CMA Forum

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CMA Team Building

Staff led by the Chief Executive, Mrs. Stella Kilonzo MBS, during the teambuilding event.

Chief Executive's Message

We have faced challenging times with declining performance of our stock market but have seized the opportunity and rallied stakeholders together in an effort to jointly address the issues that we face today as we seek to play our role in the realization of the Vision 2030 objectives.

Representatives of the capital markets industry came together recently at the Hilton Hotel in Nairobi and took the first step in the conceptualization, design, and implementation of a Capital Markets Master Plan for the next five-years, that will be jointly owned by the capital markets industry.

All stakeholders expressed unanimous support for the identification of a Steering Committee, drawn from across all stakeholders, to conceptualize and implement the Capital Markets Master Plan.

The forum included; CMA Board members led by the Chairman, Mr Kung'u Gatabaki, and representatives from the Council of the Kenya Association of Stockbrokers and Investment Banks (KASIB), the Nairobi Securities Exchange, Central Depository and Settlement Corporation, investment banks, stockbrokers, fund managers, investment advisers, and collective investment schemes.

The Authority saw the meeting as a launch pad for the conceptualization of a jointly owned Capital Markets Master Plan to serve as a catalyst for the coordinated growth of our market in line with Vision 2030.

There was broad consensus amongst all attendees on the need for the industry to focus on coordinated approaches to capital markets industry investor education, market sensitization, and marketing initiatives to harness the diverse skills, perspectives, and resources of the industry.

It was agreed that it is critical that these joint marketing efforts are to be rolled out at the county, national, regional, and international levels and be appropriately tailored for the diverse investor and issuer perspectives.

Mrs. Stella Kilonzo
Chief Executive

I would like to express the Authority's commitment to work closely with the private sector to create a facilitative environment for the innovation of new products.

I appreciate the support received from all stakeholders for the reform agenda which we have been rolling out for several years with positive results. We expect this will position Kenya as the preferred destination for investments in region and buttress the efforts to transform Nairobi into an International Financial Centre.

The Capital Markets Master Plan is expected to sharpen the focus of the entire industry towards common objectives and strategies, allocation of resources, and execution of joint initiatives geared towards positioning our market for the benefit of all stakeholders.

Anti-Money Laundering in the Capital Markets and the Risk-Based Approach

Emergence

The Crime and Money Laundering Act, 2009, has introduced new obligations for the capital market intermediaries that require the latter to, among other things, establish and maintain Anti-Money Laundering (AML) complionce programmes. It is important to note that, even though these obligations are prescribed by legislation which is external to the capital markets regulatory regime, this legislation specifically tasks the Capital Markets Authority to supervise its implementation in the industry. Thus, the Authority is currently formulating guidelines for this purpose.

For most of us in the capital markets industry, money laundering ordinarily sounds like a concept quite irreconcilable with our industry and more at home in the banking industry. Indeed, for most of the past century, the banking sub-sector has been the main target for money launderers due to its central infrastructural function, utility and location with regard to money. However, the capital markets have demonstrated a potential to extend their influence above and beyond their traditional boundaries in the financial sector, and with this has come the threat of becoming an irresistible abattoir for money laundering. Further, with this rapid emergence and development of the capital market in the modern economy, the immobilisation of cash and the development of the i-economy, the status quo has undergone and continues to undergo significant change, especially in the more developed economies. It follows that the lesser developed economies such as ours ought to take heed of these changes.

In Kenya, the financial economy is at a stage where the major difference between the mainstream banks and investment banks/stockbrokers with regard to the threat of money laundering, lies in the regulatory environment rather than in the day to day operations; that is, the Banking and Central Bank Acts (and Regulations) vis a vis the Capital Markets Act (and Regulations). In other words, the difference in terms of operations is being significantly eroded by diversification from core business and the emerging cross-cutting technological developments.

By Michael Wanyika,
Market Operations Directorate

However, ceteris paribus, the regulatory environment under which banks operate is much more developed and hence there may result in a distillation of money laundering demands to the capital markets in an attempt to take advantage of the relatively young regulatory regime. This is mainly due to the fact that the banking regulator and players have been at it for a longer period of time and have been subject to the harsher lessons of economics and necessity.

An Enabling Market Structure

The capital markets industry is structured such that it presents the launderer with the opportunity of performing the three stages of laundering (Placement, Layering and Integration) without even moving the funds to, not only another sector of the economy, but another firm. Firstly, consider that these firms are able to take in cash deposits from investors; secondly, that they have virtually unlimited access to trade in financial assets; and thirdly, that they are not subject to industry/regulatory restrictions with regard to funds transfers. Furthermore, the liquidity of many investment products would be particularly irresistible to sophisticated money launderers since it allows them to quickly and easily move their money from one product to another, mixing lawful and illicit proceeds and integrating them into the legitimate economy, and all under one roof.

Risk Based AML Compliance

The AML risks that face a firm may be either internal or external. Internal risks relate to weaknesses in internal controls and resources, while external risks may be the result of various factors such as the nature of clientele and weak regulatory guidance.

Risk based AML compliance differs from other regulatory obligations in that it is not adequately fulfilled through a simple adherence to the rules-based approach, or in other words, prescriptive legislation, which provides rigid rules of procedure relating to particular aspects of a firms' operations. On the contrary, AML compliance relies heavily on the pro-active undertakings of individual firms, such as the initiatives of the Boards of Directors or chief executive officers. In this regard, AML compliance requires firms to examine all aspects of its operations and make judgments, estimations and appraisals relating to the relationship between specific sets of circumstances or facts that occur during the normal operations on the one hand, and AML processes and procedures, on the other hand. Any risk based AML compliance program, therefore, that does not facilitate constant interaction between the functions of a firm would be ineffective. In other words, risk management should be an integral part of any AML programme as this will enable the firm to direct the scarce resources to respond to the highest identified risks.

The following are some of the benefits to be achieved in the use of risk based compliance approach to AML:

- Resource maximization – it ensures that resources are utilized cost effectively by allocating them according to the priority risk lists;
- Flexibility – it ensures that the compliance programme is flexible enough to respond to new and varied risks and threats;
- Co-operation – it requires the firm's different function areas to co-operate with each other in managing the compliance processes and also fosters closer working relations and understanding between the firm and the regulator; and;
- Reduction of compliance burden to customers – the burden placed upon the firms' clients who are classified under the lower risk categories is much lighter than would be the case if blanket compliance requirements were enforced across the board for all customers.

However, even with these benefits, implementation of this approach has various challenges such as training, expertise development and change management.

It is the responsibility of the firm, not the regulator, to consider all the firm's AML risks through risk assessment processes and compile priority risk lists upon which an AML compliance programme will be based. It also falls within the firm's responsibility to set up responses to the various risks, as these will usually be unique to the firm. The regulator's role will be largely in ensuring that the AML compliance programme is adequate and effective in as far as is required by both the legislation and its own standards.

There is no universally accepted methodology or procedure setting out how a firm shall profile AML risks, the assumption is that every firm shall take into account its own unique set of circumstances and exercise reasonable business judgement with respect to their clients. Essentially, this risk based approach should not be an impediment to the growth of the business, but should merely be designed to assist them to manage potential money laundering risks effectively.

Bond Market Reforms

The bond market in Kenya is emerging as a critical avenue for resource mobilization. It is largely dominated by Government securities and a few corporate bond issues with the first Corporate and Treasury bonds having been issued and listed at the NSE in 1996 and 1997 respectively. Main issuers of non-Government Bonds are Commercial Banks though we are beginning to see non-bank Issues such as Kengen, Shelter Afrique and Athi River Mining. On the other hand, key investors are Commercial Banks and Fund Managers comprising more than 90% of total bond holdings. However, more participation by retail investors, pension funds and insurance companies is now being witnessed.

Significant growth in the bond market began after reorganization of the market in 2002 that resulted in the bonds being listed at the Fixed Income Securities Market Segment. In the recent past, the Capital Markets Authority has also been undertaking several reforms in the Bond Market in Kenya. Currently both government and corporate bonds are trading on an Automated Trading System. The maturity profile has been extended to 30 years following the issue of a 30 Year savings bond in February 2011 and there is one approved Credit Rating Agency in Kenya.

In adopting the new Hybrid Bond market model, under the overall direction of the Bond Markets Steering Committee (BMSC), there is consideration to introduce an Over-The-Counter market for bonds alongside the Formal Exchange market. The legal and policy framework was exposed to stakeholders for a period of thirty days. In cognizance of the need to involve all stakeholders in the market and to address concerns raised during the exposure period, the BMSC organised a validation workshop on 8th April 2011 at the Kenyatta International Conference Centre. The half day meeting was well attended by over 100 stakeholders in the Bond Market in Kenya including capital market institutions, financial sector regulators, insurance companies and other Government agencies.

Making his key note address during the workshop, the Permanent Secretary, Office of the Deputy Prime Minister and Minister for Finance, Mr Joseph Kinyua, noted that inspite of the Government instituting measures to lengthen the

By Jairus Muaka

maturity of its infrastructure bonds and reduced withholding taxes for bonds over 10 years, the bond turnover to GDP ratio is far below international standards standing at just 19% compared to regional states like Nigeria. He therefore emphasized the need for stakeholder support on the reform agenda.

Stakeholder comments arising from the workshop and exposure were incorporated and the draft amendments to the law to extend CMA's mandate to regulate the proposed OTC market have been subjected to the legislative process and were approved through the Finance Act 2011 in June and shall come into effect in January 2012.

Other developments that have taken place since the workshop in April, include engagement of a consultant by IFC-ESMID to assist the BMSC develop an operational framework for the Hybrid Bond Market. The key features of the proposed model include:

- Bilaterally agreed trades to be reported to the market;
- NSE to provide the trade reporting platform;

- The market to be regulated by CMA , delegoting a supervisory role to a market/post trade organiser;
- Concentrate post trade liquidity in single order books;
- Allow for new trading participants;
- Provide for diversification regarding classification of instruments.

The design is largely based on utilising current infrastructure enabling cost efficient use of available technology, organisation, rules & regulations and skills. In order for the design to work efficiently, enhanced structures are required for:

- **Pre-validation of government bonds:**

  The Central Bank of Kenya (CBK) currently accepts requests to enable securities to be traded either as a SWIFT message, used by the commercial banks, or by a paper form seconded by physical attendance at the CBKs teller desks. However implementation of the "T24" project, with functional capabilities that will allow brokers and other authorized bond traders internet access to the CBK Central Depository System is expected to solve the problem. The Bond Market Steering Committee Task Force is working closely with CBK to develop rules and operations procedures to accommodate the requirements of all Government Bond traders in an internet regime.

- **Licensing, regulation and supervision of new trading participant type:**

  The Authority is in the process of developing regulations for new trading partcipants.

- **Strengthening of settlement processes for corporate bonds;**

  CDSC is exploring the option of having multiple settlement banks to minimise settlement risks associated with having all settlements done in a single bank. This is expected to be rolled out in December 2011. To ensure a level playing field for all bond market participants, CDSC will facilitate an agreement between stock brokers and commercial banks, enabling the stock brokers to access SWIFT services at fair rates.

Other reforms being implemented which are complementary to the Hybrid Bond Model include the introduction of Government Securities Market Makers, a process being driven by the Centrol Bank. The general impact of the implementation of the hybrid bond model is increased competition resulting from introduction of new trade participants and multiple settlement banks. This will thus increase the drive for more diversified service levels. There will be improved infrastructure support potentially shortening the trading cycle hence enhancing liquidity. Other benefits may include:

- Potential to enter brokerage business by acquiring a trading participant license;
- Potential to engage as market maker in the government securities market;
- Potential to engage as settlement bank in the corporate bond market;
- Strong growth expected for total bond market, creating growth opportunities for all market participants;
- As the competitive landscape will change, revenue growth and market share will respond stronger to innovation and business development;
- Opportunity for banks to participate in a larger part of the value chain, by being active in trading and price formation, thus creating value and increase revenues;
- Increased efficiency and transparency in the bond market will encourage international interest, creating new business opportunities for the trading community.

The Concept of Carbon Trading Demistified

We owe our presence on Earth to the delicate balance of atmospheric gases like carbon dioxide (CO2) and other greenhouse gases. These gases spewed out from below the Earth's crust before life began. The greenhouse gases:– water vapour (the main greenhouse gas), methane, ozone, carbon monoxide, nitrous oxide and CO2; absorb some of the energy released by the sun and emit it in all directions, including back towards Earth. The Earth's surface is about 34°C warmer as a result. Over millions of years, the Earth has managed to regulate concentrations of greenhouse gases through a system of sources and sinks. In modern times the burning of fossil fuels like coal, oil and natural gas – in which carbon has been stored for millions of years – combined with accelerated land clearance has led to unprecedented levels of greenhouse gas emissions. Carbon sinks can't keep up, and concentrations of greenhouse gases in the atmosphere have risen dramatically leading to an enhanced greenhouse effect. Most scientists say that as concentrations of these gases continue to rise, there will be a general and very rapid warming of the world's climate. People have become increasingly concerned about the effects of global warming. Between 1990 and 2004 global CO2 emissions increased by 28 per cent. In 1992, most developed countries in the world agreed to the United Nations Framework Convention on Climate Change (UNFCCC), which is designed to impose limits on greenhouse gas emissions and thus minimise the adverse effects of climate change.

Under the UNFCCC, countries are permitted to use a trading system to help meet their emissions targets. As a result of UNFCCC industrial nations entered into a legally binding agreement to reduce collective emissions of GHG by 5.2% compared to the 1990 levels calculated at an average over a 5-year period of 2008-2012. Separate national targets have been given to US (7%), EU (8%), Japan (6%) and Russia (0%). The protocol further reaffirms that developed countries have to pay and supply technology to other countries for climate-related studies and projects. The Protocol was initially adopted on 11 December 1997 in Kyoto, Japan and came into force on 16 February 2005. In order to facilitate the achievement of target emission limits, three additional mechanisms were agreed upon. These are: clean development mechanism (CDM), joint implementation (JI) and international emissions trading (IET).

Justus Agoti,
Regulatory, Policy and Strategy Directorate

IET: IET allows Annex I countries to "trade" their emissions (Assigned Amount Units, AAUs, or "allowances" for short). Trade could potentially allow the Annex I countries to meet their emission reduction commitments at a reduced cost. This is because trade allows emissions to be abated first in countries where the costs of abatement are lowest, thus increasing the efficiency of the Kyoto agreement.

CDM: The Clean Development Mechanism (CDM), defined in Article 12 of the Protocol, allows a country with an emission-reduction or emission-limitation commitment under the Kyoto Protocol (Annex B Party) to implement an emission-reduction project in developing countries. Such projects can earn saleable certified emission reduction (CER) credits, each equivalent to one tonne of CO2, which can be counted towards meeting Kyoto targets. The mechanism is the first global, environmental investment and credit scheme of its kind, providing a standardized emissions offset instrument, CER.

JI: Joint Implementation involves projects between industrialized countries to earn emissions offsets. Emission Reduction Units created by JI projects are treated the same way as those from emissions trading. In JI, instead of directly purchasing emission rights (AAUs), a country gains emitting permits by funding a part of the project activity in another annex I country which reduces GHG or enhances removals via carbon sinks.

How Carbon Credits are created

There are two components to the carbon market: "Cap and Trade" and "Offsets".

Cap and Trade: A regulating body, mandated by a government, decides on a target (the target being the "cap") level for all of the parties participating in the program. Each participant is then allocated a portion of the "cap" in the form of "allowances". The "cap" would be the maximum amount of pollution allowed for a group of emitters (in a particular sector such as industrial processors) over a given period of time. This target will be less than the amount of pollution these emitters would emit in a "business as usual" situation - thus creating a shortfall. Each participant needs to make a choice - either reduce their emissions or find enough permits (credits) to cover all of their emissions.

Offsets: A carbon offset (also known as carbon credit) is a unit earned by someone who has implemented a project according to international standards that generates a reduction, removal, storage or avoidance in greenhouse gas emissions than would otherwise have occurred (for example a methane capture plant). A carbon offset is issued by an authority or a Board pursuant to those international standards (one credit is issued for every metric tonne of emissions of carbon dioxide equivalent) that has been reduced, removed, stored or avoided.

Carbon Credit as a commodity

The carbon market became possible when over thirty (30) nations voluntarily adopted greenhouse gas emission reduction schedules at a UNFCCC conference in Kyoto, Japan, in December 1997. Suddenly, carbon emissions became a liability and carbon reductions an asset. One of the provisions in the Kyoto Protocol called for emission reduction trading using free market mechanisms. Emissions trading would allow national and international transfer of emission reductions among players in different industries as a way to level out costs. As a result, a commodities market was born. In this regard carbon credits are regarded as a "commodity".

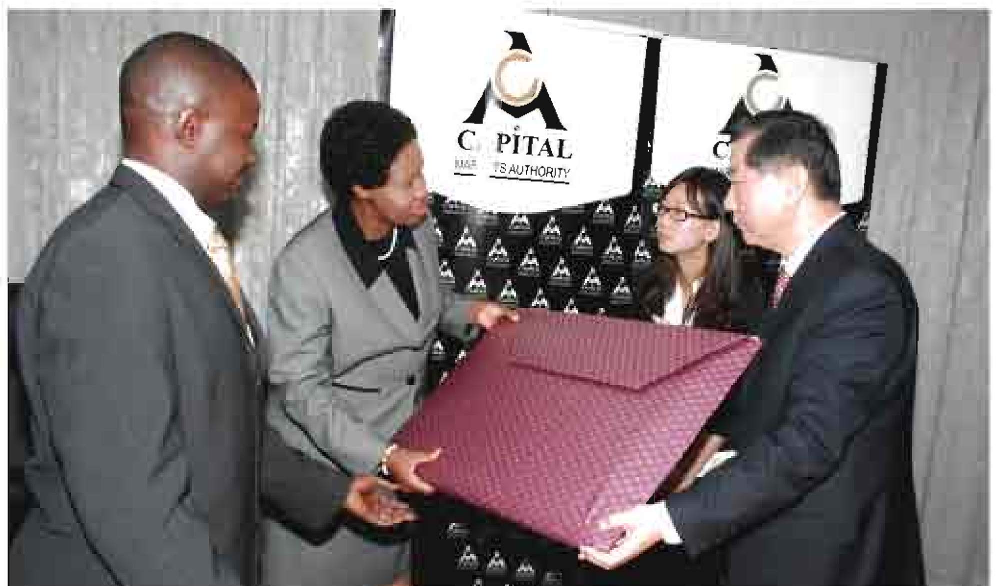
Financial instruments based on Carbon Credits

When sufficient CO_2 reduction has been registered to qualify for a tradable unit on various exchanges and/or platforms, it represents a Carbon Credit Instrument ("CCI"). Under certain circumstances, a verified CCI that meets the standards of other exchanges like the Chicago Climate Exchange or European Climate Exchange can be bundled or converted into a Carbon Financial Instrument ("CFI") that can be sold or traded. Carbon Financial Instruments – defined units of CO_2 reduction that qualify for trading on the Chicago Climate Exchange and European Climate Exchange are categorized as Carbon Financial Instruments (CFI). Essentially, a Carbon Financial Instrument represents the same concept as a Carbon Credit Instrument. The difference is the standard by which the instruments are created and recognized as tradable units. Carbon financial products include; Carbon forward and futures contracts, Carbon delivery guarantees, derivatives, insurance/guarantees and miscellaneous products: e.g., green credit cards, carbon neutral products etc.

Pictorial

The Capital Markets Authority Chairman, Mr. Kung'u Gatabaki (left), Chief Executive, Mrs. Stella Kilonzo MBS (centre), and Board Member, Mr. Humphrey Muga (right) during the African Funds and Capital Markets Conference, which was co-sponsored by the Authority

The Capital Markets Authority Chief Executive, Mrs. Stella Kilonzo MBS (centre), congratulates the Governor of the Central Bank of Burundi, Mr. Gaspord Sindayigaya (left), after Burundi was admitted as a member of the East African Securities Regulatory Authorities (EASRA), the regional body of capital market regulators, in August 2011. Looking on is the EASRA Chairman, Mr. Robert Mathu, who is also the Executive Director of the Capital Markets Advisory Council, Rwanda.



Capitol Markets Authority Board Member, Ms. Rose Detho (2nd left), presents a token of appreciation to the Chairman of the China Securities Regulatory Commission (CSRC), Dr. Shang Fulin (2nd right). Looking on is an Authority Board Member, Mr. James Waweru (1st left) and Ms Fan Yating from the Department of International Affairs, China Securities Regulatory Commission. Dr. Fulin led a delegation from CSRC on a familiarization visit to the Capital Markets Authority offices.