The Capital Markets Soundness Report

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Quarter IV. 2017

"Balancing Regulation, Innovation and Business Growth."

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SPECIAL MESSAGE FROM THE CHIEF EXECUTIVE OFFICER

Mr. Paul Murithi Muthaura, MBS
CEO, Capital Markets Authority, Kenya

Happy New Year 2018!

The Authority released its inaugural Capital Markets Soundness Report (CMSR) in January 2017, marking a new chapter in its commitment towards creating awareness on the country's Capital Markets performance. The Capital Markets Soundness Report is a publication that evaluates and analyses periodic market information & statistics and projects likely future implications on the stability and soundness of Kenya's capital markets.

The Authority is encouraged and challenged by the level of interest that this publication has drawn from diverse local and international Capital Market industry players, given that it is the first of its kind on the continent.

The ultimate objective of the CMSR is to present a practical view of market events and provide a basis of evidence based policy formulation, by identifying global, Sub-Saharan, regional and local socio-economic, cultural and political environment factors that may influence Kenya's 'open economy', while making proposals where possible, on how to improve the performance of the sector.

We appreciate, and continue to be keen on, receiving feedback on the content and recommendations of the CMSR from industry stakeholders in order to enrich our capital markets policy framework for improved deeper and more robust market. The Authority remains committed to improving the quality of the publication to make it a reliable resource document for information on Capital Markets operations and performance in Kenya.

On behalf of the Authority, I wish to thank you all for your continued support and partnership in 2017 and look forward to achieving greater heights in 2018.

Enjoy your read.

Mr. Paul Murithi Muthaura, MBS
CHIEF EXECUTIVE OFFICER

EDITORIAL

Mr. Luke Ombara
Director, Regulatory Policy and Strategy, CMA

The Authority welcomes you to the 4th quarter (October – December 2017) edition of the Capital Markets Soundness Report (CMSR).

This is the fifth volume of the Soundness Report and is themed ***"Balancing Regulation, Innovation and Business Growth."***

This theme is inspired by global developments in 2017 that saw regulators around the world welcome discussions around technological advancements within the Capital Markets industry that are projected to impact business activity within the industry.

Other international market stability issues covered include the US tax policy reform, the Chinese debt agreements with emerging and frontier markets, the UK's Brexit developments and LIBOR challenges, as well as a special feature on the observed and unprecedented behavioral relationship between credit rating of emerging countries versus foreign investments in emerging markets bonds.

Domestically, the report explores the soundness of local Capital Markets during the period, capturing snapshots of the 2017 annual performance in summary, to give perspective on performance of the markets during the year.

The report analyses the stability indicators of the market, with issues such as market concentration, foreign investor turnover and liquidity positions of the market receiving prominence in coverage.

Overall, it is our hope that you will find the report illuminating in terms of bringing you up to speed on the current capital market soundness issues and their relevance to the Kenyan economic landscape.

Happy reading!

Mr. Luke E. Ombara
DIRECTOR, REGULATORY POLICY & STRATEGY

Capital Market Soundness Report- Q4. 2017

2017 in Review

Global – Focus on FinTech

Financial Technology – 2017 saw intense debate on the role of fintech in changing business operations for increased efficiency. Discussions centered on the use of block chain technology and the relevance of digital currency to facilitate the process. Specifically, Bitcoin continued to grow in popularity, attracting increased attention from Governments and financial institutions in equal measure. Japan and Germany already recognize the digital currency, while Regulators in Asia Pacific, including those in China, Australia and Singapore have been uneasy with the rise of cryptocurrencies.

Sharp volatility in the price of cryptocurrencies has been a particular area of concern for regulators with Bitcoin's price rising by more than 1,500 percent this year, raising questions on its valuation, regulation and other more fundamental concerns on the overall effect of digital currency as a substitute to legal tender.

Despite this, more institutions have been keen on introducing financial products linked to cryptocurrencies with Goldman Sachs planning to set up a digital currency trading desk & CME Group and CBOE launching bitcoin futures contracts.

Sub- Saharan Africa

According to the African Development Bank updated forecast released on 12 October 2017, Africa's economic performance improved in 2017 compared to 2016, with the gain in momentum expected to be carried over to 2018. Gross domestic product (GDP) is estimated to have risen from 2.2% in 2016 to 3.0% in 2017, and is expected to continue to rise to 3.7% in 2018. The reasons for the improvement in growth across the continent include the recovery in the global economy and bottoming out of the commodity prices, steady domestic demand and public investments in infrastructure, strong export performance and higher government revenues narrowing fiscal and current account deficits.

East Africa is still the fastest growing region, with an estimated growth of 5.4% in 2017 and 5.8% in 2018, rising from its already high growth of 5.1% in 2016.

North Africa is the second fastest growing region, followed by Southern Africa, Central and then West Africa.

EAC Regional Developments

New East African Community Directives - Efforts towards increasing collaboration in Capital Markets regulations were boosted during the year, after the region welcomed the gazettement of a further set of Directives of the Council of Ministers on the East African Community Securities Market in October 2017, increasing the total number of regionally adopted convergence frameworks to 14, covering areas such as Collective Investment Schemes, public offers of equity and debt, regional listings and Asset-Backed Securities, among others.

Kenya

Elections was the key focus - The August and October 2017 elections were the major highlight for the year in 2017. Despite the political challenges, Kenya maintained a peaceful trajectory, with the stable economic and political environment expected to yield dividends to capital markets.

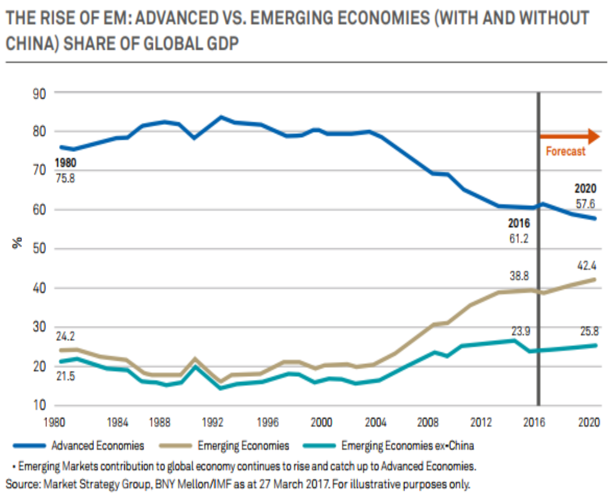
Special Feature

Opportunities in International & Emerging Markets (EMs)

According to the International Monetary Fund, the gap between the emerging and developed market growth is expected to steadily narrow over the next few years on the back of accelerated EM growth.

Emerging Market countries are issuing debt at a record rate, buoyed by the recent global economic upturn and investors' search for yield in a world of historically low returns.

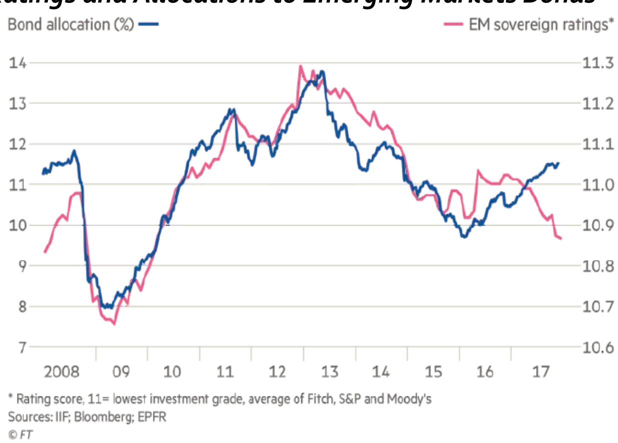
Figure 1: Depiction of contribution to Global GDP by Advanced and Emerging Economies (1980-2020)



Junk-rated emerging market sovereigns have raised $75bn in syndicated bonds so far this year, up 50 per cent year on year to the highest total on record, according to figures from Dealogic - a data provider.

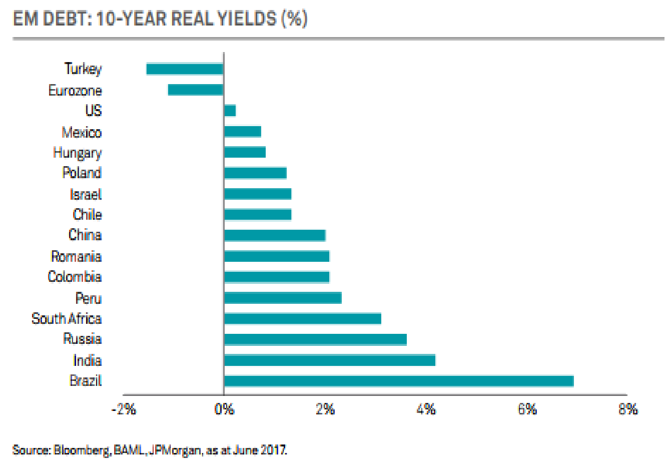
The increase has improved the total volume of debt-raising by developing economies; with non-investment grade issuance making up to 40 per cent of the new debt syndicated in EM so far in 2017[1].

Figure 2: Divergence in movement between EM Sovereign Ratings and Allocations to Emerging Markets Bonds



These developments have been attributed to attractive pricing of EM bonds, expanding economies in the emerging markets as well as diversification benefits.

Figure 3: Yield of 10-Year Bond Issues for select countries as at June 2017



A cross-jurisdictional analysis of successful bond issuances by emerging economies during 2017 reveals significant activity in the emerging markets sovereign bond issuance space.

Some of these countries include;

1. **Argentina – June 2017**

In June 2017, Argentina made history by being the second Latin American country to issue a 100 year sovereign bond, also known as a 'century bond,' after Mexico in 2010. Argentina sold $2.75bn of the debt with a coupon of 7.125 per cent, equating to an annual yield of 7.9 per cent, with the bond attracting $9.75 bn in orders from investors. This despite Argentina's history of defaulting on payments.

2. **Iraq – August 2017**

Iraq raised $1bn with a five-year, 6.75 per cent bond in August 2017, its first international debt issuance as a standalone credit since 2006 as it attempts to put decades of turmoil behind it. The bond issue was six times oversubscribed despite being its first bond without a US guarantee for more than a decade. The issuance was expected to gather significant demand from U.S. and European investors

[1] https://www.zerohedge.com/news/2017-11-13/emerging-market-junk-debt-issuance-surges-new-record-search-yield-intensifies

looking at emerging markets for yield they cannot get elsewhere. Pension funds, fund managers and sovereign wealth funds were also anticipated to take a good share of the paper. Commercial banks, bond investors and international lenders, including multilateral institutions such as the International Monetary Fund, World Bank and the Organization for Economic Cooperation and Development were estimated to contribute approximately 11.5 trillion dinars[2].

3. Nigeria - November 2017

Nigeria raised $3 billion in a two-part international bond sale as it seeks to fund a fiscal deficit and reduce its local-currency debt burden. The West African nation split the offering equally between 10- and 30-year tranches. The yield was 6.5 percent for the shorter notes and 7.625 percent for the 30-year portion. The issue received $11 billion of bids[3].

4. Greece – September 2017

Greece raised $3bn in its first sale of paper since its debt crisis at a yield of 4.625 per cent. These rates appear less comparable to our domestic borrowing rates averaging between 8% and 12%.

5. Ukraine – November 2017

Ukraine has taken advantage of a surge in appetite for high-yield debt to make its first return to Eurobond markets since a $15 billion restructuring in 2015. Ukraine is joining other junk-rated borrowers in making the most of the lowest emerging market borrowing costs in four years to sell new dollar debt. Ukraine's credit rating was recently upgraded by Moody's from, Caa3 to Caa2. The International Monetary Fund, which has been giving the country installments in a $17.5 billion bailout since 2015, foresees the nation selling $1 billion of bonds this year, $2 billion in 2018 and $3 billion in 2019.[4]

6. Bahrain – September 2017

The Kingdom of Bahrain priced its $3bn, three-tranche bond issue at 5.25 per cent for 7.5-year money, with a 12-year maturity, at 6.75 per cent and a 30-year tranche at 7.5 per cent. Strong investor demand drove demand to top $15bn. The deal included an $850m, 7.5-year maturity sukuk – the biggest Islamic finance bond to launch since the start of a row over sukuk bonds issued by UAE-based energy company Dana Gas threatened to derail the Islamic finance market earlier this year.

In addition to the Sukuk Bahrain raised $1.25bn in a 12-year maturity, and $900m in a 30-year debt tranche. Bahrain is rated BB- by S&P and BB+ by Fitch, about six levels under investment grade.[5]

7. Tajikistan – September 2017

Tajikistan raised $500m from its inaugural 10-year international bond, paying a fixed rate of 7.125 per cent in the latest evidence of keen investor appetite for relatively high-yielding sovereign debt from infrequent and new issuers.

Sovereign credit rating vs increasing international capital flows into Emerging Markets – The Paradox

According to Bloomberg Barclays indices, EM's local currency-denominated sovereign debt has returned 10.4 per cent since the start of this year, while dollar-denominated debt has returned 7.6 per cent. By contrast, US Treasuries have returned 2.5 per cent while European nations' debt has returned 0.9 per cent. Examples of substantial junk-rated issuance by emerging economies include Bahrain's $3bn debt-raising and Tajikistan's $500m market debut, both in September 2017. The government of Iraq raised $1bn in August 2017, while Ukraine raised $3bn in its first international debt-raising since 2014.

It is noteworthy therefore that, despite the lower rating, perceived challenges and risk premium associated with EMs, bond yields in these markets have been giving a tidy return

[2] https://www.reuters.com/article/us-iraq-bond/iraq-in-market-to-raise-1-billion-first-standalone-bond-in-over-decade-idUSKBN1AI1KP

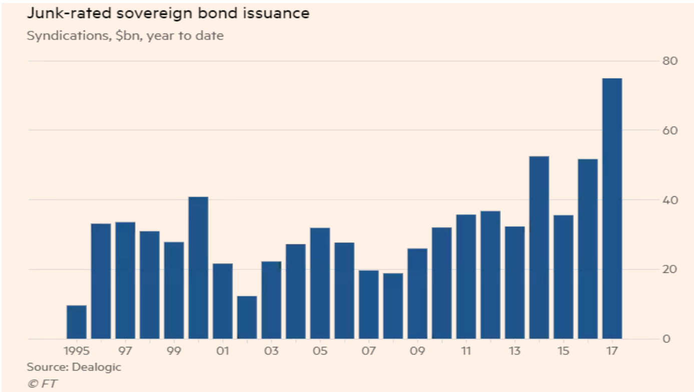
[3] https://www.bloomberg.com/news/articles/2017-11-20/nigeria-set-to-issue-3-billion-of-eurobonds-in-biggest-sale-yet

[4] http://www.intellinews.com/ukraine-to-issue-its-first-post-maidan-eurobond-this-autumn-128428/

[5] https://www.ft.com/content/5706447a-c6e4-36d8-a969-c8f2c1731a66

on investment while at the same time presenting these economies with opportunities to successfully raise capital.

Figure 4: Trend in issuance of junk-rated sovereign bond issuance (1995 – 2017)



Key Observations

- Despite a prevalence in adverse sovereign credit rating witnessed in the recent past, Emerging markets continue to attract significant levels of foreign capital inflows to their bond portfolios.
- EMs are increasingly issuing longer tenor bonds (e.g. 30years for Nigerian Sovereign Bond) with better yields attracting capital inflows despite the relatively poor ratings,
- To improve on their credibility, Credit Rating Agencies should ensure objectivity, accuracy and reliability of their ratings.

Lessons for Kenya

- Kenya, like other emerging economies has a huge infrastructural gap estimated at between $2 billion and $3 billion. Though a frontier market, Kenya has favorable factors that make it an attractive destination for foreign investments such as its favorable macroeconomic conditions, its position as a gateway into Africa, innovative prowess both globally and regionally as well as strategic infrastructural projects. The country should therefore leverage on these advantages and source for foreign capital to finance Vision 2030 development projects including energy, manufacturing, and agriculture amongst others.
- To maintain and improve its credit rating globally, Kenya should purpose to invest borrowed funds in productive sectors of the economy able to generate sufficient revenue to meet its debt obligations.
- The government should aim to issue longer tenor Sovereign bonds to build a reliable yield curve, while raising funds to finance its infrastructural projects in line with Vision 2030

4th Quarter Capital Markets Soundness

Overview – International Markets

China: Balancing Economic Growth, Lending to other EMEs and high Debt levels

According to the Bank for International Settlements, China's debt to GDP ratio reached 257 per cent in 2017, higher than the United States' 152 per cent, and more than most emerging economies. The IMF anticipates that by 2020 China's domestic credit to GDP ratio will rise to 300 per cent.

China's credit rating was downgraded by Standard & Poor's in September 2017, amid fears of rising debt. The agency lowered China's sovereign rating by one notch to A+ from AA-, putting it in the same category as countries such as the US and Austria. This is the second downgrade from a major ratings agency for Beijing in 2017 .However, it is worth noting too, that China still has large foreign exchange reserves serving as a buffer to external sovereign volatility. As at the end of 2017, China's foreign currency reserves stood at about US$3 trillion, with its annual current account surplus estimated at US$200 billion. Also, most of the country's debt is domestic, with its Central Bank - the People's Bank of China still ultimately in control of sovereign monetary policy.

Despite all the challenges faced, China continues to expand its lending to Emerging Market Economies.

Table 1: Sample Countries with project funding from China

	Country	Project	Cost	Natural Resource said to be at stake
1	Ghana	Infrastructure projects	$ 15 Billion	Mineral reserves e.g. iron ore, bauxite, manganese, limestone[6]
2	Ethiopia	Addis Ababa-Djibouti Railway	$ 4 Billion	-
3	Sri Lanka	Hambantota International Airport	$ 1.12 Billion	Hambantota Port

Sources: Various

Key observations

- Kenya is no longer considered a Least Developed Country (LDC), meaning, lending to it will increasingly be on commercial Government to Government lending terms.
- The country needs to exploit Public-Private Partnerships (PPPs) arrangements by tapping private sector financing i.e. into local pension funds which currently hold an estimated Kshs. 1 trillion in pension assets that can be redirected towards infrastructural financing.
- The legal framework for investment by Kenyan pension funds is available. There however is the challenge presented by the law that holds Trustees personally liable for long-term investments, making them remain cautious when making investment decisions.
- When taking up Government to Government funding, the Government should consider project cash flows against payment timelines and also improve on Investment discipline.

Lessons for Kenya

- The Capital Markets Master Plan recognizes Kenya's infrastructural funding gap estimated at about $2 Billion and is actively working towards unlocking the potential of both National and County Government entities to raise funds through the capital markets to promote market-based financing and to reduce reliance on concessional or government funding models that are susceptible to political risk.

i. UK: Brexit Negotiations – future still unclear

In December 2017, the European Council authorized the opening of the second round of negotiations on the UK's withdrawal from the EU and published its initial guidelines for Phase Two of the talks, which will encompass transitional arrangements and a framework for the future relationship between the UK and EU. [7]

On 8 December 2017, the European Commission published a Joint Report from the negotiators of the European Union and the United Kingdom Government on progress during Phase One of the negotiations under Article 50 on the United Kingdom's orderly withdrawal from the European Union. The report was issued subject to the caveat that nothing is agreed until everything is agreed. The Report contains 96 articles covering the three areas under consideration in the first phase namely:

i. Protecting the rights of Union citizens in the UK and UK citizens in the Union;
ii. The framework for addressing the unique circumstances in Northern Ireland and;
iii. The financial settlement.

It is Important to note that the UK will still participate in EUs annual budgets to 2020. UK will contribute to, and participate in, the implementation of the Union annual budgets for the years 2019 and 2020 as if it had remained in the Union (including revenue adjustments), on the basis of the applicable Union legal provisions including the Own Resources legislation.

Detailed EU negotiating guidelines for the transitional arrangements will be published in early January 2018, and it is hoped that an agreement in principle can be reached in early 2018. However, uncertainty has arisen following statements 3by Michael Bernard Barnier, European Chief

[6] https://www.rt.com/business/394262-ghana-china-loan-natural-resources/

[7] https://www.iiea.com/wp-content/uploads/2017/12/BrexitBrief-Issue-32-10_12_17.pdf

Negotiator for BREXIT since December 2016, ruling out a special deal for London's financial services.[8]

This remains a key subject in the second phase of the negotiations scheduled to start in January 2018. The UK Government has initially stated the need for a unique trade deal that would include financial services.

Implications for Kenya

- In November 2017, the Government outlined its plans to raise $1 billion through dual listing of the National Oil Corporation on the Nairobi Securities Exchange and London Stock Exchange in early 2019. As an interested party in London's excellence as an international financial services center, the second phase of the Brexit negotiations that will narrow down to trade negotiations remains a key interest item for Kenya in 2018.
- There is need for continuous monitoring of the possible effects of the resulting trade agreement negotiations on the participation of UK foreign investors in Kenya's financial markets which is characterized by a high foreign investor participation with foreign investors accounting for up to 70% of market turnover.
- The Authority will continue to raise awareness of opportunities for issuance of capital markets products such as Global Depositary Notes to raise funds as the country moves towards commercial oil production with heavy funding required for the pipeline, storage and handling facilities.

ii. UK: The LIBOR Question

LIBOR – the London Interbank Offered Rate – was generally accepted as a benchmark for a large cross section of global transactions until the discovery that some banks had been manipulating it for financial gain. Beginning 2012, an international investigation into the LIBOR revealed a widespread practice by some banks — notably Deutsche Bank, Barclays, UBS, Rabobank, and the Royal Bank of Scotland of manipulating these interest rates for profit from as far back as 2003.[9] Consequently, regulators in the United States, the UK, and the European Union have fined some of the banks more than $9 billion for rigging Libor, which underpins over $300 trillion worth of loans worldwide.

In July 2017, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA), announced the planned phasing out of LIBOR as the primary benchmark in financial transactions by the end of 2021 following recommendations from the Financial Stability Board (FSB) that the existing global interbank benchmarks are replaced with so called risk-free rates (RFRs).

The FSB sees the RFRs as being significantly more robust than the current global interbank rates and as being less susceptible to manipulation by the market. This has raised uncertainty and speculation on the implication of this phase-out as a number of financial products is priced on the basis of LIBOR.

Lessons for Kenya

- Kenya is home to a number of subsidiary arms of international banks. Asset pricing for most of these banks is benchmarked on the LIBOR. A change in the LIBOR or a replacement of the index is likely to affect asset pricing.

iii. United States: Bill on tax cuts passed

The U.S. tax-overhaul bill was signed into law in December 2017, delivering a major tax cut to U.S. corporations along with a package of temporary cuts for other businesses and individuals. The Bill which was effective January 1, 2018 shall see the corporate tax rate reduced from 35 percent to 21 percent (to bring it closer to that of countries like Canada, which has a 15 percent corporate tax rate, or Ireland, which has a 12.5 percent rate). According to an analysis by the Tax Policy Center, USA the Bill would reduce taxes for Americans in all income groups in 2018 — possibly increasing after-tax income by an average of 2.2 percent. It is anticipated that with time, most middle-class taxpayers would be paying a 12 percent rate; upper-middle-class households move from 25

[8] http://www.telegraph.co.uk/news/2017/12/08/brexit-divorce-deal-agreement-full-read-report-published-phase/

[9] https://www.cfr.org/backgrounder/understanding-libor-scandal

percent to 22 percent or from 33 percent to 24 percent or from 39.6 percent to 35 percent. Families could also benefit from a slightly expanded child tax credit. However, poorer Americans could lose out under the Bill, because individual tax cuts will eventually be phased out and the individual mandate will be repealed, causing an estimated 13 million Americans to lose health insurance.

Implications for Kenya

- As at November 2017, remittances from the North America accounted for about 55.85% of total remittance inflow for the country, with the US accounting for the greatest percentage of the flows. The diaspora community in the United States remain an important resource for the growth of the country's GDP and the new tax rates could have a direct impact on the level of remittances the country will receive in the coming months.

iv. China bourses lead Asia's advance in global IPO boom

According to data from IPO research firm Dealogic, as at mid-December 2018, Asian companies had raised USD$79.14 billion through initial public offerings, up 10% from 2016.

The sum represents 42% of the global tally. Asia continued to lead in both volume and total funds raised, with the region's two major economies shifting from banks to capital markets for their financing needs.

Figure 6: Top global IPO destinations in 2017 by total deal value as at December 2017

Mainland China was the top source of new supply, followed by Hong Kong and India. With exchanges in Shenzhen and Shanghai. China saw a total of 409 companies tapping $31.61 billion from the market in 2017, up 30% compared with 2016. Of the country's total funds raised, 56% was from Shanghai, making it Asia's top IPO destination. The boom is largely due to an acceleration in listing approvals[10].

Key observations

Kenya is actively pursuing efforts to improve foreign portfolio inflows. These include;

i. Removal of the foreign investor ownership cap;
ii. EAC investors have similar rights with local investors;
iii. Efforts towards establishment of NIFC;
iv. Ease of doing business (e-citizen) and access to credit facilities;
v. Establishment of special economic zones.
vi. Waiver of the Capital Gains Tax;
vii. Ongoing establishment of OTC trading platform for government bonds;
viii. Legal developments towards establishment of regulatory sandbox;
ix. Maintaining a stable macro-economic environment-local currency;
x. One stop shops for investment instruments in Kenya e.g. IGAD;
xi. Public participation through the PFMA act;
xii. Efforts towards adoption of Islamic finance through amendments of the financial regulators acts and
xiii. Promotion of Kenya in other jurisdictions through the presidency - branding Kenya.

In order to improve the level of Capital inflows, the following actions need to be taken;

i. Improve liquidity in government securities- challenge is on exit in the secondary market.
ii. Remove pre-funding at the secondary and primary market.
iii. Resolve challenges on conducting Know-Your – Client KYC for the ultimate beneficiary in securities investments
iv. Streamlining and simplifying regulations to improve fitness for purpose.
v. Involvement of regulators in online one-stop- shops
vi. Active participation of Kenya in ranking by the Morgan Stanley Capital International (MSCI) Emerging Markets Index.
vii. Encouraging local participation in the Kenyan market.
viii. Entrenching the role of independent financial advisors in financial inclusion.
ix. Easing foreign investors' access to the Government securities through FinTech.

Lessons for Kenya

- As Kenya works towards becoming a middle-income country by 2030, there is an opportunity for the country to learn from countries such as China and India that have successfully managed to make capital markets a key contributor to project finance.

v. Institutionalization of IFRS 9 Reporting Requirements

IFRS 9 represents a fundamental shift in accounting for financial instruments and will have an enormous impact on all financial institutions (FIs)—banks, insurance companies, finance companies—as well as non-FI companies that use hedging to manage risk. Changes will be seen in three major areas: classification and measurement; hedge accounting; and impairment provisions, where the biggest impact will be seen.

New impairment rules for calculating the allowance for credit losses on loans or investments are by far the most significant change brought by IFRS 9. The incurred loss model is being replaced by an expected loss model (i.e., instead of only setting loan provisions for losses actually incurred, companies will have to provide against losses they can reasonably expect to incur).[11]

Essentially, companies no longer wait until something goes wrong to recognize a loss. Rather, by following credit deterioration on every loan that goes on the books, companies can classify them as either having the same risk today as they did at origination (classified as stage 1) or having significantly greater risk than at origination (stage 2) and make loan provisions according to that risk. Historically, risk management has focused on loan risk in absolute terms; IFRS 9 looks at changing risk over the life of the loan—which is a fundamental change in thinking.

Implications for Kenya

- Since September 2016, Kenya's banking sector has been characterized with slow growth in credit offering following the interest rate capping rule which has driven substantial strategy changes with banks retracting loan offering and focusing more on investing in Government Securities. The IFRS 9 principle on impairment recognition of both incurred and expected loss could result in higher NPL (Non-performing loan) balances. A combination of the interest rate cap and the enforcement of IFRS 9 may further constrain credit growth necessary for economic development.

vi. Block chain, Cryptocurrencies and Artificial Intelligence – the new frontier

2017 witnessed the evolution and prominence of cryptocurrencies globally such as Bitcoin Litecoin, Ether,

[11] https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-9-understanding-the-basics.pdf

Ripple, Monero and Zcash with Bitcoin surging in value during the year, from $1,000 in January 2017 to a peak of about $17,000 by 6th January 2018[12]. Bitcoin crossed the $17,000 mark for the first time in its nine-year history, the latest in a price rally that has transformed the virtual currency from a curiosity to a hot topic for mainstream investors.

Figure 7: Movement in the price of bitcoin in 2017

Ordinary investors are being tempted into bitcoin by its rapid rise—a phenomenon dubbed FOMO (Fear of Missing Out).[13]

Bitcoin Developments in select countries

Japan: Japan was the first National Government to officially introduce new rules aimed at regulating cryptocurrencies, including bitcoin by stating that any money transfer business that would wish to operate any cryptocurrency would have to come under the regulatory supervision of the Japan Financial Services Agency effective October 1 2017. By regulating the currency, Japan has officially recognized bitcoin as a legal method of payment, a move that analysts say has helped the bitcoins surge to record highs.

United States: In December 2017, the Federal Reserve Chair Janet Yellen called bitcoin a *"highly speculative asset"* that *"doesn't constitute legal tender."* She stated that bitcoin played a very small role in the payment systems downplaying its ability to affect wider financial markets as it was not a stable store of value. The same sentiments were equally expressed by FINRA[14] as it cautioned investors against purchasing cryptocurrencies in the market, albeit, under a 'caveat emptor' tag. However, Nasdaq Inc plans to launch a futures contract based on bitcoin in 2018, making it the third exchange operator to plan U.S. derivatives contracts linked to the digital currency. The CME Group and CBOE Holdings - the world's largest derivatives exchanges had committed to launching the same in 2017[15].

Australia: Australia, like Japan has followed the path to regulate cryptocurrencies. Australia plans to strengthen its anti-money laundering laws and regulate digital currencies such as bitcoin in the wake of a financial scandal involving its biggest bank, Commonwealth Bank of Australia (CBA). Under the reforms, digital exchanges would be brought under the remit of Austrac, Australia's financial crime fighting Agency.

The proposed regulatory shake-up marks the first stage of a reform process aimed at updating Australia's anti-money laundering and counter-terrorism financing law. It follows a high-profile money laundering scandal involving CBA, which was accused by Austrac in August 2017 of more than 50,000 breaches of the existing legislation.[16]

Russia and Germany: More recently, Germany and Russia brought Bitcoin one step closer to legitimacy by declaring it a "unit of account," thus allowing it to be used as legal currency for tax and trading purposes, the first step towards denationalizing the production of money.[17]

Overall, discussions on cryptocurrencies have revealed the importance of the underlying block chain technology which is considered revolutionary in advancing business operations across functions; a more acceptable concept by most countries than the cryptocurrency debate. Discussions on the

[12] *https://www.economist.com/news/finance-and-economics/21731827-getting-out-such-illiquid-asset-can-be-harder-getting-bitcoins*

[13] https://www.economist.com/news/finance-and-economics/21731827-getting-out-such-illiquid-asset-can-be-harder-getting-bitcoins

[14] Financial Industry Regulatory Authority

[15] https://uk.reuters.com/article/us-nasdaq-bitcoin/nasdaq-plans-bitcoin-futures-contract-in-2018-source-idUKKBN1DT2CV

[16] https://www.ft.com/content/4cd5cc3c-8309-11e7-a4ce-15b2513cb3ff

[17] https://www.chillxseven.com/bitcoin-now-legal-currency-in-germany-video/

applicability of block chain remains active as the technology and other distributed ledger technologies (DLTs) have the potential to decentralize trading, clearing and settlement providing alternatives to CCPs as well as other trusted, regulated platforms through which the markets have operated for decades.

Kenya's approach to Fintech Innovations

Capital Markets Industry

- Currently, there is no global standard on regulation of the main Fintech innovations (e.g. cryptocurrencies) However, IOSCO gave guidance to the regulators, highlighting the inherent risks.
- Any guidance issued by the Kenya capital markets industry will therefore be in line with the guidance given by IOSCO.
- In jurisdictions where frameworks have been put in place, guidelines have been given on a case-by-case basis.

Insurance Industry

- The inherent risks in cryptocurrencies cannot be quantified and this is a major concern for the Kenyan insurance industry. Based on this, the industry is still cautious to venture into the field of cryptocurrency.

Banking Industry

- The Central Bank is still conducting research on cryptos and related fintechs to establish viability and risks to enable it provide guidance on the same.

Lessons for Kenya

- Kenya, like other countries has seen its fair share of debate on the legality and applicability of cryptocurrencies and new technologies such as blockchain as evidenced by the presence of local associations of youthful innovators looking for business opportunities in these fields.
- The Authority recognizes the extensive engagements focusing on new Fintech and its applicability in the Kenyan financial landscape which has led to the establishment of a regulatory sandbox to support innovation. The Authority welcomes informed debate that could guide future policy on these Fintech innovations.
- The Authority also sees potential in the applicability of blockchain technology as a solution to registry challenges, Crowd sourcing and funding, cross-listing of securities and sharing of KYC information, among others.
- Regulation that may take the form of guidelines/information notes highlighting the risks and what other markets are doing may go a long way in mitigating against unnecessary vulnerability in addition to protecting the investors. Before regulation, public sensitization that could take the form of roadshows, seminars etc. on the cryptocurrencies and other related fintechs may be necessary.

vii. Artificial Intelligence in the Financial Services Industry

Financial institutions are increasingly using AI[18] and machine learning in a range of applications across the financial system including to assess credit quality, price and market insurance contracts and to automate client interaction. Institutions are optimizing scarce capital with AI and machine learning techniques, as well as back-testing models in analyzing the market impact of trading large positions.[19]

In November 2017, China took a step towards inclusion of robo- advisers in its regulatory framework for its US$15.4 trillion asset management business as it seeks to close regulatory loopholes when it comes to technology-driven financial innovations.[20]

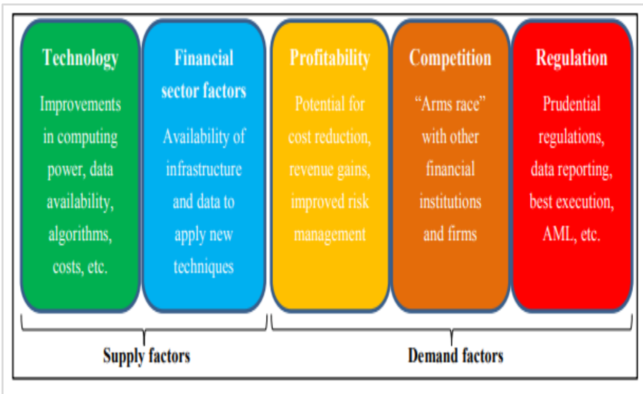
The tighter regulation of robo-advisers is expected to enable the orderly and healthy development of an emerging industry which could become the mainstay of finance industry in the near future.

[18] AI – Artificial Intelligence

[19] http://www.fsb.org/wp-content/uploads/P011117.pdf

[20] http://www.scmp.com/business/companies/article/2120603/chinese-regulators-move-ensure-investment-robots-are-not-excluded

Figure 8: Supply and demand factors of financial adoption of AI and machine learning



Source: Financial Stability Board

Financial institutions are thus required to gain regulatory approval for such new services. They will also be required to disclose to regulators the algorithms, financial models, and logic used in asset allocations, according to the draft rules.

Firms within the capital markets can consider the following key levers as identified by Accenture Consulting, to derive specific and tangible benefits from the growing applicability of Artificial Intelligence.

i. **Intelligence Automation;** by layering cognitive capabilities on automation technologies to enable self-learning and increase autonomy.
ii. **Enhanced judgement;** through leveraging AI capabilities to augment human intelligence and improve decision making.
iii. **Enhanced Interaction;** by delivering superior client experiences through hyper-personalization, conversational interfaces and the curation of real time information
iv. **Intelligent products;** Using AI to introduce new products and services and tapping into new business models and markets.
v. **Enhanced Trust;** within and outside organizations using AI.

Lessons for Kenya

- The Authority welcomes informed debate on AI that could guide future policy on these Fintech innovations in order to optimize benefits and efficiencies as well as reducing overall related costs.

Overview – Africa

According to ADB's updated 'Africa's economic outlook' released in Abidjan in October 2017, Africa's economic performance improved in 2017 compared with 2016 and is expected to gain momentum in 2018.
GDP growth in 2017 is expected at 3.0% up from 2.2% in 2016 and projected to expand to 3.7% in 2018.
However, the continent's averages compare favorably with Global economic growth projections of 3.5% and 3.6% GDP growth in 2017 and 2018, respectively.
The new set of data attributes Africa's economic rebound mainly to Recovery in the global economy and bottoming out of the commodity price bust that had set in since 2014.

Overview of Economic Performance – East Africa

Ease of Doing Business Report 2017 – EAC Performance

In the recent World Bank Ease of Doing Business 2018 Report released in November 2017, Kenya moved 12 places in 2018 to position 80 globally out of 190 countries compared to position 92 in the 2017 report.

An assessment of the key contributory factors shows that the improvement was mainly bolstered by reforms in protection of minority investors, starting a business, dealing with construction permits, getting electricity, access to credit, paying taxes and trading across borders. According to the report, Kenya improved the reliability of electricity by investing in its distribution lines and transformers and by setting up a specialized squad to restore power when outages occur. "Kenya made paying taxes easier by implementing an online platform, iTax, for filing and paying corporate income tax and the standards levy.

Table 2: Ease of Doing Business Ranking for EAC Countries

Economy	DB Rank 2017	DB Rank 2018	Movement in Ranking
Kenya	92	80	↑ 12
Tanzania	132	137	↓ 5
Uganda	115	122	↓ 7
Rwanda	56	41	↑ 15

Red – fall in ranking; Green – Rise in ranking

Compared to her peers within the East African Community, Kenya performed ahead of Tanzania and Uganda which ranked 137 and 122 positions with both countries recording a fall in their ease of doing business ranking when compared to 2017.

Rwanda remained significantly ahead of Kenya by attaining position 41.

Conspicuously absent in the ranking amongst East African nations is Burundi, which is not amongst the 190 countries participating in the Ease of Doing Business report.

New East African Community Directives

In October 2017, there was a gazettement of the new Directives of the Council of Ministers on the East African Community Securities Market as part of efforts towards ensuring convergence among Competent Authorities in the East African Community Region and licensed market intermediaries and their agents in respect of the securities markets.

The seven directives include;

i. Investor education and protection
ii. Self-Regulatory Organizations
iii. Takeovers and Mergers
iv. Licensing in the Securities Market
v. Anti-Money Laundering in the Securities Market
vi. Investor Compensation Fund and
vii. Conduct of Business in the Securities Market

The objective of this Directive (as articulated in Article 3) is to harmonize the standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme in the securities markets of Partner States with a view to;

(a) Protecting investors;
(b) Ensuring fair, efficient and transparent markets;
(c) Reducing systemic risks;
(d) Allowing for cross border operation and marketing of Collective Investment Scheme using a single set of disclosure standards/requirements; and
(e) Allowing for multiple/simultaneous listings.

The Directive shall apply to Collective Investment Schemes that are operated, promoted or marketed in more than one Partner State.[21]

Overview – Domestic Markets' Stability

Snapshot of Annual Market Performance in 2017

An analysis of equity market performance in the year showed relatively low performance in Q1.2017 as evidenced by low market capitalization levels and the NSE indices. Performance however picked up from Q2 through Q4 confirming resilience of Kenya's Capital Markets.

Foreign Investor flows during the year recorded a net outflow of KShs. 11,583 Million compared to a net inflow of KShs. 5,759 Million recorded in the year 2016, attributable to uncertainties on the political front. This situation however calmed as the year closed.

In terms of bond market performance, Treasury bond turnover represented 99.29% of total bond turnover over the period Jan-Dec 2017 with corporate bond turnover accounting for 0.71%. The substantial slowdown of the corporate debt market has been heavily influenced by the uncertainty from the slow resolution of the Imperial Bank and Chase Bank statutory managements.

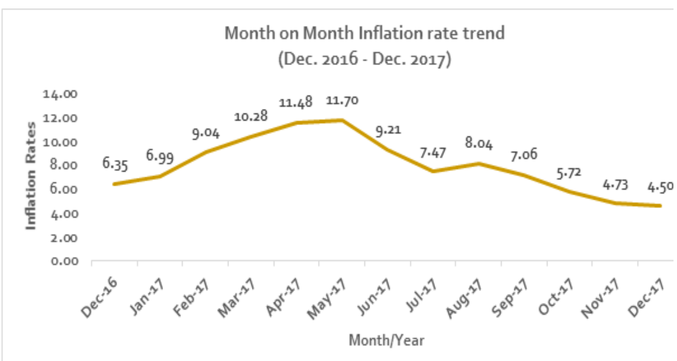
Macroeconomic Performance in Q4. 2017

[21] Directive of the Council of Ministers on the EAC Securities Market (EAC/CM/35/Directive 15)

In October 2017, the National Treasury revised the 2017 Economic Outlook forecast to 5.1% from 5.9% attributing it to drought and the political uncertainty.[22]

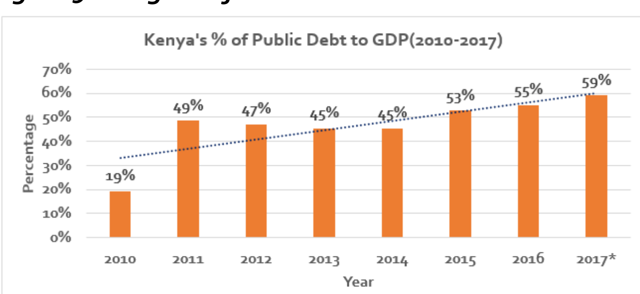
Later in December 2017, the World Bank cut its 2017 growth estimate for Kenya's economy to 4.9 percent, from its April 2017 estimate of 5.5%.[23]The World Bank however projects growth to rebound to 5.5% in 2018 and 5.9% in 2019, provided the government implements policy remedies that will stir activity in the domestic market such as review of the interest rate cap, boosting of revenue collections to narrow the annual budget deficit, pursuit of policies pegged on fiscal consolidation, recovery in the tourism and agriculture sector and increased investment in productive sectors of the economy.

Figure 10: Inflation Trends



Source: KNBS

Figure 9: Budget Deficit and Public Debt



****estimate***
Source: The National Treasury, IMF

Kenya's public debt has been on an upward trend in recent years, with projections of the public debt to GDP ratios in 2017 estimated at 60%.

Equity Markets – Secondary Market Performance

Equity turnover for Q4.2017 stood at KShs. 36.02 Billion, compared to KShs. 25.40 Billion registered in Q4.2016; a 41.81% increase confirming an increase in investor participation at the bourse. This increase can be partially attributed to the increase in volumes of trade at the exchange where trading in 1,291.15 Million shares was recorded in Q4.2017 compared to 1,102.42 Million shares recorded in Q4.2016. An increase of 30.55% was also recorded in end period market capitalization at KShs. 2,521.77 Billion was recorded in Q4.2017 compared to KShs. 1,931.61 Billion recorded in Q4.2016.

Table 3: Secondary Equity Market Performance; Q4.2016/17

Month	Equity Turnover (KSHS. Bn)	Share Volume (Mn)	NSE 20-Share Index	Market Cap (KSHS. Bn)
Q4.2016				
Oct	7.84	351	3,229.22	1,985.28
Nov	10.44	461	3,247.19	1,997.03
Dec	7.11	289	3,186.21	1,931.61
End-period	**25.39**	**1,101**	**3,186.21**	**1,931.61**
Q4.2017				
Oct	9.39	315	3,729.62	2,373.43
Nov	14.76	525	3,804.69	2,562.41
Dec	11.87	452	3,711.94	2,521.77
End-period	**36.02**	**1,291**	**3,711.94**	**2,521.77**
% Change	**41.87%**	**17.26%**	**16.50%**	**30.55%**

Source: CMA/NSE

Performance of Listed Companies

Price Gainers

Table 4: Top 10 Price gainers as at 31st December 2017

Counter	VWAP as at 30th Sep 2017	VWAP as at 31st Dec 2017	% Change

[22] https://sokodirectory.com/2017/10/treasury-downgrades-2017-economic-outlook-5-1pc-5-9pc/

[23] https://www.standardmedia.co.ke/business/article/2001262391/world-bank-cuts-kenya-s-2017-economic-growth-estimate-to-4-9-percent

KENYA AIRWAYS	4.80	17.15	257.29%
UCHUMI	3.15	4.60	46.03%
NBV	2.50	3.35	34.00%
HOMEAFRIKA	1.05	1.40	33.33%
TPS SERENA	26.75	32.50	21.50%
OLYMPIA K	3.00	3.50	16.67%
EA CABLES	4.80	5.45	13.54%
SASINI	26.50	29.50	11.32%
SAFARICOM	24.75	26.75	8.08%
CENTUM	41.00	43.75	6.71%

Source: NSE

Kenya Airways: Following the implementation of the turnaround strategy underway since 2016, the company has undergone a number of changes with the latest effected during the Q4.2017, as below:

i. Conversion of GoK loans into equity following the Governments' debt conversion and subscription agreement between KQ and GoK resulting to increase of GoK's shareholding from 29.80% to 48.90% of the total issued shares in the company.

ii. Acquisition of equity by KQ Lenders Co. (a special purpose vehicle incorporated in Kenya) equivalent to 38.1% of the ordinary voting shares in the capital of KQ.

Following the restructuring, the company's shareholding now stands as below;

	Shareholder	% Shareholding
1	Government of Kenya	48.9%
2	KQ Lenders Co. Ltd	38.1%
3	KLM	7.3%

The key objectives of the restructuring were to reduce the overall level of borrowings and increase the amount of cash available to the business. The market has seen a very strong positive response to the restructuring suggesting high expectations for the final turnaround of the airline.

Centum: During the quarter, Centum effected board changes through appointment of 2 independent directors following the retirement of 3 board members in line with the Code of Corporate Governance Practices for issuers of securities to the public 2015. In addition, in September 2017, the company issued a dividend payment notice following approval by the Company's shareholders for a final dividend of KShs. 1.20 to its registered shareholders in accordance with the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002. These could have triggered positive sentiments on the company.

Uchumi: In November 2017, the CEO of Uchumi who had been in office since 2015 resigned from the retail company and was succeeded by the immediate former Chief Financial Officer of the retail outlet in an acting capacity. The smooth transition supported by the recent recruitment of a new Chief Operating Officer, seems to indicate continuity in the restructuring activities of the company such as the raising of KShs. 3 billion from sale of a 20-acre land parcel and the Government's bailout commitment as evidenced by its commitment of KShs. 1.8 billion, with the first tranche of KShs. 500 Mn released in January 2017 and second tranche of Sh700 million released in December 2017 with a further third tranche of Kshs. 600 million projected to be used in offsetting debts in Tanzania and Uganda.

Price losers

Table 5: Top ten price losers as at 31st December 2017

Counter	VWAP as at 30th Sep 2017	VWAP as at 31st Dec 2017	% Change
KAPCHORUA	81.00	65.50	19.14%
DEACONS	4.05	3.50	13.58%
KENOLKOBIL	16.00	14.00	12.50%
NIC GROUP	38.50	33.75	12.34%
FLAME TREE	5.15	4.55	11.65%
BRITAM	15.00	13.35	11.00%
TRANSCENTURY	6.70	6.00	10.45%
SCB	231.00	208.00	9.96%
KENYA RE	20.00	18.10	9.50%
KENYA POWER	9.95	9.10	8.54%

Source: NSE

Deacons: Nairobi Securities Exchange listed retailer Deacons East Africa Plc issued a profit warning and expects the net earnings for the financial year ending 31 December 2017 to be lower than 25% or more compared to 2016's earnings. The Company attributed the poor performance in 2017 to uncertainties that were brought about by the Presidential elections in Kenya during the second half period of 2017. Other factors included non-performance and closure of some branches of major anchor tenants in several shopping malls which reduced traffic into the shopping malls, prolonged drought which led to increased inflationary pressure and a reduction in disposable income coupled with the lack of consumer credit from the banks that had a direct impact on consumer spending trends.

Performance & Stability of Bond Markets

Primary Market Performance

In the primary treasury bonds market, during Q4.2017, four (4) Treasury bonds were issued. There were three (3) tap sales[24] during the quarter, one in October for the bond offers; FXD2/2017/5 and two in December for the bond offers FXD1/2008/15 and FXD1/2017/10.

The Government sought to raise KShs. 90 Billion, KShs. 87.89 Billion worth of bond applications were received with the Government accepting KShs. 65.57 Billion worth of bonds, indicating a 74.60% acceptance rate. In addition KShs. 15.07 Billion was raised from the tap sales in October and December resulting in a total of KShs. 80.64 Billion from the bond issuances in the quarter under review. In a similar quarter in 2016, the government had sought to raise KShs. 90 billion, KShs. 93.52 billion worth of bond applications were received, with the government accepting applications worth KShs. 63.28 billion, indicating a 67.66% acceptance rate

Table 6: Primary Treasury bond Performance; Q4.2016/17

	BOND	Amt. Issued KSHS. Bn	Amt. Received KSHS. Bn	Amt. Accepted KSHS. Bn
Oct. 2016	IFB 1/2016/15	30.00	35.09	30.57
Nov.2016	FXD 3/2007/15	30.00	14.49	14.29
	FXD 1/2008/20		8.40	7.88
Dec. 2016	FXD 3/2016/2	30.00	35.54	10.54
Total		**90.00**	**93.52**	**63.28**
Oct. 2017	FXD2/2017/5	30.00	20.08	13.50
	Tap Sale		-	7.25
Nov.2017	IFB1/2017/7	30.00	45.91	42.02
Dec. 2017	FXD1/2008/15	30.00	39.07	26.41
	Tap Sale		10.09	4.68
	FXD1/2017/10		-	2.68
	Tap Sale		11.81	5.37
Total		**90.00**	**126.96**	**101.91**

Source: CBK

Table 7: Secondary Bond market Performance; Q4. 2016/17

Month	Government Bond Turnover (KSHS. Bn)	Corporate Bond Turnover (KSHS. Bn)	Total Bond Turnover (KSHS. Bn)
Q4.2016			
Oct	35.18	0.06	35.24
Nov	34.71	0.29	35.00
Dec	23.29	0.20	23.49
TOTAL	**93.18**	**0.55**	**93.73**
Q4.2017			
Oct	27.25	0.50	27.75
Nov	30.59	0.45	31.04
Dec	30.30	0.02	30.32
TOTAL	**88.14**	**0.97**	**89.11**
Q4.2017/16 %Δ	**5.41%**	**76.36%**	**4.93%**

[24] A tap sale/issue allows borrowers to sell bonds or other short-term debt instruments from past issues. The bonds are issued at their original face value, maturity and coupon rate, but sold at the current market price.

Source: CBK

Performance of Corporate Bonds

As at September 2017, seventeen corporate bonds are in issue. The issued corporate bonds are held by the following five major investment groups: fund managers, banks, investment companies and institutions, insurance companies and individuals (Retail Investors).

The total outstanding amount for the corporate bonds was KShs. 79.68 Billion as at September 30, 2017 compared to KShs. 84.72 Billion as at June 30, 2017, representing a 5.94% decrease in total outstanding bond amount. This is attributable to the redemption of Centum Bond-Senior Unsecured Fixed Rate Notes at KShs. 2.9 Billion and Centum Bond-Senior Unsecured Equity Linked Notes at KShs.. 1.27 Billion upon reaching maturity on September 18, 2017 and part redemption of the Shelter Afrique Medium Term Note by KShs.835 Million and the Consolidated Bank Medium Term Note by KShs.39.3 Million.

The fund managers category took the largest portion of the bond holding at 67.21%, followed by banks at 13.53%, insurance companies at 9.01% , retail (individual) investors at 6.37% and institutions (investment companies) at 3.88% of the total bond holding.

Issuance of corporate debt however remains muted pending the resolution of Chase and Imperial Banks statutory management.

Major Market Risks

i. Equity Market Liquidity risk

In the quarter to December 2017, average quarterly equity market liquidity stood at 1.43 percent, compared to 2.25 percent registered in the quarter to September 2017, a 0.82% decrease in turnover ratio in the equities market mainly attributable to lower turnover levels in Q4.2017 compared to Q3.2017.

Table 8: Market Liquidity Concentration in 2017

Period	Turnover (KShs Bn)	Market Cap (KShsBn)	Turnover Ratio
Q4. 2017	36.02	2,521.77	1.43%
Q3 2017	53.57	2,376.69	2.25%
Q2 2017	44.90	2,224.06	2.02%
Q1 2017	37.11	1,793.36	2.07%

Source: CMA

According to the Authority's own computations, overall, annual turnover ratio recorded in 2017 was approximately 6.81%, compared to 4.62% recorded in the year 2016, indicating a 2.19% increase in liquidity levels year on year. This is however below the MSCI's target of 15 percent for an emerging market.

To address this risk, the Authority continues to facilitate implementation of key initiatives under the CMMP to support improvement in market liquidity. Such initiatives including operationalization of Securities Lending and Borrowing (SLB) - whose regulations were gazetted on 12th January 2018 will play a significant role in improving level of activity in the market.

Other initiatives such as the introduction of OTC[25] trade reporting for Bonds; Direct Market Access and leveraging on Technology among others, are anticipated to boost market liquidity.

ii. Foreign Investor Exposure risk

As at December 2017, foreign investors accounted for 64.75 percent of the total market turnover, compared to 55.68 percent as at end of September 2017. There was increased foreign investor participation in the equity market during the quarter compared to Q3.2017 with a net outflow of **KShs. 182 Million** in Q4.2017 and a net outflow of **KShs. 11, 121 Million** in Q3.2017.

Table 9: Equity Market Foreign Investor Exposure by Turnover as at December 2017

	Month	Foreign Investor Purchases	Foreign Investor Sales	Equity Turnover	Participation of Foreign Investors

[25] OTC – Over the Counter

		KShs. Millions	KShs. Million	KShs. Millions	%
Q3 2017	Jul	9,442	11,496	21,304	49.14%
	Aug	7,508	10,776	16,024	57.05%
	Sep	6,148	11,947	16,248	55.68%
Q4 2017	Oct	7,042	6,556	9,390	72.41%
	Nov	8,142	8,592	14,760	56.69%
	Dec	7,575	7,793	11,867	64.75%

Source: NSE

Table 10: Capital Market activity in East Africa

Indicator	Uganda	Tanzania	Kenya
	Q4.2017	**Q4.2017**	**Q4.2017**
Number of Shares Traded (million)	126.22	45.24	1,291.15
Turnover (USD Billion)	0.01	0.088	0.35
Number of Deals	2,231.00	2,248	66,228
Average Market Cap (USD Billion)	6.74	10.35	24.04
Turnover Ratio	0.0015	0.0085	0.014
All Share Index (Closing)	1,962.39	2,396.23	171.20
Exchange rate to the USD	3,637.08	2,230.07	103.39

****Exchange rate as at 29th December 2017***

Possible Mitigations against risks on foreign investment

To help in mitigating against any high volatility in foreign portfolio capital flows, some of the measures that could be considered include;

i. Pegging incentives on longer-dated securities investments.
ii. Encouraging transparency in government assets' record keeping.
iii. Reducing the time and cost of litigation involving securities transactions.
iv. Clarity of Insolvency laws especially when involving capital markets securities investments and their transfer among stakeholders.
v. Establishment of a collateral register
vi. Sustaining a stable macroeconomic environment.
vii. Holding broader stakeholder engagements in development of regulatory framework.
viii. Introduction of Foreign currency denominated securities.
ix. Pursuing a Euro-clear access point.
x. Market hedging mechanisms i.e. derivatives, SLBs.
xi. Clarity and transparency of double taxation treaties.
xii. Enhancing capacity of institutions e.g. potential issuers, regulators etc.

Capital Markets Developments

i. CMA conducts Stakeholder Roundtable Discussions on 2018/19 Policy Proposals

During the period under review, the Authority convened a stakeholder roundtable forum on 14th November 2017, drawing representation from the NSE, CDSC, Financial Sector Regulators, Ministries Departments and Agencies, Issuers, listed companies and Market Intermediaries to discuss the 2018/19 policy proposals on capital markets.

The main aim of the forum was to allow market stakeholders to interrogate the policy and regulatory environment with a view to identifying, refining and subsequently making proposals to the Government, for key interventions that will revitalize the capital markets to effectively play its critical role of resource mobilization as envisaged in the Vision 2030 Blueprint.

ii. Capital Markets (Securities Lending and Borrowing (SLB) and Short Selling) Regulations Gazetted

The Capital Markets (Securities Lending & Borrowing and Short Selling) Regulations, 2017 were officially gazetted on Friday 12th January 2018 following submission to the National Treasury in November 2017. Securities lending and borrowing and short selling is intended to increase overall market liquidity and flexibility of financing by increasing the volume of securities potentially available for trading and further increases depth and efficiency in the capital markets through price discovery. It will also significantly support market making.

iii. Certification Program

The certification program in Kenya continues to be a key achievement for capital markets, with 557 individuals from intermediaries successfully undertaking the International Introduction to Securities and Investments Kenya (ISII Kenya) exams and 381 taking the Regulations and Market Practice Kenya Module as of 30th September 2017. In total 938 individuals have sat for both modules as of 30th September 2017. Additionally, the Authority is in the process of collaborating with the Chartered Institute for Securities and Investments (CISI) and the Institute of Certified Investment and Financial Analysts (ICIFA) to develop a Continuous Professional Development (CPD) Module that practitioners who have passed the exams will be required to undertake on an annual basis.

CMA Strategic direction in supporting Government to achieve Vision 2030 – 2018 onwards

The Authority notes the priority development areas by the Kenya Government and is aligning its activities towards assisting the realization of the set goals for the next five years. Key areas for consideration by the Authority include;

i. Positioning Capital Markets products for use by the Government in meeting the objectives of its big 4 agenda including food security, affordable housing, affordable healthcare and manufacturing.
ii. Working with the National Treasury and the Islamic Finance Project Management Office to support the government in the issuance of the first Sukuk in the country.
iii. Aligning the Authority's initiatives on regulatory sandbox with the Governments' efforts towards making Kenya Africa's Silicon savannah.
iv. Supporting efforts towards promoting devolution by working with the National Treasury and CMMP Working Group 1 to develop products and services to assist in mobilizing capital to finance development initiatives by County Governments in line with the Public Finance Management (PFMA) Act 2012.

*iv. **Capital Markets Resource Persons***

To further enhance the Capital Markets Resource Persons' program the Authority undertook a recruitment exercise for additional resource persons during the quarter. Management shortlisted candidates with a view to select 10 professionals to represent the Authority in speaking engagements to replace the ten persons whose contracts had been terminated for being inactive. Upon finalization of the recruitment process, the Authority held a sensitization forum for 21 Resource Persons (12 newly selected and 9 whose contract had been renewed) for an orientation session on the presentation content for the various target groups on December 5th, 2017 at the Authority offices.

*v. **Fintech and Regulatory Sandbox***

The Authority has partnered with FSD(K) in securing a two pronged consultancy aimed at conducting a diagnostic study to identify fintech companies aligned with the financial services industry and developing Policy Guidance Notes on the proposed regulatory sandbox. A Consultant has since been secured for the development of the PGN.

Capital Markets Master Plan Related Consultancies

*vi. **CMA on boards an Information Repository Consultant***

With support from the World Bank under the patronage of the National Treasury, through the Financial Sector Support Project (FSSP), the Authority on-boarded Consultants from Messrs International Securities Consultants. The consultant will be responsible for developing specifications for an information repository, Advanced Financial Analysis and Business Intelligence System, E-Learning System and Communication/IT infrastructure for the Authority to be implemented over the period of 10 months. The objective of the consultancy is to streamline the Authority's use of business intelligence through improved data collection and analysis and to strengthen internal capacity through e-learning.

*vii. **Funding Gap Consultancy***

In line with its Capital Markets Master Plan, the Authority progressed activities relating to the funding gap consultancy during the quarter under review. The project consultant, Mr. Adrianus Vugz, was in country for his second visit (between 26th Sep and 6th Oct 2017) where he conducted field studies to at least twenty state corporations with a view of collecting data on their financial positions, capital expenditures and outlook on involvement of state corporations in raising development finance through the capital markets.

The institutions visited span across different regions in the country covering Western, Nyanza, Rift Valley, Coast and Nairobi Provinces.

A survey questionnaire was developed as the data collection tool for the exercise and was sent out to over 200 state corporations.

The consultant is expected to conduct the second phase of field visits for county engagements in early 2018 as the new county government leadership settles in, following the August 2017 general elections.

Upon completion of the second phase of field visits to county governments, the consultant will consolidate and present his final report; a process that is expected to be completed during the first half of 2018.

Capital Markets Stability Indicators (CMSIs)

<table>
<tr><td colspan="9">1.0 Stock Market Volatility</td></tr>
<tr><td>Equity Market Depth</td><td>Quarter/ Year</td><td colspan="4">Statistics</td><td>Assessment of Risk Level (High – Medium – Low)</td><td>Performance Brief for the Quarter</td><td>Ongoing Intervention Measures</td></tr>
<tr><td rowspan="8">NSE 20 Index Volatility Base Year = 2010</td><td rowspan="2">Q4.2017</td><td>Oct</td><td>Nov</td><td>Dec</td><td>Q. Avg</td><td rowspan="8">Low (indicative - <10% high; >10% - low)</td><td rowspan="14">• The NSE 20 Index volatility for the quarter ending Dec 2017 averaged at 0.42% as opposed to 0.53% recorded in the previous quarter, an indication of reduced volatility of the NSE 20 share index.</td><td rowspan="14">• To mitigate against high volatility, the Authority is pursuing measures aimed at increasing market stability such as the introduction of market makers, Derivatives, Securities Lending and Borrowing, Direct Market Access among others.</td></tr>
<tr><td>0.62%</td><td>0.36%</td><td>0.28%</td><td>0.42%</td></tr>
<tr><td rowspan="2">Q3.2017</td><td>July</td><td>Aug</td><td>Sep</td><td>Q. Avg</td></tr>
<tr><td>0.40%</td><td>0.58%</td><td>0.62%</td><td>0.53%</td></tr>
<tr><td rowspan="2">Q2. 2017</td><td>April</td><td>May</td><td>June</td><td>Q. Avg</td></tr>
<tr><td>0.49%</td><td>0.43%</td><td>0.29%</td><td>0.40%</td></tr>
<tr><td rowspan="2">Q1.2017</td><td>Jan</td><td>Feb</td><td>Mar</td><td>Q. Avg</td></tr>
<tr><td>0.33%</td><td>0.38%</td><td>0.33%</td><td>0.35%</td></tr>
<tr><td rowspan="6">NASI Volatility Base Year = 2010</td><td rowspan="2">Q4.2017</td><td>Oct</td><td>Nov</td><td>Dec</td><td>Q. Avg</td><td rowspan="6">Low (indicative - <10% high; >10% - low)</td></tr>
<tr><td>0.39%</td><td>0.69%</td><td>0.42%</td><td>0.50%</td></tr>
<tr><td rowspan="2">Q3.2017</td><td>July</td><td>Aug</td><td>Sep</td><td>Q. Avg</td></tr>
<tr><td>0.27%</td><td>0.64%</td><td>0.71%</td><td>0.54%</td></tr>
<tr><td rowspan="2">Q2. 2017</td><td>April</td><td>May</td><td>June</td><td>Q. Avg</td></tr>
<tr><td>0.64%</td><td>0.65%</td><td>0.67%</td><td>0.65%</td></tr>
</table>

	Q1.2017	**Jan**	**Feb**	**Mar**	**Q. Avg**			
		0.36%	**0.19%**	**0.55%**	0.37%			
Turnover Ratio	**Q4.2017**	**Oct**	**Nov**	**Dec**	**QTR**	**Medium (indicative – annual: <8%- Low; >15% High)**	• A turnover ratio of **1.45%** was recorded in the reporting period indicating compared to 2.23% in the preceding quarter indicating decreased trading activity in the reporting period. This could be attributed to the prolonged uncertainty following the repeat presidential elections as investors may have adapted a wait and see approach to trading.	• To improve the turnover ratio, The Authority is spearheading new initiatives aimed at expanding product choice for investors e.g. GDN/R as well as continuously conducting investor education and public awareness to harness investor knowledge on capital markets trading activities and participation.
		0.40%	0.58%	0.47%	1.45%			
	Q3.2017	**July**	**Aug**	**Sep**	**QTR**			
		0.90%	0.65%	0.68%	2.23%			
	Q2. 2017	**April**	**May**	**June**	**QTR**			
		0.59%	0.70%	0.77%	2.06%			
	Q1.2017	**Jan**	**Feb**	**Mar**	**QTR**			
		0.68%	0.69%	0.66%	2.03%			
2.0 Foreign Exposure Risk								
Foreign Investor turnover as a % of total turnover	**Q4.2017**	**Oct**	**Nov**	**Dec**	**Q. Avg**	**Medium (indicative – annual: <40%- Low; >90% High)**	• Average Foreign investor participation in the review period averaged to **64.71%**, a 10.75% increase from **53.96%** recorded in the preceding quarter confirming domination of foreign investors in Kenya's markets.	• Despite the Authority's initiatives towards increasing foreign investor activity in Kenyan markets such as introduction of inbound GDR/DN as well as scrapping off the 75% foreign investor cap on ownership of listed companies, the Authority is also targeting retail and local investors to participate more in the markets by reaching out to the diaspora population as potential investors to tap into the huge diaspora remittances earned from the diaspora community.
		72.41%	56.69%	65.02%	64.71%			
	Q3.2017	**July**	**Aug**	**Sep**	**Q. Avg**			
		49.14%	57.05%	55.68%	53.96%			
	Q2. 2017	**April**	**May**	**June**	**Q. Avg**			
		72.41%	63.40%	57.94%	**67.91%**			
	Q1.2017	**Jan**	**Feb**	**Mar**	**Q. Avg**			
		79.81%	73.37%	76.87%	**76.6%**			
	Q4.2017	**Oct**	**Nov**	**Dec**	**Q. Sum**	**High**		

Net Foreign Portfolio Flow (In KShs. Millions)		486	(450)	(218)	(182)	**(indicative – annual: <Kshs (50million) - High (outflow; >KShs. 50 million High inflow)**	• Net Foreign Portfolio levels for the quarter amounted to a total inflow of **KShs. 36 Mn,** an improvement from the net outflows of **KShs. 11,121 Mn** and **KShs. 2,268 Mn** recording in the last two quarters.	
	Q3.2017	**July**	**Aug**	**Sep**	**Q. Sum**			
		(2,054)	(3,268)	(5,799)	(11,121)			
	Q2. 2017	**April**	**May**	**June**	**Q.Sum**			
		433	(1,888)	(813)	(2,268)			
	Q1.2017	**Jan**	**Feb**	**Mar**	**Q. Sum**			
		1,608	435	(55)	**1,988**			
Market Concentration (Top 5 companies by market cap)	**Q4.2017**	**Oct**	**Nov**	**Dec**	**Q. Avg**	**High (indicative – annual: >50% High concentration)**	• During the quarter, the top five companies by market capitalization accounted for 65.60% of the market value, confirming the market's susceptibility to the performance of these few companies. • The top five companies include SAFARICOM, EQUITY, EABL, KCB, and CO-OP being the predominant companies.	• Though a persistent problem, the Authority is pursuing policy proposals such as revival of privatization to enable highly profitable state corporations to list on the exchange providing investors with more options of listed companies to invest in. The Authority is also reviewing its public offers regulations to identify regulatory roadblocks inhibiting small and medium enterprise companies from listing and raising funds from the exchange.
		65.94%	65.89%	64.96%	**65.60%**			
	Q3. 2017	**July**	**Aug**	**Sep**	**Q. Avg**			
		66.10%	66.19%	65.62%	**65.97%**			
	Q2. 2017	**April**	**May**	**June**	**Q. Avg**			
		66.04%	65.49%	66.04%	**65.86%**			
	Q1. 2017	**Jan**	**Feb**	**Mar**	**Q. Avg**			
		64.8%	64.9%	63.7%	**64.5%**			
3.0 Government Bond Market Exposure								
Treasury Bond market turnover Concentration		**Oct**	**Nov**	**Dec**	**Q. Avg**	**High (indicative – annual: >50% High concentration)**	• The Treasury bond market remains dominant in the Kenyan bond market, accounting for an average of 98.81%	• Despite the challenges surrounding bond investor compensation, the Authority is through the Bond Market Steering Committee (BMSC) actively pursuing the expansion of the bond markets.
		98.39%	98.10%	99.95%	**98.81%**			
	Q3.2017	**July**	**Aug**	**Sep**	**Q. Avg**			
		99.97%	97.68%	99.93%	**99.19%**			
	Q2. 2017	**April**	**May**	**June**	**Q. Avg**			

	| | 98.84% | 98.40% | 99.01% | **98.75%** | | **Q1. 2017** | **Jan** | **Feb** | **Mar** | **Q. Avg** | | | 98.4% | 98.99% | 99.7% | **99.0%** |		during the period under review; a marginal decrease of 0.38% compared to the preceding quarter.	
Corporate Bond Market ownership	| **Category** | **No of Investors** | **Amount Outstanding (Mn)** | **% of total outstanding** | | **Local Investors** | 4,712 | 72,064.26 | 98.80% | | **East African Investors** | 21 | 183.68 | 0.25% | | **Foreign Investors** | 115 | 692.45 | 0.95% | ***Source: CDSC Data as at September 2017***	**High (indicative – annual: >50% High concentration)**	• Local Corporate bond investors were the leading investors in corporate bonds at 99.05% of amounts outstanding, while foreign bond investors held 0.95% of total corporate bond holdings.	
4.0 Investor Profiles - Equity Market				
Equity Market	| **Type of Investor** | **2014** | **2015** | **2016** | **2017*** | | E.A. Institutions (%) | 64.16 | 65.68 | 66.38 | 68.36 | | E.A. Individuals (%) | 14.58 | 12.84 | 12.49 | 11.50 | | Foreign Investors (%) | 21.26 | 21.48 | 21.13 | 20.154 | ***Source: CMA- *Data as at November 2017***	**High (indicative – annual: >50% High concentration)**	• Local investors, a sum of East African institutional and individual investors accounted for 79.86% of shares held in the equity market with 20.15% being held by foreign investors.	• To attract local investors make sizeable investments, the Authority is targeting corporate and retail investors by conducting investor education to demystify the capital markets as a safe investment option for long term investors as opposed to short-termism.
5.0 Investor Compensation Coverage				
Settlement Guarantee	| **Q4.2017** | **Oct** | **Nov*** | **Dec*** | **Q. Avg** | | | 1.57 | - | - | 1.57 |	**Medium**		

Fund (SGF) Coverage Ratio	Q3.2017	July	Aug	Sep	Q. Avg	(indicative – annual: > 1 times, implies full coverage)	• SGF Ratio for the month of Oct 2017 was 1.57, an increase from the ratio recorded in Sep 2017. This is an indication that the Guarantee Fund balances are sufficient to cover any liability that would arise following default by securities brokers.	• The Authority has been monitoring the SGF figures and the financial position of the firms to ensure that they are in good standing and that investors are protected.
		0.75	1.06	1.00	0.93			
	Q2. 2017	April	May	June	Q. Avg			
		1.15	1.03	0.87	**1.02**			
	Q1. 2017	Jan	Feb	Mar	Q. Avg			
		1.36	1.25	1.46	**1.36**			
		*Source: CDSC - Data as at October 2017 *November and December statistics were not available as at the time of the publication*						

6.0 Asset Base of Fund Managers, Stockbrokers, Investment Banks

As at 31st October 2017 (Amount in KSHS. Millions)

CMA Licensee	Total Assets	Total Liability	Net Assets			
Fund Managers	7,706.70	2,516.06	5,190.64	Medium (Indicative – the higher the figure, the more stable is the market)	• The total Asset Base of Fund Managers, Stockbrokers, Investment Banks and Investment advisers as at 31st October 2017 was KShs. 7.7 Billion, 3.07 Billion, KShs.12.19 Billion and KShs. 1.03 Billion respectively.	• The Authority continuously monitors asset levels of its licensees to ensure accurate reporting of assets and liabilities and monitoring sufficiency of liquid capital to monitor potential bankruptcy of licensees.
Stockbrokers	3,070.01	1,064.20	2,005.81			
Investment Banks	12,189.03	3,861.47	8,327.55			
Investment Advisers	1,027.53	130.08	897.45			

Source: CMA/CDSC/NSE Data as at 31st October 2017

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6. IMF Reports
7. Statutory reports/submissions (to CMA)

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