Factors Influencing the Development of Capital Markets in a Developing Economy: A Case Study of Nairobi Securities Exchange in Kenya

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Abstract

The study examined the factors influencing the growth and development of capital markets in an emerging economy. The study focused on the factors that influence the growth and development of the Nairobi Securities Exchange in Kenya (N.S.E.). This study sought to survey the factors that impinge on the growth and development of the stock market. The Nairobi Securities Exchange has experienced lack luster performance over its entire existence since it was founded in 1954. Over the years the number of stocks traded has stagnated at around 53 quoted companies. Ordinarily one would expect to find a significant degree of correlation between economic growth and the growth of the stock exchange. The former has averaged 3.8% p.a. in the period 1985-1996 while the latter averaged only 0.6% as measured by the number of quoted companies.

To achieve the study objectives both primary and secondary data was used. Primary data was generated through the administration of questionnaires to the stakeholders of the NSE. Key informants were drawn from managers of investment banks; staff of the NSE, capital markets Authorities, Ministry of finance, Economic planning and the Central Bureau of statistics. The target population were all the 53 firms listed at N.S.E. Stratified random sampling based on the segmentation of the trading counters was used for sampling the population of the study. A sample of 30 firms was selected. Data was summarized using the inferential statistical methods. Descriptive research design was adopted and used for the study.

The findings of the study indicated that the government policy reforms were viewed as having major influence on the growth and development of capital markets in Kenya. The NSE has experienced growth over the previous years, however the rate of growth has been dismal. The key factors that influence the growth and development of NSE include the strong regulatory and legal framework, good macroeconomic environment, investor education and awareness, improved market infrastructure, and increased participation by foreign investors.

Keywords: Capital Markets, Nairobi Securities Exchange

Introduction

The Nairobi Securities Exchange was established in the 1920's by the British as an informal market for Europeans only. In 1954, the market was formalized through incorporation into a company. In 1963, Africans were allowed to join and trade in the market. For many years, the market operated through the telephone with a weekly meeting at the Stanley Hotel. At the dawn of independence, stock market activity slumped due to uncertainty about the future of independent Kenya. However, after three years of calm and economic growth, confidence in the market was rekindled and the exchanged handled a number of highly over- subscribed public issues. The growth was, however, halted when the oil crisis of 1972 introduced inflationary pressures on the economy which depressed share prices. A 35% capital gains tax introduced in 1975 (suspended since 1985) inflicted further losses to the exchange. The bourse lost its regional character following the nationalizations, exchange controls and other inter- territorial restrictions introduced in neighboring Tanzania and Uganda. For instances, in 1976 Uganda compulsorily acquired a number of companies which were either quoted, or were subsidiaries of companies quoted on the Nairobi Securities Exchange.

In the 1980s the Kenyan Government realized the need to design and implement policy reforms to foster sustainable economic development with an efficient and stable financial system. In particular, it set out to enhance the role of the private sector in the economy, reduce the demands of public enterprises on the exchequer, rationalize the operations of the public enterprise sector to broaden the base of ownership and enhance capital market development. In 1984 an IFC/CBK study, "Development of Money and capital Markets in Kenya", became a blueprint for structural reforms in the financial markets, culminating in the formation of a regulatory body- The capital Markets Authority (CMA) in 1989, to assist in the creation of an environment conducive to the

growth and development of the country's capital markets.
The NSE was registered under the Companies Act in 1991 and phased out the "call over" trading system in favor of the floor- based "open Outcry System". Subsequently the stock exchange embarked on an extensive modernization exercise, including a move to more spacious premises at the Nation Centre in July 1994. The facilities included a modern information centre. The improvement of market infrastructure through the development of an automated central clearing settlement and depository system (CDS) intended to serve the East African region. With the incorporation of the central Depository & settlement corporation, share trading became electronic via the Central Depository System. This contributed to increased turnover. The Electronic Trading System (ETS) recently implemented (2007) is also expected to increase turnover and efficiency at the bourse.
The Nairobi Securities Exchange has played an increasingly important role in the Kenyan economy, especially in the privatization of state- owned enterprises. In the last 10 years, 9 public enterprises have been successfully privatized through the NSE where the government has raised billions of shillings. The privatization process started in 1988 when the government floated 7.5 million shares (20% equity) of the Kenya Commercial Bank. The issue was over- subscribed 2.3 times. Subsequent issues have also proved highly popular, with subscription rates as high as 400%. In the privatization of Kenya Airways, for example, the stock exchange enabled more than 110,000 shareholders to acquire a stake in the airline, while the KenGen IPO saw over 250,000 new shareholders join the company register in 2006.
Kibuthu (2005) in her research on the capital market in emerging economies found other factors that have contributed to the capital markets growth in Kenya as follows: in 2001 the securities market at the NSE was reorganized from two (bond and equity) to three independent market segments namely, the Main Investment Market Segment (MIMS), the Alternative Investment Market Segment (AIMS), and the Fixed Income Securities Market Segment (FISMS) in order to provide more companies with access to the capital market and a suitable trading segment to the diversity of companies and entities desiring to trade at the NSE. The pension reforms in Kenya within the last seven years through the requirement of mandatory professional management of pension funds has boosted the demand for equities at the NSE by institutional investors from the pension industry. An oversight body, the Retirement Benefits Authority (RBA) was established to ensure compliance of pension funds to the reforms and to regulate the industry. Licensing of new categories of participants such as mutual funds, unit trusts, collective investment schemes, dealers, investment banks and investment advisors by the capital Markets Authority, had the effect of increased participation of institutional investors in the market such as mutual funds and retirement benefit funds

Problem Statement

The Nairobi Securities Exchange is characterized by intermittent trading of relatively few stocks, often held by a relatively small group of investors. Thin markets are characterized by imperfections and asymmetric information and hence they cannot adequately perform their information processing and signaling functions. They may be excessively volatile; and at the extreme, are vulnerable to price manipulation by a small group of insiders. Therefore, even if a culture of saving were to be encouraged, the lack of developed financial markets may lead to economic stagnation. A robust stock market assists in the rational and efficient allocation of capital, which is a scarce resource. The fact that capital is scarce means systems have to be developed where capital goes to the most deserving user. An efficient stock market sector will have the expertise, the institutions and the means to prioritize access to capital by competing users so that an economy manages to realize maximum output at least cost. This is what economists refer to as the optimum production level. If an economy does not have efficient financial markets, there is always the risk that scarce capital could be channeled to non-productive investments as opposed to productive ones, leading to wastage of resources and economic decline.
The strength of securities markets that make them focal points of modern finance is their ability to mobilize long term savings for financing long term ventures, to improve efficiency of resource allocation through competitive pricing mechanisms, to provide risk capital (equity to entrepreneurs), and to encourage broader ownership of firms. The latter function is jeopardized if there are few listings by eligible firms as well as financial products. This is the current scenario in Kenya. The need for the development of an effective and efficient stock market is of utmost priority if the problem of access to capital is to be addressed. Therefore to promote the development of capital market, it is necessary understand the factors that impinge on its development and generate policy options available to remedy the situation so that access to capital by businesses may not be a mirage.

Literature Review

Several research studies have documented the role of capital markets. Goldsmith (1969) provided evidence of positive relationship between growth in the economy and the average rate of financial development. Levine (1990) showed that stock markets accelerate growth by facilitating change of ownership of firms and allowing investors to hold diversified portfolios. According to Mbaru (2003) the NSE acts as a vehicle for tapping international capital through foreign portfolio investments. He argued that since the NSE opened to foreign

investors in January 1995, dramatic increase in foreign capital inflows have been recorded. Fama (1991) argues that the stock market is not only a single leading indicator of the business cycle but it is also a predictor of economic activities, given that changes in stock prices reflect expected changes in economic activities and also changes in the perceived risky ness of stock cash flows. The evidence to support these arguments is found in the study by Aylward and Glen (2000), who investigate the relationship between stock prices and other economic variables in emerging and developed markets.

Equity is the oldest financial instrument in the Kenyan Market, spanning nearly fifty years. It is a unit of ownership in a company and carries limited liability. Potential investors can invest in this product through an Initial Public Offer (IPO) or a Rights Issue through the Nairobi Securities Exchange.

Presently Kenya has equity valued at Kshs 900 billion from 53 companies available for trading at the Nairobi Securities Exchange. Equity is more popular with speculators in Kenya as gains may be made from price changes but can also offer regular income to Investors in terms of dividends and bonuses. Equity holders may also benefit from Rights Issues. Treasury Bonds are debt instruments issued by the Government of Kenya (to correct various aspects of macro-economic instability) and were introduced in the Secondary Market 10 years ago. They are available in both the primary market (through auctions) and the secondary market (through the NSE). An investor needs at least Kshs 50,000 to purchase this product. They are currently the most popular financial instruments, owing to the gilt-edged factor (relatively risk free), favourable yields and transferability amongst other factors.

Since introduction to the Secondary Market Treasury Bonds worth Kshs 700 billion have been listed at the NSE.

Corporate Bonds are debt instruments issued by the private sector in the Kenyan Financial market. This Financial Instrument was first issued by a bank in Kenya (East African Development Bank) to raise capital in 1999 and was hugely successful. The issuer of this instrument targets high net worth investors who understand technical information about it like pricing, valuation, yields etc. This implies that this product is not completely open to every individual or institutional investor. Like Treasury Bonds, an investor needs at least Kshs. 50,000 to purchase this product. Loan Stocks & Preference Shares are less popular Financial Instruments in the Kenyan Market and qualify both as equity and debt. Despite priority in payment from the balance sheet of loan stockholders over equity holders, yields on these fixed income securities are very low. Collective investment schemes are pools of funds that are managed on behalf of investors by a professional fund manager. These schemes are available in the Kenyan market. They are arrangements made or offered by any company under which the contributions, or payments made by the investors, are pooled and utilized with a view to receive profits, income, produce or property, and is managed on behalf of the investors. The manager uses the money to buy stocks, bonds, or other securities according to specific investment objectives that have been established for the scheme. In return for putting money into these funds, the investor receives shares or units that represent his/her pro-rata share of the pool of fund assets. There are many kinds of CIS in Kenya but the main ones are: Unit Trusts; Investment Clubs; Mutual Funds; and Employer Share Ownership Plans (ESOPS).

Venture capital is capital invested in a project where there is a substantial element of risk, especially money in a new venture or an expanding business in exchange for shares in the business. It is not a loan. Venture capital Funds are emerging as critical in addressing the funding needs of entrepreneurial companies that generally do not have the size, assets, and operating histories necessary to obtain capital from more traditional sources, such as public markets and banks. There are currently one authorized venture capital funds in Kenya registered by the Capital Markets Authority (Kenya) i.e. Areous Fund, largely due to the absence of comprehensive regulations. In order to develop this product the authority has developed draft comprehensive legal framework that will address the financial and legal requirements that various parties are meant to observe. The draft rules and regulations of this product have already been exposed to the various stakeholders and are to be gazetted soon.

Asset-backed securities constitute a growing segment of the global capital markets. In recent years the ABS market has enabled companies and banks to finance a wide range of assets in the public debt market and has attracted a variety of fixed-income investors. Asset-backed securities are securities which are based on pools of underlying assets such as credit card receivables, mortgage loans, and automobile loans. They are said to be "backed" by assets because the performance of asset-backed securities is dependent upon the performance of the underlying assets. Said another way, the cash flows from the underlying assets are the primary source of payments on the asset-backed securities. Investors in asset-backed securities include a wide range of financial institutions such as banks, insurance companies, finance companies, mutual funds, government-sponsored enterprises, and investment banks, owing to their level of sophistication.

Despite the role that NSE plays in the overall development of the economy, several challenges hamper its development. Demirgue-knut and Levine (1993) provided a dichotomy of stock market characteristics as comprising traditional characteristics; which include market capitalization, amount of new stock offerings, number of listed companies and turnover and institutional characteristics, which include regulation, information disclosure transparency rules and trading costs and finally asset pricing characteristic. This dichotomy provides a blue print of key areas which impinge in development of stock exchange. According to Kumar and Tsetsekos

(1999) the differences between the emerging markets and developed market is based on the institutional set up. Demirguc-Kant and Levine (1996) observed that economics with strong information disclosed laws internationally accepted accounting standards and unrestricted international capital flow tend have more liquid markets. Developing markets are characterized as having a low level of liquidity, high information asymmetry and thin trading because of their weak institutional infrastructure.

Mbaru (2003) argues the key feature of a stock market is the speedy transfer of ownership. He pointed out that developing capital markets experience delays in the issue of transfer of securities. Banser-Neal and Dewenter (1999) contend that cost of trading play a major role in defining the investment strategies. This implies that the higher the cost of trading the lower the investor participation and it is expected that the cost of trading and conducting operation in emerging market is high. This is reinforced by Mbaru (2003) when he argues that investor generally have a preference to transact business fast, obtain timely and adequate information and at low cost. Kimura and Amoro, (1999) argue that the major factor contributing to poor performance of the NSE is general lack of awareness and information on the role, functions and operations of the stock exchange. For companies, the question is not so much lack of knowledge but a concern that the risks associated with additional disclosure are not adequately compensated by additional returns. In addition, banks tend to indirectly discourage the stock exchange as a means of raising capital since they play the dual role of being investment advisors as well as lenders. For the stock exchange itself, there is both inadequate marketing of itself as well as lack of a sufficient number of products to attract the investing public.

The emerging markets are directly influenced by macroeconomic conditions (Madhavan, 1992). Kim and signal (2000) made a general observation that high volatility of stock prices in emerging markets makes investors more averse to hold stocks and lead them to demand a high risk premium, thus increasing the cost of capital. There are critical building blocks necessary for a thriving securities market; macroeconomic and fiscal environment conducive to the supply of good quality securities and sufficient demand for them and a market infrastructure capable of supporting operation of securities market (Pardy, 1992). According to Osei(1998) the macroeconomic environment seems very important for foreign investors, that if more foreign investors are expected to play an active role in emerging stock market, then serious attempts should be made to reduce Inflation and rapidly depreciating currency so that their capital base not eroded. Mbaru (2003) argue that the high interest rates that have been rising because of domestic borrowing have caused many investors to liquidate their equities in preferences for high yielding government papers. Differences in effective tax rates on income from different financial Instruments can influence how investors make their financial and investment decisions (Osei, 1998). He argues that differences also determine whether an individual should invest in securities or whether a corporate body should raise funds though equity or debt instruments. Therefore high tax rates may discourage investors from investing in financial instruments.

The political environment and particularly political stability is also crucial to the development of emerging stock markets. Mbaru (2003) opines that political stability reduces the chances of unexpected violent upheavals that threaten Investments and life and this guarantees safety nets for investments. Instability on the other hand discourages foreign investments in the stock market, which is a characteristic of many emerging economies. In a study by Muyundo and Kibua (2004) a coordinated, consistent and predictable policy must be maintained to enhance the development of the stock market.

Muyundo (2003) showed empirically that there is a two-way causal relationship between stock market development and economic growth In Kenya. By analyzing low-income countries, Rindal et al (1999) found a significant positive relationship between stock market development and economic growth. Similar results have also been obtained in eleven Arab countries over the period 1980-2002. Monetary policy also has an impact on capital market behavior. A useful explanation of the impact of monetary policy on capital market performance is offered by the monetary portfolio hypothesis, which predicts that a change in the money supply results into a change in the equilibrium position of money, in relation to other assets in the portfolio. Investors respond by adjusting the proportion of the asset portfolio held in money balances. However, because all money balances must be held, the system does not adjust until changes in the prices of various assets lead to a new equilibrium. See for example, Dhakal, Kandil and Sharma (1993). The relationship can also be explained through the credit channel of monetary policy. For example, Thorbecke (1997) observes that monetary policy affects stock returns by influencing the credit position and investment level of the firm. Tight monetary policy increases interest rates, worsening the cash flow, net of interest, and therefore the balance sheet position of the firm. As a result, creditworthiness of the firm is reduced, creating a credit constraint and reducing investment. Consequently, the firm's value goes down and stocks are no longer attractive. Fiscal policy also has a direct impact on capital market behavior. .The impact of fiscal policy on capital market behavior tends to occur indirectly through transaction costs and directly through taxes. Brean (1996) notes that taxation and other government fees raise the new issue barriers by increasing the transaction costs for new listings in the stock market in South Africa. In addition, discriminatory tax policies, including personal income taxes, tax on dividends, tax on firm profits as well as on different financial assets, render inefficient the mobilization of domestic savings through the capital

market. Further, Amihud and Murgia (1997) show that higher tax on dividends is a necessary condition for dividends to signal company value. Green, Maggioni and Murinde (2000) find that stamp duty and other tax measures tend to increase transaction costs and thus serve the purpose of ”throwing sand in the wheels‘ of the stock market. Specifically with respect to emerging capital markets, there seems to be clear causality from fiscal policy to capital market behavior. For example, Evans and Murinde (1995) use the BVAR method and find that both unanticipated and anticipated monetary and fiscal policies influence capital market behavior in the Pacific Basin countries. However, it has been argued that the impact of taxation on the capital market depends on the stage of market development (Brean, 1996). In a well-developed market, asset pricing reflects factors that affect profitability and risk, including taxation. But when the market is not well developed, effects of taxation that would otherwise be reflected in returns or costs of capital fail to be properly priced and allocative effects of taxation fail to work through the mechanisms that link savings to interest rates or investment to expected return on investment.

The exchange rate impacts the capital market behavior. Most emerging economies, including Africa, have adopted flexible exchange rates such that the nominal exchange rate is not an active policy instrument, as would be the case of devaluation under fixed exchange rates. Our focus, therefore, will be on the relationship between market-induced exchange rate changes and changes in capital market behavior. The theory predicts an indirect relationship between the exchange rate and the stock market; Bodnar and Gentry (1993) and Bartov and Bodnar (1994).

Mbaru (1998) explains in detail the aspect of globalization in capital markets. In his speech, he shows how globalization of capital markets has affected the Nairobi Securities Exchange. According to him, globalization of financial markets means the lowering of national boundaries as barriers to the movement of money around the world. Globalization has made it possible for investors to move vast sums of capital across boundaries at minimal transaction costs and at high speed through electronic devices, thanks to the increased sophistication in the information technology that has gradually formed the universe into a global village. In Kenya, for example, participation by foreign investors constituted 60% of market turnover by the last quarter of 1997. The improved liquidity of stock exchanges further enhances their appeal to investors. Secondly, globalization has awakened African stock exchanges to the necessity of enhancing their standards and infrastructure, Kenya being no exception. Investors will generally have a preference for exchanges where they can transact business fast enough, obtain timely and adequate information and where there are efficient qualified personnel. Where these assets are not in place capital will move out quickly to more enabling markets. A case already in point is that of the “tiger world miracle economies” crisis.

Globalization is, therefore, increasingly forcing the NSE to improve its markets’ infrastructure if it is to be competitive. Enhancing market infrastructure includes introducing automated Central Depository and Settlement System (CDS). Again, the spillover effect cannot be overlooked. With globalization of the capital markets, the NSE is expected to reap from inflow of ideas and this to spill over to the rest of the economy leading to the more endeared goal of balanced growth. Thirdly, to the extent that it may be regarded as an offshoot of globalization, the regionalization of stock exchanges will confer further advantages to the Stock Exchange and the Kenyan economy in general. When the East African Stock Exchanges are fully integrated, hopefully in the next few years, we anticipate a number of advantages. Firstly, through cross-border listing in which foreign firms are listed on African local exchanges, shareholders will benefit from international profits by way of dividend.

Shareholders will also be able to use foreign investment in the foreign company as a hedge to local currency. Secondly, the NSE will also benefit from the listing of foreign firms on their local exchanges through facilitating the expansion of foreign companies which will create jobs, through increasing tax base of local revenue as listed companies will be taxed on local earnings and through increased foreign investments in Kenya as a result of venture capital raised offshore. Finally, economies in Africa will benefit through the listing of their companies in foreign stock exchanges. Such listings will enable local firms to raise funds offshore, to expand and become more competitive. However, globalization also imposes considerable challenges on the NSE and the economy at large. Some of these challenges relate directly to stock the exchanges while others relate to the wider economic and political circumstances obtaining in African countries. At the stock exchange level, we must address several challenges before we can be globally competitive. Firstly, the NSE must increase its liquidity to date. Kenya’s ability to mobilize capital and allocate risk is relatively poor. The comparative statistics below are worth perusal; market capitalization figures in US $ - Kenya (1,824 million), Thai (23,538 million), South Africa (232,069 million), Mauritius (1,665.1 million), Value traded ratios - Kenya (0.012), Mauritius (0.033), South Africa (0.34), Malaysia (1.64). To remedy this there must be; minimized restrictions on foreign participation beyond the 40% tag and development of an equity culture amongst local community for a wider investor base to quote but a few. Besides liquidity African Stock Exchanges in general and NSE in particular, need to improve stock market regulation. Stock market regulation is principally aimed at investor protection and is therefore important as it affects investor confidence. It is encouraging to note that reforms in African financial markets have improved investor confidence. Thirdly, stock exchanges need to improve stock market operations and especially Clearing

and Settlement procedures. Finally, the NSE needs to take measures to enable them contain systemic risks successfully. The increasing globalization of financial markets has brought increased risk that capital
All in all, a well regulated and properly functioning capital market clearly plays many roles and offers many benefits. Capital markets allow the efficient transfer of funds between borrowers and lenders. Households and investors who are short of funds to take up profitable investment opportunities that yield rates of return higher than the market are able to borrow funds and invest more than they would have done without capital markets. Consequently, all borrowers and lenders are better off than they would have been without capital markets. In the long term, a stock market fosters economic development by promoting efficient resource allocation over time. In addition, market determined stock prices and yields provide a benchmark against which the cost of capital for and returns on investment projects can be judged, even if such projects are not in fact financed through the stock markets. As stock markets are forward looking, they also provide a unique record of the shifts in investors' views about the future prospects of companies as well as the economy. In many respects, therefore, a capital market is a vast information exchange, which efficiently reduces transaction costs (Green, Maggioni and Murinde, 2000).
However, to play the above roles and attain these ideals, a capital market needs to be effectively organized and operated, with a continuous flow of orders around the equilibrium prices. Few of the new stock markets in Africa live up to this ideal. Many are characterized by intermittent trading of relatively few stocks, often held by a relatively small group of investors. Thin markets are characterized by imperfections and asymmetric information and hence they cannot adequately perform their information processing and signaling functions. They may be excessively volatile; and at the extreme, are vulnerable to price manipulation by a small group of insiders. Indeed, there is abundant evidence that stock markets are inefficient in certain key respects and may be subject to — excess volatility "and to speculative—bubbles" (Green, Maggioni and Murinde, 2000).

Methodology
The study utilized secondary data supplemented with primary data collected from key informants using questionnaires. The informants included listed companies, brokerage firms, and senior managers of NSE, and Capital Markets Authority. Key variables considered in the study included investor characteristics, institutional, regulatory and economic barriers. The method of data analysis was largely descriptive, with inferences drawn from the data.
The research design of the study utilized survey method to explore information from the listed companies at the NSE. This approach facilitated an in-depth analysis to establish the implications of the capital market in Kenya, the impact of the CMA on the listed companies with regard to promoting the growth and development of capital markets in Kenya.

Study Findings
The objective of this study was to find out the factors influencing the current growth of the Kenyan capital markets. The findings indicate that 44.4% of the respondents argued that the most significant reasons for their listing at the NSE was because of access to cheaper source of financing as well as to give the public an opportunity of ownership. Comparatively, studies by Amoro & Kimura (1995) found that 75% of the companies sampled indicated that they got listed to give a chance to local people to participate in ownership, and therefore a reflection of the success of the Government's policy of strongly urging companies to sell some of their shares to Kenyans. This is because listing at the Nairobi Securities Exchange gives an organization the opportunity to source financing from the public. This is characterized by public ownership, which is bound to enhance managerial decisions in the long run. In addition 56% of the respondents argued that opportunity to share risks associated with capital is only fairly significant as far as reasons for listing at the Nairobi Securities Exchange are concerned. The findings further indicate that 89% of the respondents agreed that they have achieved their objective for listing at the Nairobi Securities Exchange.
This implies that listing at the Nairobi Securities Exchange has been beneficial to most of the listed companies in terms of achieving the original envisaged goals. This could be because of the increasing improvements at the stock market. The analysis indicates that 74.1% of the respondents agreed that the reorganization of the stock market into MIMS, AIMS and FISMS had improved trading.
When asked about factors contributing to growth of the capital market in Kenya, 63% of the respondents argued that the government policy reforms have had the major influence on the growth of the capital market. The low performance in the macroeconomic environment is attributable to factors such as: Level of investments, Instability in interest rates, Limited international aid flows, and Poor state of infrastructure. Hence, most companies have not found it appropriate to raise funds through the capital markets. The study established that in most jurisdictions, privatizations accounted for a significant proportion of new listings.
Taxation influences on whether an individual should invest in securities or demand deposits of whether a company should raise funds through equity. The study found that newly listed companies are taxed at a lower

rate, as compared to the standard rate of 30% in the year 2005/2006. This is meant to encourage more firms to list at the NSE. Similarly expenses relating to testing shares are fully tad deductible and that new and expanded share capital for companies approved for listing or already listed are exempted from stamp duty charges. Other eligible tax deductible expense includes expenses incurred by companies to have their financial instruments rated by an Independent rating agency. It is also important to note that registered and approved venture capital funds now enjoy a 20 year holiday, investment calling by retirement benefits schemes in fixed income securities has been raised from 20% to 30%, collective movement schemes set up by employers on behalf of employees to invest in listed shares is exempt from your income tax and that currently investors can acquire shares freely in the stock market subject to a minimum reserve ratio of 25%. The study found that the tax framework has been designed to spur the development of the stock market. Over the years the government has demonstrated its commitment to develop the capital markets through various policy and fiscal interventions**.** Policy incentives to support new listings, Lower corporate tax rate of 20%, 25% and 27%, Withholding tax on dividend reduced to 5%, Issue costs are tax deductable, New capital exempted from stamp duty , Transfer of a SPV for issuing ABS are assets to exempt from stamp duty

The level of awareness was found to be too low for both potential issuers and investors. Some companies with the potential to list do not completely understand the benefits of listing. The process to raise funds through the capital markets is perceived to be a specialized and complex field compared for example to other traditional financing methods like retained earnings and commercial loans. Creating awareness requires an all inclusive approach by all stakeholders. On the profile of investors in the NSE the study found that local investors play a significant role on the NSE, which accounts for 86.4% while foreign Investors account for a paltry 13.6%. These results may be attributed to the unfavorable foreign investor perception of the NSE. In terms of value, the analysis shows that local individuals hold 61.5% of the value of investments, while institutions hold 38.5%. Interviews to establish the occupation of the individual investors in the NSE showed that middle level managers had the highest participation (25.6%) followed by chief executives (22.5%), while farmers (6.2%), artisans (7.5%) and office clerks and teachers (7.5%) had a low participation. These findings may be attributed to the fact that even though middle level managers and CEOs are few, they have more access to information and understand how the market operates. They also have income advantage and hence have financial muscle to make adequate investment in securities as compared to others. The low participation of farmers and artisans could be attributed to low level of education, while teachers who are considered educated also constitute least participation of pensioners is also significant and can be authorized to excess liquidity that pensioners might have occasioned by retirement benefits and also the expectation of the regular earnings to compensate the employment benefits.

Knowledge of investors on the Stock Market

Investors’ knowledge	**% Distribution**
Poor	15.8
Average	34.2
Good	30.8
Very Good	12.5
Excellent	6.7

Source: Survey data 2014

The regulatory framework has been viewed as being too stringent to the extent that it discourages potential issuers, requirements like the debt ratios, minimum track history, minimum number of shareholders and capital requirements are considered limiting. The need to comply with regulations may be seen as a burden and there is stronger aversion to the disclosure and reporting requirements associated with a public listing. There are cases whereby these requirements may be seen as a loss of privacy and an exposure to the public domain, which can be seen as a loss of competitive advantage. It is such information that the competing non-listed companies might access and therefore it is appropriate to device ways through which such companies are compensated for the perceived loss arising from competition. Market manipulation through fraudulent practices leads to loss of investors’ confidence. This study established that the compliance and enforcement programme initiated by CMA has been designed to protect investors and fosters investors’ confidence by preserving the integrity and efficiency of the capital market .The study observed that there are several operators in the stock market without a license to operate.

Many firms especially family owned or closely held companies are reluctant to dilute ownership and lose of voting control. Tend to rely on bank finance as well as a proven network of family and friends to raise additional capital when required. Capital market offers an opportunity not only to raise long term capital but it also ensures that the issuer benefits from good corporate practices, which all the listed companies are expected to adhere to. It is therefore recommended that: A comprehensive customized sensitisation programme targeting potential family owned companies is developed. The programme should go a long way in cultivating a positive perception about capital markets and encourage family owned businesses to appreciate the need for separation of

owners and management. Pre-issue technical assistance should be considered to ensure that potential companies are not limited due to lack of corporate finance expertise in their management. A number of measures have been undertaken to address this anomaly including: granting lower corporation tax rate to newly listed companies where.

There are direct costs of issuing shares to the public and listing at a stock exchange. This is perceived to be high especially because the companies have to pay annual listing fees. The process is subject to approval and sometimes can take too long (management time) before it is concluded which serves as a major disincentive. However, we established that the costs of equity and debt are comparatively lower to bank term loans. In addition to offering long term capital, capital markets facilitate issuers to raise such funds in large amounts that it would not be possible to get from the banks. The cost of transactions in NSE affects the development of the stock market because it tends to reduce the investors return. The study found that brokerage commission set out by the NSE range from commissions of 2.1% for transaction up to Ksh. 100,000 and 1.80% for an amount above sh. 100,000.

There is dominance of small and medium scale enterprises, which are dependent on bank loans and informal sources of financing. Many of these firms rely on overdrafts as a major source of finance, even for fixed capital. Although overdrafts are theoretically payable on demand, they are usually renewed every months and function as a source of permanent, long term financing as long as the borrower continues to meet the key covenants in the overdraft agreement.

Our capital market is characterized mainly by two products i.e. equity and bonds. Lack of integration with other stock exchanges within the region also limits the extent to which potential issuers can enjoy the benefits of listing. For the capital markets to effectively mobilize adequate long-term capital, there is need to create additional financial instruments and expand the mobilization base through rigorous pursuit of regional integration of capital markets. It is therefore recommended that: Additional financial products are introduced. All market players are sensitized on the concept, operations and benefits of cross border listing and trading. Enhanced and harmonized capital market development policy initiatives are pursued. The East African investors are treated as domestic investors

The savings levels in Kenya are low with the majority of the population living below the poverty line. The gross domestic savings ratio of less than 10% of the GDP is extremely low to positively impact on economic development. The ongoing reforms in the pension and insurance sector need to be encouraged as they form a strong mobilization base of long-term long capital.

The development of market infrastructure is important as it also influences supply and demand of capital. The level of technology impacts cost of business. The implementation of the CDS has significantly enhanced secondary market efficiency thus a critical feature for attracting foreign capital to supplement the low domestic savings level. To further modernize the capital markets and transform it to an equally competitive capital destination, it is recommended that: The implementation of the ATS is expedited. The past clearing settlement and registration infrastructure in Kenya had become increasingly inadequate as Kenya's capital market continued to develop. This inadequacy led to development of a Central Depository System (CDS), which enabled the holding and transfer of securities without the need for physical movement. The CDS is faster and more efficient that the traditional paper based systems. The results of the study showed that it is a requirement that all buying and selling of securities are done through brokers, who are licensed to conduct such operations on behalf of their clients and that most operations at the NSE are transparent especially the open out-cries system of trading as the process is open to members of the public.

The brokers who were interviewed reported that they have foreign investors as part of their clientele. These investors were from USA, UK. Canada, Australia, Germany, France, Japan, and Switzerland. The notable countries in sub-Saharan Africa included South Africa, Nigeria, Uganda and Tanzania. The analysis of questionnaires showed that the foreign investors patronized mostly multinational firms.

Conclusion

The NSE has experienced growth over the previous years; however the rate of growth has been dismal. Enhancing NSE growth and performance poses greatest challenges and key factors that impinge on the development of NSE include the weak regulatory and legal framework, poor macroeconomic environment, Lack of investor awareness, market imperfections, poor market infrastructure, and fear of loss of control.

The study found that the NSE is composed few companies constituting the largest players in the stock market and that the number of companies listed in the stock market are few leaving less options for investors. The study also established that key players in the market belong to high income threshold and that low income investors were less represented. It was also apparent that most investors in the NSE were local individual investors, which puts to question the capability of the regulatory environment to attract foreign investors. Critical issue established was that most participants in the market were literate and 84.2% had knowledge of stock market, although even with absolute knowledge, the level of income for an individual was a priority.

Recommendations

A number of recommendations can be drawn from the study in order to facilitate the growth and development of NSE. Foremost, an efficient capital market requires a stable and predictable macroeconomic environment to encourage both local and foreign investors and as such, the government should adopt prudent macroeconomic policies designed to lower and sustain the interest rates, reduce inflation, budget deficits and lengthen the maturing of government debt. The government through its agencies should continue developing tax regimes that are geared towards stimulating companies to be listed in the stock market. Since greatest impediment to the NSE is the level of knowledge of the local investors, then the Capital Markets Authority in collaboration with other market stakeholders should implement a compressive awareness and public education programme that targets both supply and demand of securities. It should implement a specialized proficiency certification programme targeting both the market intermediaries and the general public to enhance financial literacy. A programme of education for the investors' particularly educational tours and short courses offered on a continua's basis in very crucial in helping to educate the public about securities. Media can also be used to reach out to more people, particularly in explaining the significance of investing in securities. It is further recommended that the privatization programme be pursued through the capital markets by offering these enterprises to the wider public through the NSE.

There is also need for the government to improve the market infrastructure which is the epicenter on which financial market resolves. More research on the stock market should also be conducted on continuous basis and such studies should contain aspects of comparison with other stock markets, as this will facilitate innovation in the NSE. Given that participants in the stock market are largely those in high income bracket, the success of NSE depends on how the masses can be empowered in order to participate. Therefore the government should create an enabling environment in which creation of income achievable by all. A comprehensive review of the regulatory framework should be undertaken in tandem with the global trends without undermining the domestic environment needs; This will guarantee large population to participate in the activities in the stock market, which eventually increases demand for the shares pushing up the supply and hence more listing of companies in the stock market. Dissemination of market information can be done through other institutions such as secondary schools, colleges, universities, cooperative societies, community gathering or any other institution.

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