**TOPIC 1 THE SHADOW BANKING SYSTEM IN KENYA**

**Introduction**

Nonbank financial institutions, such as investment banks, hedge funds, and money market mutual funds, have become an increasingly important means for channeling money from lenders to borrowers. These nonbank financial institutions have been labeled the “shadow banking system”—matching savers and borrowers, but outside of the commercial banking system, and, in principle, lowering costs to borrowers and raising returns to

* Microfinance Institutions.
* Stock brokerage/ investment banks.
* Building Societies.
* Asset Management Firms.
* Credit Unions.
* Insurance Companies.
* Stock exchanges.
* Mutual Funds.
* Hedge Funds.
* Pension funds.

In this section we also highlight on important non-bank institutions that may not directly be involved in matching borrowers and savers, but that play a vital role in the process. These include;

* Forex bureaus.
* Credit reference bureaus.
* Rating agencies.

We also highlight on development banks.

**MICROFINANCE INSTITUTIONS**

The Microfinance Act, 2006 and the Microfinance Regulations issued there under sets out the legal, regulatory and supervisory framework for the microfinance industry in Kenya. The Microfinance Act became operational with effect from 2nd May 2008.   
  
The principal object of the Microfinance Act is to regulate the establishment, business and operations of microfinance institutions in Kenya through licensing and supervision. The Act enables Deposit Taking Microfinance Institutions licensed by the Central Bank of Kenya to mobilize savings from the general public, thus promoting competition, efficiency and access.  
  
It is, therefore, expected that the microfinance industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans.  There are 4 licensed deposit taking MFIs - Faulu Kenya Deposit Taking Microfinance Limited, and Kenya Women Finance Trust Deposit Taking Microfinance Limited, SMEP Deposit Taking Microfinance Limited, and Uwezo DTM Limited . Regulations for Non Deposit Taking Microfinance Institutions are yet to be put in place

**FOREX BUREAUS**

Forex Bureaus were established and first licensed in January 1995 to foster competition in the foreign exchange market and to narrow the exchange rate spread in the market. As authorized dealers, forex bureaus conduct business and are regulated under the provisions of the Central Bank of Kenya Act (Cap 491). Currently there are one hundred and thirty (130) licensed Forex Bureaus.

**CREDIT REFERENCE BUREAUS**

Credit Reference bureaus complement the central role played by banks and other financial institutions in extending financial services within an economy. CRBs help lenders make faster and more accurate credit decisions. They collect, manage and disseminate customer information to lenders with in a provided regulatory framework – in Kenya, the Banking (Credit Reference Bureau) Regulations, 2008 which was operationalised effective 2nd February 2009. Credit histories not only provide necessary input for credit underwriting, but also allow borrowers to take their credit history from one financial institution to another, thereby making lending markets more competitive and, in the end, more affordable. Credit bureaus assist in making credit accessible to more people, and enabling lenders and businesses reduce risk and fraud. Sharing of information between financial institutions in respect of customer credit behavior, therefore, has a positive economic impact.   
  
The Kenyan banking sector was in the 80’s and 90’s saddled with a momentous Non-Performing Loans (NPLs) portfolio. This invariably led to the collapse of some banks. One of the catalysts in this scenario were “Serial defaulters”, who borrowed from various banks with no intention of repaying the loans. Undoubtedly these defaulters thrived in the “information asymmetry” environment that prevailed due to lack of a credit information sharing mechanism.

The Banking (Credit Reference Bureau) Regulations 2008 will govern licensing, operation and supervision of CRBs by the Central Bank of Kenya. The development of a sustainable information sharing industry is therefore recognized as a key component of financial sector reforms in Kenya and almost all developing and emerging economies. There is currently only one licensed credit reference bureau in Kenya- Credit Reference Bureau Africa Ltd.

**INVESTMENT BANKS**

Are financial intermidiaries charged with the responsibility of garnering the savings of thrifty people and directing these funds into the business enterprises seeking capital for acquisition of plant and equipment, and for holding inventories.

**Functions of investment banks.**

1. Function concerning the formation of new capital.
   * Origination- Investment bankers assist issuing company to work out the details of financing including NSE registration statements and preparing prospectuses in case of public issue.
   * Underwriting- in underwriting, the investment banker enters into agreement with the issuer to take up all such securities that are not taken up by the public. In so doing, they save the issuer from the uncertainties of new issues. We can distinguish between **securities underwriting** and **bank underwriting**. Investments bank conduct **securities underwriting**, the selling of newly issued securities such as stock. Commercial banks and mortgage finance insitutions do **bank underwriting**, the detailed analysis preceeding the granting of a loan.
2. Function subordinate to capital formation.
   * Secondary distribution of large blocks of outstanding securities- Frequently owners of large blocks of securities like to liquidate their holdings in cash. This can be done via an investment bank. Investment banks also come handy for the purpose of negotiating an acquisition or merger.
   * Acting as a broker or dealer in security market- being a member of a stock exchange either as a broker or agent, the investment banks help security holders liquidate their holdings.
   * Advisory and technical services- Investment banks offer advice to companies and individuals for the management of their portfolio.
   * Research activities: investment banks undertake this function in ascertaining the quality/ financial soundness and prospects of companies that they underwrite.

**DEVELOPMENT BANKS**

The term development bank was used for the first time in the post second war period to refer to the institutional financial machinery built for fostering industarial growth in a country. These institutions are charged with supplying the basic ingridients of development- capital, knowledge and entreprenuership e.g. Development bank of Kenya, EADB.

**Functions of development banks**

1. Help alleviate endemic problems of unemployment and poverty.
2. Act as a catalyst for quickening industrial development in a country.
3. Providing term capital to entreprenuers.
4. Promote entreprenuership by undertaking potential industry surveys, identifying growth prospects, writing feasibility reports, and providing technical, and managerial to interested entreprenuers.
5. Widen entreprenuership base by organising training programmes for potential entreprenuers.

**MUTUAL FUNDS AND OTHER INVESTMENT COMPANIES.**

Investment companies

Investment companies are financial intermediaries that collect funds from individual investors and invest those funds in a potentially wide range of securities or other assets. Pooling of assets is the key idea behind investment companies. Each investor has a claim to the portfolio established by the investment company in proportion to the amount invested. These companies thus provide a mechanism for small investors to “team up” to obtain the benefits of large-scale investing.

Investment companies perform several important functions for their investors:

1. Record keeping and administration. Investment companies issue periodic status reports, keeping track of capital gains distributions, dividends, investments, and redemptions, and they may reinvest dividend and interest income for shareholders.

2. Diversification and divisibility. By pooling their money, investment companies enable investors to hold fractional shares of many different securities. They can act as large investors even if any individual shareholder cannot.

3. Professional management. Many, but not all, investment companies have full-time staffs of security analysts and portfolio managers who attempt to achieve superior investment results for their investors.

4. Lower transaction costs. Because they trade large blocks of securities, investment companies can achieve substantial savings on brokerage fees and commissions.

Types of investment companies

Unit Investment Trusts

Unit investment trusts are pools of money invested in a portfolio that is fixed for the life of the fund. To form a unit investment trust, a sponsor, typically a brokerage firm buys a portfolio of securities which are deposited into a trust. It then sells to the public shares, or “units,” in the trust, called redeemable trust certificates. All income and payments of principal from the portfolio are paid out by the fund’s trustees (a bank or trust company) to the shareholders. Most unit trusts hold fixed-income securities and expire at their maturity, which may be as short as a few months if the trust invests in short-term securities like money market instruments, or as long as many years if the trust holds long-term assets like fixed-income securities. There is little **active management** of a unit investment trust because once established, the portfolio composition is fixed; hence these trusts are referred to as unmanaged. Trusts tend to invest in relatively uniform types of assets; for example, one trust may invest in municipal bonds, another in corporate bonds. The uniformity of the portfolio is consistent with the lack of active management. The trusts provide investors a vehicle to purchase a pool of one particular type of asset, which can be included in an overall portfolio as desired. The lack of active management of the portfolio implies that management fees can be lower than those of managed funds.

Sponsors of unit investment trusts earn their profit by selling shares in the trust at a premium to the cost of acquiring the underlying assets. For example, a trust that has purchased Ksh. 5 million of assets may sell 5,000 shares to the public at a price of Ksh. 1,030 per share, which (assuming the trust has no liabilities) represents a 3% premium over the net asset value of the securities held by the trust. The 3% premium is the trustee’s fee for establishing the trust. Investors who wish to liquidate their holdings of a unit investment trust may sell the shares back to the trustee for net asset value. The trustees can either sell enough securities from the asset portfolio to obtain the cash necessary to pay the investor, or they may instead sell the shares to a new investor (again at a slight premium to net asset value).

Managed Investment Companies

There are two types of managed companies: closed-end and open-end. In both cases, the fund’s board of directors, which is elected by shareholders, hires a management company to manage the portfolio for an annual fee that typically ranges from .2% to 1.5% of assets. In many cases the management company is the firm that organized the fund. In other cases, a mutual fund will hire an outside portfolio manager. There are two types of managed companies: closed-end and open-end. In both cases, the fund’s board of directors, which is elected by shareholders, hires a management company to manage the portfolio for an annual fee that typically ranges from .2% to 1.5% of assets. In many cases the management company is the firm that organized the fund. In other cases, a mutual fund will hire an outside portfolio manager.

Most management companies have contracts to manage several funds. Open-end funds stand ready to redeem or issue shares at their net asset value (although both purchases and redemptions may involve sales charges). When investors in open-end funds wish to “cash out” their shares, they sell them back to the fund at NAV. In contrast, closed-end funds do not redeem or issue shares. Investors in closed-end funds who wish to cash out must sell their shares to other investors. Shares of closed-end funds are traded on organized exchanges and can be purchased through brokers just like other common stock; their prices therefore can differ from NAV.

Mutual funds

Mutual funds are the common name for open-end investment companies. This is the dominant investment company today, accounting for the majority of investment company assets. What are the typical products offered by the mutual funds (Bcom 330)?

Costs of investing in mutual funds

Fee Structure

An individual investor choosing a mutual fund should consider not only the fund’s stated investment policy and past performance, but also its management fees and other expenses.

* Front-End Load

A front-end load is a commission or sales charge paid when you purchase the shares. These charges are used primarily to pay the brokers who sell the funds. There exist low load funds with a front end load of around 3%. An ordinary fund will charge around 6%.

* Back-End Load

A back-end load is a redemption, or “exit,” fee incurred when you sell your shares.

* Operating Expenses

Operating expenses are the costs incurred by the mutual fund in operating the portfolio, including administrative expenses and advisory fees paid to the investment manager. These expenses are usually expressed as a percentage of total assets under management. Shareholders do not receive an explicit bill for these operating expenses; however, the expenses periodically are deducted from the assets of the fund. Shareholders pay for these expenses through the reduced value of the portfolio.

Other Investment Organizations

There are intermediaries not formally organized or regulated as investment companies that nevertheless serve functions similar to investment companies. Two of the more important are commingled funds and real estate investment trusts.

Commingled Funds

Commingled funds are partnerships of investors that pool their funds. The management firm that organizes the partnership, for example, a bank or insurance company, manages the funds for a fee. Typical partners in a commingled fund might be trust or retirement accounts which have portfolios that are much larger than those of most individual investors but are still too small to warrant managing on a separate basis.

**STOCK EXCHANGES**

A stock exchange is an institution, organization or association that serves as a market for trading financial instruments such as [stocks](http://www.wikinvest.com/wiki/What_is_a_stock%3F), [bonds](http://www.wikinvest.com/wiki/Bonds) and their related [derivatives](http://www.wikinvest.com/wiki/Derivatives). Most modern stock exchanges, like [NYSE Euronext](http://www.wikinvest.com/wiki/NYSE_Euronext), JSE and the NSE have both a trading floor and an [electronic trading](http://www.wikinvest.com/wiki/Electronic_trading) system.

The first stock exchanges date back to the Middle Age in Europe with debt trading between merchants. However the first stock trading can be found in the 17th century with the creation of various companies to explore European colonies such as the Dutch East India Company. Historically stocks and bonds were traded in a physical place or building with traders gathering on the floor and exchanging financial titles by hand.

With permission of the London Stock Exchange the Nairobi Stock Exchange started its operations in 1954 as an overseas stock exchange when Kenya was a British colony and the business of shares trading was restricted only to the resident European community though Africans and Asians were not permitted to deal in securities In1963, after independence, Africans and Asians were permitted to deal in securities, but it was complicated to convince native Kenyans of the significance of the exchange.

In 1951, an Estate Agent Francis Drummond established the earliest professional Stock broking firm, and impressed upon the then finance minister of Kenya Sir Ernest Vasey the idea of creating a stock exchange in East Africa.

In1984, A Central Bank of Kenya study, "Development of Money and Capital Markets in Kenya" was known as a blueprint for structural reforms in the financial markets which helped the creation of a regulatory body 'The Capital Markets Authority' (CMA) in 1989.

The Capital Markets Authority Act was amended and known as the Capital Markets Act. In August 2000, CFC Financial Services the first licensed dealer on the Nairobi Stock Exchange started its operations.   
  
In February 2001, basic reformation of the capital market of Kenya took place and divided the market into four independent market segments: the Main Investments Market Segment (MIMS), the Alternative Investments Market Segment (AIMS), the Fixed Income Securities Market Segment (FISMS) and later Futures and Options Market Segment (FOMS).   
  
In the2001/2002 budget, the Government offered the extra incentives to capital markets investments. On17th April 2002, the CMA declared the sanction of the new NSE trading and settlement rules with amendments. On 26th July 2002, with the introducing of a New Foreign Investor Regulations, there are three categories of investor on the capital markets; local, East African and foreign.   
  
On 5th August 2002, the Nairobi Stock Exchange, the Capital Markets Authority of Kenya, the Association of Kenya Stockbrokers, the CMA Investor Compensation Fund, and 9 institutional investors through the Capital Markets Challenge Fund have signed a Shareholder Agreement for establishment of the Central Depository and Settlement Corporation (CDSC). On Monday, 11 September 2006 live trading on the automated trading systems of the Nairobi Stock Exchange was implemented.   
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**Functions of the Stock Exchange Market**

Although the stock exchange market has multiple functions, its main activities are two:

* To promote the savings and for them to be canalized towards of carrying through investment projects that otherwise wouldn’t   be possible you need that the issuing institution of the securities to be admitted for quoting. The negotiations will be done on the primary market.
* To provide liquidity to the investors. The investor can   recuperate the money invested when needed. For it, he has to go to the stock exchange market to sell the securities previously acquired. This function of the stock market is done on the secondary market.

Other functions of the stock exchange market as an organization are:

* To guarantee the legal and economic security of the agreed contracts.
* To provide official information about the quantities that are negotiated and of the quoted prices.
* To fix the prices of the securities according to the fundamental law of the offer and the demand.
* Specifying a bit more and centering on the two main agents that intervene in the market, investors and companies, we could do the following   classification:

Functions done by the stock exchange market in favor of the investor:

* It permits him the access to the profitable activities of the big companies.
* It offers liquidity to the security investments, through a place in which to sell or buy securities.
* It permits for the investor to have a political power in the companies in which he invests its savings due that the acquisition of ordinary shares gives him the right (among other things) to vote in the general shareholders meetings of the company in question.
* It offers the possibility of diversifying   your portfolio by enlarging the field of strategy of investments due to alternative options, as could be the derived market, the money market, etc.

With respect to the function done by the stock exchange market in favor of the companies:

* It supplies them with the obtaining of long-term funds that permits the company to make profitable activities or to do determine projects that otherwise wouldn’t be possible to develop for lack of financing. Also, this funding signifies a less cost than if obtained at other channels.
* The securities quoted at the stock exchange market usually have more fiscal purpose advantages for the companies.
* It offers to the company’s free publicity, which in other way would suppose considerable expenses. The institution is objecting of attention of the media (television, radio, etc.) in case any important change in its owners (the share holders).

**BUILDING SOCIETIES**

A building society is a financial institution, [owned by its members](http://en.wikipedia.org/wiki/Mutual_organization), that offers [banking](http://en.wikipedia.org/wiki/Banking_institution) and other [financial services](http://en.wikipedia.org/wiki/Financial_services), especially [mortgage lending](http://en.wikipedia.org/wiki/Mortgage_loan). Building Societies are licensed under the Building Societies Act. Currently there is no licensed Building Society in Kenya.

**CREDIT UNIONS**

These are co-op associations whose members normally have a common bond, such as employees of the same firm. Member’s savings are loaned out only to other members. They offer the cheapest source of funds for individual borrowers. Co-ops are regulated by the co-op act.

### PENSION FUND

### A pension fund is any plan, fund, or scheme which provides retirement income. Pension funds are important shareholders of listed and private companies. They are especially important to the stock market where large [institutional investors](http://en.wikipedia.org/wiki/Institutional_investor) dominate. Open vs. closed pension funds Open pension funds support at least one pension plan with no restriction on membership while closed pension funds support only pension plans that are limited to certain employees.

A public pension fund is one that is regulated under public sector law while a private pension fund is regulated under private sector law. In certain countries the distinction between public or government pension funds and private pension funds may be difficult to assess. In others, the distinction is made sharply in law, with very specific requirements for administration and investment. In Kenya, pension funds are regulated by the RBA, governed by the RBA act, retirement benefits regulations and the investment regulations and policies issued.

Retirement Benefit Scheme can be classified in various forms as presented below:

Defined Contribution and Defined Benefit

A defined contribution (DC) scheme is a scheme in which member' and employer' contributions are fixed either as a percentage of pensionable earnings or as a shilling amount, and a member's retirement benefits has a value equal to those contributions, net of expenses including premiums paid for insurance of death or disability risks, accumulated in an individual account with investment return and any surpluses or deficits as determined by the trustees of the scheme.

DC Schemes are arrangements where the retirement benefit is not known or defined in advance. Rather the level of retirement income receivable on pay-out date is related to the:

* Level of contributions made over the accumulation period;
* The charges deducted by the product provider;
* The investment returns of the fund during the accumulation phase;
* The annuity rates at retirement.

A defined benefit (DB) Scheme is an arrangement where the benefit, which is ordinarily determined by the scheme rules, is defined in advance. Benefits are often related to the final salary and/or years of service of the employee. The main risk for beneficiaries is the solvency of the employer so as to be in a position to meet the promised benefits.

Hybrid Schemes seek to combine features of DB and DC schemes in some way and can take a variety of forms. For purposes of categorization, hybrid schemes are DB schemes because of the promises they make to members.

Provident Fund and Pension Fund

Provident fund means a scheme for the payment of lump sums and other similar benefits to employees when they leave employment or to the dependants of employees on the death of those employees.  
  
In the case of a pension fund at the point of retiring a proportion of the retirement fund is commuted as lump sum with the remainder paid out as periodical payments.  The commuted amount will be equal to no more than one quarter of the retirement benefits in a scheme where members do not make any contributions and not more than one third of the retirement benefits in a scheme where members make contributions.

**LIFE INSURANCE COMPANIES**

Take deposits in the form of annual premiums: invest these in stocks, bonds, real estate and mortgages, and finally make payments to the beneficiaries of the insured parties. They also offer a variety of tax deferred savings plans designed to provide benefits to participants when they retire.

**HEDGE FUNDS**

An aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).   
  
Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year. For the most part, hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors. You can think of hedge funds as mutual funds for the super rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies. It is important to note that hedging is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment. The name is mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market by shorting the market (mutual funds generally can't enter into short positions as one of their primary goals). Nowadays, hedge funds use dozens of different strategies, so it isn't accurate to say that hedge funds just "hedge risk". In fact, because hedge fund managers make speculative investments, these funds can carry more risk than the overall market.