Women's World Banking: Capital Markets Guide

KENYA

Women's World Banking

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KENYA

CAPITAL MARKETS ACCESSIBILITY CHART	DIFFICULTY LEVEL
Investment Considerations for Foreign Investors	
Investment Regulatory Requirements:	
Foreign Direct Investment (FDI)	Medium
Portfolio Investments (PI)	Medium
Foreign Credit	Medium
FX Convertibility	Low
Repatriation	Low
Taxes on Gains	Low
Taxes on Income (dividends)	Medium to Low (depending on jurisdiction)
Issuance Considerations for MFIs	
Publicly Registered Securities	Low to Medium
Private Placements	Low to Medium

Contents

Contents (continued)

Summary Overview of Microfinance Markets and Capital Markets

Microfinance Market Overview

History and growth

The Kenyan microfinance industry is one of the oldest and most established in Africa. Informal microfinance practices emerged alongside the introduction of money as a medium of exchange in the colonial era. Such practices included Burial Societies, Rotating Savings and Credit Associations (ROSCAs) and moneylenders.[i]

The establishment of the Joint Loan Board Scheme in the 1950s, which provided credit to Kenyans with small trading businesses, was a key step towards formalizing microfinance in Kenya. By the 1970s the main organizations providing credit to the Micro and Small Enterprise (MSE) sector were church based organizations like the National Council of Churches of Kenya (NCCK) and other smaller non-governmental organizations (NGOs). The 1980s saw the emergence of a number of indigenous financial institutions, most notably Equity Bank, K-Rep and Kenya Women Finance Trust (KWFT), which were all created to provide credit programs largely outside the banking sector as well as outside of the government.[ii]

The Association of Microfinance Institutions of Kenya (AMFI) is a network of development institutions that share a common goal of promoting economic growth. The AMFI was registered in March of 1999 with the objective of providing guidance towards regulating the microfinance industry. The 52 AMFI members include institutions of different legal structures such as co-operatives, NGOs and banks providing financial services to 6,500,000 poor and middle-class families across the country.

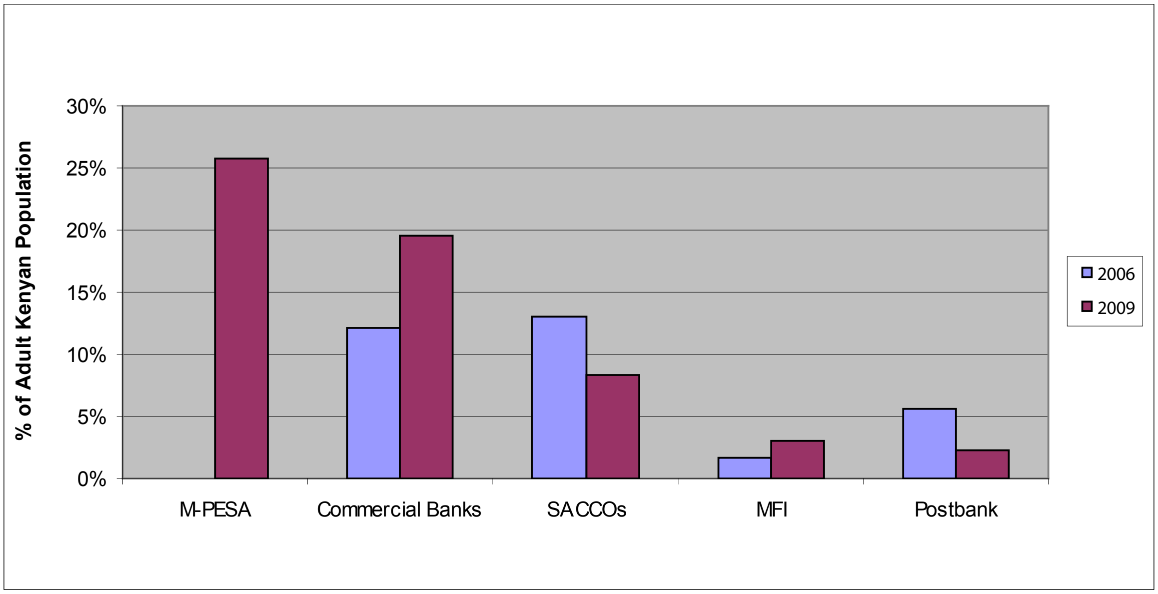
The Micro Enterprises Support Program Trust (MESPT) is dedicated to promoting economic growth through supporting business in Kenya.[iii] Founded by the Government of Kenya and the Delegation of European Union, MESPT works with intermediaries to provide financial support and business development services. The organization is focused on three key areas:

- The financial services component that makes loans to financial intermediaries for "on-lending" to enterprises.
- The business development services component that offers guidance on non-financial areas of business such as product development, technology and productivity.
- The institutional support and capacity building component that helps the financial services and Business Development Services (BDS) groups offer more effective services.

When it comes to microfinance institution (MFI) penetration, the landscape is shifting. In 2006, MFIs reached just 1.7% of the adult Kenyan population. The formal financial system served 25%, Savings and Credit Cooperatives (SACCOs) and commercial banks served 13%

and 12% of the population respectively, and 5.6% of the population held accounts with the Post Office Savings Bank (Postbank). By 2009, the picture had changed significantly. While the MFI base nearly doubled to reach 3.1%, SACCOs lost a quarter of their customers to reach a membership of 8.5% of the population, and Postbank lost half of its customer base, accounting for just 2.2% of the population. Also notable was the rapid adoption of M-PESA, the mobile transfer and payments system. By 2009, M-PESA had 5.3 million registered customers, approximately 25% of the population.[iv]

Table 1: Change in Financial Services Market Penetration 2006-2009



Source: FinAccess Financial Inclusion in Kenya Survey 2009

Today, there are three tiers of institutional players in the Kenyan microfinance space:[v]

1. Formal institutions: Banks and non-bank institutions, licensed SACCOs
2. Semi-Formal Institutions: Unlicensed SACCOs
3. Non-governmental organizations and Informal Institutions: ROSCAs and moneylenders

Governing Regulations

The Central Bank of Kenya (CBK) regulates deposit-taking microfinance institutions under the Microfinance Act of 2006. The Microfinance Act was created with the main objective of regulating Kenyan Microfinance Institutions. The Act requires mandatory audits of MFIs by the Central Bank of Kenya,[vi] and enables deposit-taking MFIs licensed by the Central Bank to mobilize savings. The Act is also intended to prevent bogus MFIs from operating, and includes provisions for fines of up to KSh 1million (US$14,376) for MFIs who do not comply with guidelines.

Faulu Kenya Limited was the first MFI to receive a license to accept deposits in Kenya from the CBK in 2009.[vii] Nine other MFIs were on track to being registered to receive licenses for deposit taking by the end of 2009,[viii] although presently only six MFIs are fully registered deposit taking MFIs with the CBK.[ix]

Table 2: Deposit Taking MFIs

MFI	DATE	BRANCHES
Faulu Kenya DTM Limited	5/21/2009	27
Kenya Women Finance Trust DTM Limited	3/31/2010	15
Remu DTM Limited	12/31/2010	2
SMEP DTM Limited	12/14/2010	6
UWEZO DTM Limited	11/8/2010	2
Rafiki DTM	6/14/2010	3

Source: Central Bank of Kenya

Regulations for non-deposit taking MFIs are not yet in place, although the Ministry of Finance is in the process of developing regulations for supervising and licensing these organizations.

The Sacco Societies Regulatory Authority (SASRA) licenses, regulates and supervises Sacco Societies under the Sacco Societies Act of 2008. The Act requires all Sacco Societies carrying out deposit-taking business to apply for licenses from SASRA (Section 23 of the Act and Regulations 4). Deposit-taking Sacco societies in the context of the Act refer to the Sacco Societies operating Front Office Savings Activity (FOSA) accepting deposits.

Branchless Banking Regulations:[x]

Safaricom, a joint venture of the Kenyan government and Vodafone, launched pioneer branchless banking in Kenya with the M-PESA mobile-phone based payment service in March 2007. As of January 2010, M-PESA has 14,700 agents and about 9 million users and has facilitated about KSh300 billion in person-to-person transfers since the business started. In 2008, legislative initiatives demonstrated a keen interest by the government in enabling an environment for branchless banking. These initiatives include:

- A 2008 regulation permitting microfinance deposit-taking institutions to use agents.
- A 2009 amendment to the Banking Act that permits banks to appoint agents to take deposits and perform other activities.
- Passage by Parliament in late 2009 of an Anti Money Laundering / Counter Terrorist Funding bill, which applies to both bank and nonbank institutions.[xi]

In addition to the above, a new National Payments Systems Bill 2011[xii] came into effect for the regulation and supervision of payment service providers. The bill seeks to reform the payment system and promote investor confidence by enhancing credible transactions. The bill also aims to secure electronic payment systems against illegal activity such as money laundering and pyramid schemes.[xiii]

Largest Players

The most influential MFIs in Kenya include: Equity Bank, KWFT, K-Rep, and Faulu Kenya (see Table 3). Many have recently become licensed to accept deposits.

Table 3: Leading Kenyan Microfinance Institutions in 2010

NAME	GROSS LOAN PORTFOLIO USD	NUMBER OF ACTIVE BORROWERS
Equity Bank	924,993,804	524,902
KWFT	152,136,208	413,040
K-Rep	74,182,292	65,073
Faulu - KEN	33,175,452	85,226
ECLOF - KEN	4,659,777	15,513
Opportunity Kenya	3,945,205	7,341
BIMAS	3,261,690	9,749
Micro Kenya	3,062,156	5,765
MCL	2,097,252	17,550
UBK	126,180	1,429

Source: http://www.mixmarket.org/mfi/country/Kenya

Notable Recent MFI Capital Market Transactions

Faulu Kenya Bonds (2005)

In 2005, Faulu Kenya Limited paved the way for MFIs raising capital through corporate issuance. Faulu Kenya was the first African MFI to issue a bond. Faulu Kenya announced plans to issue a KSh500 million corporate bond via the Nairobi Stock Exchange. The institution accessed medium-term funding with the goal of providing affordable lending to its informal clients who had previously been shut out of receiving credit. Stanbic Bank arranged the issue, which was approved by the Capital Markets Authority and the Nairobi Securities Exchange and 75% guaranteed by the French Development Agency(AFD).[xiv]

Equity Bank Initial Public Offering (2006)

When Equity Bank had its initial public offering on the Nairobi Stock Exchange in 2006, it was the second MFI to be publicly listed. In 2007, African investment firm Helios EB made an investment in Equity Bank, and became the largest shareholder, holding 25% of the stock.[xv]

Overview of Capital Markets

General Size and Activity of Local Capital Markets

The Kenyan capital market can trace its roots to as early as the 1920s stock exchange, but it was not until 1954 that the London Stock Exchange formally recognized the Nairobi Securities Exchange (NSE). More recently, through governmental growth and regulation initiatives in the past 10 years, there has been greater transparency and efficiency in the NSE that has enabled it to grow into an exchange that boasts both primary and secondary equity and debt markets.[xvi]

Equity Market

The Nairobi Securities Exchange is the principal stock exchange in Kenya. With the fifth largest market capitalization in Africa, the NSE currently has a market capitalization of approximately US$12 billion. Whereas most of Africa's other 22 stock exchanges are quite small with market capitalization under US$10 billion and with low liquidity, the NSE is able to thrive as a result of Kenya being Eastern and Central Africa's hub for financial, communications and transportation services.[xvii]

The share market was at its most vibrant prior to the global crises, with issuers like Equity Bank, Kengen and Safaricom experiencing enormous success in their Initial Public Offerings. However Kenya, like most of its African peers, is considered a frontier market. Similar to emerging markets, Kenya is susceptible to exogenous shocks. Following the global crises, the impact was evident in the sharp depression of the share indices exacerbated by the relaxed exchange control as investors rapidly unwound their equity positions. The bourse has since gradually recovered due to increased local participation and resilient corporate performance.

As of September 2011, the NSE has 58 listed companies and has slated five initial public offerings for the year. Additionally, there are multiple cross-listed equities with neighboring countries that are beneficial to both home and host countries.

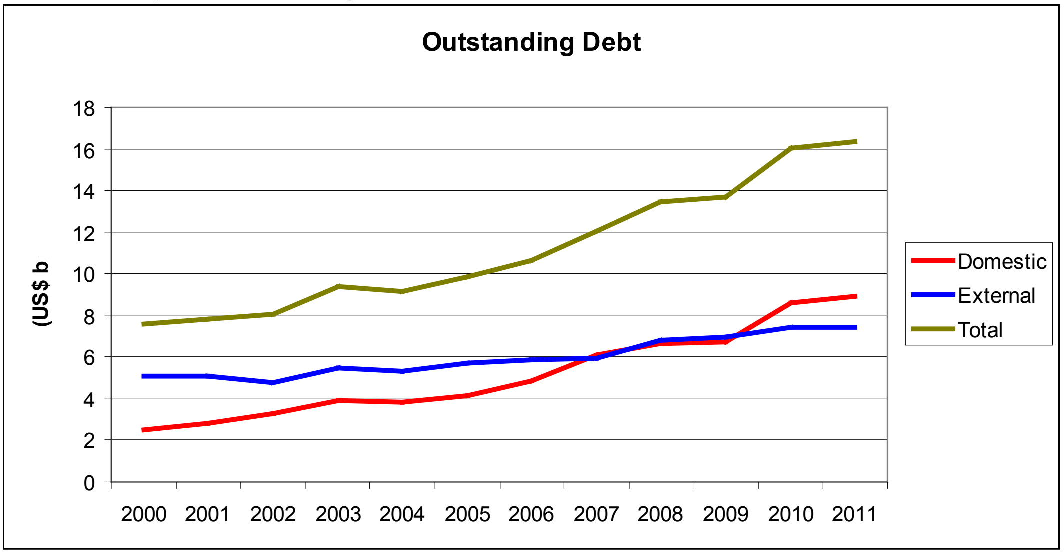
Debt Market

The Kenyan fixed income market has shown significant growth since its inception in the early 1980s. The Kenyan debt market has a variety of debt instruments ranging from traditional government bonds across short-end bills, notes and long bonds, to floating rate, corporate, and municipal bonds.

In 2009, the government introduced the region's first infrastructure bond. This formed a new class of issuance by the government in an effort to raise funds for the country's growing infrastructure needs. To date, approximately KSh94 billion (US$940 million) has successfully been raised by the government through the program, with the bonds offered across the board to retail and institutional investors. The bonds offer tax incentives for holders, and consequently attract active interest from the offshore community, especially from the Kenyan diaspora.

As of February 2011, Kenya's outstanding public debt is KSh13 billion, which encompasses both domestic and external debt, with the former contributing to 55.4% compared to the latter's 44.6% of outstanding debt.[xviii]

Table 4: Kenyan Outstanding Debt 2000-2011



Source: Central Bank of Kenya Monthly Economic Review February 2011, p.5[xix]

The domestic debt issuance is primarily concentrated in government issued bills and bonds. More recent developments in the debt markets include the debut of long bonds, which increase the Kenyan yield curve to the 30y tenor point. This has additionally provided a platform for the pricing of mortgage products of similar maturity in the marketplace.[xx] Multilateral creditors hold 60% of external debt in the Kenyan markets. Bilateral creditors hold 36%.[xxi]

Growth of Markets

In a continued dedication to growing the Kenyan capital markets, the following short term initiatives are planned to further increase local and international participation within the market place:

Demutualization

Via the Finance Act of 2010, the NSE will transform from a member-owned entity into a shareholder corporation. The clear decoupling of being a shareholder of the NSE and a member of the Exchange will allow for greater efficiency and shareholder driven initiatives. The current project is being spearheaded by the Exchange in collaboration with the Kenya Association of Stockbrokers and Investment Banks (KASIB) and the Capital Markets Authority (CMA).[xxii]

Technology

There has been significant investment (KSh104 million) by the Government of Kenya to improve and streamline the integrity of trading systems. The investment will implement a standard Broker Back Office system that will be interwoven with the existing Automated Trading System (ATS) and Central Depository System (CDS) to create a straight through processing workflow. This will minimize human interaction and maximize market security and efficiency.[xxiii] By investing in such improvements, the government continues to grow consumer confidence and create greater access to the markets via internet trading.

New products

In an effort to meet the demands of the public and expand its equity offerings, the NSE (in conjunction with the CMA), will look to expand into Real Estate Investment Trusts (REITS) and Exchange Traded Funds (ETF) in the coming year.[xxiv] An indication of the global outlook of the NSE, the exchange is also partnering with FTSE International to introduce NSE/FTSE branded equity and fixed income indices. With more ways to invest, the NSE looks to continue its growth from international investors within their markets.

Key Players

As of January 2011, 58.2% of total equity turnover can be attributed to domestic investors, whereas foreign investors contribute 41.8%.[xxv] Advancements in recent legislation and market infrastructure and increases in depth of products have given rise to an increase in foreign investor involvement.

The Kenyan diaspora has also impacted investments. Given the increased importance of the contributions made by the diaspora in the creation of wealth and investment into the country, the Central Bank of Kenya has recorded remittances on a monthly basis since 2004. From that time, the year to date amount of remittances has reached over US$600 million.

In the local fixed income market, the main issuer of domestic debt is the Kenyan Central Bank. As of early 2011, more than 95% of the outstanding KSh720 billion was in traditional government bonds, localizing mainly in the front and short end of the yield curve. The holders of these treasury instruments are primarily the local commercial banks. In the external debt market, the main creditors can be deconstructed to multilateral and bilateral creditors. The largest players in the external debt market continue to be the International Development Association (multilateral) and Japan (bilateral).

Regulatory Framework and Bodies

There are three main regulatory frameworks within the Kenyan Capital Markets:

Capital Markets Authority (CMA) is the government regulator in charge of licensing and regulating the capital markets in Kenya. Established under the Capital Markets Act of 1989, the CMA regulates all market participants and public offerings, while also overseeing the long term development and refinement of the Kenyan capital markets.

The Central Depository and Settlement Corporation (CDSC) provides clearing, delivery and settlement services for securities traded at the Nairobi Stock Exchange. The CDSC provides an efficient and safe way for buyers and sellers to make their exchanges.

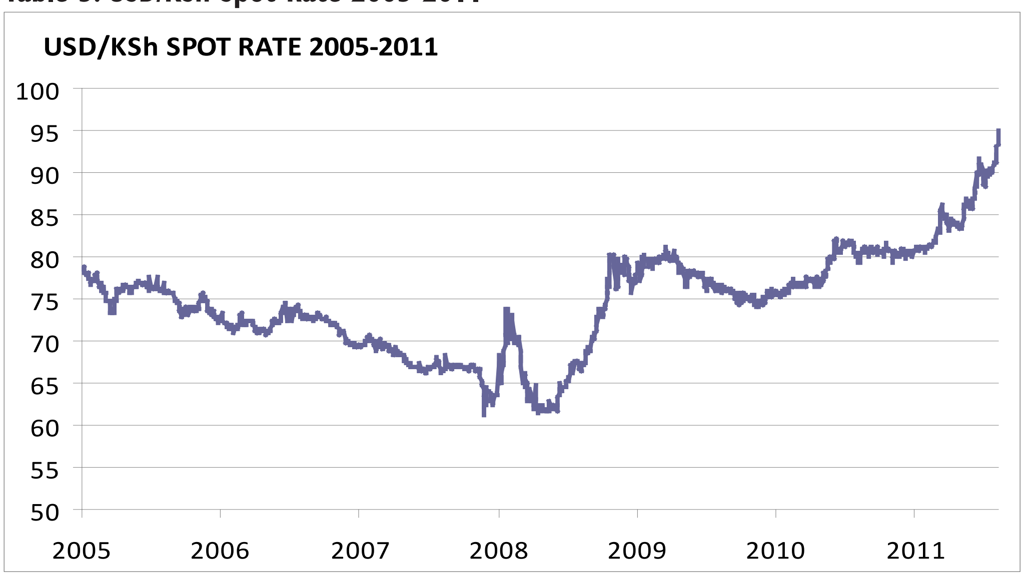
The Nairobi Stock Exchange, although licensed and regulated by the Capital Markets Authority, also has the mandate of providing a trading platform for listed securities and overseeing its member firms.

Local Currency and Description of Convertibility

The Kenyan Shilling is the official currency of Kenya, and has a floating exchange rate against other foreign currencies. The CBK will occasionally intervene at limited levels to smoothen volatility, using U.S. dollars as the principle intervention currency. [xxvi]

The shilling has been relatively stable in recent years until late 2007, when it increased significantly in value, even trading briefly below KSh60 to the dollar. In the aftermath of post-election violence on December 27, 2008, both the economy and the shilling suffered a serious decline. Recent escalation of oil and food prices has also taken its toll on the Kenyan economy, and as of November 2011, the shilling was trading at more than KSh90 to the dollar. [xxvii]

Table 5: USD/KSh Spot Rate 2005-2011



Source: Bloomberg

Kenya has no restrictions on converting or transferring funds associated with investment, as the Exchange Control Act (which severely limited the scope of foreign currency transactions) was repealed in 1996 to promote investment. Foreign exchange is now readily available from commercial banks and foreign exchange bureaus, and can be freely bought and sold by local and foreign investors.[xxviii]

However, recent volatility in the local market has forced the CBK to implement extraordinary measures to protect the currency such as restrictions to foreign investment that are intended to be temporary. As such, investors are advised to fully investigate the extent of these changing restrictions and their impact before pursuing investments.

Accounting Standards Prevalent for the Market, and Reconcilability with US GAAP or IAS

The regulation of accounting and auditing standards in Kenya has been controlled by the ICPAK (Institute of Certified Public Accountants of Kenya) since the early 1980s. In 1998, the Council of the ICPAK adopted international standards for financial reporting in Kenya, which thereby became Kenyan standards. Enterprises of all sizes and types must be compliant with International Accounting Standards (IAS), and all financial statements covering periods beginning January 1, 1999 must be prepared in accordance with IAS. [xxix]

Foreign Participation

The Kenyan equity markets have become increasingly open to foreign investment over the last five to seven years. In 2004, foreign participation in the NSE (Nairobi Stock Exchange) was largely non-existent. At the end of 2010, however, it stood at 28.1%, and has jumped to 56% by December 2011.[xxx]

A number of blue chip companies that trade on the NSE have significant foreign ownership, including Barclays (69.9% foreign ownership), Unilever Tea Kenya (88.3%), Standard Chartered Kenya (74.8%), Bamburi Cement (71.5%), BAT Kenya (62.4%), Total Kenya (79.1%), Standard Group (69.6 %), PBS Eastern Africa (68.6%) and BOC Kenya (66.2%). According to some estimates, Kenyan policies on foreign investment generally have been favorable, and seventy percent of the industry is owned from abroad.[xxxi]

Kenya's corporate bond market is still in the early stages of development, and foreign participation has been low due to limited liquidity. [xxxii]

Securities Exchanges

Overview of Debt/Equity Exchanges

Established in 1954, the Nairobi Stock Exchange was the principal stock exchange of Kenya and the leading securities exchange in East Africa. The exchange is licensed and regulated by the CMA which is the government regulator established to promote, regulate and facilitate the development of orderly, fair and efficient capital markets in Kenya.

Recently the Nairobi Stock Exchange changed its name to the Nairobi Securities Exchange in anticipation of offering a wider range of products on the exchange such as futures, derivatives and REITs. The Nairobi Securities Exchange offers a platform for the issuance and trading of debt securities and the change of name is in line with its strategic plan to evolve into a full service securities exchange which supports trading, clearing and settlement of equities, debt, derivatives and other associated instruments.

Both debt and equity instruments are traded on the NSE. As of October 18th, 2011, the capitalization of the index stood at 881.10 with total shares traded amounting to 5,543,100.

The NSE-20 share index, which tracks the performance of the top 20 blue-chip stocks is the key indicator. The NSE All Share Index, introduced in early 2008, tracks the overall market performance and stood at 3301.18 as of October 18th, 2011.

The NSE has recently moved to a T+3 settlement cycle for both bond and equity transactions in line with international best practices. This progression is intended to increase efficiency, reduce risk and improve liquidity in the market, making it more attractive to domestic and foreign investors. This move is in line with the NSE's vision of becoming a leading securities exchange in Africa that maintains a global reach.

Rating Requirements

Currently the CMA does not require capital market transactions to be rated. The reason for this is that global agencies such as Fitch, Standard and Poor's and Moody's have historically not provided a national scale of ratings for jurisdictions such as Kenya. Investors typically perform their own due diligence. As the capital markets evolve to cater to more structured products such as asset backed securities, ratings may become a requirement. However, some issuers have voluntarily obtained ratings from Global Credit Ratings (a South African ratings firm active in the region) which is currently the only firm registered with the CMA to provide national ratings, and which has rated a handful of issues in the local capital market.

Notable Recent Transactions

Shelter Afrique, a credible Pan African housing finance institution in Africa listed a KSh2.5 billion (US$26.7 million) 3 year tranche under its KSh3 billion (US$32 million) medium-term note (MTN) program in September 2011.[xxxiii] The issue was fully subscribed with banks taking 47.2% of notes whilst institutional and retail investors took 42.9% and 9.9% respectively. This issue is larger in size than previous issues (KSh350 million in 2000 and KSh500 million in 2006) clearly demonstrating the confidence that the market is well regulated, deep and liquid. Funds raised through the Shelter Afrique MTN will be used to develop private housing infrastructure for Kenya's growing middle class.[xxxiv]

British American Investment Company Ltd. ("Britak") launched an IPO in July 2011 which represented the first IPO to be listed on the NSE in 2011, and the first since the Co-Operative Bank IPO in 2008. Britak issued KSh650 million new ordinary shares at KSh9 (US$0.10) each. Investors comprised of East African retail investors (30%), foreign investors (30%), institutional investors (37%) and employees, agents and individual life policy holders (3%). KSh1 billion of the proceeds will be used for new investments and entry into the regional market and KSh1.3 billion would be used to grow its Kenyan insurance businesses and to expand its asset management business.[xxxv]

Safaricom Limited, Kenya's largest mobile operator, required financing for capital expenditure for its expanding network. Safaricom wished to establish itself in the capital markets as a standalone issuer, as its previous bond was issued under an ECA guarantee. The company set up a KSh12 billion (US$128 million) DMTN programme to tap the local debt capital markets. A first tranche of KSh7.52 billion (US$80.2 million) was issued in November 2009 and a second tranche of KSh4.5 billion (US$48 million) in December 2010. Both tranches were raised locally and fully subscribed indicating strong investor demand for this type of credit. The investor base consisted of banks and fund managers with Old Mutual Asset managers, Co-Operative Bank of Kenya Ltd., Stanbic Investment Management Services, Kenya Commercial Bank Ltd. and Equity Bank Ltd. being amongst the top 5 investors.[xxxv]

The Central Bank of Kenya recently issued a 12 year infrastructure bond targeted at Kenya Diaspora through which it managed to raise KSh11.6 billion (US$123.7 million). The coupon rate offered was 12%. The proceeds of the bond will be used to finance infrastructure projects for the roads, energy and water sectors. [xxxv]

Current corporate bond issuers as at Q2 2011 include Shelter Afrique, Safaricom, KenGen, Mabati Rolling Mills, Barclays and PTA Bank. Maturities of corporate bonds range from 2 to 9 years. In July 2011, outstanding corporate bonds amounted to KSh57 billion– having more than doubled 2008 levels – as a result of a few large corporate borrowers including Kengen (KSh15 billion) and Safaricom (KSh12 billion) issued in 2009 and 2010. [xxxv]

Banking Sector Overview

Brief Overview of the Banking Sector

The Central Bank of Kenya (CBK) is the main regulatory body for the banking sector in Kenya.[xxxv] The CBK falls under the Ministry of Finance and its primary objective is to formulate and implement monetary policy to achieve and maintain stability in price levels as well as to foster liquidity, solvency and proper functioning of a stable market based financial system. The Kenyan Bankers Association (KBA) is the body which protects the banking sectors interests. The KBA is formed by banks and is the main forum to address issues affecting member banks.

The Companies Act, the Central Bank of Kenya Act, the Banking Act, and the various prudential guidelines issued by the CBK are the main regulations in the Kenyan banking industry. In 1995, the banking sector was liberalized and exchange controls were lifted. The Microfinance Act of 2006 also plays a key role in the banking sector, especially with respect to its efforts in deepening the financial markets in Kenya. By allowing for deposit taking MFIs, it has helped mobilize savings from the general public.

Mobile banking plays a significant role in the Kenyan banking sector. M-Pesa, a small-value electronic payment system accessible through a mobile phone network, has been adopted by approximately 40% of the Kenyan population.[xxxvi] The system met with heavy resistance from the commercial banks in Kenya, but following a CBK audit M-Pesa has been allowed to continue operating since it promotes financial inclusion within the country. Banks are now becoming an agent of the product.

Key Players

As of June 30, 2011, the Kenyan financial sector comprises 43 commercial banks, one mortgage finance company, six deposit taking microfinance institutions, two credit reference bureaus, three representative offices and 124 foreign bureaus. The five largest banks (by total assets) are Kenya Commercial Bank, Barclays of Kenya, Co-Operative Bank of Kenya, Standard Chartered Bank of Kenya and Equity Bank. It is interesting to note that Equity Bank is considered one of the biggest banking players in Kenya but is also classified as an MFI, indicating that microfinance plays a significant role in the banking sector.

The sector is dominated by local players[xxxvii] with 27 institutions accounting for 58% of the industry's total assets in 2010.[xxxviii] During the year of 2010:

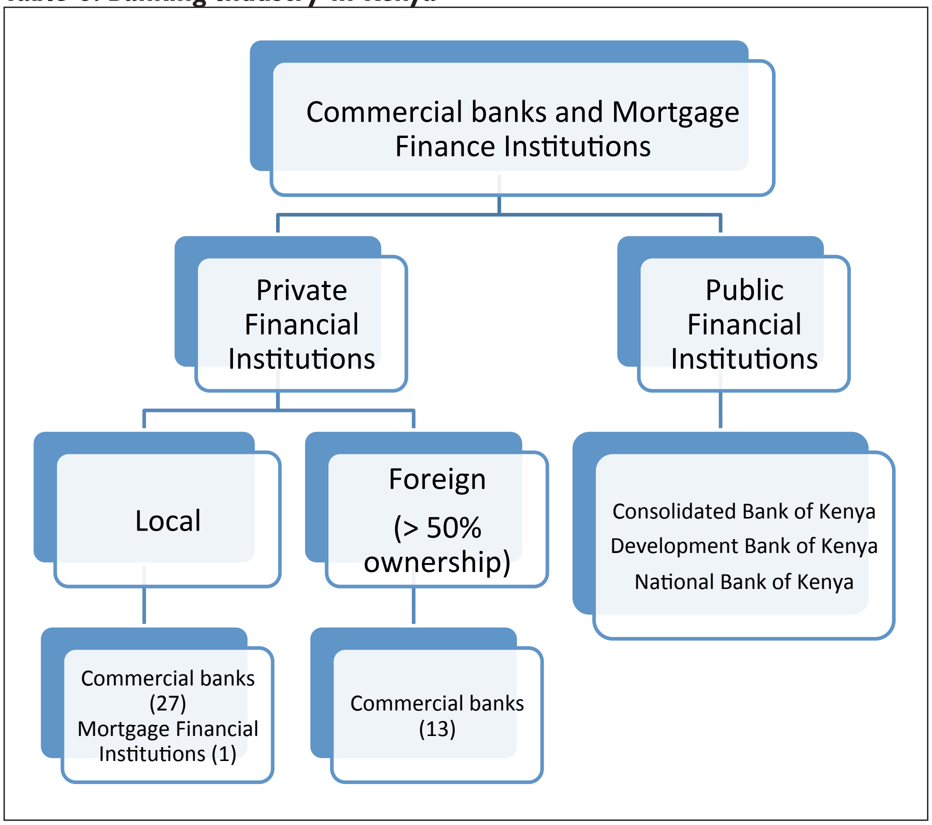
- 3 local public financial institutions accounted for 5% of net total assets (KSh 81,155 million)
- 27 local private financial institutions accounted for 58% of net total assets (KSh 973,404 million)
- 13 foreign financial institutions accounted for 37.2% of net total assets (KSh 623,553 million)

Given the competition between the large number of players and the more onerous capital requirements set out under Basel III, a consolidation within the banking sector might be imminent. However, timelines for adoption of Basel III and similar regulations in Kenya have not yet been made public.

Growth in the banking sector has continued in the last few years in terms of product offerings, service quality, stability and profitability. This is mainly a result of the branch network expansion efforts of most banking players in Kenya and wider East Africa. There is evidence of the banking sector evolving into a more client-centric model, focusing on more bespoke products as opposed to only offering traditional banking products. [xxxix]

These product innovations along with new market entrants (including deposit taking MFIs) and the mobile banking technology providers have contributed to increased competition within the banking sector over the past few years.[xl]

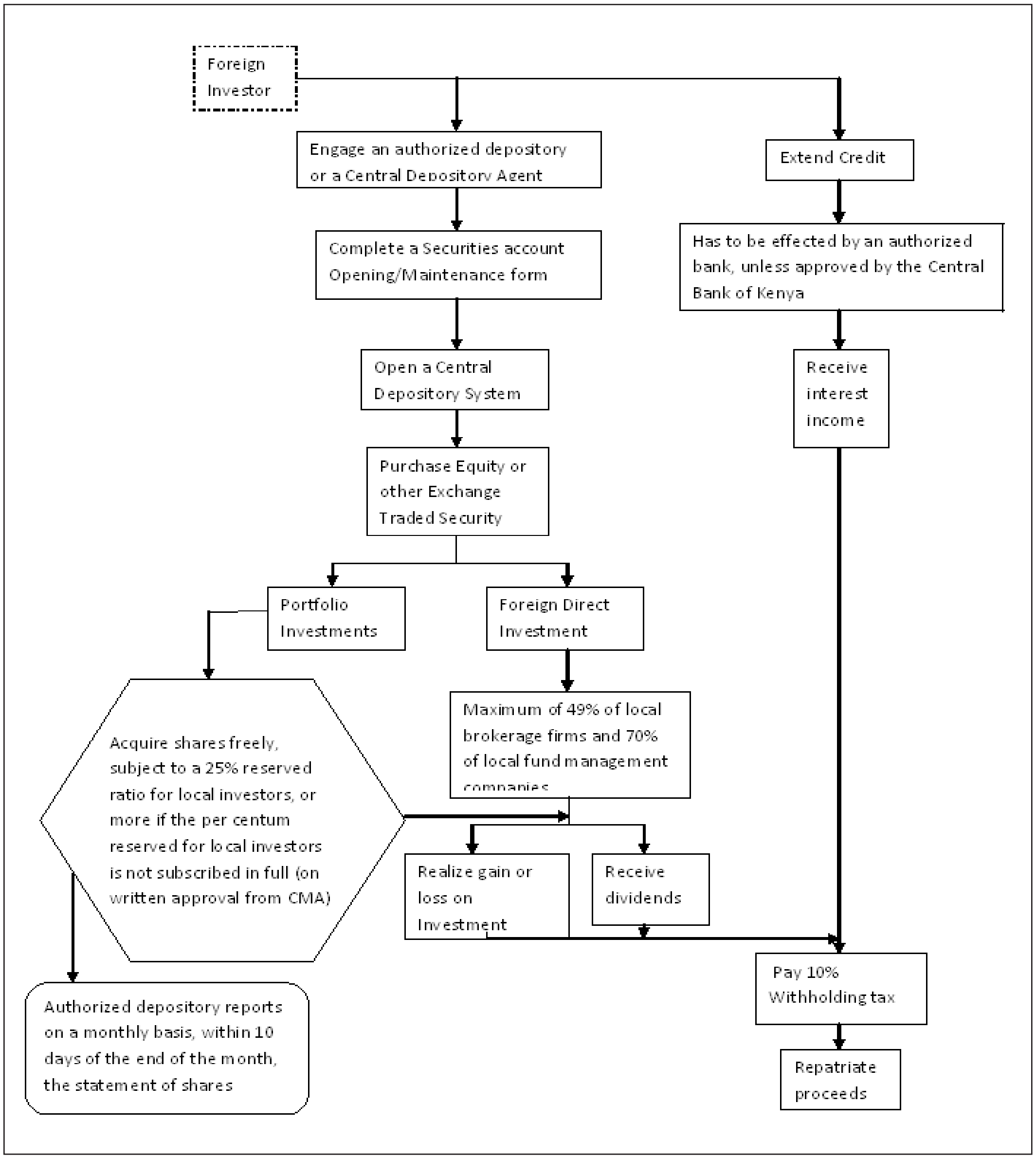
Table 6: Banking Industry in Kenya



Source: Central Bank of Kenya

Summary Chart: Key Steps for Investments and Repatriation in Local Country Capital Markets

Table 7



Source: [xli, xlii, xliii, xliv]

Overview

While Kenya was a prime choice for foreign investors seeking to establish a presence in East Africa in the 1960s and 1970s, a combination of politically driven economic policies, corruption, lack of quality public services, and poor infrastructure has discouraged foreign direct investment (FDI) since the 1980s. Starting in 2003, Kenya's performance in attracting FDI has been marginally better at nearly US$6 per U.S. $1,000 of GDP (US$82 million in total). However, this is lower than the FDI levels in neighboring countries with smaller economies. Kenya was listed in UNCTAD's 2008 World Investment Report as a poor performer within the East Africa region in terms of attracting FDI. The stock of FDI in Kenya stood at $183 million that year. After enjoying a banner year in 2007 attracting $729 million in FDI, Kenya only received $96 million in 2008 and $141 million in 2009. Recent press articles indicate that domestic investment now exceeds FDI and is making a significant impact on development in Kenya.

Foreign direct investment, net inflows (BoP, current US$)[xlv]

Agriculture related activities (horticulture, tea, coffee, pyrethrum, livestock, sugar, cotton, oil crops, fishery) and tourism are the areas in which the government most wants to attract FDI. Other sectors that provide investment opportunities include mining (minerals and oil exploration), manufacturing for both the domestic and the regional markets (textiles and apparel, paper products, steel and iron, vehicle parts and assembly, electronics and electrical equipment, plastics, chemicals and pharmaceuticals), infrastructure (port facilities, roads, waterways and waste management) and energy.[xlvi]

Key Regulations Governing Foreign Direct Investments

Local regulations define a foreign investor as "any person who is not a local investor in Kenya or an East African investor." A "local investor" is defined in the regulations as:

- a natural person who is a Kenyan citizen.
- a company incorporated under the Companies Act (Cap 486), in which Kenyan citizens or the Kenyan government currently has a beneficial interest in 100% of its ordinary shares.
- any other body established or incorporated in Kenya under the provisions of any written law.

An "East African investor" is defined as: (i) a legal person incorporated or registered in the East African Community partner states of Tanzania or Uganda, in which 100% of the beneficial interest is held by citizens of Tanzania or Uganda; or (ii) a natural person who is a citizen of the East African Community partner states of Tanzania or Uganda.

Kenya has a number of tax treaties and investment promotion and protection agreements to encourage FDI. Exporters from Kenya enjoy preferential access to world markets under a number of special access and duty reduction programs.[xlvii] The Kenyan constitution guarantees against expropriation of private property except for purposes of public use or security, and guarantees prompt and fair compensation in the event of such expropriation.

Other advantages include:

- The Foreign Investment Protection Act, which guarantees against expropriation of private property by government.[xlviii]
- The Multilateral Investment Guarantee Agency (MIGA) (an affiliate of the World Bank to which Kenya is a signatory and member) which guarantees investors against loss of investment to political problems in host countries.
- The International Centre for Settlement of Investment Disputes (ICSID) which is a channel for settling disputes between foreign investors and host governments and to which Kenya is also a signatory.

Investment opportunities exist in nearly all the sectors and especially in agricultural, machinery and building materials based industries.

Key Regulations Governing Market Investments

A listed company is required to reserve at least 25% of its ordinary shares for investment by local investors in the issuer or listed company. The shares to be reserved should be the percentage of the ordinary shares already listed on the securities exchange. A listed company would have to immediately report to the NSE all transactions that would result in the percentage of ordinary shares held by foreign and East African investors reaching 70% or more. If the 25% reserved for local investors is not subscribed in full during a public offering, the issuer may, with the written consent of the CMA, allocate the remaining shares to East African and foreign investors. [xlix]

The legal and regulatory framework within which the CDS was established and continues to operate is embodied in the Central Depository and Settlement Act and the Central Depositories (Capital Markets) Rules. The objective of the act is to facilitate the establishment, operation and regulation of central depositories, to provide for the immobilization and eventual dematerialization of, and dealings in, securities deposited there within Kenya, and for connected purposes. Generally, the rules relate to safe custody and transfer procedures of deposited shares such as how a shareholder can deposit shares into the CDS, what safeguards assure entitlements, and how to transfer, mortgage and withdraw shares from the CDS. [l]

Key Regulations Governing Direct Lending

Direct lending in Kenya must go through an authorized dealer. The Kenyan Central Bank has the power to advise and make recommendations to authorized dealers with regards to the conduct of general business and to issue directions regarding measures to improve management of business methods of the authorized dealers.[li]

Restrictions on Foreign Holdings

The government encourages investment and the Kenyan economy remains open to foreign investors. There are no restrictions on foreign investment, foreign ownership, and repatriation of profits or capital.[lii]

Expatriation and Repatriation of Capital

Currency Convertibility / Transferability / Controls

In general, the Kenyan currency is a favorable exchange for most international currencies. Although under Kenyan law amounts above KSh500,000 (US$6,500) have to be declared as a check against money laundering, the law is rarely enforced because of a lack of supporting legislation.[liii]

Taxation Considerations

Corporate Income Tax Rates in Kenya for 2010-2011 are as follows:

Resident corporation		**30%**
Non-resident corporation		**37.5%**
Export Processing Zone	First 10 years	**Nil**
	Next 10 years	**25%**
Registered Unit Trusts/Collective Investment schemes		**Exempt subject to conditions**
Newly listed companies approved under the Capital Markets Act:	With 20% issued shares listed first 3 years after listing	**27%**
	With 30% issued shares listed first 5 years after listing	**25%**
	With 40% issued shares listed first 5 years after listing	**20%**

1. Capital gains taxes

According to the Kenya Revenue Authority, capital gains tax was suspended in Kenya in 1985.[liv]

2. Dividends or other international tax income

Corporate tax presently stands at 30%. Withholding tax on dividends is 5%. Inter-corporate dividend payments between closely held companies are exempt from withholding tax. Dividends received by financial institutions as trading income are not subject to tax.[lv]

3. Withholding Taxes

A full list of other withholding taxes are included in the Appendix. Lower rates may apply where there is a tax treaty in force. Dividends paid to citizens of the East African Community (EAC) are taxed at 5%.

4. **Tax treaties with other nations**

Kenya currently has tax treaties in effect with Canada, Denmark, India, Norway, Sweden, Zambia, the United Kingdom, and Germany. France and Italy are awaiting enforcement and a "Double Tax Agreement" is awaiting conclusion. Currently, there are tax treaties under negotiation for South Africa, Mauritius, Iran, Thailand, Malaysia, and Kuwait.

Further explanation of taxes can be found in "Doing Business: Know your Taxes" an East African tax guide for 2010-2011 published by PricewaterhouseCoopers. The tax guide provides tax explanations for Kenya, as well as neighboring countries. [lvi]

Other Legal Restrictions on Capital Transfers

In December 1995, Kenya repealed its Foreign Exchange Control Act. There are no remaining restrictions on converting or transferring funds associated with an investment. Foreign investors may freely transfer profits after complying with tax obligations. Kenya has enacted the Foreign Investment Protection Act (FIPA) to protect foreign investment against expropriation.

Capital Transfer Allowances

The Foreign Investment Protection Act (Cap 518) secures capital repatriation, remittance of dividends, and interest to foreign investors. Foreign investors can freely convert and repatriate profits including un-capitalized retained profits, i.e., proceeds of the investment after payment of the relevant taxes and the principal and interest associated with any loan.

There are no restrictions in Kenya on converting or transferring funds associated with investments. Parliament passed the Kenyan Proceeds of Crime and Anti-Money Laundering Bill and President Kibaki signed it into law at the end of 2009. The legislation took effect in June 2010, however, implementing regulations have not been drafted as of yet. Kenya is part of the Eastern and Southern Africa Anti-Money Laundering Group and is collaborating with the intergovernmental Financial Action Task Force (FATF).[lvii]

Availability of Access to Capital Markets

The market based economy of Kenya provides incentives for foreign investors. The Kenya Authority (KenInvest), a government regulatory body set up through the Investment Promotion Act of 2004, provides free professional assistance to both foreign and local investors. There are various investment information opportunities available at KenInvest including: Agricultural, Tourism, Manufacture, Wholesales & Retail, ICT/ Business Outsourcing and Banking and Financial Services.

Kenya serves as the East African business hub for many international companies such as General Motors, Proctor & Gamble, Microsoft, Ogilvy and Mather, Coca-Cola and

Citibank. A third of Kenyan banks are foreign owned, controlling 51% of total banking assets in the country.[lviii]

In 2007, a legal notice reduced the threshold of foreign ownership of listed companies on the former Nairobi Stock Exchange from 75% to 60%, creating a disincentive for foreign-owned firms interested in an NSE listing. On the other hand, in order to promote the spread of technology and skills, the government allows foreign investors to acquire up to 49% of local stockbrokerages and up to 70% of local fund management companies. Foreign ownership goes up to 66.7% for insurance companies and 80% for telecommunications companies.[lix]

Public Exchanges

For foreigners to invest in the NSE, the following procedures are necessary:

- A foreign investor would need to open an account with the Central Depository and Settlement Corporation (CDSC), through a local stockbroker.
- The investor is required to trade through an authorized securities trader or authorized money manager. There are currently 19 licensed licensed member firms of the NSE.[lx]
- Original documents are eventually required, but for immediate activity the necessary forms are located on the stockbrokers' website. The investor would provide scanned copies of a recent passport-size photo, a driver's license or passport, and a tax return or utility bill.
- A minimum trade size is 100 shares. The commission and fees are regulated by the CMA. Stockbrokers earn a commission of 1.8% for their services. The commission is negotiable up to 1.5% for shares worth more than KSh 100,000.00.
- Upon opening a CDSC account the investor must state preference for deposit of any dividend. The investor can have a local bank account or a foreign account, but with a foreign account one must consider the transfer fees and currency fluctuation. [lxi]

To protect investors' funds, the NSE stockbrokerage platform has become more standardized. It has introduced an automated trading system with a more stringent capitalization, and has included additional disclosure requirements. The NSE is divided into three market listings:

1. **Main Investment Market Segment (MIMS) listings:**
    - Agricultural sector
    - Commercial and Services
    - Industrial and allied
    - Finance and Investment

2. **Alternative Investment Market Segment (AIMS)**

3. **Fixed Income Security Market Segment (FISMS)**

Table 8: The Primary Products and Requirements to Trade at the NSE

REQUIREMENTS	MAIN INVESTMENT MARKET SEGMENT (MIMS)	ALTERNATIVE INVESTMENT MARKET SEGMENT (AIMS)	FIXED INCOME MARKET SEGMENT (FIMS)
Definition (public company limited shares and registered under the Companies Act (CAP 486)	Stocks are grouped into four sectors: Agriculture, Commercial and Services, Financial and Industrial, and Allied. The shares are displayed in alphabetical order in each group for easy location by investors viewing trading from the public gallery	Attracts smaller growing Equity market listings. A wide range of businesses join AIMS seeking access to growth capital	Debt Instuments issued by the government, Treasury Bonds and Treasury Bills. Company Bonds issued companies
Share Capital	The minimum requirements must be KSh50 Million	The minimum requirements must be KSh20 Million	The minimum requirement must be KSh20 Million
Net Assets	Net Assets > KSh100 Million prior to the public offering	Net Assets > KSh20 Million prior to the public offering	Net Assets > KSh100 Million prior to the public offering
Transferability and Liquidity of Shares	Freely transferable and highly liquid	Freely transferable and highly liquid	May or may not be transferable and sporadic or low on liquidity
Financial Records (for auditing purposes)	Financial statements must be kept for 5 years	Financial statements must be kept for 3 years	Financial statements of a corporation must be kept for 3 years
Dividend Policy	The issuer must have a clear future dividend policy	The issuer must have a clear future dividend policy	Not Required
Track Record	The issuer must have positive 3 of 5 years after tax profitability	The issuer must be in business for at least two years and display growth potential	Not Required
Share Ownership Structure	At least 25% of the shares must be by the issuer, and have a minimum of 1000 shareholders	At least 20% of the shares must be held by the issuers, and have a minimum of 1000 shareholders	Not Required

OTC (Over the Counter)

The Capital Markets Authority has started to review OTC trading. There is a proposal to amend the Capital Markets Act to begin introducing the OTC trading for bonds. Although the Alternative Investment Market Segment (AIMS) that targets small and medium firms exists, there isn't a formal OTC market with the appeal of fewer restrictions and the ability to raise cheap capital.

Private Placements

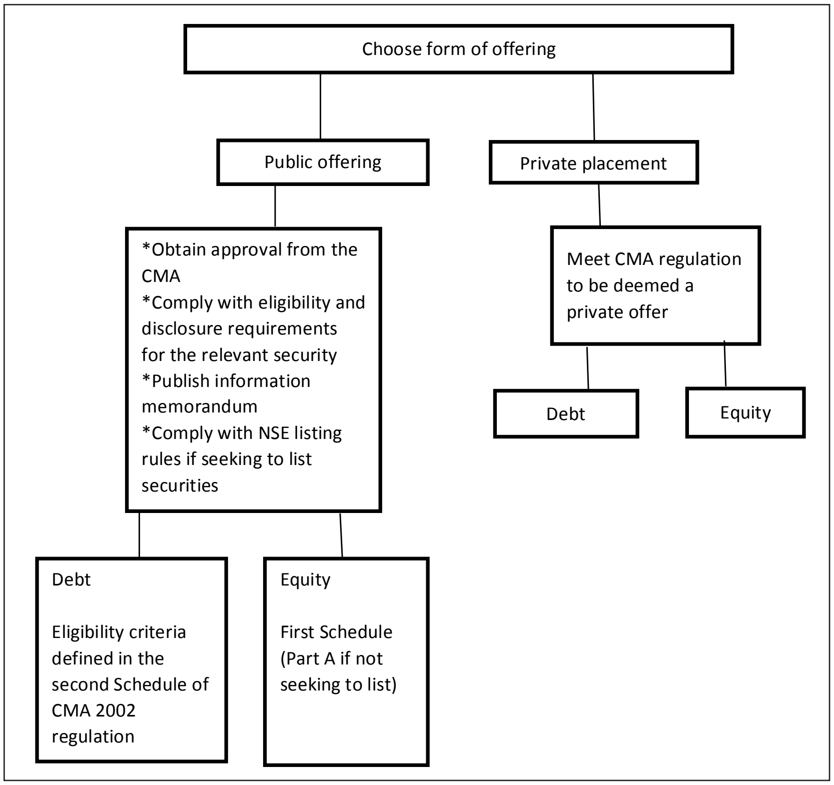
Private Placements are not regulated by the CMA and are not the traditional alternative for small businesses to get funds for expansion or operations in Kenya. There isn't much publicized effort, and therefore most small and medium size firms are unaware of the uncharted option of inviting small individual investors to participate. Although the CMA has discussed the possibility of establishing other venues for raising capital for small businesses on the NSE, there has been no progress to date.

Private Placements instead are a platform for institutional investors such as investment banks and insurance companies. This selected shareholder base provide greater freedom as opposed to an IPO which is generally more costly and open to private and institutional investors.[lxii]

Local Microfinance Issuer Considerations

Summary Chart: Key Steps for Microfinance Issuers to Issue in Local Markets

Table 9



Regulation regarding issuance is defined by the CMA under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002. The regulation applies to all offers of securities, whether or not the issuer is seeking a listing on any securities exchange in Kenya.

One of many roles of the CMA is to steer market development and uphold investors' interests. One of the attributes of the CMA centers on the implementation of a system in which participants in the market regulate themselves as far as possible. The CMA also has the ability to grant and retract approvals in the market and to review offer documentation to ensure that issuers have met the necessary disclosure requirements.

The general public is an active participant in the exchanges, and the general framework around the issuances has been developed to encourage retail participation in securities – both equity and debt. As a result, the disclosure requirements for issuers are designed to provide for a wider audience and are expected to be publicly available. An investor is required to hold an account with the CDSC.

The CMA prescribes respective eligibility and disclosure requirements for the listing of securities on the Main Investment Market, Alternative Investment Market, and the Fixed Income Securities Market segments of the securities exchange. Issuers who do not wish to list on any market segment of the exchange need to comply with eligibility and disclosure requirements set out for the AIMS, if issuing equity, or for the FISMS, if issuing fixed income securities to the public.

The first and second schedules of the CMA regulation define eligibility criteria for public offerings of shares and fixed income securities while the third schedule outlines substantive disclosure requirements thereof. An issuer is expected to publish a prospectus (information memorandum) which must comply with provisions of the CMA and require approval from the authority before publication.

Eligibility requirements for issuance of equity/fixed income securities and listing include:

- If listing on the investments markets, the issuer must be a public company limited by shares and registered under the Companies Act if listing on the investments markets. If listing on the FISMS, the issuer must be a corporate body.
- Minimum capital requirements and net asset values of the issuer as stated in the first and second schedules of the 2002 CMA regulation. For the MIMS and AIMS listings, the minimum share capital requirements are KSh 50million and KSh 20million respectively while net assets immediately before the public offering or listing of shares are required to be not lower than KSh 100million and KSh 20million respectively.
- Audited financial statements comply with International Financial Reporting Standards (IFRS) for an accounting period ending no more than four months prior to the proposed date of the offer or listing.
- Listed shares must be freely transferable and not subject to any restrictions on marketability or any pre-emptive rights.
- Requisites on management experience and structure of the board.

Domestic Market Overview

There is no formalized OTC market. Informal OTC trading occurs mainly in equity with price fixed through negotiations between counterparties. The CMA is in the process of implementing policy framework for OTC bond trading.[lxiii]

Kenyan legislation also allows for companies to raise funds by way of private placements. CMA regulation sets out specifications in which a securities offer is deemed a private offer, including that the securities are i) offered to no more than one hundred persons, ii) offered to members of a club or association, and iii) not freely transferable.

Debt

1. Major Product Categories

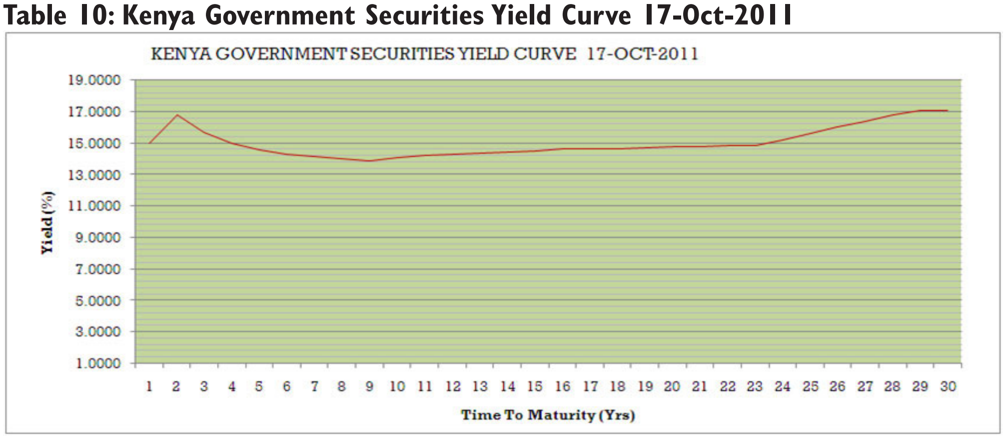
Debt securities available within the Kenyan debt capital markets are dominated by government Treasury bonds and bills, with other products including corporate bonds, commercial paper and money market products. Legislation has been amended to allow for asset-backed securities, however there has not been issuance in this space to date. Products available for issuance are currently limited to the main products mentioned above.

The Central Bank of Kenya issues Treasury bills and bonds on behalf of the Government. Treasury bills issued have tenors of 91, 182 and 364 days. [lxiv] Treasury bonds were introduced to the market in the early 1980s and were primarily characterized by short maturities, with tenors typically ranging from 1-10 years. The shift towards longer maturities did not occur as quickly and naturally as was desired, due in part to the attractive rates on offer in the Treasury bill market.[lxv]

To give impetus to the shift from shorter to longer-term debt, the government decided to reduce the proportion of debt in short term securities in favor of long term securities. These efforts have proven auspicious, despite the lagged nature of progress. In 2009, issuance of 15 to 20 year bonds took place in an effort to lengthen the yield curve. Until recently, Treasury bonds were available in tenors of 1, 2, 5, 10, 15 and 20 years. In Q1 2011, Kenya issued its first 30-year bond. This 30-year bond was a savings bond that raised KSh17 billion.[lxvi] This shift towards longer term debt means that issuers looking to access the market can reference longer yield curves, although liquidity is thin on the longer end.

Types of Treasury bonds issued include fixed, floating, and zero coupon bonds; as well as infrastructure bonds, restructuring/special bonds and amortized bonds,[lxvii] in order to roll over debt and finance new projects, multiple price auctions are held once a month.

Table 10: Kenya Government Securities Yield Curve 17-Oct-2011



Source: Central Bank of Kenya

Despite the introduction of corporate bonds to the market in the mid-1990s, development within this arena has proven to be more challenging, with very few corporates accessing the market thus far. Commercial banks are the primary issuers of non-government bonds, however a few corporates have started to access the market.[lxviii]

Due to direct funding and syndication, the commercial paper market has been dormant for the last three years.[lxix] Furthermore, the introduction of securitized products into the market has not been met with much success, and the market for asset-backed facilities and collateralized deposits is underdeveloped and currently dormant.

The growing preference for both investors and issuers in the capital markets can, to a large extent, be attributed to an increasing community of institutional investors acting as key liquidity providers, and to the relative underperformance of the share market following the global financial crises that led to increased popularity for the fixed income segment.

The development of a salubrious government bond market generally serves as a prerequisite to the development of the corporate bond market, and with the recent accomplishments within the government bond market, it would appear that the debt capital markets within Kenya are set for some promising growth.

2. Restriction on Issuance by Law and by Form of Issuer

Regulations surrounding debt securities, as per the CMA, include The Capital Market Securities, Public Offers Listing and Disclosure Regulations 2002, which sets out, amongst other things, the eligibility criteria for public offering of debt securities and listing on the Fixed Income Securities Market Segment. Furthermore, the Capital Markets (Assets Backed Securities) Regulations 2007, governs issuance of asset backed securities.

There are no specific restrictions with regard to the form of issuer or investor who is able to participate in the bond market, even if they are a foreign investor. As long as the eligibility requirements stipulated in the Capital Markets' Regulations 2002 are met, government agencies, as well as public institutions and corporate entities, may issue and list bonds. Regulation 7(1)(c) of the Capital Markets Regulations 2002, sets out the disclosure requirements for bond issuers pertaining to Government and corporate securities. Financial performance ratios are an important part of these requirements.

In regards to issuances in general, there are no regulatory minimum sizes unless instruments are listed. In this case, listing requirements apply from section 3(b)(i). Due to the fact that the OTC market is underdeveloped, issuers primarily seek to list their debt issuances, meaning that they ultimately have to comply with listing requirements, as mentioned previously.[lxx]

Other requirements surrounding issuers include the need for the issuer to place agents of Treasury bonds. Furthermore, prior to placing bonds in the primary market, corporate issuers must publish a prospectus which includes information surrounding the issuer, directors, auditors, shareholders, financials and the debt issue at hand.

According to the Capital Market Authority Act (Cap 485A), there is no requirement for an issuer to obtain a credit rating on a bond.

Equity

1. Major Product Categories

Equity is the predominant and oldest financial instrument in Kenya. Ordinary Shares can be issued through initial public offerings, rights offerings, private placements and the NSE. Companies may also raise new funds by issuing loan stock or preference shares, though these are less frequently used since these instruments qualify both as equity and debt.

2. Restrictions on Issuance by Law and Form of Issuer

Regulatory criterion for the offer of shares and listing in the investment market of the NSE require the issuer to be a public company limited by shares and registered under the Companies Act. The issuer is also expected to have a minimum authorized issued and fully paid up ordinary share capital of KSh50 million (for listing on the MIMS) or KSh20 million (for AIMS). Free transferability of listed shares is required of issuers, and the shares must not be subject to any restriction on marketability or any preemptive rights. Further eligibility requirements for a public offering of equity and listing are detailed under the first schedule of the CMA Capital Markets Regulation 2002.

Appendices

Appendix I. Licensing Procedures for Deposit Taking Sacco Societies.

In effect from June 18th 2010, the date of publication of the Sacco Societies (Deposit Taking Sacco Business) Regulations 2010, All Sacco Societies intending to operate FOSA shall apply for license from SASRA (section 23 of the Act and regulation 4(2)); and All Sacco Societies already operating FOSAs are required to apply for license from SASRA by 17th June 2011.[lxxi]

The licensing procedures are detailed in Section 24 of the Act and Section 4 of the Regulations. These procedures are split into five main stages:

Stage One: Application for License: Duly complete and submit the "APPLICATION FORM FOR A LICENCE" coded SASRA 1/001) in the regulations for SACCO Societies (Deposit Taking Business) to SASRA.

Stage Two: Letter of Intent: SASRA will assess the application for fulfillment of the requirements in the first stage and if satisfied issue a Letter of Intent to the Sacco Society to put the following in place:

- Institutional Infrastructure or business premises appropriate for deposit taking Sacco business.
- Management Information System: The Sacco Society's Information Management System must be capable of performing and accounting for all transactions and providing the minimum reports required by the Authority in an accurate and timely manner. The system should be operationally integrated and provide adequate security, including data back up.
- Risk Management policies and internal control systems: Sacco Societies face constant risks in the course of their business including credit, liquidity, interest rate, operational, reputation and regulatory risks. The Authority will require the Sacco Society to develop risk management policy framework addressing each of the risks identified.

Stage Three: Onsite inspection: Upon completion of all the requirements specified in the Letter of Intent, the Sacco will notify SASRA so that an independent on-site inspection can be conducted to ascertain compliance. The inspection will be carried out within 30 days of the date of notification.

Stage Four: Letter of Compliance: If SASRA is satisfied, upon completion of on-site inspection, that the Sacco Society has complied with all the conditions as stated in the letter of intent, it shall issue a compliance letter allowing the Sacco Society to pay the license fees within 30 days.

Stage Five: Issuance of a License: SASRA will issue a license to the applicant Sacco Society upon payment of a license fee of KSh50,000 for head office and KSh20,000 for each branch. The license will be issued within 14 days of the date that license fees are paid.

Appendix II. Other withholding tax in Kenya for 2010-2011:

	RESIDENT %	NON-RESIDENT %
Dividend > 12.5% voting power	Exempt	10
Dividend <12.5% voting power	5	10
Interest bearer instruments	25	25
Interest Government bearer bonds 2yrs or more	15	15
Other interest (other than qualifying)	15	15
Qualifying Interest: Housing bonds	10	N/A
Qualifying Interest: Bearer instruments	20	N/A
Qualifying Interest: Other	15	N/A
Royalty	5	20
Management and professional fees	5	20
Consultancy fees: Citizens of East African Community	0	15
Training (including incidental costs)	5	20
Contractual Fee	3	20
Rent/Leasing Immovable	N/A	30
Rent/Leasing Other	N/A	15
Appearances e.g. an entertainment, sporting, including organizing	N/A	20
Pension/retirement annuity	Applicable bands depending on circumstances	5
Insurance commission: Brokers	5	20
Insurance commission: Others	10	20

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