The Role of the Capital Markets in Economic Development & Cytonn Weekly #12 2019

Focus of the Week

Ensuring economic growth and development is a primary objective of all countries. According to the World Bank, an estimated USD 4.0 trillion in annual investment is required for developing countries to achieve the Sustainable Development Goals (SDGs) by 2030. In light of the investment requirement, there is a greater need to develop and strengthen capital markets in order to mobilize commercial financing. The role that capital markets have in financing infrastructure development, large enterprises, and Small and Medium Enterprises (SMEs), and the links with economic growth, are increasingly being highlighted.

Economists traditionally have looked to factors such as capital, labor and technology as the major factors affecting economic growth. The recent financial crisis has shown that there are substantial economic effects when there is lack of confidence in the financial systems. Therefore, the functioning of financial systems has received special attention in academic literature in recent years. A well-functioning financial system permits an economy to fully exploit its growth potential, as it ensures that the best investment opportunities receive the necessary funding, while the inferior opportunities are denied capital; in this regard, we endeavor to investigate the role that capital markets play in economic development. This focus addresses the topic as follows:

i. Introduction to Capital Markets, where we highlight the capital market framework, key players and products,
ii. How Capital Markets Facilitate Economic Development, where we look at the fundamental channels through which capital markets are connected to economic growth and development,
iii. Challenges of Developing Capital Markets, where we highlight the effects on the economy when capital markets don’t work as they are supposed to,
iv. Case Study - Capital Markets in South Africa, & Learnings for Kenya, and,
v. Steps Kenya Should Take to Expand its Capital Markets as Complementary to Bank Funding

Section I: Introduction to Capital Markets

Capital markets are a general category of markets that facilitate the buying and selling of securities with medium-term and long-term maturity, of one year or more. Capital markets channel savings and investment between suppliers of capital and users of capital through intermediaries. Examples of these key players in the capital market’s process are:

a. **Suppliers of Capital:** Also known as surplus units, suppliers receive more money than they spend or have immediate use for. They can be termed as investors. They provide their net savings to the financial markets for a return on the capital provided. Examples include retail investors and institutional investors,
b. **Financial Intermediaries:** A financial intermediary is an institution or individual that serves as a

middleman among diverse parties in order to facilitate financial transactions. Common types include commercial banks, investment banks, stockbrokers, fund managers, and stock exchanges,

c. **Users of Capital:** Also known as deficit units, users of capital spend more money than they receive or need funds for investments or development. They are also termed as borrowers. They access funds from the capital markets. Examples include businesses, the government and individuals.

Products in the capital markets are also referred to as capital market securities. These are debt securities, with a maturity of more than one year, and equity securities. Funds received from these products are mostly used to purchase capital assets, such as buildings, equipment, or machinery. The key capital markets securities are as follows:

a. **Bonds:** These are medium to long-term debt securities issued by firms and governments to raise large amounts of funds. Bonds are differentiated by the issuer and can be classified as Treasury bonds, municipal bonds, or corporate bonds,
b. **Equity Securities:** An equity security represents ownership interest held by shareholders in an entity realized in the form of shares of capital stock, which includes shares of both common and preferred stock. They are classified as capital market securities because they have no maturity and therefore serve as a long-term source of funds.

Section II: How Capital Markets Facilitate Economic Development

The capital markets are a network of specialized financial institutions, series of mechanism, processes and infrastructure that in various ways facilitate the bringing together of suppliers and users of medium to long-term capital. Capital markets connect the monetary sector with the real sector, which is the sector of the economy concerned with the production of goods and services. Considering this role in the economy, the capital markets play an important role in economic development as they facilitate growth in the real sector by giving producers of goods and services, and entities tasked with infrastructure development. access to long-term financing.

The fundamental channels through which capital markets are connected to the economy, economic growth and development can be outlined as follows:

a. **Creating a Bridge Between Suppliers of Capital and Users:** The contact between agents with a monetary deficit and the ones with monetary surplus can take place directly through direct financing, but also through a financial intermediary in form of indirect financing, which is a situation whereby specific operators facilitate the connection between the real economy and the financial market. In this case, the financial intermediaries could be banks, investment funds, pension funds, insurance companies, or other non-bank financial institutions,
b. **Promoting Saving and Investments:** The capital markets increase the proportion of long-term savings (pensions, life covers, etc.) that is channeled to long-term investment. Capital markets enable the contractual savings industry (pension and provident funds, insurance companies, medical aid schemes, collective investment schemes, etc.) to mobilize long-term savings from small individual household and channel them into long-term investments. It fulfills the transfer function of current purchasing power, in monetary form, from surplus sectors to deficit sectors, in exchange for reimbursing a greater purchasing power in future. In this way, the capital markets enable corporations to raise funds to finance their investment in real assets. The implication will be an increase in productivity within the economy leading to more employment, increase in aggregate consumption and hence growth and development. It also helps in diffusing stress on the banking system by matching long-term investments with long-term capital. It encourages broader ownership of productive assets by small savers. It enables them to benefit from economic growth and wealth distribution, and provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investments that translate to economic growth,
c. **Facilitating Efficient Allocation of Scarce Financial Resources:** The capital markets

facilitate the efficient allocation of scarce financial resources by offering a large variety of financial instruments with different risk and return characteristics. This competitive pricing of securities and large range of financial instruments allows investors to better allocate their funds according to their respective risk and return appetites, thereby supporting economic growth,

d. **Financing Utility and Infrastructure Development:** The capital markets also provide equity capital, debt capital and infrastructure development capital that have strong socio-economic benefits through development of essential utilities such as roads, water and sewer systems, housing, energy, telecommunications, public transport, etc. These projects are ideal for financing through the capital markets via long dated bonds and asset backed securities. Infrastructure development is a necessary condition for long-term sustainable growth and development. In addition, capital markets increase the efficiency of capital allocation by ensuring that only projects that are deemed profitable can successfully attract funds. This will, in turn, improve competitiveness of domestic industries and enhance ability of domestic industries to compete globally, given the current momentum towards global integration. The result will be an increase in domestic productivity which may spill over into an increase in exports and, therefore, economic growth and development,
e. **Financing Private Public Partnerships, "PPPs":** Capital markets promote PPPs, thereby encouraging participation of private sector in productive investments. The need to shift economic development from public to private sector to enhance economic productivity has become inevitable as resources continue to diminish. It assists the public sector to close the resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project-based capital. It also attracts foreign portfolio investors who are critical in supplementing the domestic savings levels and who facilitate inflows of foreign financial resources into the domestic economy, thereby supporting economic growth.

Section III: Challenges of Developing Capital Markets

Economic growth in a modern economy hinges on an efficient and effective financial sector that pools domestic savings and mobilizes capital for productive projects. The absence of effective capital markets could leave most productive projects that carry developmental agendas unexploited. However, there are challenges in developing capital markets as they are to a large extent dependent on the level of economic and structural development of a country. Factors affecting the development of capital markets include;

a. **Country Fundamentals**: The size of the economy in terms of aggregate gross domestic product and per capita income affect the development of capital markets. This explains in large part why, in general, capital markets are at an embryonic stage in smaller and low-income countries, while more developed countries have more robust capital markets. This can be explained as more developed economies have greater institutional development, a larger institutional investor base, higher levels of contractual savings such as pension funds, political stability and macroeconomic stability.
b. **Macroeconomic Policies Framework**: An essential condition for well-functioning capital markets is the existence of sound macroeconomic policy frameworks. Capital markets depend on investor confidence. Strong institutions thrive in stable macroeconomic conditions and investors can also be confident that their capital will not be eroded by factors such as hyper-inflation and exchange rate risks when there is a strong macroeconomic framework in place.
c. **Access to Information**: Access to information is a major factor that affects the development of capital markets. Access to information gives investors' confidence in the functioning of the capital markets. Access to information and transparency allows for the monitoring of users of funds, which increases investor confidence.
d. **Regulatory Framework**: To reliably extract the benefits of well-functioning markets, adequate regulation of users of funds, investors, and intermediaries in addition to robust supervisory arrangements to protect investors, promote deep and liquid markets, and manage systemic risk

are critical.

e. **Efficient Market Infrastructure**: Lack of adequate and efficient market infrastructure for issuing, trading, clearing and settlement is a major issue for capital market development as it pushes away potential investors to an economy.
f. **Knowledge of Retail Investors**: The lack of investor education for retail investors is another factor affecting the development of capital markets. It is important to educate retail investors on investment products and the benefits of saving, in order to channel savings to the capital markets.

Section IV: Case Study - Capital Markets in South Africa, & Learnings for Kenya

According to the Africa Financial Markets Index 2018, by Absa Group, while most capital markets in African countries are relatively underdeveloped, those countries which introduced reforms that are geared towards development of capital markets have been able to grow at relatively higher and sustainable rates. The Africa Financial Markets Index tracks progress on financial market developments of selected African countries annually across a range of indicators. These indicators are; (i) market depth, (ii) access to foreign exchange, (iii) tax and regulatory environment, (iv) market transparency, (v) capacity of local investors, (vi) macroeconomic opportunity, and (vii) legality and enforceability of standard financial markets master agreements. According to the first report published in 2017 and the subsequent report in 2018, South Africa ranked first in both occasions as the most developed financial market in Africa, hence the reason we have picked it as a case study.

A summary of rankings from the report is highlighted in the table below, where the higher the score the more developed the capital markets are based on the indicators above:

ABSA Africa Financial Markets Index

2017		2018	
Country	**Aggregate Score**	**Country**	**Aggregate Score**
South Africa	92	South Africa	93
Mauritius	66	Botswana	65
Botswana	65	Kenya	65
Namibia	62	Mauritius	62
Kenya	59	Nigeria	61

According to the African Capital Markets Watch 2018 report by PWC, South Africa again ranks as the most active capital market on the continent. This is supported by a strong financial markets infrastructure and robust legal and regulatory frameworks. The South African capital markets consists of:

- **Equities:** The Johannesburg Stock Exchange (JSE) is the largest exchange in Africa with over 400 listed firms and a market capitalization of USD 13.7 tn,
- **Bonds:** The South African-listed bond market is estimated to be ZAR 2.7 tn (USD 186.4 bn). It is largely dominated by bonds issued by National Treasury, which account for 68.4% of the outstanding debt, followed by bonds issued by the financial sector (16.0%) and state-owned entities [parastatals] (11.2%). In terms of turnover, the monthly average amount traded on the JSE is ZAR 2.3 tn (USD 158.8 bn),
- **Derivatives:** Derivatives are traded in exchanges under the umbrella of the JSE, and over-the-counter (OTC). Exchange-traded products are standardized, and free of counterparty risk. The JSE permits trading in equity, commodity (mainly agricultural), currency, and interest rate derivatives,
- **Real Estate:** South Africa has the largest and most established REITs market in Africa. The South African listed property sector has a market capitalization of approximately ZAR 380.0 bn (USD

26.2 bn) at the end of 2016, which is 6.4% of GDP.

South Africa continues to lead capital markets in Africa, supported by a strong financial markets infrastructure and a robust legal framework. South Africa has developed its capital markets by;

a. **Establishing Progressive Policies**: South Africa has established progressive policies that support the development of financial markets such as the 'twin peaks' strategy for improving financial regulation, which separates regulatory functions between a regulator that performs prudential supervision and one that performs market conduct supervision. This separation clearly defines the objectives and mandates of the respective agencies and also separates the role of regulator and promoter.
b. **Promoting Investor Education and Financial Inclusion**: South Africa has also introduced frameworks to increase financial literacy with South Africa's newly-created Financial Sector Conduct Authority established to supervise financial markets and promote financial education. Its consumer education department holds workshops on financial literacy and investor education, particularly in rural areas and among groups that have been excluded from financial services.
c. **Adopting Standardized International Markets Framework**: South Africa also uses international markets and standardized frameworks to develop its capital markets such as the Master Agreement of the International Swaps and Derivatives Association, the Global Master Repurchase Agreement and the Global Master Securities Lending Agreement, which helps the country to be more prepared to drive product innovation and growth in the derivatives market and open up its capital markets to international investors.
d. **Using Technological Innovation**: South Africa also makes use of technological innovation to make its capital markets more efficient. For example, the South African Reserve Bank has set up an electronic trading platform for primary dealers in an effort to improve liquidity and transparency in the government bond market. There are plans to expand this to other market participants and for other securities, including corporate bonds.

Due to the efficiency of the South African capital markets, businesses have credible alternative sources of funding and they do not have to over-rely on banks in South Africa to have access to capital markets funding. This makes South Africa an attractive destination for businesses, including multinationals to set up operations.

Section V: Steps Kenya Should Take to Expand its Capital Markets as Complementary to Bank Funding

We look at what Kenya can learn from South Africa as South Africa has the most robust capital markets in Africa. In our view, Kenya should adopt the following recommendations that will address the existing bank dominance, reduce the funding reliance we have on banks, and support the expansion of capital markets as an alternative to banks:

a. **Focus Legislation and Policies to Stimulating the Capital Markets and Alternative Products, as Opposed to Focusing Mainly on Banks:** A lot of legislative action has focused on the banks, yet we also need legislation to promote competing products that will diversify funding sources, which will enable borrowers to tap into alternative avenues of funding that are more flexible and pocket-friendly. This can be done through the promotion of initiatives for competing and alternative products and channels. In developed economies, 40% of business funding comes from the banking sector, with 60% coming from non-bank institutional funding such as capital markets and alternative sources. However, in Kenya, 95% of all funding is bank funding, and only 5% from non-bank institutional funding, showing that the economy is highly dominated by the banking sector and should have more capital market products for funding businesses. Not to mention that cost of bank funding is too high. To try and address cost of funding and access to funding, the legislation has focused on the wrong issues such as legislating cost of borrowing and trying to allocate a certain amount of loans to SMEs. Our view is that legislation ought to be more focused on creating a more supportive environment to capital markets and alternative funding,

b. **Support Product Development and Innovation:** The capital markets regulators and participants need to look at how to enhance non-bank funding, by encouraging product development and innovation. The Total Assets Under Management (AUM) held by Unit Trust Fund Managers declined slightly, by 0.7%, to Kshs 56.1 bn in 2017, from Kshs 55.5 bn recorded in 2016, while commercial banks AUM grew by 8.3% over the same period, to Kshs 4.0 tn in 2017 from Kshs 3.7 tn in 2016. The capital markets regulators are already doing a lot, such as establishing REIT regimes, derivatives and exchange traded funds, but more needs to be done to encourage product development and innovation,
c. **Consumer Education and Protection:** The implementation of a strong consumer protection, education agency and framework, to include robust disclosures on cost of credit, free and accessible consumer education, enforcement of disclosures on borrowings and interest rates, while also handling issues of contention and concerns from consumers,
d. **Promote an Efficient Capital Markets Infrastructure:** Efficient capital markets infrastructure is crucial to developing deep and vibrant capital markets. The Capital Markets Authority (CMA) could improve market efficiency by (i) making it easier for new and structurally unique products to be introduced in the capital and financial markets. The market remains largely a plain vanilla products market with equities and fixed income products, (ii) instituting predictable and transparent timelines for processing submissions from market applicants and expedite processing of applications. For example, an online portal showing when applications come in and how long they take to be processed be helpful, and (iii) pushing for a one stop shop for applicants such that an approval from the authority on products such as REITs would suffice, as opposed to current structure where applicants have to chase other approvals from other agencies such as KRA,
e. **Addressing the Tax Advantages that Banks Enjoy:** Level the playing field by making tax incentives available to banks to be also available to non-bank funding entities and private investment funds. For example, providing alternative and capital markets funding organizations with the same withholding tax incentives that banking deposits enjoy, of a 15% final withholding tax, so that depositors don't feel that they have to go to a bank to enjoy the 15% withholding tax; alternatively, normalize the tax on interest for all players to 30% to level the playing field,
f. **Freeing Capital Markets Infrastructure from Banking Sector Control:** To spur growth of capital markets in areas such as Unit Trust Funds / Mutual Funds, we need to reduce the dominance of banks in the capital markets infrastructure. For example, for a fund manager to set up a Unit Trust Fund, they require a Custodian and a Trustee as part of the governance structure. In the current capital markets governance structure framework, both the Custodian and the Trustees have to be banks. It is understandable to have custody under banks because banks traditionally play the roles of custody and safekeeping of assets. However, we should expand Trusteeship beyond banks. In Kenya, being a trustee is based on Regulation 26 (1) of the Capital Markets (Collective Investment Schemes) Regulations, 2001, which provides that a trustee must be a bank or financial institution appointed by the Capital Markets Authority. However, when we look at two other jurisdictions very relevant to us, that is South Africa and UK, the role of Trustees has been expanded to include other entities:
    a. In South Africa, Section 69 of the Collective Investment Scheme Control Act, 2002, a Trustee may be: (a) a public company under the Companies Act; (b) a company or institution incorporated under a special Act, excluding a close corporation referred to in the Close Corporations Act, 1984 (Act No. 69 of 1984); (c) an institution or branch of a foreign institution, which is entitled to carry on the business of a bank under the Banks Act, 1990 (Act No. 94 of 1990); or (d) an institution which is registered as an insurer under the Long-term Insurance Act, 1998 (Act No. 52 of 1998). The companies or institutions listed above must also: (a) maintain capital and reserves together amounting to not less than ZAR 10.0 mn (USD 0.7 mn); and (b) be registered by the registrar as a trustee or custodian
    b. In the UK, Section 55A, Part 4A of the Financial Services Act, 2012, Section 243, and the GCA Collection Investment Scheme Information Guide 2019, a Trustee may be (a) an individual; (b)

a body corporate; (c) a partnership; or (d) an unincorporated association, that has received permission from the Financial Conduct Authority to act as a Trustee, and must be independent of the manager of the fund.

Looking at the above case studies, there is a compelling case to consider expanding our current closed framework where Trusteeship is only open to banks, and in fact only 4 banks currently offer Trustee services to the 18 currently registered Unit Trust Funds. It is arguably that banks may not support capital markets products that are threatening to their own core banking business, thereby curtailing the development of capital markets products that offer alternatives to banking products.

g. **Increased Transparency:** This can be achieved through a reduction of the opacity in debt pricing. This will spur competitiveness in the banking sector and bring a halt to excessive fees and costs. Recent initiatives by the CBK and Kenya Bankers Association (KBA), such as the stringent new laws and cost of credit website being commendable initiatives,

In conclusion, a well-developed capital markets creates a sustainable, low-cost distribution mechanism for multiple financial products and services across the country. This in turn helps the business community to raise long-term funds that are used to purchase capital goods, thereby propelling their growth and supporting the country’s economic growth. Capital markets also enhance efficient financial intermediation. It increases mobilization of savings and therefore improves efficiency and volume of investments, economic growth and development. Capital markets can create greater financial inclusion by introducing new products and services tailored to suit investors’ preference for risk and return, as well as borrowers’ project needs and risk appetite. One of the key missing pillars of the President's Big Four Agenda is how to bring in private sector funding, we believe that the 7 points outlined above can play a big role in mobilizing private sector funding of the Big Four Agenda.

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