



**THE PRIVATE ENTERPRISE PARTNERSHIP FOR AFRICA
EFFICIENT SECURITIES MARKETS INSTITUTIONAL DEVELOPMENT INITIATIVE**

**EAC REGIONALISATION:
STRATEGY AND PLAN REPORT**

SUBMITTED BY

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1 EXECUTIVE SUMMARY

This executive summary from page 4-11 both summarises the findings in the 'models and findings' report and the recommendations made in this 'strategy and plan' report, before delineating the detailed recommendations themselves from page 12 onwards. More details about the initial analysis may be found in the 'models and findings' report itself: the table on page 9 below gives references to sections of this report and that report for the convenience of readers.

This EAC capital markets 'Strategy and Plan' regionalisation report is drafted for submission to those attending a workshop to be held in Kampala on 11 July 2008 as part of the ESMID regionalisation project. The regionalisation project is one of four ESMID projects currently under way, the three others being focused on: bond market infrastructure (OMX/NASDAQ); bond market law and regulation (ISC) and capacity building for securities markets participants (Devpar).

The objective of this report is to set out a strategy and plan for EAC regionalisation, based on the 'models and findings' report, previously submitted to ESMID, which is available in full but whose key findings are summarised below. Presentations based on this report will be made by the consultants to the regionalisation workshop in Kampala on 11 July 2008 and comment invited on the recommendations made.

The strategy and plan set out in this report are based on three key premises outlined in the 'models and findings' report.

- i. **Relevance of other models to EAC regionalisation:** there is no one regionalisation model internationally which it is proposed that the EAC should adopt; rather that parts of different models are relevant and useful. Indeed, many of the lessons to be drawn from other models are negative rather than positive. Key messages here are (refer section 3 of the 'models and findings' report for more information):
 - a. That it is necessary to have clearly defined objectives and to have a plan and schedule for implementation to which a strong commitment is made; to monitor the plan's implementation; to publish updates on progress regularly and to have mechanisms to enforce compliance. While the EAC has set some objectives and has an outline plan and schedule, it does not publish progress reports nor does it have effective mechanisms to tackle non-compliance. The strong role of the European Court of Justice in enforcement of EU Directives is not effectively replicated within the EAC, whose Court, although apparently having the power to issue Directives that are binding on member state, appears only to operate ad hoc
 - b. It is absolutely essential to have full capital account liberalisation, leading to free access to all markets by all market users
 - c. A single legal and regulatory regime and a single regulator is neither critical nor necessary; harmonised standards agreed by multiple regulators can and do work elsewhere including Europe
 - d. It is necessary to have a safe and efficient clearing and settlement systems and CSD systems - CSD systems should be protected from default risk

- e. A single stock exchange is not necessary though a single settlement system is ideal since it reduces costs, increases efficiency and improves reliability, as EU experience has shown
- f. It is not necessary to have a single currency for some measure of regionalisation to be achieved: however it is unlikely that the private sector will start to base its own strategy on regionalisation unless there is a coherent and sustainable plan for monetary union in place - this took well over a decade in the case of the EU, but had an immediate and substantial effect on integration of capital markets when a firm date was announced
- g. An EAC-specific issue is the competing regionalisation blocs (SADC, COMESA, etc) which both complicate strategic business considerations and divert much-needed attention from EAC regionalisation
- h. A single fiscal regime is not necessary and has not been achieved elsewhere
- i. Regionalisation can proceed with new members joining subsequently, but having an inescapable obligation to adjust their legal frameworks to harmonise with existing regional standards
- j. It is not necessary for all members to move at the same pace, though this is preferable
- k. It is essential not only to have minimum harmonised standards, but also to enforce them: again, within the EU the role of the European Court of Justice is very important
- l. It is absolutely essential to have effective regional co-operation (which even seems to be possible amongst twenty-seven countries) between governments, regulators and market participants
- m. It is necessary for regulated investment institutions from one member of a bloc to be able to invest in assets in any other member country of the same bloc without hindrance, subject to harmonised domestic prudential regulations. This has contributed to the rapid growth of life assurance, pensions¹ and collective investment schemes throughout the EU since greater investment can be attracted when greater diversification is available
- n. Regionalisation should result in those holding a financial licence in one member country being permitted to offer their products and services into other member countries without licensing and establishing companies in those countries in order to achieve improved economies of scale; this is now the trend in European financial legislation and is referred to as 'passporting'
- ii. **Use of benchmarks against which to assess EAC regionalisation:** the report concluded that the EU's financial sector benchmarks - being those set by the most developed regionalisation bloc internationally - establish a highly relevant standard for the EAC. In summary these are (refer sections 3.2.1 and 3.2.2 of the models and findings report for more information):
 - a. *Wholesale and institutional - a single wholesale market*
 - o To enable corporate issuers to raise finance on competitive terms on an EU wide basis

¹ Fully funded pensions are only a feature of certain EU/EEA countries for example Holland, the UK, and Switzerland. Others, such as France, Germany and Italy have yet to undertake substantial pension reform

- o To provide investors and intermediaries with access to all markets from a single point of entry
 - o To allow investment service providers to offer their services across borders without encountering unnecessary barriers
 - o To establish a sound and well integrated prudential framework for investment by fund managers
 - o To create a climate of legal certainty so that the carrying out and settling of trading in securities are safe from counterparty risk
 - b. *Retail - an open and secure retail financial services market*
 - o To give retail customers the information and safeguards they need to participate in the single financial market
 - o To remove unjustified barriers to providing cross border retail financial services
 - o To enable consumers to make small value cross border payments without excessive charge
 - c. *Regulation - state of the art prudential rules and supervision*
 - o To ensure that legislation and regulations have the flexibility to evolve with changes to the regulatory environment and changes in industry risk management practice
- iii. **Small scale of EAC regional markets and its implications:** there is very little cross-border capital markets business within the EAC - even the three cross-listed stocks are usually traded on their Kenyan home market and it appears clear that the expense of cross listing outweighs the trade generated (though perhaps not other intangible benefits). Capital does not flow freely across borders due to foreign investment and ownership restrictions, fiscal policy, regulatory policy and in the case of Tanzania (and Burundi), capital controls. East African capital markets also are individually small in scale relative to some other African markets - even the combined market capitalisation of the three original EAC members would only place an integrated EAC market 4th in size in sub-Saharan Africa. All the EAC securities markets (with the possible exception of Kenya) lack economies of scale and are therefore less cost efficient and attractive than they might be. EAC regionalisation would both give all members greater standing both within an African and an international context and make EAC investment more attractive and competitive with other African and international emerging markets. Thus, recommendations made with regard to regionalisation also need to take into account the need to develop and expand the size and volume of EAC capital markets as well as regionalise them. It is only through such expansion that all will achieve a positive benefit - for foreign and domestic investors, a wider choice and a more liquid market; for issuers, a greater ability to raise capital; for market participants, exchanges and CSDs, expanded business potential; and for economies, greater availability of capital to finance government and companies. Review of East African markets indicates also that while there is plenty of demand for securities (partly deriving from mandatory pension contributions), there is a lack of supply other than privatisations (refer section 4.1 below)

The conclusion of the 'models and findings' report was that there were a large number of barriers to EAC regionalisation (refer section 4). These barriers were legal

and fiscal, regulatory, operational or political relating - for example - to preservation of vested interests or a more general lack of drive or commitment.

This report makes recommendations as to the strategy and the plan to implement EAC regionalisation, based on the findings of the previous report. The objective of the strategy and plan is to achieve an EAC capital markets regime that permits capital to flow and participants to operate freely across EAC borders and which becomes increasingly attractive to foreign as well as regional investors. At the end of the regionalisation process:

- ⌚ Market intermediaries should be able to offer their services and deliver them in each of the EAC countries
- ⌚ EAC investors should be able to invest in any security throughout the EAC through a single point of access
- ⌚ EAC issuers should be able to seek investors in any part of the EAC
- ⌚ Transfer of funds and securities across EAC borders would be quick, easy, secure and cost effective

The terms of reference for this project require:

- i. first an assessment of the requirement for “harmonised regulatory regimes, or single regulatory regime, trading platforms, clearing and settlement regimes including requirements for central depositaries”
- ii. second “a proposal on the strategy to be pursued to achieve the selected regionalisation model... and an action plan for implementation... include detailed recommendations on the changes that will be needed on the market infrastructure, the regulatory and institutional framework and on the overall capacity of the industry players”

1.1 HARMONISED OR SINGLE REGIME

The clear recommendation of this report is that EAC regionalisation should be implemented in legal and regulatory terms through a harmonised rather than a single overarching regime: the main reasons against introduction of a single regime being the varying levels of commitment which would mean movement only at the pace of the slowest; the lack of a strong consensus which again will delay progress; the lack of implementation and enforcement capacity which will hinder progress; the lack of viability of a single market operating on top of existing markets which will be resistant to change; the lack of availability of the necessary quality and capacity of infrastructure; the lack of a single currency or a viable plan for one despite its introduction being due in 2012 (the EU took around a decade to move from agreement to monetary union in the Maastricht Treaty of 1992 to the introduction of the Euro currency in 2002 but made its first attempt in this direction in the 1970's); and the lack of cost effectiveness.

A harmonised regime, by contrast, can encompass: varying levels of commitment, moving at the pace of the fastest; varying levels of consensus moving ahead where it is greatest; will not require much greater capacity; will not damage viability of individual markets; will not require simultaneous adoption of identical infrastructure; will not require a single currency and is relatively more cost effective

since, rather than developing a whole new regime, it will build on the existing ones. In this context, by “harmonisation” we mean the implementation of minimum standards of regulation, with acceptance of different application of the standards in different countries in the EAC. Each country would recognise the regulatory regime of other countries, with responsibilities divided according to normal “home” / “host” state principles (refer section 4.2.4 for more information).

In relation to market infrastructure, the recommendation of this report is also harmonisation; in the case of exchanges, through the continuing operation of the individual national markets, but under the ownership of a single EAC Exchanges company (EACEx) which uses a single ATS trading platform to achieve economies of scale. This follows the lines of NOREX and OMX within Europe. It is proposed that EACEx would also create and own an EAC Index and an EAC unified investor information system. In the case of clearing and settlement, the recommendation of this report is that the national CSD functions be separated from national exchanges and merged into a single EACClear company which uses the linked national RTGS systems for cross border settlement. It is also the recommendation of this report that the subsequent creation of a Central Counterparty be evaluated. At the initial stage, it is the recommendation of this report that the quality of IT and communications linkages and support and independent backup for the exchanges and CSDs be greatly improved.

It is the belief of the consultants that harmonising EAC markets will, over the longer term, lead to a single market being achieved. However definite and deliverable plans for monetary union will be a pre-requisite for achieving a single market. Bearing in mind the EU experience, introduction of an EAC currency union in 2012 as presently envisaged is very unlikely for practical as well as economic and political reasons. Thus we do not believe it to be realistic to plan for a single market being able to be achieved within the period we envisage this project to cover - ie until 2014 as set out in the plan in section 6 below.

It should be noted that this report does not make detailed recommendations in relation to the development of bond market law, regulation and infrastructure or on mutually recognised competence standards, since these will be made by other ESMID projects. It does, however, take bond markets and the need for competence standards into account in terms of regionalisation of capital markets.

1.2 KEY RECOMMENDATIONS

The key recommendations of this report are given in the table below, under the benchmarks identified by the EU (which are given in greater detail in section 3.2 below). It is estimated that these activities will take place in three stages over a six year period (more details on the detailed activities under each stage appear in section 6):

- ⌚ Stage 1: January 2009 to June 2010
- ⌚ Stage 2: July 2010 to June 2012
- ⌚ Stage 3: July 2012 to June 2014

In summary, it is the recommendation of this report that the EAC move from the present position shown in the left hand column below to the position shown in the central column below; the right hand columns give references to the more detailed policy sections (starting with the number 4) or activity sections (starting with the number 6) of this report and the previous 'models and findings' report.

Table 1: Key changes to be made

From:	To:	Strategy report reference	Models report Reference
Limited EAC capital markets integration plan; limited disclosure of progress	Clearly defined medium term plan; annual publication of progress	3.1.1	3.7
Lack of prioritisation and commitment to EAC regionalisation; lack of accountability and penalties for non compliance	Clear commitment to prioritise EAC regionalisation; 'name and shame' non compliant or apply EAC CoJ penalties if possible	3.1.1	3.2.1 4.4.4
No monetary union implementation plan for 2012	Monetary union working group operational and plan and feasible schedule defined; progress published annually	4.1.1	3.4
Lack of capacity of industry players re regionalisation and capital markets	Appoint expert advisory panel to capital markets regionalisation working group to provide input and training; develop an EAC-wide set of competence standards for market participants and regulators	3.1.2 4.4	
EAC investors only able to invest in domestic markets through a domestic intermediary	EAC investors able first to invest in other EAC markets through local intermediary ; by last stage, EAC investors able to invest in other EAC markets via domestic or EAC intermediary licensed in home country but able to offer services and deal in host countries	4.1.2.3	2.3.2.3 4.1.3
Intermediaries and financial institutions required to apply for a licence in each EAC country separately	Intermediaries and institutions with licence in one EAC country able to operate in all countries without further regulatory approval	4.2	2.3.2.3
All EAC equities dealt only in their domestic markets	All EAC equities dealt through individual (but linked) national stock exchanges	4.2	2.2.1.1
EAC bond markets lack an appropriate legal framework and market infrastructure; no credit rating agency framework	Introduce harmonised EAC bond market framework and infrastructure including credit rating agencies; OTC trading of bonds enabled	4.1	4.1.12 4.2.4
Each EAC member country has its own stock exchange	All EAC national stock exchanges owned by EACEx; all use same ATS systems	4.3	2.3.2.3 4.1.10
Each EAC stock exchange has its own CSD	CSDs first separated out and then merged into EACClear; back up system in at least one other country	4.3	4.1.10
Unable to conduct IPOs across EAC borders	IPOs approved by one EAC regulator under harmonised standards automatically accepted by others	4.2	4.1.6 4.2.4 4.2.5

From:	To:	Strategy report reference	Models report Reference
Issuers make separate disclosures to each regulator in each country.	Issuers make a single home country disclosure disseminated by exchanges/regulators to counterparts in host EAC countries.	4.2	4.2.4
No IT links between stock exchanges and between CSDs	Reliable and sustainable IT platforms established	4.3	2.2.3.2
No unified source of EAC investment information	Unified EAC stock information system established and owned by EACEx	4.3	4.3.3
No EAC Index	EAC Index established and owned by EACEx	4.3	
Arbitrage between markets is impossible (no short selling, etc)	Barriers removed and arbitrage possible	4.2	4.1.11
Formal and informal barriers to competition (domestic and EAC)	Barriers removed	4.2 & 4.3	4.4.1 - 4.4.6
Capital cannot flow freely across borders: domestic institutional investors' ability to invest in other EAC countries often limited or non-existent; foreign ownership limits on securities mostly apply to EAC investors; Tanzania and Burundi have exchange controls	Barriers removed from legislation	4.2.5.6 & 6.2.2	2.4.1 4.1.1 4.1.3-16
Tax treatment of listed and unlisted companies varies between member states; the same applies to stamp duties	Tax study undertaken, policy agreed and consistency achieved	4.1.1.4	4.1.7
No double tax treaties so cross border EAC investment unattractive for institutional investors	Double tax treaties introduced	4.1.2.1	4.1.7
Inconsistent prudential requirements for institutional investors	Harmonised EAC wide prudential standards introduced	4.2.5	4.2.2
Legal definitions and requirements for capital market participants vary between EAC members; banks and insurers are exempted from securities dealing requirements	Harmonised EAC wide standards agreed and enacted	6.2.1 & 6.3.1.1.3	4.1.8 4.2.3
Regulators cannot approve/have no powers over non-domestic EAC capital markets entities	Necessary powers in place; EAC intermediary licensing categorisations introduced - able to offer services and deal across EAC markets	6.2.1	2.3.2.3
Regulators have no MoUs enabling them to regulate cross border EAC activity	Necessary MoUs in place defining home and host country regulatory responsibility	6.2.2 & 6.3.1.1.3	2.3.2.3
Cross listed stocks must comply with each country's requirements ab initio	All stocks on all exchanges available through each exchange; all filings with home regulator communicated to host regulator	4.1.1.5	2.3.2.3 4.1.6 4.2.4 4.2.5
EAC domiciled CIS cannot be offered cross border between EAC countries	EAC domiciled CIS able to be 'recognised' for offer in other EAC states	4.2.5.1	2.3.2.4
Closed ended CIS suited to illiquid assets largely absent from EAC	Study undertaken and new forms introduced	4.1.2.4	2.3.2.4
Electronic settlement not possible in Uganda	Electronic settlement enabled	6.2.1.1	2.2.3.2
Securities settlement in non-domestic	Securities settlement in any other	6.2.1.1	2.2.3

From:	To:	Strategy report reference	Models report Reference
CSD not possible	EAC member CSD enabled		
Securities money settlement not secure within EAC	Secure money settlement established using linked RTGS system and possibly at the last stage a CCP	4.3.2	4.3.1
Varying levels of investor compensation payable	Investor compensation standards harmonised	6.3.1.1.3	4.1.9
Weak IT and communications and market infrastructure in all countries	Strong and secure IT communications and market infrastructure established	4.3.2.3	3.3.1.4.2
Lack of private sector issuance	Improve bond regime and infrastructure and introduce new bond types (OMX/NASDAQ & ISC); address crowding out of private sector issuance by public sector issuance; introduce fund forms suited to illiquid markets; reduce costs and complexities of issuance; reform pension system in Tanzania and Uganda and other measures listed above	4.1 & 4.2.6.3	Appendix A
Audit requirements vary	Consistent EAC audit standards are established	4.5 6.2.1.5	4.1.13
Poor access to unreliable company data	Create EAC Companies Registrar along lines of UK Companies House	6.2.1.7	4.3.3

A key factor in achieving the programme set out above will be political commitment at the highest level.

The following quote is both interesting and apposite.

“If the [Safaricom] issue is oversubscribed, it will prove to regional governments once and for all that what ails this region is not lack of finance but the political will to mobilise it” *New Vision, 4 April 2008*

The issue has since been oversubscribed 254% by local investors or 282% taking international investors into account². The lack of political will noted in this comment is likely, if it persists in relation to EAC capital markets and their regionalisation, to lead to lack of progress and, quite possibly, mean that other regional blocs will prove more successful. Then their capital markets will broaden and deepen, as they attract a greater number of issuers, investors and intermediaries, while the EAC will atrophy and experience greater problems in financing its own governments and companies. The consultants therefore note and welcome the start of negotiations for an EAC Common Market launched in April, due for agreement by end 2008.

The regionalisation approach set out in this report broadly chimes with that for implementation shown on the EAC website, as follows:

² East African Standard, 8 May 2008

Harmonisation of Fiscal and Monetary Policies	<ul style="list-style-type: none"> • Continue consultations to harmonize fiscal and monetary policies
Free Movement of Capital	<ul style="list-style-type: none"> • Put in place mechanisms to facilitate introduction of single currency • Establish credit rating of all financial institutions/instruments
	<ul style="list-style-type: none"> • Cross-listing of Companies on National Stock Exchanges • Full liberalization of Capital Account in all Partner States • Establishment of an East African Stock Exchange
	<ul style="list-style-type: none"> • Establish mechanism for monitoring and management of foreign exchange flows associated with liberalized capital Account • Harmonisation of capital market policies
	<ul style="list-style-type: none"> • Conduct a study to ascertain the exact areas of harmonizing the legal frameworks governing the operation of stock exchange markets

end

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