any particular plan to strengthen and lubricate the workings of the financial market. Instead, they indicated such activity will come in good time and are pressing for liberalization of credit controls. And, third, the principal concentration, is on the Nairobi Stock Exchange and its existing equity apparatus.

Nevertheless, the Act provides the framework for several factors that would have to precede the development of a financial market in Kenya--it has the apparatus for encouraging a secondary market; it can enforce the type of disclosure that would be required of municipal borrowers and other dealing in a municipal market; and it can represent the needs of persons involved with financial market to the GoK. Perhaps more importantly, the creation of the Authority indicates the importance the GoK places on the development of capital markets. Again, in the 1990 Budget Message the Vice President and Minister for Finance noted:

As the House will recall, we have embarked on the development of the capital market through the expansion and the deepening of the securities markets and particularly the stock market. The capital market will enable Kenyan companies to raise funds through equity or the stock market rather than by borrowing from commercial banks and through retained earnings.

2. Proposed Changes in Relevant Tax Law

The 1990 Budget Message proposed several tax law changes designed to augment various components of the capital market.

First, the message proposed elimination of double taxation on Unit Investment Trusts. Unit Investment Trusts have been allowed under Kenyan Law since the Unit Trust Act of 1976 but were never practical because of tax treatment. Generally a Unit Investment Trust is a fixed portfolio of securities sold to investors in trust "units", which represent fractional undivided ownership interests in the portfolio. The same securities are held in the portfolio until maturity or redemption. A UIT is a "closed end" fund, i.e., with a fixed number of units available to investors. Previously, in Kenya, a UIT was essentially taxed twice, first, when the dividend was earned by a corporation and again as it was received by the UIT holder. New legislation, as yet unrevealed, will alter the tax system to effectively tax the payment only once. Unit Trusts will be subject to withholding taxes of 15% on dividends and 10% on interest which will be final and not subject to corporate tax. Furthermore, Unit Trusts will be licensed and supervised by the Central Bank.

The concept has intriguing possibilities in that the system could be used to package various loans (packaging reduces overall risk somewhat like an insurance fund), and sell them on an organized exchange as a "pass-through" security--that is, where principal and interest payments are passed from the borrower directly through to the investors. Banks, insurance companies and building societies expressed interest in the concept.

Second, various fees and expenses for public issues were reduced. Where dividend and interest income is received by tax exempt persons such as pension plans, the income will not be subject to withholding tax. Furthermore, stamp duties payable for retail share transactions quoted in the Nairobi Stock Exchange, both for individuals and institutional investors, are to be abolished. Finally, legal fees and other costs of public issues of shares, debentures and bonds will be made a deductible expense so as to promote such public issues.

3. Relevant Regulatory Changes

In March of this year the GoK indicated that the Housing Finance Company of Kenya was among organizations prescribed by the Insurance Act of 1985 into which insurance companies can invest their assets and have them counted toward the reserve requirement. Alico, for example, has placed considerable deposits already with HFCK. In admitting the HFCK to the category the GoK has exempted the institution from the restrictions governing the proportion of assets that insurance companies may invest in HFCK. Accordingly, insurers carrying on long term business can invest more than five percent of their assets in the HFCK. Similarly, insurers carrying on general insurance business can now invest more than 10 percent of their assets in the HFCK. The implication of the action is to enhance the ability of the HFCK to source investible funds from the assets held by insurance companies and to reinvest the funds in housing development.

III. SUMMARY AND CONCLUSIONS

The charge by USAID of this project as cited in the Terms of Reference is: "...to determine if U.S. Government guaranteed local currency loans generally and municipal and corporate bonds specifically are feasible program instruments for AID use in furthering its shelter, urban development and private sector programs in developing countries." Specifically the project was to view two issues:

(1) the efficacy of a local currency guarantee on housing and shelter financing; and

(2) the long run efficacy of a credit market which might support a municipal market for urban infrastructure.

A. THE EFFICACY OF AN AID LOCAL CURRENCY HOUSING GUARANTY

First, with regard to the local currency guarantee, the LCHG provides the advantage of eliminating exchange rate risk to the local country and perhaps most importantly, assisting in developing local financial institutions to a greater degree than would a dollar denominated guarantee. The relevant questions are:

(1) Is the Government of Kenya guarantee still necessary?
(2) Is the US-AID guarantee necessary?
(3) Are there financial institutions in Kenya which are subsidiaries of US firms sufficient to provide the necessary funds?
(4) Is the removal of exchange rate risk sufficient to make the program attractive to the GoK, the lender and the USAID?
(5) Irrespective of the local currency variation, is the mortgage rate sufficiently higher than the cost of money to allow the program to operate?

The data and insights sketched above would seem to indicate the following:

- The paucity of available funds coupled with the narrow band of investment opportunities create a situation where there is little appetite for any risky asset--particularly a long term one. Discretionary funds are flowing to either high yielding commercial real estate or very liquid (and also pretty high yielding) short term assets such as GoK bonds. At the very least a guarantee for 100% of the principal, and timely payment of interest would be necessary to compete. Most institutions indicated that the USAID guarantee would be sufficient without the guarantee of the Government of Kenya. Despite the popularity of GoK bonds, a US guarantee is held superior to the GoK guarantee. Some even questioned the value of the Government of Kenya guarantee in light of recent payments history and new pressures (including the bailout of Kenya Airways).

- There are institutions within Kenya which could be configured to meet the current requirements of law regarding US ownership--Citibank and Alico[39], for example. Both indicated they have an appetite for the loan if it is appropriately priced. The Insurance Company of East Africa, although currently ineligible, indicated that it would not be interest in participating in any such issue as its current interest for any discretionary investment was for commercial property or high income housing development. Of course, removal of the U.S. ownership requirement would broaden the applicability of the program considerably and expand the ability of the HG to bring more integration of Kenyan financial markets.

- Exchange rate risk (and the risk is rather easily translated to certainty at this point) is a detriment to whomever bears that risk. The USAID guarantee effectively removes the exchange rate risk from being borne by the Government of Kenya and ultimate borrowers in Kenya. The consideration is substantial and was well recognized by the financial managers we spoke to.

- Effective mortgage rates are 22 to 23 percent annually for 10 to 20 year mortgages. Building societies will nominally lend up to 90 percent[40] of the value of the property while other institutions lend as little as 60% loan to value. The cost of money is only slightly less than the effective mortgage rate--because of the compression caused by managed credit markets. The average cost of money residing with various institutions is somewhat less than the rate for new funds (Alico, for example, indicated that the average cost for funds on hand was 17 1/2 percent although the cost for the HFCK is surely less because of its holdings of NSSF). For banks, on the other hand, the

[39] Alico Kenya is 80% owned by American Life Insurance Co. Ltd, which is a member company of the American International Group, headquartered in the US.

[40] Other considerations reduce the effective loan to value ratio to about 60%.

average cost of money is the cost of new money because of the short duration of their portfolio.

- Because housing loans qualify under various categories of permissible investments for both insurance companies and building societies it is possible that an appropriate mix could be found to induce an institution to participate in the LCHG program despite the fact that the spread between the real cost of money and the effective mortgage rate is very small.

- There was no particular evidence developed that localities would be willing to borrow for purposes of infrastructure finance even if the bond market were developed. Representatives of the Ministry of Local Government indicated their belief that such need existed, but a definitive response would require some survey of potential borrowers.

Generally, it would appear that the spread between the mortgage rate and the local cost of funds is slightly too narrow to make the LCHG program work (as of June, 1990) although there may be institutions with low average cost of funds which would view the LCHG as the investment alternative with the highest/safe return. It would not take a great deal of movement in interest rates, however, for the program to be the favored vehicle, however. Of course, the probability of finding an interested institution would be increased considerably if the US ownership requirement were removed. Furthermore, most every financial observer contemplates that the constricted nature of credit market (its short term nature with a compression of rate structures) will ease over the next one to two years as the Kenyan government moves toward decontrol and convertability.

B. POTENTIAL FOR DEVELOPMENT OF MUNICIPAL AND CORPORATE BOND MARKETS

Relevant questions developed in this paper have related to:

(1) What are the economic conditions that impact both the domestic economy and the domestic economy as it relates to various aspects of the world economy?
(2) What is the amount of savings, degree of liquidity, and maturity of existing debt in the market both now and in the future?
(3) What is the structure and tax characteristics of the various categories of potential suppliers of loanable funds?
(4) What are the needs and credit characteristics of the potential borrowers?
(5) What is the nature of existing financial intermediary institutions and the needs for other types of intermediary institutions?
(6) What is the legal ability of the debt to fulfill certain categories of Kenyan law--e.g.:
    (a) tax exemption,
    (b) count as reserve holdings
    (c) to provide arbitrage earnings to the issuer?

(7) What are the needs of potential lenders relative to maturity, rates? Should such rates be fixed or variable?

(8) What is the nature and extent of the equity market in Kenya and can it be augmented by the types of municipal issues under discussion here?

All evidence basically condenses to the conclusion that the development a public securities market suffers from:

(1) the poor credit of the potential borrowers,
(2) the lack of a secondary market for the securities, and
(3) the necessarily long maturity of debt.

The problems have been noted before. According to the USAID Country Development and Action Plan 1990-1995:

"Problems in the Kenyan financial sector are of three types. First, inadequate macroeconomic policy has its initial impact on the financial sector. Since the Central Bank works for the Government, the Government and its parastatals have first claim on banking system credit. As a result, deficit financing crowds out private sector credit. Second, a series of public sector policies is hindering the further development of a financial system which could adequately serve the needs of an outward looking and rapidly developing economy."

"The most important of these are exchange controls and interest rate controls. The former prevent the development of financial instruments needed by a modern export sector. The latter prevent the credit needs of small business from being adequately addressed. (The experience of USAID/Kenya's private sector portfolio is that financial institutions are usually willing to carry the credit risk of lending to small enterprise, providing their administrative costs are covered.) Finally, there are a number of institutional constraints which need to be addressed. Chief among these are the development of an adequate regulatory institutional framework for equity markets and foreign investment."

The issues have been discussed sufficiently in the preceding paper to know that development of a capital market would be a difficult and cumbersome task. Nevertheless, the overriding need, and signs of life in the capital markets, and the encouragement shown by the Government of Kenya in recent months seem to indicate that it might be possible to construct a viable instrument both in the near term and a more meaningful instrument in the future.

- Several local governments warrant investigation as possible candidates for early entry into the market[41]: Eldoret (1980 population 20,000); Thika (1980 population 21,000); Malindi (1980 population 12,000); Karatina (1980 population about 10,000); and Nakuru (1980 population 132,000). The target communities would have to be evaluated on the basis of set criteria relating both to their own credit worthiness and the value of the project to be financed. The criteria must relate to past credit history, prospects for repayment, evaluation of the project, local government management, revenue base, prospects for the local economy, audited financials and other factors that would provide comfort to a potential investor and underwriter. It would seem desirable from the first to provide an offering statement to the potential investor outlining the items mentioned above.

- The ability of a community to meet is debt obligation and retire its debt can be analyzed through a series of specific ratios. These include net debt to assessed valuation, net debt to estimated valuation, debt per capita, debt service to annual revenues, debt trend, and revenue collection history. It is doubtful that such data exist in all cases for Kenyan localities or that they are even relevant, but it is certain that a viable set of measures can be developed which might rank Kenyan localities in terms of credit risk. The February, 1990 Price Waterhouse paper "Prefeasibility Study of An AID Guaranty of Local Currency Bond Issues by Municipal and Housing Authorities" presents an outline of such consideration on pages 42 to 44 of the study.

- Because the advent of a secondary market is necessary for long term debt issuance one of two course seems prudent:

  (1) to issue only short term bridge financing similar to the so-called RAN (revenue anticipation note) in U.S. municipal markets (if such a need exists) for a period of one month to one year, or

  (2) investigate the possibility of supporting an emerging secondary market. As mentioned, several groups have endeavored or are endeavoring to create one. A consortium of financial institutions which have the capacity to hold longer term liabilities (such as the building societies) would appear to be the best prospects. Recognizing the need for a secondary market as a prerequisite for

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[41] Based upon discussions with the Ministry of Local Government and other knowledgeable individuals indicating that they seemed to (1) have a sufficient tax base, (2) had a comparatively good record of tax collection, (3) have historically had relatively auditable books that were generally up to date, and (4) perhaps most importantly, had individuals in key positions who were known to be strong and knowledgeable. Of course additional analysis, including knowledge of the project to be financed, would be necessary before any real selection could be made, including analysis suggested in the items below.

the development of most every variety of capital market, the Capital Markets Authority has indicated a willingness to assist in the effort.

- A guarantee[42] would be necessary on the initial issues, although the nature of the guarantee might be interest plus, say, 80% of principal. Capital markets are essentially a method of handling risk and if all risk is alleviated there can be little growth of capital markets.

- The bond indenture should include whatever incentives for repayment that can be legally constructed such as *pari passu* cross default references, giving certain powers of enforcement to a third party Trustee (essentially holding a deed of trust), prohibitions on additional borrowings during the duration of the lien, or providing a primary lien on relevant revenues. The initial issue should include a detailed and factual Offering Statement to provide comfort to actual and potential bond buyers. It is a practice that should continue (as it has grown in the US) even as the municipal market in Kenya enlarges.

- A revenue bond may be more salable because the source of revenue is readily recognizable by the buyer. However, indications are that a segregated revenue lien is not widely recognized in most African communities which recognize the higher purpose concept of general obligation--the full faith and credit of the locality.

- If a sufficient number of bidders, perhaps syndicates, can be encouraged to bid, the project should be bid rather than consummated by negotiation to remove any taint of special dealing--evidently a overriding suspicion when dealing with local governments.

- A consortium of banks might also be assembled to serve as underwriter for an issue, possibly agreeing to a best effort sale rather than a full underwriting of the issue.

- Because costs of issuance can be substantial, an umbrella issue including the needs of several communities may be desirable. As noted, many costs are of a lump sum nature and would not increase with the size of the issue. Furthermore, the payment to the underwriter, the largest single cost in U.S. markets, presumes certain responsibilities including underwriting and making a secondary market. To the extent that such services are not included, the basic underwriting fee might reduce to a mere sales fee.

- Private placement is an option where bonds, or at least a sizable block of bonds are sold outright to a predetermined buyer at an agreed upon negotiated price. Buyers are usually large banks, insurance companies or pension funds. The institution that

[42] The guarantee could be by the Gok or, perhaps, by USAID.

takes the private placement becomes both underwriter and buyer. Its advantage is that underwriting fees can be avoided, and in a complex transaction the nature of the bond can be more easily appreciated. Its drawback is that such a sale misses the impersonal competitive pressures of bidding, and the full gamut of institutions necessary for the eventual success of a bond market are not established. Nevertheless, a private placement may be the most practical way to enhance the chances for success of the initial bond offerings.

- It is possible that the bonds could trade on a revitalized Nairobi Stock Exchange. There is no *a priori* reason why such an exchange could not handle debt as well as equity. As noted, municipal debt did trade on the exchange in prior years.

- It is important in the context of Kenyan financial markets that the bonds be bearer bonds and anonymity maintained.

- Although there is reason to believe that the tax exemption makes little difference now it would still be desirable to press for the designation:

  (1) to maintain the option for the future, when sector reforms may make the exemption more effective in allocating credit to high growth areas, and

  (2) because it doesn't seem to do any harm and, as some mentioned, will still subtract some amount from the overall required yield.

- The adjusted tax treatment of Unit Investment Trusts opens the possibility that various municipal projects, including housing projects, could be rolled into a series of "pass through" securities. Payments on the bonds would "pass through" to the holder of the Unit Investment Trust, and the UIT could trade on the NSE as any other stock.

- If the instrument is of intermediate or long term maturity it should be structured in such a way as to provide maximum arbitrage earnings. This device has been used by municipalities in the past and does not appear to confront any law or regulation in Kenya and could reduce the costs of issuance significantly.

C. <u>RECOMMENDED NEXT STEPS</u>

- In structure, abstracting from the current circumstances, the LCHG appears to be workable and advantageous. In practice, the LCHG should be workable again one year to two years from now as GoK economic reforms and monetary policies began to stabilize inflation and expectations. It is possible that some institution, such as the National Social Security Fund, has funds which reflect much cheaper sources of money and might be willing to place the funds in the LCHG program, although, should the opportunity arise, the question of adequate spread cannot be answered without actually negotiating a rate.

- RHUDO/ESA can assist the development of capital markets in two ways in Kenya. The first way is through appropriate application of the guarantee as discussed above but the second way is through using the auspices of USAID to match appropriate entities with appropriate roles in a capital market. For example, the Ministry of Local Government should coordinate requirements for disclosure and record keeping with the Capital Markets Authority[43]. Entities such as Dyer and Blair, HFCK and Minet Insurance have expressed some desire to operate as a secondary marketing agent, or at least to facilitate a secondary market. The potential of keeping the NSE available for trading municipals should be kept open with the CMA and the NSE. The design of an appropriate Unit Investment Trust should be outlined in conjunction with such entities as Citibank Kenya, First American Bank and Alico Insurance, all of whom expressed interest and would be natural markets for the instrument.

- RHUDO/ESA can assist in identifying the companies or individuals who might serve as underwriter, trustee, and bond counsel. The Trustee, an extremely important position in an evolving credit market which lacks the culture of a capital market, could conceivably be a government institution or a board such as the CMA. It is vitally important to cloak the Trustee with security, trust and integrity.

- The capability of local governments and their desire to use bond financing is a question which was not even attempted in this study. RHUDO/ESA can develop an objective points system, in conjunction with the Minister of Local Government to evaluate projects and municipal credit. The outline of such a system was provided in the Price Waterhouse paper of February 12, 1990 but needs an analysis of specific ratios, data and project requirements along with specific weights to be applied so that the ranking of projects and credits to be supported by a guarantee will be subjected as little as possible to charges of favoritism. Similarly, the evaluation will provide data necessary to provide the comfort that is necessary to potential municipal bond buyers through an offering statement (OS).

- To shift the concept of development from a study to a working reality it would seem important to sponsor the development of a pro forma bond indenture, a working underwriting agreement, a schedule of cash flows, the agreement to invest fund proceeds until drawn, a loan agreement specifying the nature of responsibility under

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[43] It has been noted that for this to occur the MLG would have to be convinced that it must look beyond the Local Government Loan Authority or a municipal development bank, and it would have to become a much stronger and effective consultant to local government than it presently is.

a pool loan (umbrella) arrangement, the guarantee agreement and the workings of reserve funds (if any). Once these concepts are on paper, and tailored to the needs of specific Kenyan institutions a local governments, the actual mechanics of the bond market will become much more clear.

- As the first offerings progress, there will without question be a need to guide all participants through the process. It would seem that RHUDO/ESA would be well equipped to provide this service. There is potential earnings for several actors in the process--an underwriter, a bond counsel, secondary market makers, issuers and bond buyers. It is doubtful, however, that the potential will be spotted without guidance.

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