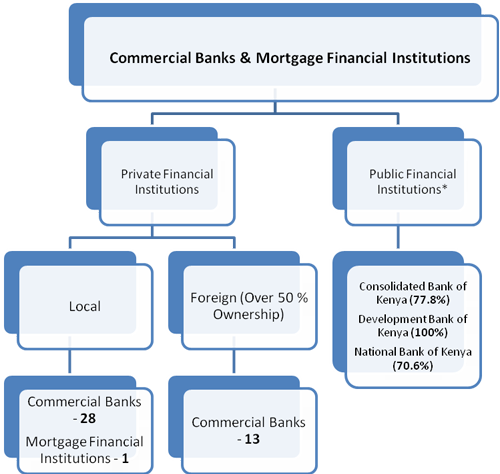
FINANCIAL INSTITUTIONS AND MARKETS MARKING SCHEME

1. Briefly discuss the following financial institutions found in Kenya, highlighting their FUNCTIONS.
   1. Commercial banks and mortgage finance institutions (4 marks).

***Commercial Banks and Mortgage Finance Institutions*** *are licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued thereunder. They are the dominant players in the Kenyan Banking system and closer attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with the laws and regulations. Currently there are there are 44 licensed commercial banks and 1 mortgage finance company.   
  
Out of the 46 institutions, 33 are locally owned and 13 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the Government and State Corporations, 29 commercial banks and 1 mortgage finance institution. The ownership structure of the commercial banks and mortgage finance company is as depicted in the chart below:* ***  
\*Shareholding by the Government and state corporations***

* 1. Credit reference bureaus (4 marks).

*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 licenced credit reference bureau in kenya- Credit Reference Bureau Africa Ltd.*

* 1. Investment banks (4 marks).

*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.*
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.*
   1. Development Banks (4 marks).

*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.*
   1. The Stock market (7.5 mks).

*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.*

*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).*

1. “The existing regulatory framework for the financial sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub sectors”. Discuss the structure of financial sector regulation in Kenya and highlight 4 GAPs and 2 OVERLAPS (Use diagrams where appropriate) (23.5 marks)

*The existing regulatory framework for the financial sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub sectors. The recent creation of the Insurance Regulatory Authority has completed the shift from having departments under the Ministry of Finance to having independent regulators for each sub-sector.*

*The current regulatory structure is characterized by regulatory gaps, regulatory overlaps, multiplicity of regulators, inconsistency of regulations and differences in operational standards. For example, some of the regulators have at least partial exemption from the State Corporations Act while others do not, some have tax exemption, others do not. Some regulators have powers to issue regulations while in other cases the power is retained by the Minister for Finance.*

**STRUCTURE OF FINANCIAL SECTOR REGULATION IN KENYA**

**SACCO SOCIETIES REGULATORY AUTHORITY (SASRA)**

*The Sacco Societies Regulatory Authority (SASRA) is established under the Sacco Societies Act of 2008 with the following mandate:*

* *License Sacco Societies to carry out deposit taking business;*
* *Regulate and supervise deposit taking Sacco Societies;*
* *Manage the Deposit Guarantee Fund under the trustees appointed under the Act;*
* *Advise the minister on national policy on deposit taking Sacco Societies in Kenya.*
* **THE GAPS IN THE REGULATORY FRAMEWORK**

**The Kenya Post Office Savings Bank (KPOSB)**

*The Kenya Post Office Savings Bank (KPOSB) was incorporated in 1978 under the KPOSB Act (Cap 493B). The mission of the bank is “to sustainably provide savings and other financial services to our customers, through a countrywide branch network, by use of modern technology in delivery of efficient and effective customer service, and to the satisfaction of all stakeholders.”*

*Section 8(1) KPOSB Act that provided for the Government guarantee over the deposits placed with the savings bank was repealed via the Finance Bill 2001. The repeal of the section implies that new avenues should be found for deposit protection. It also implies that the bank should be adequately capitalised as a first step to protect deposits against possible losses.*

**Companies Act (CAP 486)**

*The Companies Act, which is a holdover of pre-colonial British Law, is creating problems for private sector activities in Kenya and indeed the financial services sector. Old-fashioned UK companies’ law, currently in use, is complicated, cumbersome, inconsistent and at odds with modern “enabling” regulation of corporations. Another layer of complexity and compliance is added to an already burdensome structure, leading to multiple disclosure*

*requirements, overlap and expensive duplication. The regulation of companies is currently under the Registrar of Companies in the Office of the Attorney General but could be brought under the financial sector regulatory framework for more responsiveness to market dynamism.*

**Development Finance Institutions (DFIs)**

*DFIs have always provided the impetus for economic development be it in the developed or developing countries. In Kenya, DFIs were specifically established to spearhead the development process by:*

*Availing credit funds to those venturing into commerce, tourism and industry.*

*• Assisting those wishing to venture into small-scale manufacturing enterprises.*

*• Assisting in the initiation and expansion of small, medium and large-scale industrial and tourist undertakings.*

*• Provide long-term lending (Project financing) to sustain economic development*

*• Provide Technical Assistance/Co-operation extension services*

*• Provision of special Financing and Support services to stimulate Private Sector to live up to its potential and create jobs and wealth, develop and expand indigenous skills*

*The existing framework has potential for disharmony as they fall under different regulators. For example ICDC/KIE are under the Ministry of Trade and Industry, IDB is under the Central Bank of Kenya and AFC the Ministry of Agriculture.*

**Premium and Other Financing**

*A number of premium finance companies have evolved in the Kenyan market. These companies offer financing to companies and individuals to meet insurance premium payments. This is clearly a financial service but is currently not regulated by any of the existing regulatory institutions. Similarly, there are other money lenders and financers who are totally unregulated. There is also need for regulation of leasing which is a developing financial service.*

**E- Banking and Mobile banking/ cash transfer**

*The advent of electronic banking has raised new concerns for banking regulation, specifically about security and privacy*

*Three Kenyan mobile telephone firms have ventured into m-banking- Yu, Zain and Safaricom. The services provided range from cash transfer to payment of bills to shopping. A number of banks also operate e- banking solutions where a customer may access his/ her account through the internet.*

*There exists a regulatory gap in mobile banking, especially when such services are being offered by telecommunication firms as opposed to mainstream financial institutions. There is a lack of a precise definition of the supervisory structure for mobile phone banking entities as regards customer protection, distinction between payments and deposits, and provision for cash deposits/ withdrawals by agents.*

*Worries about the security of electronic banking and e-money are an important barrier to their increased use. With electronic banking, you might worry that criminals might access your bank account and steal your money by moving your balances to someone else’s account. Indeed, a notorious case of this happened in 1995, when a Russian computer programmer got access to Citibank’s (USA) computers and moved funds electronically into his and his conspirators’ accounts. Private solutions to deal with this problem have arisen with the development of more secure encryption technologies to prevent this kind of fraud. However, because bank customers are not knowledgeable about computer security issues, there is a role for the government to regulate electronic banking to make sure that encryption procedures are adequate. Similar encryption issues apply to e-money, so requirements that banks make it difficult for criminals to engage in digital counterfeiting make sense.*

*Electronic banking also raises serious privacy concerns. Because electronic transactions can be stored on databases, banks are able to collect a huge amount of information about their customers—their assets,* *creditworthiness, what they purchase, and so on—that can be sold to other financial institutions and businesses. This potential invasion of our privacy rightfully raises customer concerns.*

**Problems in Regulating International Banking**

*Particular problems in bank regulation occur when banks are engaged in international banking and thus can readily shift their business from one country to another. Bank regulators closely examine the domestic operations of banks in their country, but they often do not have the knowledge or ability to keep a close watch on bank operations in other countries, either by domestic banks’ foreign affiliates or by foreign banks with domestic branches. In addition, when a bank operates in many countries, it is not always clear which national regulatory authority should have primary responsibility for keeping the bank from engaging in overly risky activities.*

*The difficulties inherent in regulating international banking were highlighted by the collapse of the Bank of*

*Credit and Commerce International (BCCI). BCCI, which was operating in more than 70 countries, including the United States and the United Kingdom, was supervised by Luxembourg, a tiny country unlikely to be up to the task. When massive fraud was discovered, the Bank of England closed BCCI down, but not before depositors and stockholders were exposed to huge losses.*

*Cooperation among regulators in different countries and standardization of regulatory requirements provide potential solutions to the problems of regulating international banking. The world has been moving in this direction through agreements like the Basel Accords and oversight procedures announced by the Basel Committee in July 1992, which require a bank’s worldwide operations to be under the scrutiny of a single home-country regulator with enhanced powers to acquire information on the bank’s activities.*

1. Briefly discuss the following terms, highlighting their relevance in the stock markets
   1. The theory of rational expectations (6 mks)

*John Muth developed an alternative theory of expectations, called rational expectations, which can be stated as follows: Expectations will be identical to optimal forecasts (the best guess of the future) using all available information. To explain it more clearly, let’s use the theory of rational expectations to examine how expectations are formed in a situation that most of us encounter at some point in our lifetime: our drive to work on a matatu. Suppose that when Kamau travels when it is not rush hour, it takes an average of 30 minutes for his trip. Sometimes it takes him 35 minutes, other times 25 minutes, but the average non-rush-hour driving time is 30 minutes. If, however, Kamau leaves for work during the rush hour, it takes him, on average, an additional 10 minutes to get to work. Given that he leaves for work during the rush hour, the best guess of the driving time—the optimal forecast—is 40 minutes.*

* 1. The strong form market efficiency (6 mks).

*The strong-form EMH contends that stock prices fully reflect all information from public and private sources. This means that no group of investors has monopolistic access to information relevant to the formation of prices. Therefore, this hypothesis contends that no group of investors should be able to consistently derive above-average risk-adjusted rates of return. The strong form EMH encompasses both the weak-form and the semi strong-form EMH. Further, the strong form EMH extends the assumption of efficient markets, in which prices adjust rapidly to the release of new public information, to assume perfect markets, in which all information is cost free and available to everyone at the same time.*

* 1. The weak form market efficiency (6 mks).

*The weak-form EMH assumes that current stock prices fully reflect all security market information, including the historical sequence of prices, rates of return, trading volume data, and other market-generated information, such as odd-lot transactions, block trades, and transactions by exchange specialists. Because it assumes that current market prices already reflect all past returns and any other security market information, this hypothesis implies that past rates of return and other historical market data should have no relationship with future rates of return (that is, rates of return should be independent). Therefore, this hypothesis contends that you should gain little from using any trading rule that decides whether to buy or sell a security based on past rates of return or any other past market data (This is a vindication to the Technical analysts- Chartists).*

* 1. The random walk hypothesis. (5.5 mks)

*The term random walk describes the movements of a variable whose future changes cannot be predicted (are random) because, given today’s value, the variable is just as likely to fall as to rise. An important implication of the efficient market hypothesis is that stock prices should approximately follow a random walk; that is, future changes in stock prices should, for all practical purposes, be unpredictable. The random-walk implication of the efficient market hypothesis is the one most commonly mentioned in the press, because it is the most readily comprehensible to the public. In fact, when people mention the “random walk theory of stock prices,” they are in reality referring to the efficient market hypothesis. It has generally been confirmed that stock prices are not predictable and follow a random walk.*

1. ‘In addition to common stock investments, it is also possible to invest in derivative securities, which are securities that have a claim on the common stock of a firm’. In light of the above, discuss the following.
   1. Call options (6 mks)

*A call option is similar to a warrant because it is an option to buy the common stock of a company within a certain period at a specified price called the striking price. A call option differs from a warrant because it is not issued by the company but by another investor who is willing to assume the other side of the transaction. Options also are typically valid for a shorter time period than warrants*

* 1. Put Options (6 mks)

*The holder of a put option has the right to sell a given stock at a specified price during a designated time period. Puts are useful to investors who expect a stock price to decline during the specified period or to investors who own the stock and want protection from a price decline.*

* 1. Warrants (6 mks)

*A warrant is an option issued by a corporation that gives the holder the right to acquire a firm’s common stock from the company at a specified price within a designated time period. The warrant does not constitute ownership of the stock, only the option to buy the stock.*

* 1. Futures (5.5 mks)

*This agreement provides for the future exchange of a particular asset at a specified delivery date in exchange for a specified payment at the time of delivery.*

1. *‘Like commodities, most investors view real estate as an interesting and profitable investment alternative but believe that it is only available to a small group of experts with a lot of capital to invest*.’. Discuss 4 types of low cost real estate alternatives (23.5 mks).

* **Real Estate Investment Trusts (REITS)**

*A real estate investment trust is an investment fund designed to invest in various real estate properties. It is similar to a stock or bond mutual fund, except that the money provided by the investors is invested in property and buildings rather than in stocks and bonds.*

* **Direct Real Estate Investment**

*The most common type of direct real estate investment is the purchase of a home, which is the largest investment most people ever make.*

* **Raw Land**

*Another direct real estate investment is the purchase of raw land with the intention of selling it in the future at a profit. During the time you own the land, you have negative cash flows caused by property maintenance, and taxes. An obvious risk is the possible difficulty of selling it for an uncertain price. Raw land generally has low liquidity compared to most stocks and bonds.*

* **Land Development**

*Land development can involve buying raw land, dividing it into individual lots, and building houses on it. Alternatively, buying land and building a shopping mall would also be considered land development. This is a feasible form of investment but requires a substantial commitment of capital, time, and expertise. Although the risks can be high because of the commitment of time and capital, the rates of return from a successful housing or commercial development can be significant.*