AN EVALUATION OF THE IMPLEMENTATION OF POLICY MEASURES FOR DEVELOPMENT OF THE NAIROBI STOCK EXCHANGE

BY

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DECLARATION

This management research project is my original work and has not been presented for a degree award in any other university.

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This Management project has been submitted for examination with my approval as a university supervisor.

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DEDICATION

To my parents Mr. and Mrs. Zedekiah Shieshia, My sisters Mildred and Caroline and brothers Klein, Herem and brother-in-law Brian. For their endless love, guidance, encouragement and support. May this be an inspiration to you to strive for even greater heights.

To you all,

I dedicate this work

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To all the lecturers of the faculty of commerce who were involved in the noble task of imparting knowledge and to all my colleagues in the MBA class, I sincerely thank each one of you.

To God Almighty, Thank you very much for making this possible.

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ABSTRACT

This study examines how the implementation of policy measures has had an impact on the development of the Nairobi Stock Exchange. The two objectives of the study were namely: (i) to evaluate the implementation of policy measures for development of the NSE. (ii)to ascertain the nature of impediments encountered in implementing the policies and recommend remedies.

In order to meet these objectives the pertinent primary data was collected. Primary data was obtained from 36 registered stock market players at the Nairobi Stock Exchange. The respondents of the study were senior managers who are responsible for developing policies in their organizations. These organizations included NSE, CMA, stock brokerage firms, investment banks and fund managers.

The study established that the CBK, NSE, RBA and the CMA have addressed the implementation of development of the NSE to a great extent through official supervision, monitoring of trading, imposition of portfolio rules upon banks, facilitation of better access to capital through floating of shares to the general public but have not adequately been able to act on product innovation through future options and financial derivatives and efforts to decentralize the NSE operations to other cities have been implemented to a small extent.

The limitations of the research were the refusal of some senior managers of registered market players of the NSE refusal to participate in filling the questionnaires because they considered it as a waste of time.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Study

Capital markets play a crucial role in the financial system of any country; they provide the means for domestic resource mobilization hence a great contribution towards economic development and growth. They bring about the reallocation of financial resources from dormant to active agents and long-term investments are made liquid as the transfer of securities between shareholders is facilitated (Masinde and Kibua 2005). Capital markets are ordinarily governed by policies, rules and regulations set by the regulatory body set up by the government; market players and the stock market itself have their own policies and regulations to ensure market discipline that will boost investor confidence.

Shaw and Mc Kinnon (1973) state that lately there has been burgeoning of interest in financial development and capital market operations appertaining to sub-Saharan countries. Intelligent examination is now directed at the possibility that there might be something in the capital market development and coherent analysis of this possibility is conducted within frameworks that provide for simultaneous consideration also of trade, investment and exchange rate policies.

In 1914 a major element in the growth of London stock exchange was the issue and subsequent trading of securities of railway, tramway, canal, dock, gas, electricity and water companies operating in Britain and the colonies (Morgan, 1965). In sub-Saharan countries of today, such activities still belong to the government sector. The most notable characteristics in sub Saharan capital markets is the great and often increasing importance of government as both issuer and buyer of securities. So far as new issues are concerned government securities accounted for 60-80 per cent of total new issues of securities 1965 to 1970 in 13 countries surveyed by Wai and Patrick (1973)

Evidence has shown that it is necessary to adopt policies that promote stable macro economic environment conducive to sustainable growth and development. Consequently any specific policy measures for fostering the growth of securities market should be introduced as part of a general programme for economic and financial development (Wai and Patrick, 1973). In view of complexities and developmental problems in Sub-Saharan African (SSA) countries policy recommendations should be formulated to satisfy short term and long-term policy objectives. Mc Kinnon and Shaw (1973) argue that sub- Saharan capital markets should be viewed and assessed in relation to the country's limited economic and financial development, emphasis being on the curbing of inflation and freeing interest rates if sub- Saharan capital markets are to germinate and flourish.

An Empirical study sponsored by a body known as Equity and Growth through Economic Research (EAGER) which seeks to encourage and improve the use of policy in sub- Saharan Africa, has identified various policy impediments that constrain capital market development with particular reference to Ghana. In view of these, policy recommendations have been designed to address some of the problems facing the Ghana capital market. In the case of the Ghana stock exchange (Ziorklui, 2001), expert opinion is of the notion to adopt policies that lead to the following; low inflation because it affects the real value and yield of bonds and debentures whose yields are fixed at a different interest rate, stable foreign exchange rates and stable prices, low fiscal deficits and a balanced budget. In addition the establishment of a distinct and independent central bank to ensure expedient monetary policy that enhances resource mobilization, enforcement of capital market regulations and promotion of political stability, which then increases investor confidence to increase their financial, holding. A provision of a policy measure of tax exemption on listed companies should be extended on indefinitely while special tax rebates to be considered on initial public offerings.

Interest rates ceilings stifle capital markets in SSA and a more liberal policy should be encouraged. Mc Kinnon and Shaw (1973) are united against government interference with the pattern of interest rates and allocation of investible funds that would be determined by the free play of market forces. In essence, market determined interest rates would be higher than the rates of interest, which prevail, currently in the organized financial sectors of SSA capital markets. For instance higher rate of interest charged on bank loans would encourage company borrowers to seek equity finance instead (Drake, 1969). Any net increase in attractiveness of equities for individual savers would depend on availability and marketability of equity assets outweighing the lure of increased interest obtainable on deposits in banks and other financial institutions.

A number of policy recommendations have been put forward in an attempt to improve the growth of Nairobi Stock Exchange. Both the Exchange and the regulatory body Capital Market Authority (CMA) which was established in 1990 have played a significant role in formulating and implementing these policies. As the regulatory body of the Kenyan capital market, CMA endeavors to promote development of an orderly, fair, efficient, transparent and secure capital market in Kenya. It strives to remove impediments, create incentives for long-term investments, attract a wider participation of general public by establishing a nationwide system of stock market and brokerage service, protect investor interests and develop a framework to facilitate use of e-commerce for development of capital markets in Kenya (Capital Markets Authority, 2001).

The Nairobi Stock Exchange has up to twenty-six stock broking firms that act as financial advisers to their clients. The exchange deals in both variable income securities (ordinary shares) and fixed income securities (Treasury and Corporate bonds, preferred stock and Debenture stocks). To improve the quality of information available to the players in the market, there was need to shift to floor trading to increase investor participation therefore enhancing transparency in the price discovery process (Basweti, 2002).

Over the years, a number of policies and measures have been put in place to foster the growth of the exchange (Basweti, 2002). In 1991, the call-over trading system was phased out in favor of floor based open outcry system that led to the establishment of a trading floor at Nation Center. Controls on capital flows and repatriation of earnings were removed. Commissions charged by stockbrokers were reduced from 2.5% to between 2% and 1%. In 1998, incentives to foreign investors, tax-free venture capital fund and removal of capital gain tax on insurance companies were implemented. In 1999, strict entry requirements were put in place, employment of qualified personnel was made mandatory. There were also plans to license a Credit Rating Agency and integrate the three East Africa Exchanges. In year 2000, the central depository system act was passed by parliament and received presidential assent paving way to implementation of the CDS on 18 August 2000. which lead to the Central Depository and Settlement corporations to be the legal entity that will own the clearing, settlement, depository and registry system of the capital market. This was to enhance investor confidence and create a smooth transition into an electronic based settlement and registry (NSE, 2002).

The move to reduce costs of cross listing bore fruits in 2001 when the cross border listing of East Africa Breweries took place. In the same year, newly listed companies were given a concession of being taxed at reduced corporate tax of 27% instead of 30%. In year 2002 a 25% minimum reserve on the issued share capital for locals was implemented with the balance of the 75% becoming a free float for all classes of investors(NSE, 2002). Structural reforms in financial markets created the Capital Markets Authority in 1989 to facilitate creation of an environment conducive to growth and development of the country's capital market. In June 2000, the government removed exchange controls and introduced a favorable tax regime with non-residents paying a 7.5% withholding tax on dividends and 5% for local investors. Foreign investment in the local subsidiaries of foreign controlled companies was banned in order to encourage input into Kenyan companies.

The Kenyan government initiated further measures to boost growth through increase in foreign investment: the NSE opened for foreign investors for the first time in January 1995, but with a maximum limit of 20% shareholding for institutions and 2.5% for individuals. The ceiling of investment has been increased to 40% for institutions and 5% for individuals. Commission rates have come down considerable in the recent past. All these policies were geared towards improving the growth of the exchange (Basweti, 2002).

Recent growth policies have paid off, though not to a large extent. Improvements in product innovations and liquidity, tightening of provisions dealing with insider trading, regulation of e-commerce activities, redefining compliance department of the exchange to proactively inform or monitor the market through more sophisticated systems (revised trading rules, revised disclosure standards, revised management and membership rules governing the admission and management of members) are some of the policies that have been implemented by the exchange.

1.2 Statement of the Problem

The government has put forward various direct and indirect policy measures for growth by the exchange since independence but they have achieved little success in developing the stock market (Masinde and Kibua, 2005). From the perspective of companies listed on the stock exchange the results show that there is inappropriate pricing of securities, competition from money markets, rigid bureaucratic procedures, high listing requirements, uncertain political environment, volatile interest and foreign exchange rates and low demand for securities (Wagacha, 2001). Masinde and Kibua (2005) state that the establishment of the CMA as a market regulator has not achieved much either, the stock market made significant gains between 1990-1994 due the change from call over system to open out cry system but since 1995 the performance has been dismal. The stock market development is entangled with politics of privatization and parastatal reform and although Kenya's exchange remains so far the most advanced in East Africa in terms of financial service delivery, weak investor confidence has made the country fail to take up its regional leadership role (Masinde and Kibua, 2005). Before the last general elections in Kenya in 2002 the NSE experienced a decline in market performance due to political and economic policies adopted by the government that led to withdrawal of donor funding. Kibuthu (2005) states that there are various emerging factors that the NSE is facing as challenges and need to be addressed: NSE by international standards is considered small, illiquid and volatile with regards to price and returns, Few and stagnant number of companies listed in the exchange only 48 since 2004 after 8 companies were de-listed due to poor performance, stringent eligibility requirements as exemplified in the requirements for listing at the NSE creating high barriers to potential entrants such as family owned businesses, the rate at which securities change hands is very low with few market participants establishing a highly concentrated market. lack of public awareness and information on the role, functions and operations of the NSE, Market infrastructure is underdeveloped with regard to the trading system which is slow, costly and limits the range of products provided as manual "open outcry" system dominates their operations. In addition Masinde and Kibua (2005) state that there is multiplicity of regulators and regulations at play in the Kenyan capital markets. they include the central bank of Kenya, Retirement Benefits Authority, Capital Market Authority and the Commissioner of insurance. All these bodies enact policies that affect the development of the stock market. They give non-coordinated and sometimes conflicting policies that often lead to poor performance of the stock exchange (Masinde and Kibua, 2005). It is imperative that the numerous growth policy challenges be given a fresh focus and coordinated look with view of identifying critical bottlenecks and making policy adjustments that would dynamise the stock exchange. Therefore solving policy bottlenecks and ensuring policy consistency and predictability in the Nairobi stock exchange is paramount. Thus there is urgent need to take fundamental reforms of the current market structure to ensure effective implementation of chosen policies. Since the policies for growth are appropriate, the low level of development of the exchange can only be attributed to poor implementation of the policies hence the need to carry out this research

1.3 Objectives of the Study

1. To evaluate the implementation of policy measures for the development of the Nairobi Stock Exchange.
2. To ascertain the nature of impediments encountered in implementing the policies and recommend remedies.

1.4 Research Questions

1. What are the critical success factors in implementation of policy measures for development of the Nairobi Stock Exchange?
2. What role does each of the key players in policy making perform in the effective implementation of the policies?
3. How does the exchange and CMA categorize the impediments faced in the implementation of the policies?
4. What can be done to overcome the impediments encountered in the implementation of the policies?
5. Has the government done enough to make the process of policy formulation and implementation successful?

1.5 Importance of the Study

To researchers: recommendations and findings of the study provide them with useful insights on various factors (market specific and extraneous) that affect implementation of policy measures for the growth of the market. With the insights, researchers would be able to address various aspects of the market forces affecting implementation of chosen practices.

Academicians: The findings, conclusions and recommendations of this research will in addition to the existing paradigm of knowledge on the Kenyan capital market. The research adds new concepts to an aspect of the Kenyan capital market that has not been adequately studied in the past.

The government: the findings of the study will enable the government to be conversant with various issues that affect the successful implementation of growth policies. This will enable its policy formulators to come up with more effective measures that will lead to successful implementation of chosen policies.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Capital Markets In Kenya

A typical capital market comprises of several institutions, namely: banks, insurance companies, mutual funds, mortgage firms, finance companies and stock markets (Wagacha, 2001). The key role of the capital markets is to provide long term resources for productive investment, to alleviate poverty, enhance mobilization of substantial capital resources over a long time horizon, serve as an important gateway to Kenya for global investors and foreign direct investments and provide avenues for investment opportunities thereby encouraging a thrift of culture and increasing domestic savings and investment ratios essential for rapid industrialization (NSE, 2002). An improved macroeconomic environment is a fundamental pre-requisite in the development of the capital market.

The Nairobi Stock Exchange (NSE) was formed in 1954 as a voluntary organization of stock brokers registered under the societies act (NSE, 1997a).It is an emerging capital market (a market at its infant stages of development). It was founded following deliberations amongst local brokers who intended to raise funds for the expansion of private enterprises and the economy. The major operation of NSE involves the buying and selling of different types of financial instruments like equities and bonds. The Capital Market Authority (CMA) is the regulatory body of the NSE. CMA Act and other rules and regulations guide its operations. Some of the regulations pertain to trading activities; exchange of information between different parties, relationships between various key players, and the administration of the NSE is located on the

1st floor, Nation Center, Kimathi Street, Nairobi. The Capital Market Authority is (CMA) is the regulatory body of the NSE.

As a capital market institution, the stock exchange plays an important role in the process of economic development. It helps mobilize domestic savings thereby bringing about the reallocation of financial resources from dormant to active agents. Long-term investments are made liquid as the transfer of securities between shareholders is facilitated. The exchange has also enabled companies to engage local participation in their equity, thereby giving Kenyans a chance to own shares. Companies can also raise extra finance essential for expansion and development. Capital market intermediaries include: stock brokers, investment advisers, stock dealers, credit rating agencies, investment brokers, custodians, investment bankers, and mutual funds and unit trusts (Mishkin and Eakins, 1998). Edmister (1986) states that law, friendship, contracts link these parties and communications network that form internally viable capital market structure.

There are a number of instruments traded in the capital market: (KIPRA 2003) corporate bonds including revenue bonds and mortgage backed securities, collective investment vehicles like unit trusts and mutual funds, commercial paper, state and local government bonds, stock and convertible securities, corporate stock (common stock, preferred stock and convertible securities). In developing markets, effective implementation of policies determines the rate of growth of the market a great deal; various key players in the market influence the implementation process. The Capital Markets Authority (the regulator) plays the most significant role in the effective implementation of the growth policies: it has the responsibility of identifying key market sectors that should be targeted for change, formulating appropriate policies, advising the government on various aspects of implementation, assessing the implications of the proposed changes on different market players hence ensuring that policies are market friendly. An ineffective regulatory body will lead to poor growth policies hence poor implementation. Well trained and experienced professionals are therefore an ingredient of successful implementation of policy measures.

2.2 The role of the Nairobi Stock Exchange in the economy

The NSE is an example of an emerging stock market that has been characterized by humble beginnings yet has grown considerably over time. In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world with a return of 179 % in dollar terms (Odundo, 2004). The major roles that the stock exchange has played and continues to play in many economies are that it promotes savings. (NSE 2001) the very fact that institutions exist where savers can safely invest their money and in addition earn a return is an incentive to people to consume less and save more. Secondly, the stock exchange assists in the transfer of savings to investment in productive enterprises as an alternative to keeping savings idle. Therefore mechanisms for channeling those savings into activities that create wealth should be encouraged to avoid misallocation of the savings which may then lead to economic stagnation, due to lack of developed financial markets.

Thirdly, it assists in the rational and efficient allocation of capital. Since capital is a scarce resource systems have to be put in place to ensure that capital goes to the deserving user (NSE, 2001). An efficient stock market will have the expertise, the institutions and the means to prioritize access to capital by competing users so that an economy manages to realize maximum output at least cost. This is what economist refer to as the optimum production level so as to avoid scarce capital being channeled to non-productive investments. Fourthly, stock markets promote higher standards of accounting, resource management and transparency in the management of business. This is because financial markets encourage the separation of owners of capital, on the other hand from managers of capital, on the other. This separation is important because we recognize that people who have money not necessarily have the best business ideas and people with the best ideas may not have the money. Therefore the stock exchange becomes an important link because the two need each other.

Fifthly, the stock exchange improves the access to finance of different types of users by providing flexibility for customization. This is made possible as the financial sector allows for different users to raise capital in ways that are suited to meet their specific needs. Sixthly, investors are able to liquidate their investment in securities through the stock exchange. The fact that investors are able to sell what they hold when they want is a big incentive for investment as it guarantees mobility of capital in the purchase of assets. It also serves as an instrument of privatization, the NSE has provided an avenue of liberalization of sectors previously dominated by the government and facilitated public divesture of its shares in public enterprises such as Kenya Airways, Mumias Sugar Company and Kenya Commercial bank.

The stock exchange plays a specific role to individuals, corporations and the government. This is can be seen through encouragement of public floatation of private companies which in turn allows greater growth and increase of the supply of assets available for long term investment. Facilitation of equity as opposed to debt financing, studies has shown that debt financing has been the undoing of many enterprises in both developed and developing countries especially in the recession periods. In addition it helps in correlating stock rocking activities of members and facilitates exchange of information with clients and to the public, co-operating with associations of stockbrokers and stock exchanges to obtain information likely to be of advantage of them and clients and enforcing of decisions relating to irregularities and complaints in the dealings of members and clients.

2.3 Benefits of Capital Markets

Mc kinnon and Shaw (1973) states that capital markets serve as an engine of general financial development and may in particular accelerate the integration of unorganized or traditional financial systems with the organized and institutional financial sector. Shares and bonds may directly displace traditional assets such as gold and stocks of produce. It provides a first rate breeding ground for skills and judgment needed for entrepreneurship, risk bearing, portfolio selection and management. In addition, enhances the scope and provides institutional mechanisms for the operation of monetary and fiscal policy.

The existence of capital market allows competition between various financial instruments, which leads to efficiency in stock prices. Transfer of ownership is achieved through the capital market; those with funds are able to transfer them to those with financial instruments in order to satisfy their needs.

Horch (1988) notes that capital markets have no ceilings on returns on securities one can be able to sell securities at any price without restrictions. We also find that a wider ownership base is available since private parties are welcome to the market as opposed to having one man show (the government).

Since there are regulations governing operations, there is improved efficiency of the financial system through minimization of wastages of resources. Jefferies (1995) reasons that capital markets provide citizens of a country with a wide variety of portfolio to choose from which in turn helps in the privatization and commercialization of organizations especially those that are run by the government hence increasing private sector solvency. Mobilization of revenue is also encouraged through buying and selling of shares by brokers at the stock exchange.

Hicks (1969) and Bagehort (1973) argue strongly on the important role capital markets development play on the in promoting economic growth. They support the claim by arguing that industrial revolution in England was the result of a functioning capital market that was instrumental in mobilizing and allocating long term capital to productive enterprises of the country. Various empirical studies have investigated the link between financial sector development and economic growth. Early studies supporting the finance-led growth hypothesis include Greenwood and Smith (1996); Smith, Bencivernag and Star (1996); and Levine (1991, 1993, 1997). While many of these studies emphasize the role of the banking sector in providing credit to the productive sectors of the economy, others emphasize the capital (equity) market in mobilizing and allocating long-term capital to promote economic growth.

Greenwood and Smith in (1996) conclude that stock markets lower the cost of mobilizing financial savings for investing in productive business entities. Other empirical evidence strongly suggests that well-functioning capital markets have the potential to promote long-term economic growth. Such studies postulate that capital market indicators such as market liquidity; capitalization, turnover and efficient allocation of financial resources are strongly associated with economic growth and capital accumulation for high productivity. Smith, Bencivernag and Star (1996) and Levine (1991) corroborated this finding and concluded that the stock markets provide investors with insurance of easy liquidity for selling their investments in the stock markets.

2.4 Factors Limiting the Growth of Sub- Saharan Capital Markets

Various theories attempt to explain the under development of SSA Capital markets. Mc Kinnon and Shaw (1973) and Fry (1988, 1982) consider the underdevelopment of the capital market to be a direct result of government regulation of the financial sector allocation of credit and determination of interest rates.

On the other hand, Gurley and Shaw (1955, 1960) and Goldsmith (1969), postulate that economies at various levels of development possess different levels of financial structures. At the early stages of economic development characteristics of underdeveloped countries, business entities, capital investment is mainly self financed or financed by internally generated capital. However, as the economy begins to develop, depository institutions emerge to intervene between surplus spending and deficit units. These deposits institutions issue secondary securities to surplus entities for mobilizing savings for allocation of deficit entities. Stock markets evolve as long-term capital needs of the business community cannot be met by the banking sector, which essentially focused on providing short-term credit to the private sector. Moreover the inflationary pressures and weak domestic currencies in many SSA countries provide no incentive for holding long-term securities.

To begin with Sub-Saharan countries are dominated with agriculture economies, which are usually organized in small lines. Where corporate agriculture exists they are usually foreign controlled and their shares are predominately held abroad. Foreign companies generally have little need or desire to raise capital locally unless persuaded or obliged to do so by local authorities. Drake (1969), clan companies are common in sub – Saharan countries and are usually reluctant to admit outside capital due to risk of dilution of control. The limited supply of private securities is related to small size and limited horizons of many local businesses.

Maniatis (1971) argues that individual savings accrue to unsophisticated people who are financially inexperienced and have conservative attitudes towards money. Such people are pathetic towards advanced forms of wealth holding. In sub Saharan countries share ownership by individuals tends to be confined to those with high incomes who may spread their risks through diverse portfolios; there is not sufficiently large class of well to do to sustain a corporate securities market. Masinde and Kibua (2005) observe that constraint to demand for securities in Kenyan is the low level of savings, currently estimated at 10 percent of GDP. Although Kenya is comparatively ahead of the other Eastern Africa countries in terms of capital market development, over 75 percent of her population whose savings are negligible lives in rural areas. Therefore, potential investors amount to a small proportion of the entire population. In this sense, the country has a small pool of effective demand for securities than the overall GDP and population numbers indicate.

Investors on the stock market are unaware as a result of lack of accurate information. The quality of accounting information and the disclosure by listed firms constrain efficient price discovery and valuation of underlying companies listed on the exchange. This makes the costs of obtaining information high and in turn makes investment in securities extremely risky. Trading procedures are not automated leading to insufficient trading and settlement practices. Wagacha (2001) observes that the NSE continues to utilize manual trading and clearing settlement systems, which are inherently slow and costly. Although the system served well in a low volume-trading environment, it cannot sustain significant changes in volumes traded and settled. This system limits the range of services that can be provided. Equally trading in products that require prompt completion of the transaction cycle is seriously hampered. They also hinder international integration that can only thrive under automation. In addition the lack of product innovation, limited and unfamiliarity of number of investment instruments traded in the stock exchange also act as a constraint by limiting the stock exchanges attractiveness to domestic and foreign investors.

The role of the stock market in promoting capital market deepening is also hampered by government's divesture programs, which emphasize privatization through the strategic investor financing rather than through the stock exchange. The tax structure on dividends and capital gains is a cause of concern for some investors. For example fiscal policy for taxing capital gains and exempting interest income on treasury bills provides a disincentive for holding portfolios in the stock market.

In developing markets, formulation and implementation of growth policies are impeded by various factors: some of the factors are extraneous. Institutional and structural impediments are also inevitable. Most developing markets lacks qualified professionals to formulate effective policies; political influence has a significant bearing on stock market policies. Lack of appropriate institutions to carry out the implementation of policies significantly affects the implementation of chosen policies. Due to the low economic status of the developing economies, most regulatory bodies lack the financial ability to set up appropriate institutions within the capital markets.

2.5 The Role of the Government in Capital Markets

The intervention of the state in overseeing the operation of capital markets is crucial. The government is en trusted with the responsibility of putting in place regulatory and institutional framework to avoid financial failures (Stiglitz, 1993). Institutions created channel resources equitably to avoid market concentration and enhance effective resource allocation. The government further ensures that all relevant information is available to ensure that there is informed decision making. To ensure there is effective monitoring of activities, the government creates a regulatory body and various institutions to run the activities of the market. A number of market failures can prompt government innovation in capital markets: moral hazards, missing and incomplete markets, imperfect competition, adverse selection problems, Pareto inefficiency, lack of adequate information, externalities as a result of macro economic interruptions (Stiglitz 1993).

Governments intervention can take the form of regulating market institutions, directing investments in the market, creating institutions in the market, intervening in the market institutions through other regulatory mechanisms and other interventions (intention al or unintentional) as per the government policy. All these actions are geared towards improving financial markets. The government takes primary responsibility for creating new financial institutions or institutional arrangements as it finds it necessary. Since not all variable are observable, regulators must rely on indirect control mechanisms as well. Setting regulatory standards that are appropriate depends ion how well the variable in question can be measured. However, the state experiences two major problems in risk assessment: incentive and resources (Stiglitz, 1993).

2.6 Policy Measures to Develop Sub-Saharan Capital Markets

Since independence, the Kenya government has initiated various policies pertaining to capital market development. The main policies include: fiscal and monetary policies, financial sector policies, regulatory policies and regional integration policies. Indeed, the policy environment has changed over the years. There have been positive developments that favor the expansion and deepening of the Kenyan capital market. However, limited gains can be credited to these policy developments.

Masinde and Kibua (2005) observe that efficient capital markets require a stable and predictable macroeconomic environment, especially interest rate and foreign exchange stability and predictability. It recommends that the Kenyan government should therefore make vigorous efforts to sustain price stability and maintain a sound monetary policy by establishing an independent central bank in order to lower and sustain low-level interest rates and reduce crowding out of private investors. Further efforts to reduce budget deficits and lengthen the maturity of government debt should be undertaken, as this will boost the development of the capital market. In the case of the Ghana stock exchange Ziorklui (2001) states that fiscal deficits, accommodated by issuing high yield government securities has adversely affected the demand for securities being issued by private firms for raising long-term capital. As a result many potential investors prefer to hold short-term government treasury bills. This has led to the disinter mediation of financial resources and the crowding out of small and medium sized enterprises from the capital market

Enforcement of capital market regulations and sanctions should be encouraged. The CMA needs to establish a regulatory environment for licensing of brokers- dealers as is customary in other markets. There is also need to promote other intermediaries including discount houses, primary dealers and investment banks for the purpose of enhancing market liquidity. The stockbrokers should be encouraged to open branches at regional capitals in order to reach a wider pool of investors and the activities of the NSE decentralized to ensure wider patronage (Wagacha, 2001). Kenya capital market needs to develop an effective legal system that could serve as the basis of developing the regional market. This would include harmonizing of policies on cross border listings, foreign portfolio investors, auditing and financial reporting. These issues are highlighted in the seven pillars of the CMA through the amendment of CMA Act Cap 485A in the year 2000. This would then minimize country specific risks and achieve diversification through cross border listing.

Ziorklui (2001) observes that the government should encourage the establishment of national rating agency to perform risk assessment and performance evaluation of listed and unlisted companies. This then enables the domestic and foreign investors to assess the risk and valuations of domestic companies before making informed decisions. Masinde and Kibua (2005) note that Kenyan's market infrastructure is still not fully developed, a well-organized market will include an organized exchange as well as over the counter markets and venture capital arrangements. The later two are lacking in Kenya.

In order to attract a wider audience of both foreign and local investors, product innovation and development is crucial. Products such as futures options and financial derivatives for risk management would increase the stock exchange attractiveness. Kenya also has the challenge of attracting small investors. This can be achieved by putting in place mechanisms to help investors pool their funds and lower the risk of investment in shares traded on the exchange. Unit trusts and mutual funds hold tremendous opportunity for people to pool resources. Unit trusts in Kenya are still not fully developed and the knowledge and operations of mutual funds are still in their infancy stages.

Specific measures to promote the supply of marketable securities are concentrated on the concessions, which may encourage companies to issue shares and debentures. This tactic has been tried in various European countries and used in Brazil with great success (Ness, 1971). Stronger measures would be to oblige firms above a certain size to offer shares publicly and to restrict the granting of bank credit to under capitalized firms, in order to force them to seek equity funds through public issues of shares. But such drastic measures would be difficult to implement and clearly conflict with the economic philosophy of the free capital market. (Wai and Patrick, 1973)

Foreign firms will not see the need to issue shares and debentures so long as they continue to have ready access to cheap local bank loans or international capital markets, which provide self, financed expansion. Therefore consideration should be given to the policy of requiring foreign corporations to issue some local equity, or requiring them to do so by penalizing overseas borrowing. Such actions will certainly be in tune with nationalistic sentiments. The pressures for increased local participation in such companies should not only be confined to securing the appointment of local people such as senior personnel who are without much responsibility in policy decisions.

Arowolo (1971) makes two proposals in respect to local enterprises. First he suggests that statutory corporations engaged in essentially industrial activities could offer their securities either directly or through their subsidiaries to the public. Secondly, he argues that when joint ventures are undertaken between government and private interests the base of equity ownership could be substantially broadened if the government could divest itself of part of the ownership of such ventures as they become successful.

Ness (1974) gives account of the Brazilian experience in the form of a rich and detailed illustration on how fiscal incentives may foster growth of the capital market. Brazilian incentives included: (a) Provisions for share holders to deduct a substantial proportions of the purchase cost of shares from taxable income (b) Provisions for part personal income tax exemption of dividends, and concessional rates of with holding tax for shareholders in those open capital companies which undertook to achieve a wide dispersion of equity. (C) Provisions for individuals and corporations to discharge a proportion of their tax liabilities by subscribing to special mutual funds and withdrawals from these funds could not begin for at least two years. Secondly, indexation of the principal and income of nominal value securities. this is a solution to protect buyers of bonds and debentures from inflation because they are capital values expressed in fixed money amounts and whose yields are fixed as a given rate of interest. This would enhance the demand for such securities.

Thirdly, distinct from giving protection against inflation, government may guarantee the redemption value and dividend rates of certain securities in order to alleviate risk (Wai and Patrick, 1973). Fourthly, the demand for securities may greatly be augmented by the imposition of portfolio rules upon banks and other financial institutions. In relation to this is to restrict capital outflow generally to prohibit the transfer abroad of funds accruing to financial institutions and that finance houses be required to hold a proportion of their assets in the form of local securities. A demand for such securities is readily generated. Finally, official supervision of trading in the securities markets is imperative if the shares or bonds are to become attractive assets.

2.7 Characteristics of Capital Market Development

The most notable characteristic is the increase in government holdings in financial assets (this leads to a boost in investor confidence) so far as new issues are concerned, government securities accounted for 60-80 percent of total new issues of securities in countries surveyed by Wai and Patrick (1973). Secondly, regional integration of capital markets through encouraging cross listing attracts foreign capital inflows, promotes transparency, efficient management of domestic firms. Ziorklui (2001) notes that relics of colonialism that has had adverse effect on regional integration was the partition of

African countries into various enclaves under the former colonial powers. For example partitioning West African region into francophone and Anglophone countries has militated against promoting regional capital market integration. Hence the best approach is to integrate the two through the capital market.

Thirdly, increased levels of financial activities with increased number of market participants due to high levels of investor awareness leading to more companies being listed on the stock exchange. The rate at which securities change hands is expected to increase which may lead to product innovation and financial deepening. Fourthly, increase in the number of intermediaries, low levels of volatility of returns, low transaction costs and efficiency of the market in pricing assets (Zior, 2002).

2.80 Principal Functions Performed by a Financial System

As a Capital Market institution the Stock Exchange plays an important role in the process of economic development Haque (2002) states that there are seven basic functions performed by a financial system and are categorized as follows:

2.81 The mobilization of capital

Capital providers often desire liquidity (ability to exit on short notice), along with attractive returns commensurate with underlying risk exposure. Capital markets help through risk pooling and through provision of alternative instruments to facilitate diversification and allow for maturity transformation. This risk pooling and maturity transformation allows entrepreneurial firms to invest and grow.

2.82 Efficient clearing and settling

Modernization and automation of trading system should be put in place so as to improve liquidity, attract foreign investors and reduce transaction cost. This will also complement the current automation of the depository, settlement and delivery and facilitate the NSE to cope with increase in new listings or increased trading and turnover. An important function of the NSE is to provide an efficient way for people and businesses to make payments to each other when goods and services are bought. Efficient payments and settlement technology allows the speedy completion of transactions. Long delays in intercity check cashing and lengthy time requirements for registration of financial assets are impediments to market development (Haque 2002).

2.83 Facilitation of better governance and control

Given the crucial role of transparent financial statements in fostering confidence of financial markets, the NSE can play a vital role by improving the corporate governance by creating an environment for the establishment of globally accepted accounting and disclosure rules and regulations. The growing consensus is that the board of directors has to be independent of the chief executive officer through appointments of directors who are outsiders with no serious business interests with the firm. In fact the audit committee of the board should be composed entirely of outside directors. A well functioning market promotes efficient governance and control of an organized enterprise by exerting external pressure and discipline on its operation. Inefficient management is typically removed through takeovers which allow unfriendly raiders to accumulate shares in the open market and take control of the firm, often takeover threats is a powerful mechanism of disciplining management (Haque 2002).

2.84 Pooling of resources and diversification of ownership

A proper functioning market provides a mechanism for the pooling of funds at large scale that are beyond the scale of one individual to undertake and also allows individual household to participate in investments that require large sums of money by pooling their funds and then subdividing shares in the investment. The pooling of funds allows for redistribution of risk as well as the separation of ownership and management (Haque 2002).

2.85 Information production, price discovery and exchange of control

Price signals contain information on quantity, scarcity and value and thereby help agents allocate resources to their best use. A well functioning financial market processes and aggregates all available information in to the value or price of the commodity. On balance, the evidence indicates that the market for stocks, particularly those listed on the New York stock exchange, reasonably is efficient hence a strong form of market efficiency. Security prices appear to be a good reflection of available information and market prices adjust quickly to new information.

2.86 Dealing with incentive and agency problems

Developed financial markets promote contractual efficiency in an environment characterized by incentive conflicts thus leading to allocation efficiency. Incentive contracts for alignment of diverse interests between management, shareholders and bondholders can be facilitated through financial contracts. Incentive features may include equity participation by management, executive stock option plans that link incentives to fortunes of companies that are being managed.

2.87 Risk management and resource allocation

A well functioning financial market enables multiple investors to share a projects risk allowing high risk, high return investments to be undertaken. In the absence of such risk pooling and risk sharing arrangements, such high risk, high return projects may be rationed out of the market destroying, rather than creating, value for the economy. (Haque 2002). Financial markets therefore facilitate allocation efficiency. International integration of stock markets induces portfolio shift from safe but low yield investments, towards riskier, high return investments leading to accelerated long run growth in recipient markets.

Thus, capital markets perform multiple functions as discussed above. Policy makers need to be aware about the multiple functions of capital markets in implementing growth policies for efficient functioning of the Nairobi stock exchange. The depth of the exchange is then measured on the basis of efficiency with which the various functions are carried out. It is therefore imperative for us to use the multiple functions of capital markets as a guiding principal in the evaluation of implementation of policy measures for growth.

CHAPTER THREE:
RESEARCH METHODOLOGY

3.1 Research Design

This study is descriptive in nature and the researcher used survey method. Mugenda and Mugenda (1999) notes that a survey research attempts to collect data from members of a population and describes existing phenomena by asking individuals about their perception, attitudes behavior or values. Moreover, it explores the existing status of two or more variables at a given point in time. Primary data collected from such a population or census is more reliable and up-to-date. The descriptive research enhanced a systematic description that is as accurate, valid and reliable as possible regarding the responses on the implementation of policy measures for growth of capital markets in Kenya.

3.2 Population

The population of the study comprised of 50-registered stock market players at the Nairobi Stock Exchange. These included the NSE, CMA, stockbrokers, investment securities and fund managers. Appendix iii provides the population frame. The targeted respondent for each of the organizations were senior managers. In this study, a census was conducted since the target population is small. According to Tortora (2003) when the sample size is small, a census should be conducted. A census is an operation of actively collecting information from individuals on a range of topics at a specified time, accompanied by the compilation, evaluation, analysis and dissemination of data. It pertains to all the population members. Census has the merit of providing a snap shot of the entire population at a particular point in time and the availability of data for relatively small geographic domains.

3.3 Data Collection

The researcher designed a semi-structured survey questionnaire incorporating the variables identified in review of literature. The list of the factors were then be presented to the respondents for evaluation on the extent to which each policy measure is implemented for growth of Kenya's capital markets on a 5-level Likert scale from 1 (very great extent) to 5 (very small extent). For purposes of data validation, the questionnaire was be pilot tested with 10 respondents and final revisions effected. The researcher then adopted a drop and pick approach in collecting the data.

3.4 Data Analysis

The collected data from the field was edited and screened for errors and omissions, accuracy, uniformity and completeness and then arranged to enable coding and tabulation before statistical analysis is carried out (Cooper and Schindler, 2003). The data was then initially be analyzed using descriptive statistics in SPSS.

Section I and II is presented using various tools and techniques to show the occurrence in line with the objectives. Computation of percentages and measures of central tendency such as mean on the impediments encountered by CBK, NSE, CMA in the implementation of policy measures for growth of capital markets in Kenya.

Section I covers the extent to which then various agencies: CBK, NSE, and CMA have implemented the various approaches/ measures that relate to successful policy growth of Sub-Saharan Capital Markets. The measured scales on various levels of agreement on the extent to which these have been implemented for successful policy growth of Sub-Saharan Capital Markets were reduced using factor analysis.

Factor analysis technique group together factors that show significant similarity in characteristics and reduce the responses to manageable levels. Usually known as a data reduction tool, factor analysis is a statistical technique for classifying a larger number of interrelated variables to a limited number of factors. It is an efficient method for re-organizing factors to be investigated into conceptually more precise groups of variables. The analysis also ranks the factors to indicate which factors are considered important than others (Kipkosgei, 2005). The factor analysis was performed using more advanced statistical analysis software package, SPSS version 11.5, to ease the work of generalization and formatting the output. Response on open ended questions were first be coded around themes, entered into SPSS spreadsheet and analyzed and presented in continuous prose to bring out clarity the pattern of the issues in question.

CHAPTER FOUR

4.0 DATA ANALYSIS AND RESULTS

4.1 Response Rate

Out of the 50 respondents targeted, 36 responded, representing a response rate of 72%. The low response rate is typical to social science and can be attributed to "questionnaire fatigue" by corporate officers, many of whom did not even both to acknowledge the receipt of the questionnaires.

4.2 Quantitative Data Analysis

4.2.1 Policy Implementation Approaches at the NSE

Respondents were presented with a list of 27 approaches that relate to successful policy implementation measures for development of the Nairobi Stock Exchange and were asked indicate the extent to which the relevant CBK, the NSE, and the CMA have implemented the measures for development of the Nairobi Stock Exchange in Kenya. The table below shows the descriptive analysis of the responses captured.

Table 4.1 Mean Scores and Rankings for Policy Implementation Approaches

Policy Implementation Approaches	Mean score	Rank
The mobilization of capital	2.00	22
Risk management and resource allocation	2.25	20
Pooling of resources and diversification of ownership	3.13	9
Information production, price discovery and exchange control	2.63	16
Facilitating better governance and control	3.50	7
Efficient clearing and settling	2.75	15
Lengthened maturity of government debts	2.13	21
Dealing with incentive and Agency problems	3.13	9
Move towards regional integration of capital markets (Cross border listing)	3.75	4
Efficient provision of market information; stock prices, information of financial soundness and future prospects of companies.	2.37	19

Efforts towards enhancing better corporate governance that gives investors confidence that their funds will not be stolen or wasted	3.00	11
Facilitation of better access to capital through the floating of shares to the general public.	3.87	3
Liberalization of restrictions on private sector borrowing from abroad	3.00	11
Enhancing of market liquidity through discount houses, primary dealers and investment banks	3.50	7
Efforts towards decentralization of NSE operations and brokerage services to other cities in Kenya	1.37	23
Product innovation through future options and financial derivatives for risk	1.23	24
Fiscal incentives	3.00	11
Imposition of portfolio rules upon banks and other financial institutions	3.88	2
Official supervision and monitoring of trading in capital markets	4.00	1
Efforts towards low level volatility of returns and transactions costs	2.87	14
Sustenance of price stability	3.62	6
Curbing inflation rates	2.25	20
Sustenance of low level interest rates	2.25	20
Liberalization of foreign exchange flows in the balance of payments	2.50	17
Reduction in budget deficits though issuing of government securities, Parastatal privatizations	2.25	20
Simplification of red-tape requirements for direct and portfolio investments	2.38	18
Enforcement of capital market regulations and sanctions	3.75	4

Source: Survey Data (2006)

The mean score were used to gauge the overall opinions of the respondents in general. The statements in table 4.1 are ranked based on the mean scores. A score of 1 represents very small extent, 2- small extent, 3- moderate extent, 4- great extent and 5- very great extent. The mean scores indicate that the respondents were of the opinion that were the relevant financial bodies (CBK, the NSE, RBA, and the CMA) have implemented the measures for development of the Nairobi Stock Exchange to a great extent: official supervision and monitoring of trading in capital markets, imposition portfolio rules upon banks and other financial institutions, facilitation of better access to capital through the floating of shares to the general public, move towards regional integration of capital markets (cross border listing), enforcement of capital market regulations and sanctions, sustenance of price stability, enhancing of market liquidity through discount houses, primary dealers and investment bank and facilitating better governance and control.

However, efforts towards decentralization of NSE operations and brokerage services to other cities in Kenya and product innovation through future options and financial derivatives for risk have been implemented to a very small extent.

Principal component analysis was (PCA) was then run to perform factor analysis on section 1 of the questionnaire. The purpose of performing PCA was to transform a set of interrelated variables into a set of unrelated linear combinations of these variables into a set of uncorrelated linear combinations. Varimax rotation together with Kaiser Criterion was used to classify and reduce the policy Implementation Approaches into interpretable components. The results are as below:

Table 4.2: Rescaled Communalities

Policy Implementation Approaches	Communalities	
	Initial	Extraction
The mobilization of capital	1.000	.955
Risk management and resource allocation	1.000	.989
Pooling of resources and diversification of ownership	1.000	.990
Information production, price discovery and exchange control	1.000	.980
Facilitating better governance and control	1.000	1.000
Efficient clearing and settling	1.000	.992
Lengthened maturity of government debts	1.000	.987
Dealing with incentive and Agency problems	1.000	1.000
Move towards regional integration of capital markets (Cross border listing)	1.000	.995
Efficient provision of market information; stock prices, information of financial soundness and future prospects of companies.	1.000	.990
Efforts towards enhancing better corporate governance that gives investors confidence that their funds will not be stolen or wasted	1.000	.998
Facilitation of better access to capital through the floating of shares to the general public.	1.000	.999
Liberalization of restrictions on private sector borrowing from abroad	1.000	1.000
Enhancing of market liquidity through discount houses, primary dealers and investment banks	1.000	1.000

Efforts towards decentralization of NSE operations and brokerage services to other cities in Kenya	1.000	1.000
Product innovation through future options and financial derivatives for risk	1.000	1.000
Fiscal incentives	1.000	1.000
Imposition of portfolio rules upon banks and other financial institutions	1.000	.994
Official supervision and monitoring of trading in capital markets	1.000	1.000
Efforts towards low level volatility of returns and transactions costs	1.000	1.000
Sustenance of price stability	1.000	.998
Curbing inflation rates	1.000	.999
Sustenance of low level interest rates	1.000	.999
Liberalization of foreign exchange flows in the balance of payments	1.000	1.000
Reduction in budget deficits though issuing of government securities, Parastatal privatizations	1.000	.999
Simplification of red-tape requirements for direct and portfolio investments	1.000	.997
Enforcement of capital market regulations and sanctions	1.000	1.000

Source: Survey Data (2006)

Table 4.2 represents the communalities for policy implementation approaches at the NSE. The communality is the squared multiple correlation coefficient for variables using the factors as predictors. The communality measures the percentage of variance in a given variable explained by all the factors jointly and can be interpreted as the reliability of the indicator. It is the proportion of variance that each item or variable has in common with other items. For instance, 99.7% of variability in the policy implementation approaches "Simplification of red-tape requirements for direct and portfolio investments" is jointly explained by the factors.

The analysis of the above communalities reveals that most of the variability in the policy implementation approaches were fairly captured by the components. The lowest variability was captured for the statement "The mobilization of capital" with a communality of 95.5%

Table 4.3: Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	13.182	29.047	29.047	7.065	26.168	26.168	4.811	17.820	17.820
2	8.280	18.246	47.293	4.887	18.100	44.268	4.712	17.453	35.273
3	7.544	16.624	63.917	5.337	19.768	64.036	4.279	15.850	51.123
4	6.583	14.506	78.423	3.837	14.209	78.245	3.590	13.298	64.421
5	4.213	9.284	87.707	2.366	8.764	87.009	3.380	12.519	76.940
6	3.231	7.119	94.826	2.296	8.503	95.512	3.256	12.059	88.999
7	2.103	4.635	99.461	1.072	3.969	99.480	2.830	10.482	99.480
8	.245	.539	100.000						
9	1.612E-15	3.553E-15	100.000						
10	1.138E-15	2.508E-15	100.000						
11	1.022E-15	2.252E-15	100.000						
12	7.009E-16	1.544E-15	100.000						
13	5.956E-16	1.312E-15	100.000						
14	3.652E-16	8.048E-16	100.000						
15	3.497E-16	7.705E-16	100.000						
16	2.612E-16	5.754E-16	100.000						
17	1.538E-16	3.389E-16	100.000						
18	-1.476E-16	-3.251E-16	100.000						
19	-2.009E-16	-4.427E-16	100.000						

20	-2.907E-16	-6.405E-16	100.000						
21	-4.502E-16	-9.921E-16	100.000						
22	-6.584E-16	-1.451E-15	100.000						
23	-7.452E-16	-1.642E-15	100.000						
24	-8.879E-16	-1.957E-15	100.000						
25	-1.202E-15	-2.648E-15	100.000						
26	-1.329E-15	-2.928E-15	100.000						
27	-1.758E-15	-3.873E-15	100.000						

Source: Survey Data (2006)

Table 4.3 represents the total variance explained by each component (factor). A total 7 components were extracted from the Policy Implementation Approaches. The components are orthogonal to one another, meaning they that they are uncorrelated. For a component to account for at least one variable, it should have an Eigen value of at least one. This is the cut off point for determining the number of components to be extracted as defined by Kaiser Criteria. Component 1 accounts/ explains the highest observed variance followed by component 2 and so on. Variables regarded as significant are assigned to component 1, followed by components 2 and so. From the table, component 1 accounts for 29.047% of the total observed variability while component 2 explains

18.246%, component three 16.624%, component four 14.506%, component five 9.284%, component six 7.119%, and component seven 4.635%. The seven extracted components explain 99.461% of the total variability for all the 27 variables.

Table 4.4: Rotated Component Matrix

	Component						
	1	2	3	4	5	6	7
The mobilization of capital	.780	-.014	-.366	.338	.171	.035	.261
Risk management and resource allocation	.217	-.629	-.372	-.507	.181	-.024	-.342
Pooling of resources and diversification of ownership	-.492	-.563	.167	.270	.361	-.257	-.365
Information production, price discovery and exchange control	.638	.514	-.432	.101	-.140	-.115	.283
Facilitating better governance and control	.601	-.056	.230	.329	.035	-.669	.161
Efficient clearing and settling	-.699	.147	-.270	.231	.314	.505	.029
Lengthened maturity of government debts	.068	-.049	.802	.486	.308	-.040	.053
Dealing with incentive and Agency problems	.529	-.039	-.459	.519	-.451	.174	-.066
Move towards regional integration of capital markets (Cross border listing)	.364	.786	.186	-.152	.413	.007	-.131
Efficient provision of market information; stock prices, information of financial soundness and future prospects of companies.	-.536	-.261	.358	-.259	-.623	-.040	.224
Efforts towards enhancing better corporate governance that gives investors confidence that their funds will not be stolen or wasted	-.829	-.081	.533	.087	-.051	.039	-.093
Facilitation of better access to capital through the floating of shares to the general public.	.704	-.351	.083	-.462	.204	.071	.338
Liberalization of restrictions on private sector borrowing from abroad	.769	.205	.479	-.203	-.256	.045	-.166
Enhancing of market liquidity through discount houses, primary dealers and investment banks	.302	.542	-.218	.347	-.116	.656	.056
Efforts towards decentralization of NSE operations and brokerage services to other cities in Kenya	.655	-.073	.640	.165	-.293	.083	-.190
Product innovation through future options and financial derivatives for risk	.645	.617	.191	-.389	.035	.026	-.116

Fiscal incentives	-.103	.966	-.015	-.103	-.011	-.151	-.151
Imposition of portfolio rules upon banks and other financial institutions	-.579	.285	-.244	.302	-.484	-.404	.167
Official supervision and monitoring of trading in capital markets	-.710	.168	.037	.084	.561	.056	.376
Efforts towards low level volatility of returns and transactions costs	.127	-.232	.811	.097	.395	.289	.151
Sustenance of price stability	-.448	.449	.475	-.463	-.160	.315	-.177
Curbing inflation rates	-.005	.608	-.386	-.490	-.250	.380	.184
Sustenance of low level interest rates	.432	-.277	.045	.720	-.069	.450	-.095
Liberalization of foreign exchange flows in the balance of payments	.367	-.577	.410	.212	-.229	.500	.125
Reduction in budget deficits though issuing of government securities, Parastatal privatizations	-.309	-.473	.162	-.720	-.155	.239	.229
Simplification of red-tape requirements for direct and portfolio investments	.093	-.196	-.909	.327	.085	.000	-.101
Enforcement of capital market regulations and sanctions	.066	.073	.760	.548	.326	-.074	.025

Source: Survey Data (2006)

Table 4.4 presents the rotated component matrix that was used to extract independent variables highly related to particular components. Orthogonal Varimax rotation together with the Kaiser Normalization was used to force the entries in the initial factor matrix to be near 0 or 1. Such loadings show more clearly which variables go together and thus easily interpretable. The final matrix represents both a pattern and a structure matrix. The coefficients in the rotated matrix in the rotated matrix represent both the correlation coefficient and the regression weights. A summary of the Policy Implementation Approaches corresponding/ loading heavily to a particular component is shown in table 4.5.

Table 4.5: Summary of heavy loading statements

Components	% of Variance	Cumulative %
1. Approaches by both NSE & CMA	29.047	29.047
2. Approaches by NSE	18.246	47.293
3. Approaches by CMA	16.624	63.917
4. Approaches by CBK	14.506	78.423
5. Approaches by RBA	9.284	87.707
6. Approaches by Commissioner of Insurance	7.119	94.826
7. Approaches by Ministry of Finance	5.174	100.000

Source: Survey Data (2006)

The first three components explain 63.917% of the observed variance. These components capture policy implementation approaches in table 4.2. The three components clearly indicate that the major implementation of policy measures for the growth of capitals markets in Kenya relate to measures expected of both the NSE and the CMA.

4.2.2 Nature Of Impediments Encountered In Implementing Policy Measures For Development of the Nairobi Stock Exchange

Table 4.6 below presents a summary of the impediments corresponding to heavy loading to particular principal components for the factor analysis of the nature of impediments encountered in implementing policy measures for growth capital markets in Kenya.

Table 4.6: **Summary of heavily loaded statements concerning the impediments**

Components	Variables	% of variance explained	Cumulative %
1. Macro economic impediments	❖ Volatile/unstable interest and foreign exchange rates ❖ High inflation rates ❖ Unfavorable international trade regimes ❖ Undeveloped capital market infrastructure in Kenya	17.31	17.31
2. Fiscal/ Monetary Impediments	❖ Government budget deficit ❖ High corporate tax regimes ❖ Differential tax rates on dividends and interest income ❖ Failures and inefficiencies of commercial banks ❖ Low income levels	15.196	32.508
3. Institutional and regulatory constraints	❖ Bureaucracy and regulations at the CBK ❖ Bureaucracy and regulations at the RBA ❖ Bureaucracy and regulations at the CMA ❖ Bureaucracy at the Commissioner of insurance ❖ Delivery and settlement procedures ❖ Low public awareness ❖ Absence of electronic trading system ❖ Slow Central Depository System ❖ Absence of derivatives ❖ Ceiling on foreign investors ❖ Poor implementation approaches by CMA ❖ Slow process of public sector privatization parastatal reform ❖ Few listed companies at NSE ❖ Multiplicity of regulators and regulations (conflicting) ❖ Stringent requirements for listing the NSE	13.228	45.756
4. Political/ legal impediments	❖ Political instability/ wrangling ❖ Cross-border listing requirements ❖ Inadequate laws protecting investors ❖	10.874	56.611
5. Social Impediments	❖ Weak foreign investor confidence	8.672	65.803

Source: Survey Data (2006)

The first four components explain 55.611% of the observed variability. The four components explicitly indicate that the major impediments encountered by the NSE and the CMA in implementing policy measures for growth capital markets in Kenya relate to macro economic constraints followed by fiscal and monetary constraints and institutional and regulatory constraints. These findings imply that macro economic, fiscal and monetary and institutional and regulatory constraints have played a key role in the underdevelopment of the Kenya Capital Markets.

4.3 Qualitative data analysis

4.3.1 Recent Developments/ initiatives by the NSE and the CMA for the development of local investment vehicles

The policy framework in Kenya is considered conducive for Nairobi Stock Exchange development as a wide range of fiscal and other incentives have been put in place to encourage capital market activities. In addition, privatization policies are being implemented through the capita market to encourage wider ownership of public enterprises and to provide a key source of new listings. These include:

a) The Legal and regulatory framework for capital markets
b) Reduction of withholding tax on dividend from 15% to 7.5% for foreign investors and 5% for local investors.
c) Full tax deductibility of expenses related to issuing shares to the public.
d) Exemption from stamp duty for new and expanded share capital, the transfer of assets for the issuing of asset-backed securities and transfer of listed securities.
e) Ten-year tax holiday for venture capital funds.
f) Tax exemption on income accruing to registered collective investment schemes.
g) Negotiable commissions.
h) Free repatriation of capital and returns.

i) Sufficient brokerage services.

j) Up to date market information.

k) No exchange Controls

l) Government commitment to market reforms.

There has also been an improvement of market infrastructure through the development of an automated central clearing, settlement and depository system (CDS) intended to serve the East African region.

Pension reform in Kenya within the last seven (7) years through the requirement of mandatory professional management of pension funds has boosted the demand for equities at the NSE by institutional investors from the pension industry. An oversight body, Retirement Benefits Authority (RBA), was established as an oversight body to ensure the compliance of pension funds to the reforms and to regulate the pension fund industry.

Licensing of new categories of participants such as mutual funds, unit trusts, collective investment schemes, dealers, investment banks and investment advisors by the Capital Markets Authority has also taken root. The effect of this has been the increased participation of institutional investors in the market such as mutual funds and retirement benefits funds.

In the last five years (2000-2005) activity in the bond market far exceeded the primary and secondary equity markets as a result of the introduction of treasury and corporate bonds

Cross boarder listing in the Uganda Securities Exchange and the Dar-es-Salaam Stock Exchange by Kenya Airways and the East African Development Bank, which are also listed at the NSE is worth noting. Inflation has been low and in single digits and this has been conducive to the holding of long-term financial assets.

4.3.2 Challenges Facing The NSE

Limited Listing at the NSE

The limited supply of new equities in the capital market has restricted the use of the equity market as a source of financing. In view of the past failure to attract new equity, the most difficult hurdle for the NSE is increasing the number of medium-sized and large family-owned businesses and state-owned companies operating in Kenya listed at the NSE. Generally, the main factors limiting the supply of equities include the reluctance of small, family-owned businesses to dilute ownership, the costly and tedious process of making public offers and the perception by many eligible companies that the risks associated with additional disclosure are not adequately compensated by additional returns.

When companies are considering whether to list their securities at the NSE, the factors inducing listing include:

a) Access to cheaper sources of financing.

b) Suitability of the NSE as a vehicle for trading equity.

c) The opportunity to share the risks associated with sourcing capital

On the other hand the factors inhibiting listing include:

a) Disclosure of information seems to be a major impediment to listing at NSE. The risks associated with additional disclosure are perceived to be inadequately compensated by additional returns. Some unlisted companies consider the cost of disclosure not commensurate with benefit accrued by listing.

b) The dual role played by commercial banks in Kenya as investment advisors and lenders has indirectly discouraged the use of the stock exchange as a means of raising capital. Since banks do not require public disclosure of a company's affairs like the NSE does, many firms prefer to remain unlisted and source their capital from the banks.

c) Fear of loss of control by opening up firms to public ownership particularly by family owned companies.

d) Limited diversity of products at the NSE to attract eligible firms. Currently, the market provides firms with the option of trading in ordinary and preference shares, commercial papers, government bonds and corporate bonds. More firms may opt to list on the NSE if other products are introduced such as a futures and options market, an over-the counter (OTC) market, and trading in asset-backed securities.

e) The ability of firms to raise start-up capital from own savings, loans from domestic commercial banks and foreign sources.

f) Stringent listing requirements before an entity can qualify for listing have contributed to the elimination or disqualification of many business enterprises.

g) Inadequate marketing of the NSE to eligible companies.

Public awareness

Generally, there is lack of awareness and information on the role, functions and operations of the stock exchange and the CMA among potential investors and business entities. Many Kenyans throughout the country do not know enough about the NSE and the CMA, and the market does not seem to market itself sufficiently to potential investors or provide a variety of products to attract companies. This may be attributed to financial and human resource constraints. The lack of public awareness on NSE operations is a major hindrance to corporate participation in stock market.

Economic and political conditions

Kenya experienced poor output performance with an average GDP growth of about 1.3% between 1997 and 2002. Listed companies experienced losses or low profits and individuals faced low income thereby resulting in low demand for equities. In addition, the foreign investors turnover and net foreign inflow declined between 2000 and 2002 due to political and economic uncertainties thereby reducing the amount of foreign portfolio investment that had been attracted into the country in previous years. There is however a new lease of life since economic conditions started to improve in 2004-2005 financial years following a series of public and private sectors reforms by the government.

Market Infrastructure

The current manual trading system is slow, costly and limits the range of products that can be provided. It has also hindered international integration of the market. The fact that the NSE is not linked to other international markets outside East Africa has attracted some foreign investors because shocks in other international markets do not significantly affect the NSE. However, this separation limits the growth, liquidity and expansion of the capital market. Prior to November 2005, delivery and settlement of traded shares was conducted manually. Although it was intended that transactions be conducted on a T+5 cycle (day of trading plus five days), investors waited for weeks, sometimes months on end, to receive their certificates after purchases.

Bond Market

Government bonds have dominated the debt market in the NSE. Since the year 2002, there has been increased trading in the corporate bond and of longer-term government treasury bonds resulting in increased turnover in the bond market. Lack of suitable pricing benchmarks for pricing of corporate bonds and the absence of rating agencies has hampered the development of the corporate bond market. However, CMA, in 2003 accredited Duff and Phelps (South Africa) to offer rating services. Also noted during the interviews with were liquidity problems. Low liquidity is particularly evident in the secondary bonds and equity markets.

Insurance Industry

The insurance industry has played a relatively smaller role in the capital than it is capable of doing because non-life companies whose liabilities are short-term and not suitable for investment in capital markets dominate it. Most of the reserves in the insurance industry have been utilized in short-term government securities and bank deposits. The few life insurance companies have utilized their reserves in real estate, t-bills and short-term bank deposits.

Challenges Facing the CMA

CMA's main challenge remains to educate the public on the capital markets in Kenya and the opportunities that lie therein for long-term investment. It has a limited number of staff members available to conduct an aggressive marketing and education campaign. The CMA has however responded to the challenge of investor education by hosting workshops on themes pertinent to the development of capital markets, giving presentations at professional and business functions and publishing an annual report that is available to all market players. In addition, it has made arrangements for its members of staff to visit other countries and learn how they have worked to develop their capital markets in an attempt to build its capacity and learn from other more successful markets. However, there is need to improve the coverage of its investor education not only to large corporations and the business community in the city of Nairobi but also to the general public in other parts of the country.

CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Conclusions

The changing attitudes towards the role of the private sector in the development of African economies has facilitated the development of the capital markets because of the inherent potential of these markets to meet the fixed-capital needs of the private sector. Capital markets can ensure the efficient and sustainable funding of governments, corporations and banks for large-scale or long-term projects.

In this regard, developing countries are working towards reforming and deepening financial systems, through the expansion of capital markets in order to improve their ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy. Significant progress has been made in the development of many stock markets in Africa.

The growth in market capitalization in Africa has been described as remarkable in the last decade, new legal and regulatory regimes are being set up and progress is being made in the development of market infrastructure such as the automation of trading and settlement. However, emerging stock markets face significant challenges to their development and growth as exemplified in the NSE. Hence the need to ensure that legal, technical and operational structures are in place so that African and other emerging capital markets function like their counterparts in more developed countries.

From the data analysis it can be inferred that major implementation of policy measures for the growth of capitals markets in Kenya relate to measures expected of both the NSE and the CMA. It is also noted that the major impediments encountered by the NSE and the CMA in implementing policy measures for growth capital markets in Kenya relate to macro economic constraints followed by fiscal and monetary constraints and institutional and regulatory constraints. These findings imply that macro economic, fiscal and monetary and institutional and regulatory constraints have played a key role in the underdevelopment of the Kenyan Capital Markets.

5.2 Recommendations

In view of the challenges discussed in the previous sections with regard to the NSE and African capital markets in general, the following recommendations are proposed. They make specific reference to the NSE but may be applicable to other emerging markets.

NSE should increasingly play an educational role and embark on a vigorous campaign to market itself and educate potential investors about the opportunities available in the market and how to effectively exploit them.

The efforts by NSE and CMA to improve public awareness of the opportunities available in the capital markets in Kenya need to be strengthened by using a variety of means of communication such as media campaigns through the radio, television and newspapers, engaging in one-on-one meetings with eligible firms and potential investors, and distribution of literature to firms and potential investors across the country. The NSE and

CMA should compile a list of potential issuers of both equity and debt and initiate contact with them to educate and improve their awareness of the benefits and relevance of capital markets for their operations. In addition the two institutions should set up branch offices at the district and provincial levels to facilitate outreach to the general public. Investor education may also be done through incorporating information on investment and the capital markets in the high school and college curriculum to enhance the awareness by the younger generation of Kenyans who make up more than half of the total population. Out of a total population of about 30 million in Kenya, it is estimated only about 580,000 are investors in the NSE. This is a very low rate and the number can be increased as more Kenyans are informed of the investment opportunities available to them at an early stage of their lives.

Capacity building at CMA and NSE is essential to facilitate the effective conduct of operations and implementation of the marketing campaigns. This may be achieved through hiring members of staff well trained in marketing, research and market analysis. It is essential for the NSE to diversify the products available to potential issuers and investors. Examples of products that can boost activity in the market include a futures and options market that will be attractive to the agricultural sector and the establishment of an Over-The-Counter (OTC) market for companies that are currently ineligible to list at NSE such as medium-sized family businesses as well as eligible companies that issue shares but are not listed at NSE such as cooperative societies.

For the overall development of capital markets, NSE needs to relax the minimum requirements for trading securities in order to accommodate companies that have shares that are transferable to members of the public yet they do not meet the stringent listing requirements. The challenge will be to simplify and ease listing conditions without compromising investor protection. Streamlining public offering procedures and limiting the number of market agents involved in the issuing process are examples of simplification of the listing requirements.

Continued privatization of state enterprises is essential as the most viable source of equity. In this regard, the implementation of the privatization bill through the stock exchange will increase the supply of equity in the market and trigger resurgence of primary equity activity. However, weak and non-performing public enterprises should not be dumped in the market in the guise of privatization.

Pursuit of the development of the life-insurance industry is important in order to generate long-term funds that can be invested in the NSE In addition to encourage the free flow of capital across borders through the regional integration of capital markets in East Africa, NSE should pursue the continental and global integration to markets such as the Johannesburg, Nigerian, Cairo and Mauritius stock markets.

Modernization of the trading system to improve liquidity, attract foreign investors and reduce transaction costs is necessary. Automation of trading will complement the current automation of the depository, settlement and delivery and facilitate the ability of the market to cope with increase in new listings or increased trading and turnover particularly with the imminent privatization of many state-owned companies. An enhanced automation of trading will be necessary to complete the process of modernizing the NSE, which is currently underway as evidenced by the automation of the automated clearing and settlement system. Transaction, settlement and exchange of shares will be conducted instantaneously. The success of the modernization process will require coordination, action and support by the various market players, including banks, brokers, shares or accounts owners, the NSE and the regulatory authorities including the Capital Markets Authority and the Central Bank of Kenya.

Continued macroeconomic stability and lengthening of maturity of government debt will encourage the development of the bond market. Economic and political policies directly affect confidence and activity in the market, hence the need for close public-private partnership between the government and the private sector to ensure that policies are formulated with guidance from both sectors with an objective to ensure the overall economic welfare.

The Capital Markets Authority has been criticized as being heavy-handed in its approach to regulation of the capital. Its relationship with the NSE has been described as adversarial. A more supportive approach that is proactive and creative in enhancing a more vibrant environment will enable CMA to be a catalyst in rather than a hindrance to development of the market.

Demutualization of the NSE is essential to ensure proper monitoring and regulation of members and market participants. Demutualization refers to conversion of a member-owned company to shareholder-ownership. Presently, the NSE is a member owned company whose board membership has more representatives of stockbrokers than other market participants. This has poses a challenge to the enforcement of regulations on errant stockbrokers.

Its inevitable to re-emphasize that the future success and relevance of the NSE as a driver and participant in the growth of Kenya's economy will depend on how well and effectively new and innovative financial products are launched and attract new listings. In addition, there is need to diversify the sector representation at the NSE to include the insurance industry and the co-operative movement.

5.3 Limitations of the study

The major setback for this study was the refusal of some corporate to participate since they considered filling the questionnaires as a waste of their time. However, there is no reason to believe that their responses could have significantly altered the findings since the response rate is representative of the target population.

5.4 Suggestions for further research

In an economy like Kenya of many private enterprises, many firms list in the market while others that qualify do not. NSE authorities may be unaware of factors that may inhibit qualified firms from listing. Therefore a further study can be carried out on understanding the negative factors.

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APENDIX I: QUESTIONNAIRE

The questionnaire to be answered by the chief executive officers and senior managers of NSE and CMA, Compliance officers of CMA, Trading officers of the NSE, investment advisors and sales executives of investment banks and fund managers who are market players at the Nairobi Stock Exchange.

SECTION I: SUCCESSFUL POLICY IMPLEMENTATION APPROACHES

The following approaches relate to successful policy implementation measures for development of the Nairobi Stock Exchange. Indicate the extent to which the relevant agencies (CBK, RBA, CMA) have implemented the measures for development of the Nairobi Stock Exchange.

	Measure	Very great extent	Great extent	Moderate extent	Small extent	Ver Sma exte
1	The mobilization of capital					
2	Risk management and resource allocation					
3	Pooling of resources and diversification of ownership					
4	Information production, price discovery and exchange control					
5	Facilitating better governance and control					
6	Efficient clearing and settling					
7	Lengthened maturity of government debts					
8	Dealing with incentive and Agency problems					
9	Move towards regional integration of capital markets (Cross border listing)					
10	Efficient provision of market information; stock prices, information of financial soundness and future prospects of companies.					
11	Efforts towards enhancing better corporate governance that gives investors confidence that their funds will not be stolen or wasted					
12	Facilitation of better access to capital through the floating of shares to the general public.					
13	Liberalization of restrictions on private sector borrowing from abroad					
14	Enhancing of market liquidity through discount houses, primary dealers and investment banks					
15	Efforts towards decentralization of NSE operations and					

	brokerage services to other cities in Kenya					
16	Product innovation through future options and financial derivatives for risk					
17	Fiscal incentives					
18	Imposition of portfolio rules upon banks and other financial institutions					
19	Official supervision and monitoring of trading in capital markets					
20	Efforts towards low level volatility of returns and transactions costs					
21	Sustenance of price stability					
22	Curbing inflation rates					
23	Sustenance of low level interest rates					
24	Liberalization of foreign exchange flows in the balance of payments					
25	Reduction in budget deficits though issuing of government securities, Parastatal privatizations					
26	Simplification of red-tape requirements for direct and portfolio investments					
27	Enforcement of capital market regulations and sanctions					

SECTION II: NATURE OF IMPEDIMENTS ENCOUNTERED IN IMPLEMENTATION OF POLICY MEASURES FOR DEVELOPMENT OF THE NAIROBI STOCK EXCHANGE

How would you classify the following impediments encountered in implementation of policy measures for development of the Nairobi Stock Exchange?

		Great extent	Moderate extent	Small extent
1	Volatile/unstable interest and foreign exchange rates			
2	High inflation rates			
3	Unfavorable international trade regimes			
4	Undeveloped capital market infrastructure in Kenya			
5	Government budget deficit			
6	High corporate tax regimes			
7	Differential tax rates on dividends and interest income			
8	Failures and inefficiencies of commercial banks			
9	Low income levels			
10	Bureaucracy and regulations at the CBK			
11	Bureaucracy and regulations at the RBA			
12	Bureaucracy and regulations at the CMA			
13	Bureaucracy at the Commissioner of insurance			
14	Delivery and settlement procedures			

15	Low public awareness			
16	Absence of electronic trading system			
17	Slow Central Depository System			
18	Absence of derivatives			
19	Ceiling on foreign investors			
20	Poor implementation approaches by CMA			
21	Slow process of public sector privatization parastatal reform			
22	Few listed companies at NSE			
23	Multiplicity of regulators and regulations (conflicting)			
24	Stringent requirements for listing the NSE			
25	Political instability/ wrangling			
26	Cross-border listing requirements			
27	Inadequate laws protecting investors			
28	Weak foreign investor confidence			

APPENDIX II: INTERVIEW SCHEDULE FOR TRADING OFFICERS AT THE NAIROBI STOCK EXCHANGE AND COMPLIANCE OFFICERS OF THE CAPITAL MARKETS AUTHORITY

1. What improvement recommendations would you prefer to over come the above impediments?

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2. What are the recent developments/ initiatives by the NSE and the CMA for the development of local investment vehicles?

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Thank You For Your Cooperation

APPENDIX III: POPULATION FRAME

Nairobi Stock Exchange Ltd
Capital Markets Authority

Stock Brokers

Ashbhu Securities
Crossfield Securities
Discount Securities
Dye & Blair
Equity Stock Brokers Ltd
Faida Securities Ltd
Fechim Investments
Fransis Thuo & Partners
Hak Securities Ltd
High Value Securities Co
Kenya Funds Management Co Ltd
Kenya Wide Securities Ltd
Kestrel Capital (EA) Ltd
Metro Stock Securities Ltd
Ngenye Kariuki & Co Ltd
Nyaga Stock Brokers
Reliable Securities
Satima Securities
Sha Munge & Partners
Simlo Enterprises
Solid Investments Securities Ltd
Standard Stocks Ltd
Sterling Securities Ltd
Suntra Stocks Ltd
Town & Country Securities Ltd

Investment management, Securities & Fund Managers

Stannic Investment Services
Old Mutual Asset Managers K. Ltd
Kenindia Asset Management
Cooperative Trust Investment Services
ICEA Investments
IAG Global Investments
Madison Asset Management Services
Jubilee
African Alliance
CFC Financial Services Ltd
Genesis K Ltd
Bridges Capital
Comcraft Kenya Ltd
Dry Associates
Investment Promotion Ltd
Kairo investment Ltd
Loita Capital Partners Ltd
Prudential Capital Securities Ltd
Zimele Asset Management Ltd
Dao Investment Co Ltd
Effem Investments Ltd
Endeavor Investments Services Ltd

Peekway Ltd