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**AN EVALUATION OF THE DETERMINANTS OF CAPITAL  
MARKETS DEVELOPMENT IN KENYA  
(A Case study of the Nairobi Stock Exchange)**

**BY**

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## DECLARATION

This research report is my original work and has not been presented for any award or degree in any other university. All sources of information contained herein have been specifically acknowledged by means of references.

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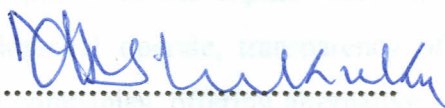
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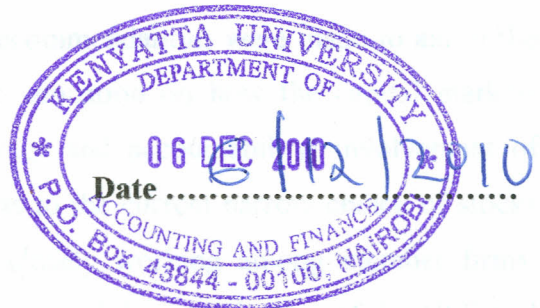
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## ABSTRACT

The purpose of the study was to evaluate the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange (NSE). The NSE is considered a more liquid and active market than those of its East African counterparts (Uganda and Tanzania) and in sub-Saharan Africa in general. However, by international standards, it is small, illiquid and volatile with regard to price and returns. Low liquidity is particularly evident in the secondary bonds and equity markets. The NSE is a highly concentrated market with most of its activity centered on a few listed companies (Wagacha, 2001). The specific objectives of the study included: (i) to determine how the changes in institutional factors affect the capital markets development in Kenya; (ii) to determine the impact of macroeconomic factors or stability on capital markets development in Kenya and (iii) to determine the effect of the regulatory changes and political risk on the capital markets development in Kenya. For the research the population of the study was composed of selected employees of the Nairobi Stock Exchange, key informants, from the listed companies and the member firms. A census was drawn from the total population of 104 respondents. Data was collected by use of questionnaire method which had both closed and open ended questions. Data was analyzed using descriptive statistics including frequency distribution tables, means, mode and standard deviation. From the study the researcher established the key determinants of the capital markets development in Kenya. The response from the respondents showed that institutional factors (78%), macroeconomic factors (75%), political risk and regulatory changes (63%), as the respondents stated the extent of the effect as being on the great and very great extent. From the study the following recommendations were made to aid in the development of the capital markets; public education on how the capital markets development operate, transparency of dealings and accountability, involvement of more companies, offering alternative products to the current narrow choice of stocks and bonds, prompt action on fraud cases, closely working among member firms, online reliable trading, research on new policies and demutualization of the NSE and subsidized favourable taxation on member firms.

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God bless

## DEDICATION

This work is dedicated to my parents, siblings and friends who have motivated me to carry out this study. God has equally blessed me with a wonderful wife Judith, who has stood by me in good and difficult times. And of course to my beautiful daughter Kayla who has given me reason to climb to whatever height

ACKNOWLEDGEMENTS	1
LIST OF CONTENTS	1
LIST OF FIGURES	2
LIST OF TABLES	2
LIST OF ABBREVIATIONS	2
<b>CHAPTER ONE</b>	
1. INTRODUCTION	1
1.1 Background to the study	1
1.2 Statement of the problem	2
1.3 Objective of the study	2
1.4 Research Questions	2
1.5 Significance of the study	2
1.6 The Scope and Limitation of the Study	2
<b>CHAPTER TWO</b>	10
2. LITERATURE REVIEW	10
2.1.0 Introduction	10
2.1.1 Capital Markets	10
2.1.2 History of Stock or Capital Market	11
2.1.3 Overview of the Nairobi Stock Exchange	12
2.2 Theoretical Literature review	16
2.2.1 Capital Market Theory	16
2.2.1.1 Capital Asset Pricing Model (CAPM)	17
2.2.2 Arbitrage Pricing Theory (APT)	17
2.2.3 Interest Rate of Capital Asset Pricing Model (ICAPM)	18
2.2.4 Markowitz Pricing Theory (MPT)	18
2.3 Empirical Literature review	19

# TABLE OF CONTENTS

	<b>Page</b>
DECLARATION.....	ii
ABSTRACT .....	iii
ACKNOWLEDGEMENT .....	iv
DECLARATION.....	v
TABLE OF CONTENTS.....	vi
LIST OF FIGURES .....	ix
LIST OF TABLES.....	xi
LIST OF ABBREVIATIONS .....	xi
<b>CHAPTER ONE</b> .....	<b>1</b>
1.1 INTRODUCTION .....	1
1.1 Background to the study.....	1
1.2 Statement of the problem .....	6
1.3 Objectives of the Study .....	7
1.4 Research Questions.....	7
1.5 Significance of the Study .....	8
1.6 The Scope and Limitation of the Study.....	9
<b>CHAPTER TWO</b> .....	<b>10</b>
2.0 LITERATURE REVIEW.....	10
2.1.0 Introduction .....	10
2.1.1 Capital Markets.....	10
2.1.2 History of Stock or Capital Market .....	12
2.1.3 Overview of the Nairobi Stock Exchange.....	13
2.2 Theoretical Literature review .....	16
2.2.0 Capital Market Theory .....	16
2.2.1 Capital Asset Pricing Model (CAPM) .....	17
2.2.2 Arbitrage Pricing Theory (APT).....	17
2.2.3 Inter-temporal Capital Asset Pricing Model (ICAPM) .....	18
2.2.4 Markowitz Pricing Theory (MPT).....	18
2.3 Empirical Literature review.....	19

2.3.1 Institutional factors .....	19
2.3.2 Macroeconomic factors .....	21
2.3.3 Regulatory changes and political risk .....	23
2.4 Critical review .....	24
2.5 Summary and gaps to be filled by the study.....	24
2.6 Conceptual Framework .....	25
<b>3.0 CHAPTER THREE .....</b>	<b>26</b>
3.0 DESIGN RESEARCH AND METHODOLOGY .....	26
3.1 Study Design.....	26
3.2 Target population .....	27
3.3 Sampling design.....	27
3.4 Data collection procedure.....	28
3.5 Data analysis .....	28
<b>4.0 CHAPTER FOUR.....</b>	<b>30</b>
4.0 DATA ANALYSIS AND PRESENTATION OF RESULTS .....	30
4.1 Introduction .....	30
4.2 Response Rate.....	30
4.3 Demographic Information .....	32
4.4 Capital Market Development.....	36
4.5 Effects of Institutional Factors.....	38
4.6 The Impact of Macroeconomic Factors .....	41
4.7 The effect of Regulatory changes and political Risk .....	44
4.8 Qualitative analysis .....	47
4.8.1 General suggestions on Capital Market Development.....	47
4.8.2 Suggestions on Institutional Factors .....	47
4.8.3 Suggestions on Macroeconomic Factors.....	47
4.8.4 Suggestions regulatory changes and political Risk.....	48
<b>5.0 CHAPTER FIVE .....</b>	<b>49</b>
5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS .....	49
5.1 Introduction .....	49
5.2 Summary of Findings.....	49

5.4	Conclusions .....	52
5.5	Recommendations.....	52
5.6	Suggestion for further research .....	53

REFERENCES .....	54
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APPENDIX I –BUDGET PLAN.....	56
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APPENDIX II –LISTED COMPANIES .....	57
-------------------------------------	----

APPENDIX III –LIST OF MEMBER FIRMS OF NSE .....	59
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APPENDIX IV –QUESTIONNAIRE .....	60
----------------------------------	----

Figure 1.1: Efficiency and sustainability of the capital market in Kenya	10
--	----

Figure 1.2: Extent to which institutional investors affect the development of the capital market in Kenya	11
---	----

Figure 1.3: Market structure of the capital market in Kenya	14
---	----

Figure 1.4: Stability of the Kenyan economic environment	15
--	----

Figure 1.10: Extent to which macroeconomic policy affects the development of the capital market in Kenya	21
--	----

Figure 1.11: Market structure of the capital market in Kenya	24
--	----

Figure 1.12: Regulatory and political changes	25
---	----

Figure 1.13: Extent to which regulatory and political changes affect the development of the capital market in Kenya	26
---	----

Figure 1.14: Market structure of the capital market in Kenya	27
--	----

## LIST OF FIGURES

	<b>Page</b>
Figure 2.6.1 Conceptual Framework .....	25
Figure 4.1 Response Rate .....	31
Figure 4.2 Respondents Gender.....	32
Figure 4.3 Respondents Experience.....	34
Figure 4.4 Respondents' level of education .....	35
Figure 4.5 NSE and the development of the Capital Markets in Kenya.....	36
Figure 4.6 Extent to which NSE plays in the development of the Capital Markets .....	38
Figure 4.7 Efficiency and accountability .....	39
Figure 4.8 Extent to which institutional factors affects development of the Capital Markets in Kenya .....	41
Figure 4.9 Stability of the Macroeconomic environment .....	42
Figure 4.10 Extent to which macroeconomic factors affects development of the Capital Markets in Kenya .....	43
Figure 4.11 Regulatory and political changes .....	45
Figure 4.12 Extent to which regulatory and political changes affects development of the Capital Markets in Kenya .....	46

## LIST OF TABLES

**Page**

Table 3.1 Target population .....	27
Table 4.1 Response Rate .....	31
Table 4.2 Respondents Gender .....	32
Table 4.3 Respondents Experience .....	33
Table 4.4 Respondents' level of education .....	34
Table 4.5 NSE and the development of the Capital Markets in Kenya .....	36
Table 4.6 Extent to which NSE plays in the development of the Capital Markets .....	37
Table 4.7 Efficiency and accountability .....	39
Table 4.8 Extent to which institutional factors affects development of the Capital Markets in Kenya .....	40
Table 4.9 Stability of the Macroeconomic environment .....	42
Table 4.10 Extent to which macroeconomic factors affects development of the Capital Markets in Kenya .....	43
Table 4.11 Regulatory and political changes .....	44
Table 4.12 Extent to which regulatory and political changes affects development of the Capital Markets in Kenya .....	46

## LIST OF ABBREVIATIONS

<b>APT</b>	– Arbitrage Pricing Theory
<b>CAPM</b>	– The Capital Asset Pricing Model
<b>CBK</b>	– Central Bank of Kenya
<b>CBS</b>	–Central Bureau of Statistic
<b>GDP</b>	– Gross Domestic Product
<b>CDS</b>	–Central Depositories System
<b>CDSC</b>	–Central Depository & Settlement Corporation Ltd
<b>CIC</b>	–Capital Issue Committee
<b>CMA</b>	– Capital Markets Authority
<b>ICAPM</b>	– Inter-temporal Capital Asset Pricing Model
<b>IFC</b>	–International Finance Corporations
<b>MPT</b>	– Modern Portfolio Theory or Markowitz Portfolio Theory
<b>NSE</b>	– Nairobi Stock Exchange

## CHAPTER ONE

### 1.0 INTRODUCTION

#### 1.1 Background of the Study

Before the late 1980s, international donors and governments in developing countries held the notion that entrepreneurial functions could be served better by the state through state ownership of the means of production, taxation, licensing and regulation. Individual entrepreneurs were perceived to be few and local subsidiaries of multinational firms formed a large part of local private sector activity. Poor performance of the public sector, misallocation of resources, market distortions and negative economic growth influenced a re-evaluation of the state-led development strategy. In the following years liberalization and privatization have become dominant themes in development strategies particularly in Africa. Donors, governments and development practitioners have exhibited changing attitudes towards the role of the private sector in the development of African economies and acknowledged the need to facilitate private sector development (Rwelamira, 1993).

Considerable attention has been drawn as to what are the major determinants of investment in the stock market both in developed and emerging economies and many scholars have argued the crucial role that the stock market plays in the economy at the same time examined the impetus that growth in an economy provides to the capital markets. Developing countries have been working towards reforming and deepening financial systems, through the expansion of capital markets in order to improve their ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy. A significant policy change has been the establishment privatization programs, which have facilitated reduction in public debt, improved

incentives and efficiency in the operations of the privatized entities, and facilitated better access to capital through the floating of shares to the general public(Schmukler et al,2005)

Demirguc-Kunt and Levine (1996), Singh (1997), and Levine and Zervos (1998) found that stock market development plays an important role in predicting future economic growth. Recently, an extensive empirical research has shown that the development of stock markets is robustly and positively related with the level of economic development and accumulation of capital. This conclusion solidly supports the idea that as economies develop equity markets tend to expand both in terms of the number of listed companies and in terms of market capitalization [Atje and Jovanovich, (1993); Demirguc-Kunt and Levine, (1996, 1996); Korajczyk, (1996); Demirguc-Kunt and Maksimovic, (1996); Levine and Zervos, (1996, 1998) and Blackburn et, al (2005)].

Other studies by Mario Catalan et al (2000) found that the contractual savings are powerful enough to increase the supply of long-term funds and develop the capital markets in an economy. This is because contractual savings institutions have long-term and illiquid liabilities on their balance sheets. The paper intends to examine the relationship between Kenya's gross national savings and the stock market development.

Over the past few decades, the Kenyan stock market has surged, and privatizations have accounted for a large amount of this boom. The pace and nature of stock market development in the country has been unprecedented and has led to fundamental shift both in the financial structures that exist in the country and the capital flows from developed nations. Foreign investors have made a big impact in determining the size of the stock market through the stock market liquidity.

Financial intermediaries (banks, insurance companies, and pension funds) have also played a role in determining the level of investment in the stock market hence its development. Demirguc-Kunt and Levine (1996) have found that most stock market indicators are highly correlated with banking sector development. Countries with well-developed stock markets tend to have well-developed banking sector. This paper intends to investigate if this positive relationship between banking sector development and stock market development could be observed in the Kenyan situation.

The analysis on the impact of institutional quality on stock market development is related to the recent literature on the link between the legal institutional framework and corporate finance. Laporta et al (1997) find that countries with lower quality of legal rules and law enforcement have smaller and narrower capital markets and that the listed firms on their stock markets are characterized by more concentrated ownership.

Demirguc-Kunt and Maksimovic (1998) showed that firms in countries with high ratings for the effectiveness of their legal systems are able to grow faster by relying more on external finance. The analysis in this paper contributes to this literature by looking at the relationship between stock market development and political risk, a measure of the institutional framework that supports the viability of external finance.

The paper looks at the impact of institutional framework on stock market development because it is believed that the strengthening and protection of property rights broaden the appeal and confidence in stock market investment. Equity investment usually become more attractive as political risk is resolved over time (Perotti and Van Oijen, 2001). Therefore, the development of

good quality institutions can affect the attractiveness of equity investment and lead to stock market development.

Lastly, the level of investment in the stock market is a multi-dimensional concept. It can be measured by the market size that is market capitalization, stock market liquidity which can either be the equity turnover as a ratio of the GDP. We use market capitalization as a percentage of GDP to measure stock market development because we believe it is a good proxy and less arbitrary than other individual measures of stock market development.

### **1.1.1 The Nairobi stock Exchange**

The Nairobi Stock Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital. Prior to 1991, it was registered as a voluntary association of stockbrokers under the Societies Act in 1954. The NSE is an example of an emerging stock market that has been characterized by humble beginnings yet has grown considerably over time. It stands out as an average stock market with great potential for growth, one that is making considerable effort to be a more significant driver of economy in Kenya and the East African Region. In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world with a return of 179% in dollar terms (Odundo, 2004).

NSE facilitates the mobilization of capital for development and provides savers in Kenya with an alternative saving tool. Funds that would otherwise have been consumed or deposited in bank accounts are redirected to promote growth in various sectors of the economy as people invest in securities. Economic growth is promoted through improved efficiency in mobilization of saving as capital is allocated to investments that bring the most value to the economy ([www.cma.or.ke](http://www.cma.or.ke)). Long-term savings are, therefore, mobilized for financing long term ventures

through competitive pricing mechanisms. NSE provides enterprises with a non-bank source of financing through the sale of shares to the public. It provides not only the substitution but also diversification of risk to entrepreneurs as they raise capital through equity. The government and local authorities use the NSE as an alternative source of funds to increasing taxes in order to finance development projects. Through the issue of bonds to the public, funds are raised for different types of projects (Wagacha, 2001).

### **1.1.2 Capital Markets Authority**

The Capital Markets Authority (CMA) was established in 1989 as a body corporate with perpetual succession through an Act of Parliament to regulate and oversee the orderly development of Kenya's capital markets. The mission of Capital Markets Authority is to promote the development of orderly, fair, efficient, secure, transparent and dynamic capital markets in Kenya within a framework which facilitates innovation through an effective but flexible system of regulation for the maintenance of investor confidence. CMA has a board of directors consisting of; a chairman appointed by the President of Kenya on the recommendation of the Minister of Finance; Six members appointed by the Minister of Finance to serve for three years. These have experience and expertise in legal, financial, banking, accounting, economics or insurance matters, and are eligible for re-appointment for another three years ;The Permanent Secretary to the Treasury or his representative; The Attorney General or his representative ;CMA'S Chief Executive who is appointed for four years and is eligible for a second four-year term. CMA draws the bulk of its financial support from prescribed fees paid by licensed members of the CMA and NSE. The government of Kenya provides an annual grant of about 5% of CMA's annual budget. Although the CMA is a statutory body, it is operates as an independent entity in contrast to a government department ([www.cma.or.ke](http://www.cma.or.ke)).

## 1.2 Statement of the problem

Many of Africa's stock exchanges are small, underdeveloped and illiquid. They tend to operate in isolation from other markets, have low trading volumes, are sheltered from competition by national regulations and face barriers to capital mobility because of high costs of travel and communications. Further stringent eligibility requirements have discouraged local entrepreneurs and indigenous enterprises that wish to raise funds from capital markets. The eligibility requirements as exemplified in the requirements for listing at the NSE have created high barriers to potential entrants to the stock exchanges such as the numerous family owned businesses in Africa. Thus, the stock exchanges tend to operate like closed membership organizations. ( Asea, 2003).

Ngugi (2003) argued that performance of the NSE to a large extent reflects on the policy and institutional framework and the political environment. Over the past few decades the stock markets have surged and the main indicators increased. Ngugi (2003) postulated that though the increased interest and participation within the last 5 years has been attributed largely to the economic growth that the country experienced, it can also argued that privatizations through initial public offers (IPO) and rights issues have played a significant role. Investors, investment bankers and financial managers have never had one single way of explaining the reasons for growth in the capital markets. We have also witnessed the rise and fall of brokerage firms and increased awareness amongst market participants. Of interest is to note that there has also been a significant shift amongst investors in the stock market in terms of the age profile. Currently, investment in the stock market is not only reserved for the old but the young adults too.

In Kenya, very little research has been done to evaluate the determinants of capital market development. This study will therefore fill the gap by collecting information on the determinants such as the impact of domestic savings, investment, stock market liquidity, macroeconomic stability, private capital flows, banking sector development, and institutional quality and how they impact on the capital market development at the NSE

### **1.3 Objective of the study**

#### **1.3.1 General Objective**

The main objective of the study was to evaluate the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange.

#### **1.3.2 Specific Objectives**

The specific objectives of the study were:

- i. To determine how the changes in institutional factors affect the capital markets development in Kenya.
- ii. To determine the impact of macroeconomic factors or stability on capital markets development in Kenya
- iii. To determine the effect of the regulatory changes and political risk on the capital markets development in Kenya.

### **1.4 Research Questions**

- i. How do changes in the institutional factors affect the capital market development in Kenya?
- ii. Do macroeconomic factors have an effect on capital markets development in Kenya?

iii. What is the effect of the regulatory changes and political risk on the capital markets development in Kenya?

## **1.5 Significance of the Study**

This study was considered important to the following

### **The government**

The study would act as a guide for the government future policy changes in deepening the financial and capital markets. It also helps the government in determining whether to inject more funds or reduce funds to the organization in terms of future investments.

### **Organizations**

The study would influence strategic decision making of organizations that are intending listing at the exchange and the ones that are listed currently on the factors that might influence the decisions to go public.

### **Potential investors**

The study was expected to give the major reasons why an individual might be persuaded to invest into a company that is listed at the stock exchange. It also helps the investors in decisions making concerning the company financial position and its performance.

### **Shareholders**

The study would be useful to shareholders who are interested in determining the effect of certain economic variables in the stock market. It also helps to evaluate the performance, financial position of the company and the potentiality of expansion of the company

## **Scholars and academicians**

Scholars and academicians would use the study to undertake further research in this field of corporate finance. It also helps them to use as reference in the future endeavours in the field of academics.

### **1.6 Scope and Limitations of the Study**

The study therefore aimed to evaluate the determinants of capital market development with special reference to Nairobi Stock Exchange and the companies that are listed therein. The scope was preferred since the data required was readily available at the NSE, CMA, CBK and CBS and therefore was convenient for the researcher to conduct the study due to time and economic constraints on the researcher. The study posed some challenges to the researcher in terms of data collection, financial and time constraints. The researcher overcame these challenges by ensuring strict adherence to budget and time plans. With regard to data collection the researcher mitigated these by the use of introductory letter from the University informing an individual or organization contacted that this was an academic research meant for academic purposes only whose finding can be helpful.

## **CHAPTER TWO**

### **2.0 LITERATURE REVIEW**

#### **2.1.0 Introduction**

This chapter gives the basic definitions and review the stock market history, participants, operations and importance so as to better serve as a basis for understanding the factors that influence investments at the capital market further the theoretical literature was reviewed. Besides, review of other studies was done in this chapter to give the various dimensions of the capital markets in an economy.

#### **2.1.1 Capital Markets**

The rate of development of our knowledge of the nature of capital markets at both the theoretical and empirical levels has been extremely rapid in recent times. A capital market is a market for securities (debt or equity), where business enterprises (companies) and government can raise long term funds. The capital market includes the stock market and the bond market. The primary role of capital market is allocation of ownership of the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation; that is a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firms' activities under the assumption that security prices at any time "fully reflect" available information.

Capital market can be divided into two segments viz. primary and secondary. The primary market is mainly used by issuers for raising fresh capital from the investors by making initial public offers or rights issues or offers for sale of equity or debt. Primary market comprises of a

market for new issues of shares and debentures, where investors apply directly to the issuer for allotment of shares/ debentures and pay application money to the issuer. Primary market helps public limited companies as well as Government organizations to issue their securities to the new or existing shareholders by making a public issue / rights issue thus increase capital by expanding their capital base. This enables them to finance their growth plans or meet their working capital requirements, etc. After the public issue, the securities of the issuer are listed on a stock exchange(s) provided it complies with requirements prescribed by the stock exchange(s) in this regard. The securities, thereafter, become marketable.

The secondary market provides liquidity to these instruments, through trading and settlement on the stock exchanges. Thus, trading of securities on stock exchange results in exchange of money and securities between the investors. A stock exchange is the single most important institution in the secondary market for providing a platform to the investors for buying and selling of securities through its members. In other words, the stock exchange is the place where already issued securities of companies are bought and sold by investors. Thus, secondary market activity is different from the primary market in which the issuers issue securities directly to the investors. Secondary market provides liquidity to the securities on the exchange(s) and this activity commences subsequent to the original issue.

Capital market is, thus, important for raising funds for capital formation and investments and forms a very vital link for economic development of any country. The capital market provides a means for issuers to raise capital from investors (who have surplus money available from saving for investment). Thus, the savings normally flow from household sector to business or

Government sector, which normally invest more than they save. A vibrant and efficient capital market is the most important parameter for evaluating health of any economy

There has been considerable interest in the development of capital markets in many developing countries in the last twenty years or so, and, evidence of the role of financial markets in economic development is well documented. Capital market development has been deemed an important goal, as growing evidence supports the view that a sound financial system is not just correlated with a healthy economy, but actually causes economic growth.

### **2.1.2 History of Stock or Capital Markets**

In the 12<sup>th</sup> century France, the Courratier de change was concerned with managing and regulating the debts of agricultural commodities on behalf of banks and hence they could be called the first brokers since they traded with debts. In early 13<sup>th</sup> Century Bruges commodity traders gathered inside the house of a man called Van der Beurse, and in 1309 they institutionalized trading and called it the Brugse Beurse. The idea quickly spread around the neighboring counties such as Ghent, Beurzen and Amsterdam.

Around the same time, Venitian bankers began to trade in government securities. In 1351, the Venetian government outlawed spreading rumours intended to lower the price of government funds. Bankers in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14<sup>th</sup> century.

The Dutch later started joint stock companies, which let shareholders invest in business ventures and get a share of their profits or losses. In 1602, the Dutch East India Company issued the first shares on the Amsterdam Beurse, in the early 17<sup>th</sup> century. The Dutch pioneered short selling,

option trading, debt equity swaps, merchant banking, unit trusts and other speculative instruments.

As the level of trade increased, an informal market gradually developed around coffee houses in the city of London. At first, dealing was haphazard and unorganized but by the end of 17<sup>th</sup> Century a highly developed market had emerged. It was however an unregulated market as some dealers was licensed by the city of London to trade in shares while others were just wandering off the streets. Due to lack of rules and sharp practice market rigging was not uncommon and disreputable dealers often sold to unprotected investors worthless shares.

In 1773, a group of reputable dealers raised a subscription and took over a building of their own concerned those who were permitted to trade there and aimed to reduce risk of corruption. Now, there are stock markets in virtually every developed country and most developing countries.

### **2.1.3 An Overview of the Nairobi Stock Exchange (NSE)**

The Nairobi Stock Exchange (NSE) has a long history that can be traced to the 1920's when it started trading in shares while Kenya was still a British colony (IFC/CBK, 1984). While share trading was initially conducted in an informal market, there was a growing desire to have a formal market that would facilitate access to long-term capital by private enterprises and also allow commencement of floating of local registered Government loans.

The first stock brokerage firm was established in 1951 by Francis Drummond who later approached the then Finance Minister Sir Earnest Vasey and impressed upon him the idea of having a stock exchange in Kenya. Foreign investors dominated share trading mainly because they had the knowhow of operating organized capital markets and also because their high income sufficiently permitted them to accumulate savings and investment in securities (Aworolo, 1971).

Participation of local citizens was very limited, accounting for about 5%, mainly because of their low income and statutory restrictions during the pre-independence period.

Immediately after independence, the government adopted the Kenyanisation policy which saw a change in the ownership structure of various businesses. The previously foreign-dominated market saw an increased share of locally-controlled firms. This was facilitated by loan advances to those who were interested.

The Government made a first attempt to regulate the stock market with the establishment of the Capital Issue Committee (CIC) in 1971. The idea was aroused from the observed practice of foreign investors in the process of Kenyanisation. This was also followed by taxation policies that were aimed at curbing repatriation of profits abroad for instance in the 1974/75 fiscal year, the rate of tax on dividend paid to nonresidents was raised from 12.5% to 15%; the rate of withholding tax on resident dividends also went up to 15%.

A statutory regulatory framework was established as part of the ongoing capital market reforms in an effort to strengthen the regulatory infrastructure. The establishment was recommended by the IFC/Central Bank of Kenya study (1984) and reaffirmed in the Sessional Paper No. 1 of 1986. In order to establish a regulatory body, legislation was adopted to facilitate formulation of rules and enhancing the effectiveness and efficiency of the operations of the Capital

### **Capital Market Authority (CMA).**

The Authority was established in 1990 through the Capital Market Authority Act (Cap 485A). The process involved the Government setting up a Capital Market Development Advisory Council in November 1988 whose role was to work out modalities for establishing the CMA. In November 1989, the Bill was passed by Parliament and the CMA was constituted in January 1990 and inaugurated in March 1990. In 1995, the idea for a Central Depository was mooted and

a study commissioned to look into its viability. A Draft bill was submitted to Parliament in 1997 and three years later the Central Depositories Act, 2000 was passed. CDSC was incorporated with the signing of a shareholders' agreement.

On 1st August 2000, a delivery versus payment (DvP) was introduced whose main aim was to enhance investor confidence and liquidity by making the settlement period shorter and safe. It was also aimed at moving the market close to a CDS environment of T+3 by shortening the period within which certificates are issued and centralizing registration at the NSE. The system was also aimed at enabling brokers to concentrate on core business by taking over post-trading back-office tasks at the NSE. In November 2004, CDS operations commenced. CDS account opening began in earnest, and Immobilization (a process of converting shares from physical certificates to electronic form and depositing into CDS accounts) and Delivery versus Payment (DVP) Settlement began in tranches.

On 28th February 2005, full DvP settlement for all listed companies at the NSE was achieved. The KenGen Initial Public Offer in 2006 was the first major operation for CDSC. This saw a huge increase in the number of CDS accounts opened. CDSC also played a fundamental role in the listing of Safaricom, the largest IPO in the East and Central Africa region, where the number of CDS accounts increased from 0.8 to 1.7 million.

For many years, worldwide buyers and sellers were individual investors such as wealthy business men, with long family histories to particular corporations. Over time, markets have become more institutionalized with buyers and sellers largely institutions e.g. pension funds, insurance companies, mutual funds, hedge funds, investor groups and funds. Now participants in the capital market range from small individual stock investor to large hedge fund traders, who can be based anywhere.

Most securities are traded on exchanges the Nairobi Stock Exchange (NSE), which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor, by a method known as open outcry. The other type of exchange is a virtual kind composed of a network of computers where trades are made electronically via traders at the computer terminals. Actual trades are based on an auction market paradigm where a potential buyer bids a specific price for a stock and potential seller asks a specific price for a stock. When the bid and ask prices match, a sale takes place on a first come first serve basis if there are multiple bidders and askers at a given price. The purpose of a stock exchange is to facilitate the exchange of securities between buyers and sellers, thus providing a market place i.e. virtual or real (Wambui 2005).

## **2.2 Theoretical Literature review**

### **2.2.0 Capital Market theory**

Capital market theory is a generic term for the analysis of securities. In terms of trade off between the returns sought by investors and the inherent risks involved, the capital market theory is a model that seeks to price assets, most commonly, shares. Over the intervening years, capital market theory have been developed and modified to form an elegant and comprehensive framework for understanding asset pricing and risk. Capital Market Theory sets the environment in which securities analysis is preformed. Without a well constructed view of modern capital markets, securities analysis may be a futile activity. Capital market theory is a positive theory in that it hypothesizes how investors do behave rather than how investors should behave, as in the case of modern portfolio theory (MPT). It is reasonable to view capital market theory as an extension of portfolio theory, but it is important to understand that MPT is not based on validity, or lack thereof, of capital market theory.

### **2.2.1 Capital Asset Pricing Model (CAPM)**

The specific equilibrium model of interest to many investors is known as the capital asset pricing model, typically referred to as the CAPM. The capital asset pricing model (CAPM) of William Sharpe (1964) and John Lintner (1965) marks the birth of asset pricing theory (resulting in a Nobel Prize for Sharpe in 1990). The attraction of the CAPM is that it offers powerful and intuitively pleasing predictions about how to measure risk and the relation between expected return and risk. It allows us to measure the relevant risk of individual security as well as to assess the relationship between risk and the returns expected from investing. The CAPM is attractive as an equilibrium model because of its simplicity and its implications. As a result of serious challenges to the model over time, however, alternatives have been developed. The primary alternative to the CAPM is the arbitrage pricing theory, or APT, which allows for multiple sources of risk. While the CAPM is a simple model that is based on sound reasoning, some of the assumptions that underlie the model are unrealistic. Some extensions of the basic CAPM were proposed that relaxed one or more of these assumptions (e.g., Black, 1972).

### **2.2.2 Arbitrage Pricing Theory (APT)**

Instead of simply extending an existing theory, Ross (1976a, 1976b) addresses this concern by developing a completely different model: the Arbitrage Pricing Theory (APT). Unlike the CAPM, which is a model of financial market equilibrium, the APT starts with the premise that arbitrage opportunities should not be present in efficient financial markets. This assumption is much less restrictive than those required to derive the CAPM.

### **2.2.3 Inter-temporal Capital Asset Pricing Model (ICAPM)**

Both the CAPM and the APT are static, or single-period models. As such, they ignore the multi-period nature of participation in the capital markets. Merton's (1973) inter-temporal capital asset pricing model (ICAPM) was developed to capture this multi-period aspect of financial market equilibrium. The ICAPM framework recognizes that the investment opportunity set might shift over time, and investors would like to hedge themselves against unfavorable shifts in the set of available investments. If a particular security tends to have high returns when bad things happen to the investment opportunity set, investors would want to hold this security as a hedge. This increased demand would result in a higher equilibrium price for the security (all else constant). One of the main insights of the ICAPM is the need to reflect this hedging demand in the asset pricing equation.

### **2.2.4 Markowitz Portfolio Theory (MPT)**

Capital market theory is built on the Markowitz portfolio theory. Any discussion of the theory of stock price behavior has to start with Markowitz (1952, 1959). The Markowitz model is a single-period model, where an investor forms a portfolio at the beginning of the period. The investor's objective is to maximize the portfolio's expected return, subject to an acceptable level of risk (or minimize risk, subject to an acceptable expected return). The assumption of a single time period, coupled with assumptions about the investor's attitude toward risk, allows risk to be measured by the variance (or standard deviation) of the portfolio's return. Building on the Markowitz framework, Sharpe (1964), Lintner (1965) and Mossin (1966) independently developed what has come to be known as the Capital Asset Pricing Model (CAPM). This model assumes that investors use the logic of Markowitz in forming portfolios.

Capital market theory therefore involves a set of predictions concerning equilibrium expected returns on risky assets. It typically is derived by making some simplifying assumptions in order to facilitate the analysis and help us to understand the arguments without fundamentally changing the predictions of assets pricing theory. (<http://en.wikipedia.org/wiki/Definition>)

### **2.3.0 Empirical Literature review**

#### **2.3.1 Institutional factors**

NSE is considered a more liquid and active market than those of its East African counterparts (Uganda and Tanzania) and in sub-Saharan Africa in general. However, by international standards, it is small, illiquid and volatile with regard to price and returns. Low liquidity is particularly evident in the secondary bonds and equity markets. The NSE is a highly concentrated market with most of its activity centered on a few listed companies (Wagacha, 2001).

The institutional infrastructure provides the operational basis for the market, relates to intermediaries that provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the-counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services (Osei, 1998).

In Africa, the legal, institutional, accounting, fiscal and technical environment of financial operations in general and stock markets in particular is on the whole archaic, are hardly

favourable for their internal development and can hardly attract foreign investors who do not have a lot of confidence in dispute resolution mechanisms and in the stability of rules established both in the legal domain and business tax system. The small proportion of foreign direct investment that Africa receives is characteristic of the unfavourable business climate, which also affects African economic operators. In some countries, it is difficult to know the norm applicable for transactions or particular activities. Legal insecurity is considered as one of the most serious impediments to attracting investors. Furthermore, the diversity of regulations in force and existing technologies are major challenges to the integration of stock exchanges in Africa. Although there are several initiatives designed to harmonise the business laws and environment in some Regional Economic Communities, the level of conformity is not adequate for the creation and blossoming of a stock market (Kibuthu, 2005).

Institutional quality is important for stock market development because efficient and accountable institutions tend to broaden appeal and confidence in equity investment. Equity investment thus becomes gradually more attractive as political risk is resolved over time. Therefore, the development of good quality institutions can affect the attractiveness of equity investment and lead to stock market development. Yartey (2007) finds good quality institutions such as law and order, democratic accountability, bureaucratic quality as important determinants of stock market development in Africa because they reduce political risk and enhance the viability of external finance. Bekaert (1995) provides evidence that higher levels of political risk are related to higher degrees of market segmentation and consequently low level of stock market development. Erb et al (1996) show that expected returns are related to the magnitude of political risk. They find that in both developing and developed countries, the lower the level of political risk, the lower is

required returns. The evidence in the literature suggests that political risk is a priced factor for which investors are rewarded and that it strongly affects the local cost of equity, which may have important implications for stock market development.

### **2.3.2 Macroeconomic factors**

On the whole the recent favourable trend of improved macro-economic policies and performances and the high level of external capital flows have induced the stabilization of exchange rates in most countries. Many African countries have improved the convertibility of their currency among themselves while the majority have refrained from resorting to multiple exchange rates and have liberalized their exchange rate system. This situation is nevertheless fragile owing to the persisting dependence of Africa on commodity exports and the present difficulties encountered by Africa in promoting the diversification of its production base. The various trends analysed above, contributed to the increase of domestic savings and investments to 26.3% of GDP and 21.4% in 2006 as against 18.4% and 17.1% in 1990 respectively. In East and Pacific Asia, the rate of investment on GDP reached an average of 35% in the period 1990-2003, and the savings rate related to the GDP stood around the same figure. In African oil producing countries, the rates are higher; 26% for the investment rate (19.6% for non-oil producing countries) and 33.7% for the savings' rate (6.6% for non-oil producing countries) (ECA Economic Report, 2007 and 2008)

A stable macroeconomic environment is crucial for the development of the stock market. Macroeconomic volatility worsens the problem of informational asymmetries and becomes a source of vulnerability to the financial system. Low and predictable rates of inflation are more

likely to contribute to stock market development and economic growth. Both domestic and foreign investors will be unwilling to invest in the stock market where there are expectations of high inflation. Garcia and Liu (1999) finds that sound macroeconomic environments and sufficiently high income levels—GDP per capita, domestic savings, and domestic investments—are important determinants of stock market development in emerging markets. The development of the banking sector is important for stock market development in Africa. At the early stages of its establishment the stock market is a complement rather than substitute for the banking sector. Developing the financial intermediary sector can promote It must be noted that the conduct of macroeconomic policies not only affects but may also be affected by the condition of the financial system. For example, if non-performing loans represent a greater proportion of banking assets, the central bank may find it very difficult to tighten monetary policy.

Many East Asian countries are successful examples. Support services from the banking system contribute to the development of the stock market. Consequently, liquid inter-bank markets, largely supported by an efficient banking system, are important for the development of the stock market. Conversely a weak-banking system can constrain the development of the stock market. On the empirical front, Demirguc-Kunt and Levine (1996) found that most stock market indicators are highly correlated with banking sector development. Countries with well-developed stock markets tend to have well developed financial intermediaries. Yartey (2007) finds that a percentage point increase banking sector development increases stock market development in Africa by 0.59 percentage point controlling for macroeconomic stability, economic development and the quality of legal and political institutions.

### **2.3.3 Regulatory changes and political risk**

The current manual trading system is slow, costly and limits the range of products that can be provided. It has also hindered international integration of the market. The fact that the NSE is not linked to other international markets outside East Africa has attracted some foreign investors because shocks in other international markets do not affect the NSE. However, this separation limits the growth, liquidity and expansion of the market. Prior to November 2005, delivery and settlement of traded shares was conducted manually. Although it was intended that transactions be conducted on a T+5 cycle (day of trading plus five days), investors waited for weeks, sometimes months on end, to receive their certificates after purchases (Waiyaki, 2004).

Asea (2001) points out those stringent eligibility requirements have discouraged local entrepreneurs and indigenous enterprises that wish to raise funds from capital markets. The eligibility requirements as exemplified in the requirements for listing at the NSE have created high barriers to potential entrants to the stock exchanges such as the numerous family owned businesses in Africa. Thus, the stock exchanges tend to operate like closed membership organizations. In addition, investors, particularly minority shareholders, lack confidence in the market as some listed companies continue to operate under poor corporate governance structures. In some stock markets, participants are subject to multiple regulators thereby causing regulatory complexities, uncertainties and increased costs of compliance with different regulatory regimes. In Kenya, the NSE and CMA both serve as regulators of market participants. Each has its own requirements for membership, listing and participation in the market and though there are similarities, the multiplicity creates uncertainty as to which requirements are applicable in different situations

Sheena and Zhavala (2003) add that creating an efficient regulatory system for securities exchanges is a difficult goal to achieve and maintain. Hence, some African stock exchanges have limited institutional capacity to police and enforce rules. Most of the smaller African exchanges lack the trained manpower and experience to adequately police the modern regulatory regimes they have adopted. Consequently, enforcement actions are rare and abuses are not uncommon. Political uncertainties and economic policies in some African countries have facilitated the decline in confidence in and subsequent poor performance of the stock markets because of the risk of deterioration in the business climate.

#### **2.4 Critical Review**

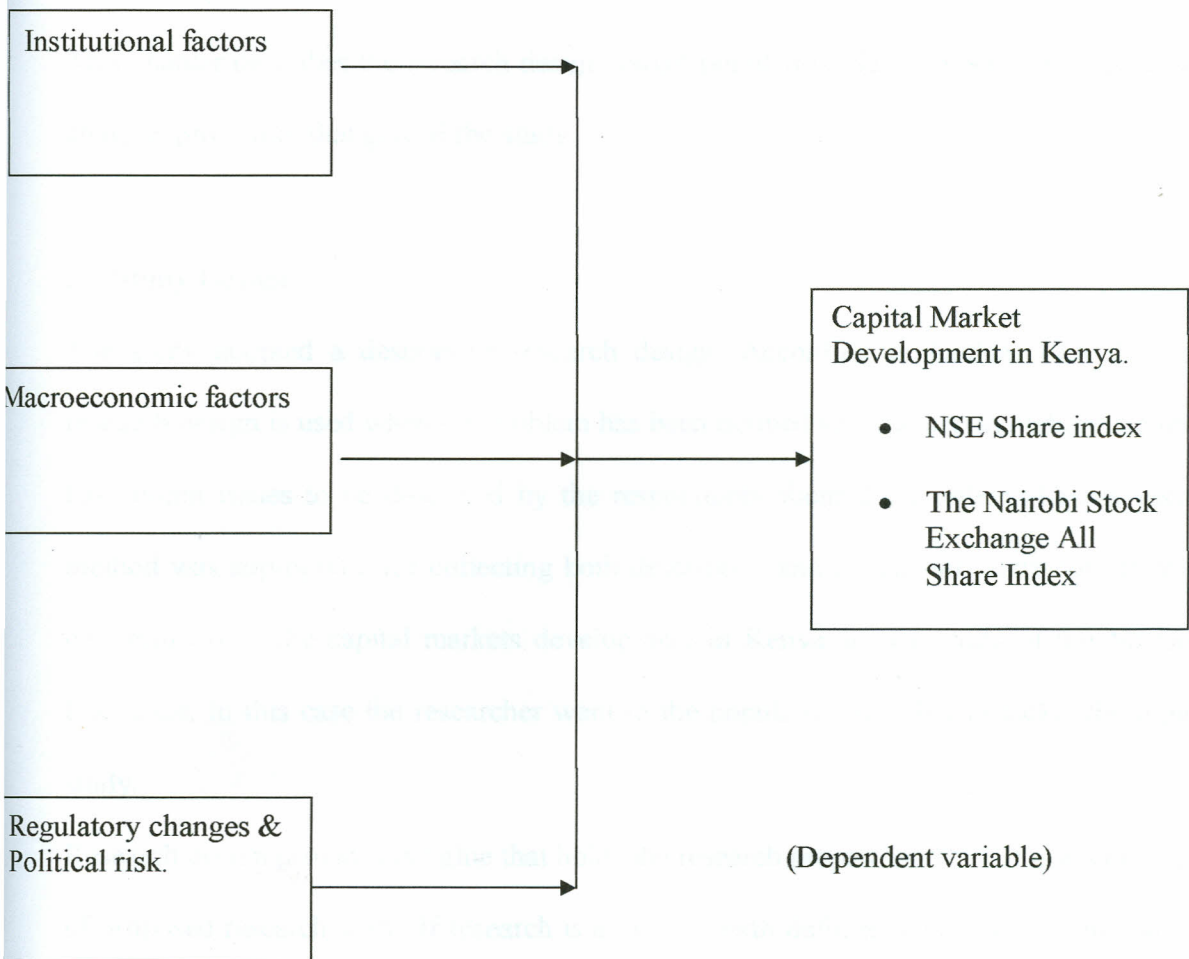
The Capital Markets Authority has been criticized as being heavy-handed in its approach to regulation of the capital markets. Its relationship with the NSE has been described as adversarial. A more supportive approach that is proactive and creative in enhancing a more vibrant environment will enable CMA to be a catalyst in rather than a hindrance to development of the market (Wagacha, 2001). Further little research has been done with regard to the determinants of capital markets development at the NSE, therefore the variables layed out in the literature review may not clearly relate with each other.

#### **2.5 Summary and gaps to be filled by the study**

Due to the fact that little research with regard to the determinants of the capital markets development with specific reference to the Nairobi Stock Exchange has been done; new data may thus be collected and thus shed light on the area of the study. Given that the literature is based on specific objectives creates a gap that the study will endeavor to fill.

## 2.6 Conceptual Framework

Figure 2.6.1 Conceptual Framework



Independent variables.

Source: Author 2010

## CHAPTER THREE

### RESEARCH DESIGN AND METHODOLOGY

#### 3.0 Introduction

This chapter describes the research design, target population, data collection procedure and data analysis procedure that guided the study.

#### 3.1 Study Design

The study adopted a descriptive research design. According to Kothari (2000), descriptive research design is used when the problem has been defined specifically and where the researcher has certain issues to be described by the respondents about the problem. This is because the method was appropriate for collecting both descriptive and explanatory data concerning on the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange. In this case the researcher went to the population in a bid to tackle the topic of the study.

Research design provides the glue that holds the research project together. It is a tentative outline of proposed research work. If research is a journey with definite points of departure and arrival, then the design of it must project and predict in between sequences of activities like target, geography, resources, means, plan, synopsis, time schedule and final plan to share the experience with others. Proper research design provides firm foundation and leads to maximum yield of information and reliability of results. It also helps in organizing ones ideas, gives chance to foresee flaws and inadequacies, and incorporates learning from others critical comments and evaluations. (Wikipedia, 2010)

The meaning and steps in research design, preparation of synopsis and contents of research plan are explained. Design is a decision making process. Research design, as strategy, has to be comprehensive, flexible, appropriate, efficient, and economical. The process involves a series of steps including identification and delimiting of variables. There will always be a trade off of resources, cost, time and reliability of results with fruits expected of the study. If the design is for an experimental study which is proof oriented and requires substantial resources in terms of efforts and costs the results are likely to be more decisive. (<http://wiki.answers.com/Q/>)

### 3.2 The Target Population

The target population consisted of selected employees of the Nairobi Stock Exchange i.e. 38, NSE key informants, from the 47 listed companies and from the 19 member firms. This was as depicted in the table that follows.

Group	Population	Percentage
Nairobi stock Exchange	38	36
Listed companies	47	45
Member firms	19	19
<b>TOTAL</b>	<b>104</b>	<b>100</b>

**Table 3.1 Target Population**

**Source: NSE (2010)**

### 3.3 Sampling Design

From the above population of 104, a census was taken from the population due to the relatively small size of the population. According to Mugenda & Mugenda (2003), a representative sample is one that is at least 10% of the population of interest. In addition this, the sampling technique should be used when the population of interest is not homogeneous, in this particular case the population of interest was composed of the various job groups and the daily customers as depicted in the table above. These groups were mutually exclusive and were expected to give

answers that were unique to the topic of the study. The sample was obtained as indicated in the following table:

### **3.4 Data Collection procedures**

Data was collected mainly by use of questionnaire method. Oppenheim (2001) suggests that this method of data collection ensures a high response rate and accurate sampling. He also urged that greatest care is needed in briefing the respondents, or they may, with the best intentions, introduce fatal bias.

The questionnaire was aimed at a representative sample of stakeholders, although it is who will be stratified into clusters according to their position as shown in the table above. Questions were directed towards the variables as brought out in the conceptual framework. The questionnaire had six sections which were as follows: general information, Capital markets development, institutional factors, macro-economic factors, regulatory changes and political risk. Questions were not included related to the actual skill-based content.

### **3.5 Data Analysis**

The data was analyzed quantitatively using descriptive statistics. Nachmias and Nachmias (2006) state that descriptive statistics has an advantage to the researcher because it allows a researcher to organize information in an effective way and also allows information to be reduced to an understandable form.

Descriptive statistics was used to present the opinions of the respondents on the effect of institutional factors, macroeconomic factors, political risk and regulatory changes on the development of capital markets in Kenya. The first objective was to determine whether the changes in institutional factors affect the capital markets development in Kenya. There was the use of questionnaires to collect data. This was achieved by analyzing frequency distribution and

percentages. The second objective was to determine the impact of macroeconomic factors on the capital markets development in Kenya. This was achieved by analyzing the frequency distribution and percentages. The third objective was to determine effect of the regulatory changes and political risk on the capital markets development in Kenya. There was the use of questionnaires to collect data. The questions were analyzed by use frequency distribution and percentages. The data was presented in tables and figures.

In a nutshell data was summarized using charts, tables and figures. There was the use of the Microsoft Excel to aid in the analysis. Reliability of the questionnaire was done by carefully structuring of the questions and confirming the layout. In addition, test retest was performed on the questionnaires to confirm the consistency of the feedback.

4.0 DATA ANALYSIS AND PRESENTATION OF RESULTS

4.1 Introduction

This chapter presents the results of the data collected and further discusses these findings. It tackles both quantitative and qualitative analysis corresponding with the sections found in the questionnaires. The tables and figures in this chapter are derived from the findings of the study.

This chapter presents an analysis of the findings of the research. Several descriptive analyses were made to achieve the objectives of the study which were: to determine how the changes in institutional factors affect the capital markets development in Kenya; to determine the impact of macroeconomic factors or stability on capital markets development in Kenya and to determine the effect of the regulatory changes and political risk on the capital markets development in Kenya

The instrument used in the research was pre-tested to improve their validity and reliability basing on the objectives of the study. Questionnaires were edited as soon as they were received to ensure completeness. Filling in questionnaires was voluntary and participants were assured of anonymity and confidentiality.

4.2 Response Rate

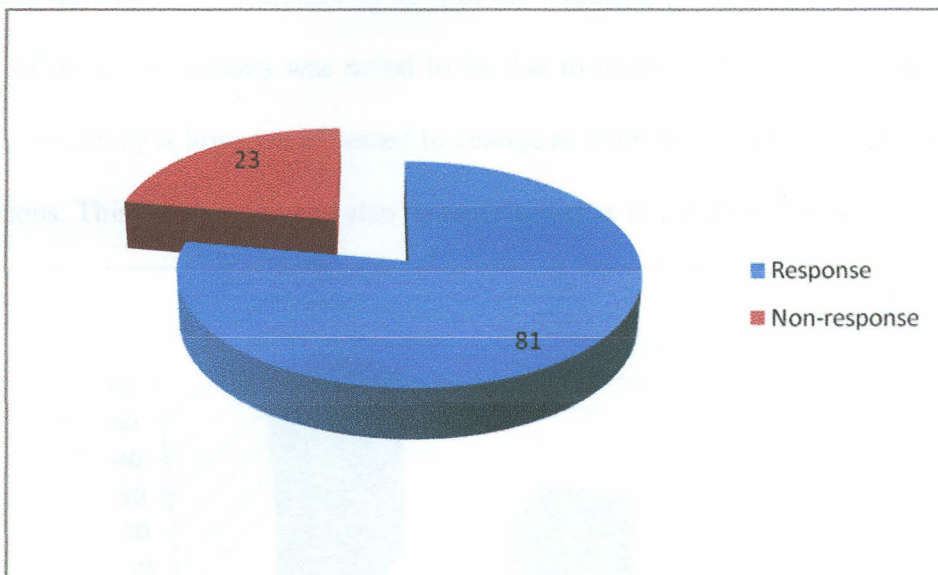
Quantitative analysis deals with preliminary analysis procedures of sorting, frequencies and consistency checks on the data obtained. This further improved the quality of the data collected. Further and detailed analysis was also done. Eighty one (81) out of one hundred and four (104) questionnaires given out were answered, thus the analysis was done using eighty one (81) questionnaires received from the respondents. The results are presented as shown below in Table 4.1.

The study targeted 104 respondents with, 81 respondents answered the questionnaires comprising a 78 % response while the remaining 23 respondents comprising 22 % did not answer. Mundy (2002) points out that a 60% response rate is acceptable but a 70-80% response rate is desirable for any research. This is as depicted in the table below:

	<b>FREQUENCY</b>	<b>PERCENTAGE (%)</b>
Response	81	78
Non-response	23	22
<b>TOTAL</b>	<b>104</b>	<b>100</b>

**Table 4.1: Response Rate**

*Source: Research Data (2010)*



**Figure 4.1 Response Rate**

*Source: Research Data (2010)*

### 4.3 Demographic Information

The respondents were profiled using three different criteria that included their gender, the duration which the respondents had been working in the industry and their education level.

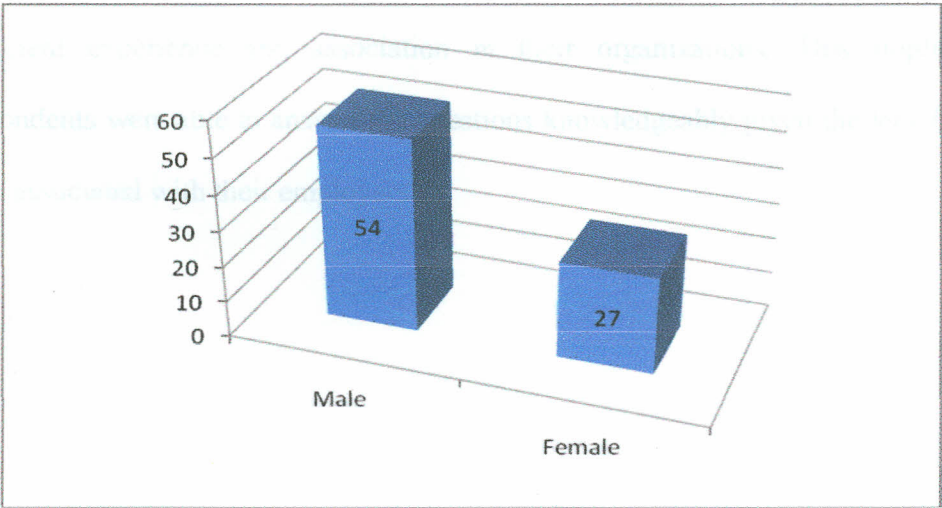
The table below represents the gender of the respondents:

GENDER	FREQUENCY	PERCENTAGE (%)
Male	54	67
Female	27	33
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.2: Respondents Gender**

*Source: Research Data (2010)*

The above table shows the respondents' gender. From the findings, the majority of the respondents were males as indicated by 67% of the response, while 33% were females. The great tendency of male respondents was noted to be due to more men being educated in the earlier years. This tendency is however expected to change as women are gaining the relevant academic qualifications. This information can also be represented as in the chart below:



**Figure 4.2: Respondents Gender**

*Source: Research Data (2010)*

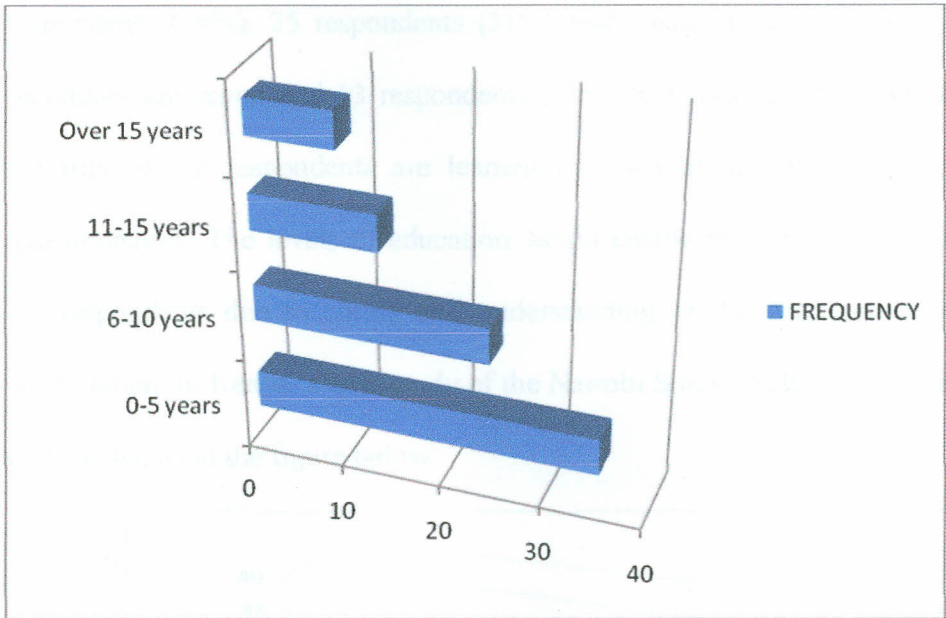
## Respondents Experience

EXPERIENCE	FREQUENCY	PERCENTAGE
0-5 years	35	43
6-10 years	24	30
11-15 years	13	16
Over 15 years	9	11
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.3 Respondents Experience**

*Source: Research Data (2010)*

The respondents were requested to indicate the number of years they had worked in their organisations. The data in Table 4.3 indicates that majority of the respondents as shown by 43% had worked for their organisations for 0-5 years, 30% had worked for the organisation for 6-10 years, 16% for 11-15 years and 11% for over 15 years. This implies that most respondents had sufficient experience and association in their organizations. This implies also that the respondents were able to answer the questions knowledgeably given the length of time they had been associated with their employers.



**Figure 4.3 Respondents' Experience**

*Source: Research Data (2010)*

**Respondents' level of education**

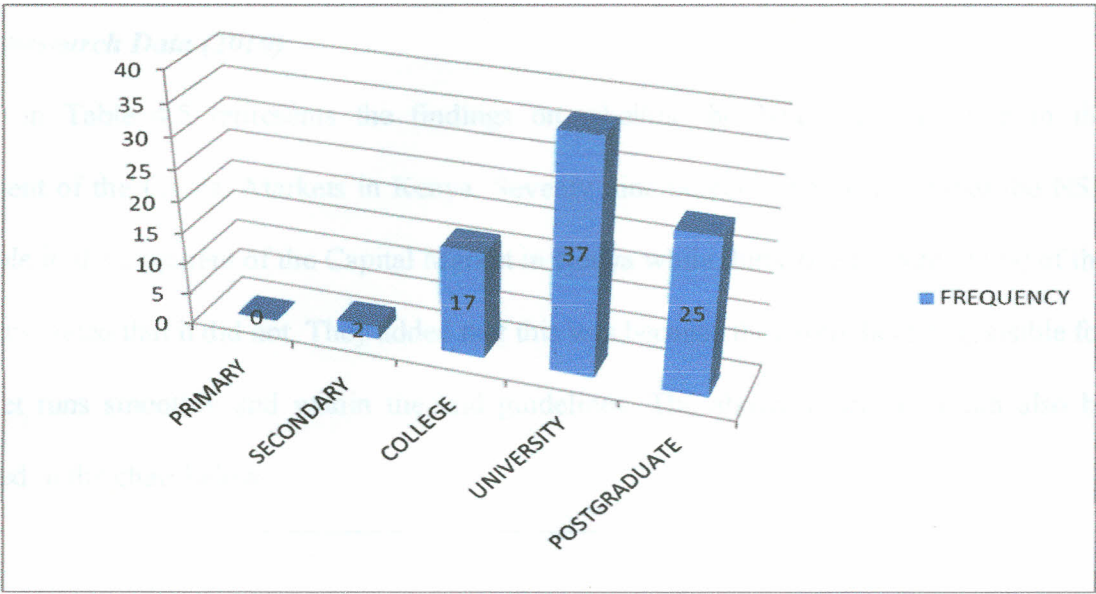
EDUCATION LEVEL	FREQUENCY	PERCENTAGE
PRIMARY	0	0
SECONDARY	2	2
COLLEGE	17	21
UNIVERSITY	37	46
POSTGRADUATE	25	31
TOTAL	81	100

**Table 4.4 Respondents' level of education**

*Source: Research Data (2010)*

Table 4.4 represents the findings on the respondents' level of education. From the findings the researcher found out that majority of the respondents had University education as shown by 37

respondents (46%), 25 respondents (31%) had postgraduate degrees, 2 respondents (2%) had secondary education and 13 respondents (16%) had college education. The findings show that majority of the respondents are learned thus would be able to understand and answer the questionnaires. The levels of education would enable relevant information to be obtained from the respondents due to clarity and understanding of the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange. This information can also be represented as in the figure below:



**Figure 4.4 Level of Education**

*Source: Research Data (2010)*

This general information was very important to the researcher as it helped to know how well the respondents were versed on to clarity and understanding of the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange which mainly depended on their level of education and duration the respondents had associated with the firm. This would thus be a great contributing factor with regard to the answers that would be expected from the respondents.

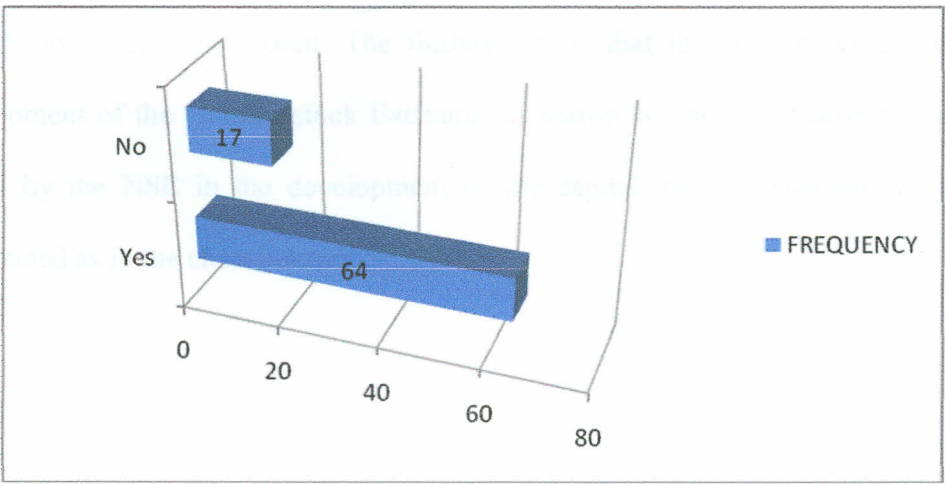
### 4.4 Capital Market Development

RESPONSE	FREQUENCY	PERCENTAGE (%)
Yes	64	79
No	17	31
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.5 NSE and the development of the Capital Markets in Kenya**

*Source: Research Data (2010)*

The data in Table 4.5 represents the findings on whether the NSE plays its role in the development of the Capital Markets in Kenya. Seventy nine percent (79%) stated that the NSE plays its role in development of the Capital Market in Kenya while thirty one percent (31%) of the respondents stated that it did not. They added that this was because they were held responsible for the market runs smoothly and within the laid guidelines. The above information can also be represented in the chart below:



**Figure 4.5 NSE and the development of the Capital Markets in Kenya**

*Source: Research Data (2010)*

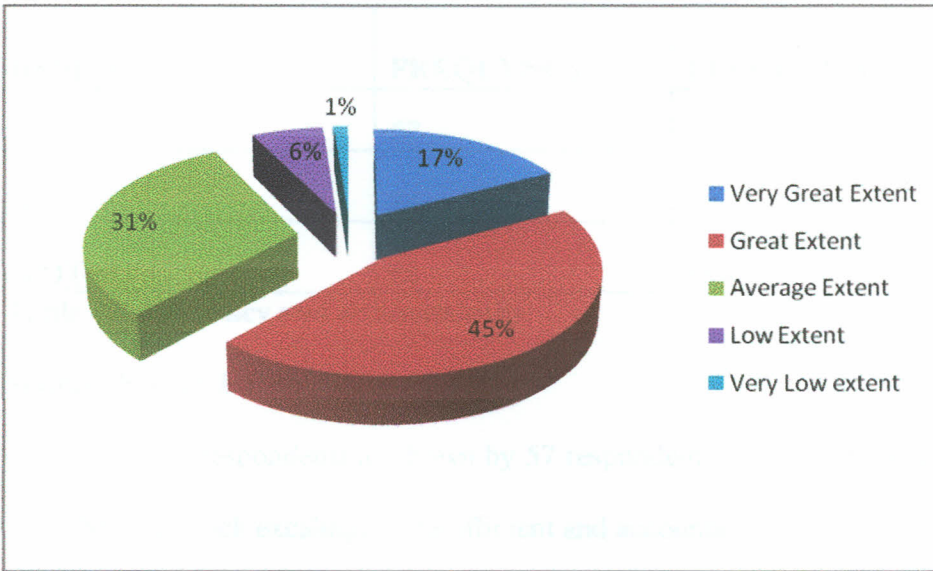
<b>RESPONSE</b>	<b>FREQUENCY</b>	<b>PERCENTAGE (%)</b>
Very Great Extent	14	27
Great Extent	36	44
Average Extent	25	31
Low Extent	5	6
Very Low extent	1	1
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.6 Extent to which NSE plays its role in the development of the capital markets**

*Source: Research Data (2010)*

Figure 4.6 represents the extent to which NSE plays its role in the development of the capital markets. Majority of the respondents as shown by 44% stated the extent was great, 27% stated the extent was to a very great extent, 31 % reported an average extent, 6% reported a low extent and 1% to a very low extent. The findings show that the NSE plays a critical role in the development of the Nairobi stock Exchange as shown by large response in support of the role played by the NSE in the development of the capital market. This information can also be represented as in the chart below:

The following table represents the responses given regarding the role played by the NSE in the development of the capital markets. The table shows that the role of the NSE in the development of the capital markets is very critical and should be given more attention.



**Figure 4.6 Extent to which NSE plays its role in the development of the capital markets**

*Source: Research Data (2010).*

#### **4.5 Effects of Institutional Factors**

The first objective of the study was to determine whether the changes in institutional factors affect the capital markets development in Kenya. The data was presented in tables and figures.

This was done by looking at efficiency and accountability of institutions listed at the NSE, relationship between institutional factors and capital markets development, extent of the effect of institutional factors and capital markets and the improvements that need to be made at the capital markets in Kenya.

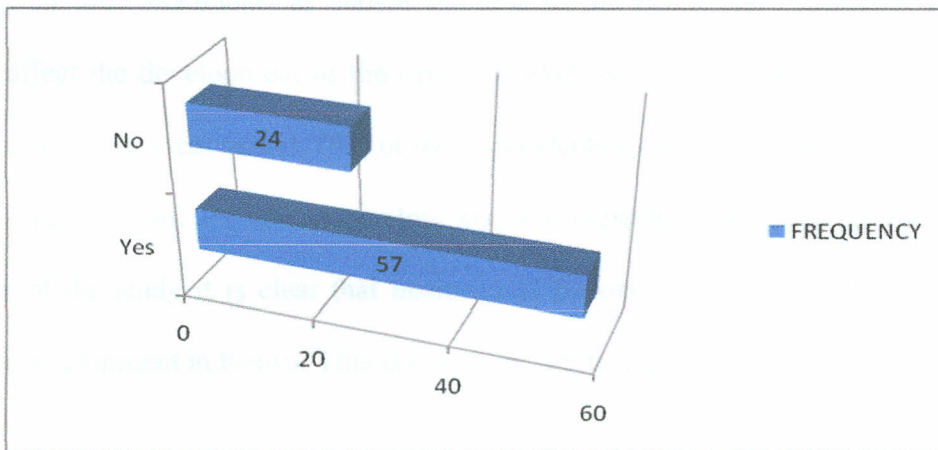
The following table represents the response when respondents were asked whether institutions that are listed at the NSE are efficient and accountable to bring appeal and confidence to investors.

RESPONSE	FREQUENCY	PERCENTAGE (%)
Yes	57	70
No	24	30
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.7 Efficiency and accountability**

*Source: Research Data (2010)*

Majority of the respondents as shown by 57 respondents (70%) indicated that institutions quoted in the Nairobi stock exchange were efficient and accountable to bring appeal and confidence to the investors while the minority (30%) were of the opinion. The majority of the respondents stated that most listed companies are profitable and are reputable. From the response of the study it can be pointed out that institutions listed at the NSE are appealing to both the current investors and the potential investors. This information can be represented as in the chart below:



**Figure 4.7 Efficiency and accountability**

*Source: Research Data (2010)*

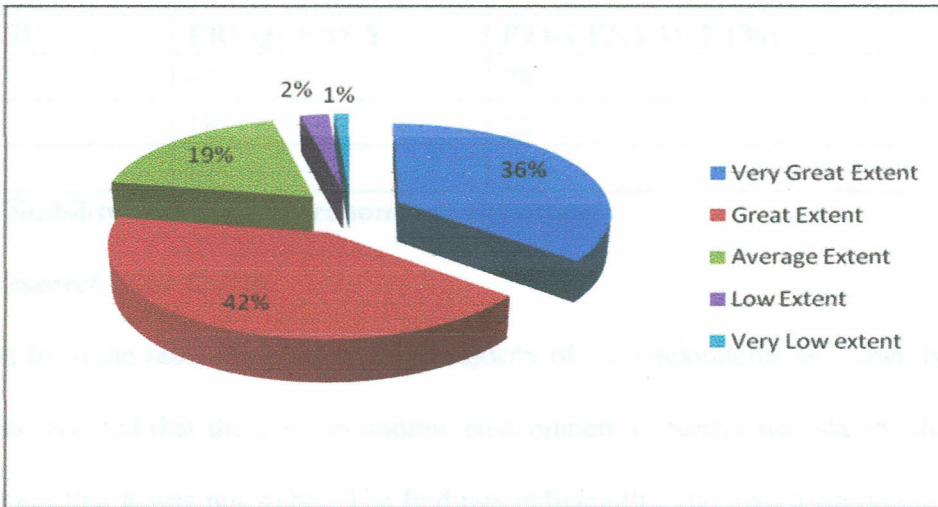
The following table represents the response on the extent to which institutional factors affect the development of the capital markets in Kenya.

<b>RESPONSE</b>	<b>FREQUENCY</b>	<b>PERCENTAGE (%)</b>
Very Great Extent	29	36
Great Extent	34	42
Average Extent	15	19
Low Extent	2	2
Very Low extent	1	1
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.8 Extent to which institutional factors affect the development of the capital markets in Kenya**

*Source: Research Data (2010)*

Majority of the respondents as shown by 42% of the respondents indicated that institutional factors affect the development of the capital markets to a great extent, 36% of the respondents indicated to a very great extent, 19% of the respondents indicated the extent as average, 2% of the respondents indicated the extent as slow and 1% indicated the extent as very low. From the findings of the study it is clear that institutional factors affect the development of the Capital markets development in Kenya. This information can be represented as in the chart below:



**Figure 4.8** Extent to which institutional factors affect the development of the capital markets in Kenya

*Source: Research Data (2010)*

#### **4.6 The Impact of Macroeconomic Factors**

The second objective of the study was to determine the impact of macroeconomic factors on the capital markets development in Kenya. There was the use of questionnaires to collect data. The data was presented in tables and figures. This was achieved by looking at stability of the macroeconomic environment in Kenya, relationship between macroeconomic factors and capital markets development, extent of the effect macroeconomic factors on capital markets developments and what needs to be done with regard to macroeconomic factors to improve the development of capital markets.

In the table below, the respondents were requested by the researcher to give their views on whether the macroeconomic environment in Kenya is stable.

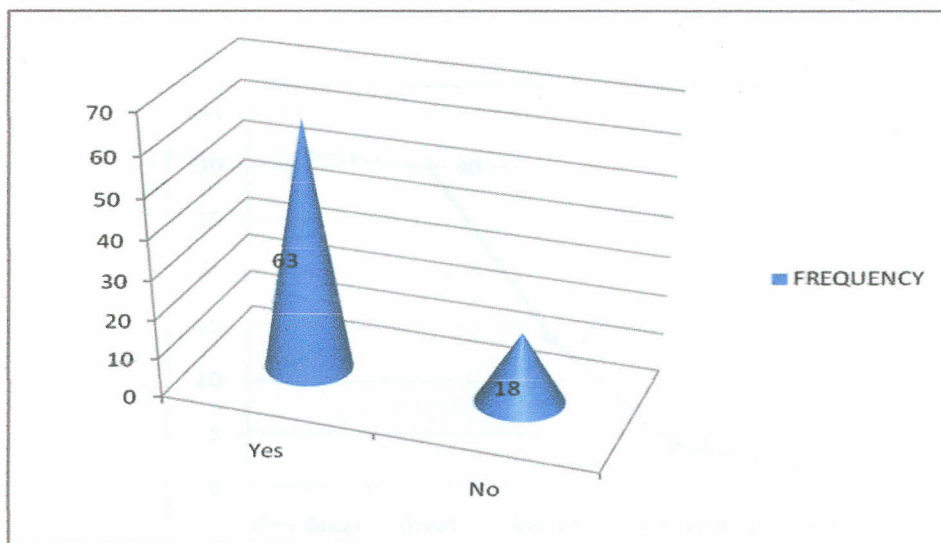
RESPONSE	FREQUENCY	PERCENTAGE (%)
Yes	63	78
No	18	22
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.9 Stability of the macroeconomic environment**

*Source: Research Data (2010)*

The results from the table above show that majority of the respondents as shown by 78% of the respondents reported that the macroeconomic environment in Kenya was stable while 22% were of the opinion that it was not stable. The findings indicate that the macro-economic environment in Kenya is stable. The respondents mainly attributed to the political and legal structure which is in the country thus providing a conducive environment for investors to carry on their business.

This information can also be represented as in the chart below:



**Figure 4.9 Stability of the macroeconomic environment**

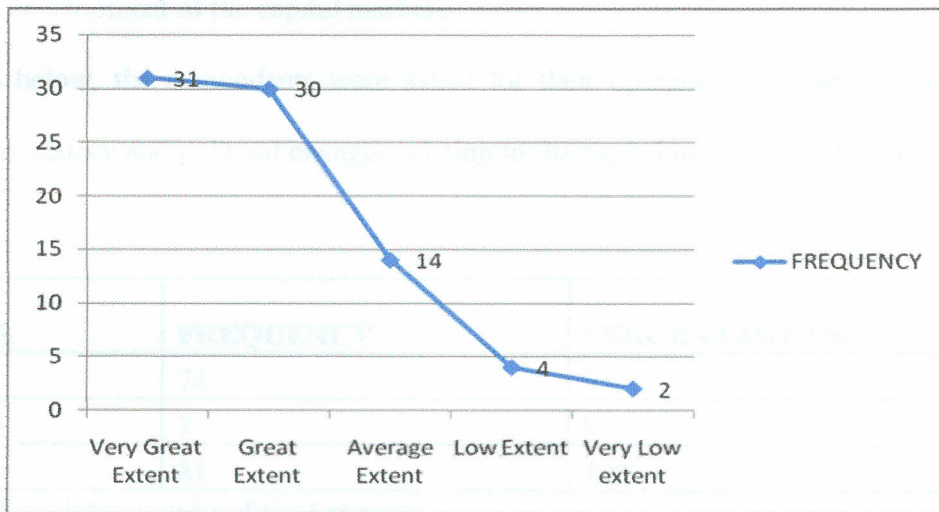
*Source: Research Data (2010)*

In the table below the respondents were requested by the researcher to give their views on the extent to which macro-economic factors affects the development of the capital markets in Kenya.

RESPONSE	FREQUENCY	PERCENTAGE (%)
Very Great Extent	31	38
Great Extent	30	37
Average Extent	14	17
Low Extent	4	5
Very Low extent	2	3
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.10** Extent to which macro-economic factors affect the development of the capital markets in Kenya

*Source: Research Data (2010)*



**Figure 4.10** Extent to which macro-economic factors affect the development of the capital markets in Kenya

*Source: Research Data (2010)*

Majority of the respondents as shown by 38% stated that this effect was to a very great extent, 37% stated to a great extent, 17% stated to an average extent and 5% to a low extent while 3% to a very low extent. The findings clearly indicate that macro-economic factors contribute to the development of the capital markets in Kenya. This can also be represented as in the figure 4.10

#### 4.7 The effect of Regulatory changes and Political Risk

The last objective of the study was to determine effect of the regulatory changes and political risk on the capital markets development in Kenya. The objective was achieved by looking at significant and regulatory changes in the capital markets development, effect of regulatory and political changes, extent of effect of regulatory and political changes on capital markets development and what needs to be done with regard to regulatory changes and political risk to improve the development of the capital markets.

In the table below, the respondents were asked for their opinion on whether there had been significant regulatory and political changes relating to the capital markets that had occurred in the recent past.

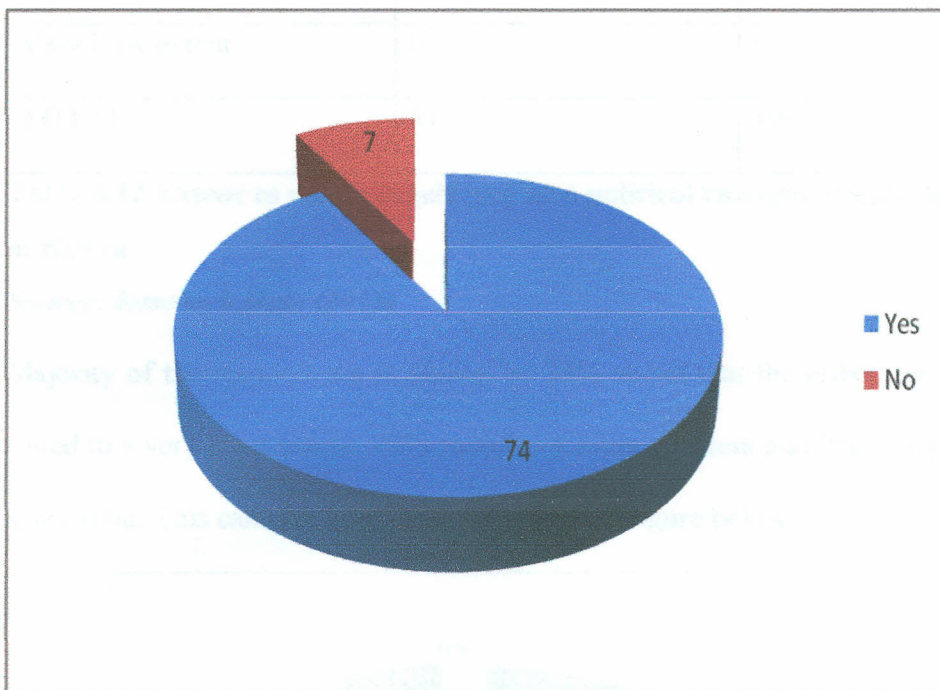
RESPONSE	FREQUENCY	PERCENTAGE (%)
Yes	74	91
No	7	9
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.11 Regulatory and political changes**

*Source: Research Data (2010)*

Majority of the respondents as shown by 91% responded in the affirmative that regulatory and political changes relating to the capital markets had occurred in the recent past while 9% responded that they had been no relevant changes that had occurred in the recent past. The

findings show that there is a considerable level of regulatory and political changes relating to the capital markets that had occurred in the recent past. They attributed it to the divestiture of public corporations, demutualisation of the NSE, creation of the Capital markets Authority and the political climate following the post election violence. This can also be represented as in the figure below:



**Figure 4.11 Regulatory and political changes**

*Source: Research Data (2010)*

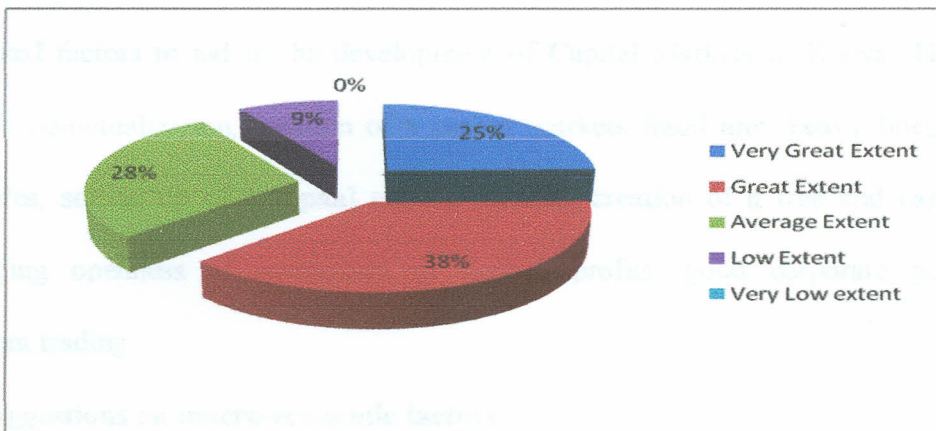
In the table below respondents were asked to give their views on the extent to which regulatory and political changes affects the development of Capital Markets in Kenya

RESPONSE	FREQUENCY	PERCENTAGE
Very Great Extent	20	25
Great Extent	31	38
Average Extent	23	28
Low Extent	7	9
Very Low extent	0	0
<b>TOTAL</b>	<b>81</b>	<b>100</b>

**Table 4.12 Extent to which regulatory and political changes affects the capital development in Kenya**

*Source: Research Data (2010)*

Majority of the respondents as shown by 38% stated that the effect was to a great extent, 25% stated to a very great extent, 28% stated to a average extent and 7% to a low extent, 0% to a very low extent. This can also be represented as in the figure below:



**Figure 4.12 Extent to which regulatory and political changes affects the capital development in Kenya**

*Source: Research Data (2010)*

## **4.8 Qualitative analysis**

Qualitative analysis focuses on answers to open ended questions and any other relevant information. This was as shown below:

### **4.8.1 General suggestions on development on Capital Markets**

The respondents were asked to suggest what can be done on to aid the development of the Capital Markets development. The respondents suggested public education on how the capital markets development operate, transparency of dealings and accountability, involvement of more companies, offering alternative products to the current narrow choice of stocks and bonds, prompt action on fraud cases, closely working among member firms, online reliable trading, research on new policies and demutualization of the NSE and subsidized favourable taxation on member firms.

### **4.8.2 Suggestions on institutional factors**

The respondents were asked by the researcher to suggest what can be done with regard to institutional factors to aid in the development of Capital Markets in Kenya. The respondents suggested demutualization, creation of a capital markets fraud unit, heavy fines to those who break rules, setting up of a capital market tribunal, creation of a free and capitalist market, encouraging openness of companies to declare profits, good corporate governance and transparent trading.

### **4.8.3 Suggestions on macro-economic factors**

The respondents were asked by the researcher to suggest what can be done with regards to micro-economic factors to improve on capital markets development. The respondents suggested the establish policies that favour private organisations, formulation of mechanisms to fight inflations, stabilization of interest rates, implementation of the new constitution, legal ,land and business

registration reforms, limit directorships for quoted companies, separation of owners from the management of companies and regulation of interest rates on loans to encourage people to obtain loans to do investments.

#### 4.8.4 Suggestions on regulatory changes and political risk

The respondents were asked by the researcher to make suggestions on regulatory changes and political risk to aid in the development of the capital markets. The respondents suggested closer monitoring of investment banks and brokers, government to ensure political stability, institutions to follow up on internal control, wide consultations with stakeholders on regulations and ensuring political risk, training both players and investors to mitigate against risks, free market without government intervention, introduce insurance policies against loss of shares and enhancement of policies that enhance company growth.

## **CHAPTER FIVE**

### **5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter presents a summary of findings to the study, and in the process, draws conclusions based on the finding of the study. The chapter subsequently makes recommendations arising from the conclusions of the study. Finally the chapter makes suggestions for further research in connection with certain specific areas of this study.

The purpose of the study was to evaluate the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange. Data was analyzed according to the objectives of the study. Data from each of the respondents was compiled and subjected to analysis. The summary of the results areas are as represented in the previous chapter.

#### **5.2 Summary of Findings**

The purpose of the study was to evaluate the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange (NSE). The NSE is considered a more liquid and active market than those of its East African counterparts (Uganda and Tanzania) and in sub-Saharan Africa in general. However, by international standards, it is small, illiquid and volatile with regard to price and returns. Low liquidity is particularly evident in the secondary bonds and equity markets. The NSE is a highly concentrated market with most of its activity centered on a few listed companies (Wagacha, 2001). The specific objectives included: (i) to determine how the changes in institutional factors affect the capital markets development in Kenya; (ii) to determine the impact of macroeconomic factors or stability on capital markets development in Kenya and (iii) to determine the effect of the regulatory changes and political risk on the capital markets development in Kenya. For the research the population of the study was composed of selected

employees of the Nairobi Stock Exchange, key informants, from the listed companies and the member firms. A census was drawn from the total population of 104 respondents. Data was collected by use of questionnaire method which had both closed and open ended questions. Data was analyzed using descriptive statistics including frequency distribution tables, means, mode and percentages. From the study the researcher established the key determinants of the capital markets development in Kenya. The response from the respondents showed that institutional factors (78%), macroeconomic factors (75%), political risk and regulatory changes (63%), as the respondents stated the extent of the effect as being on the great and very great extent. From the study the following recommendations were made to aid in the development of the capital markets; public education on how the capital markets development operate, transparency of dealings and accountability, involvement of more companies, offering alternative products to the current narrow choice of stocks and bonds, prompt action on fraud cases, closely working among member firms, online reliable trading, research on new policies and demutualization of the NSE and subsidized favorable taxation on member firms.

The first objective was to determine whether the changes in institutional factors affect the capital markets development in Kenya. The objective was measured by looking at efficiency and accountability of institutions listed at the NSE, relationship between institutional factors and capital markets development, extent of the effect of institutional factors and capital markets and the improvements that need to be made at the capital markets in Kenya. Majority of the respondents as shown by 42% of the respondents indicated that institutional factors affect the developments of capital markets to a great extent, 36% of the respondents indicated to a very great extent, 19% of the respondents indicated the extent as average, 2% of the respondents

indicated the extent as low and 1% indicated the extent as very low. The findings clearly show that institutional factors have a contribution on the development of the capital markets in Kenya.

The second objective was to determine the impact of macroeconomic factors on the capital markets development in Kenya. The objective was measured by looking at stability of the macroeconomic environment in Kenya, relationship between macroeconomic factors and capital markets development, extent of the effect macroeconomic factors on capital markets developments and what needs to be done with regard to macroeconomic factors to improve the development of capital markets. Majority of the respondents as shown by 38% stated that this effect was to a very great extent, 37% stated to a great extent, 17% stated to an average extent and 5% to a low extent and 3% to a very low extent. From the findings of the study, macroeconomic factors contribute to the development of the capital markets as depicted by the high response supporting the relationship between the variables.

#### 5.3 Regulatory Changes

The last objective was to determine effect of the regulatory changes and political risk on the capital markets development in Kenya. The objective was measured by looking at significant and regulatory changes in the capital markets development, effect of regulatory and political changes, extent of effect of regulatory and political changes on capital markets development and what needs to be done with regard to regulatory changes and political risk to improve the development of the capital markets. Majority of the respondents as shown by 38% stated that this effect was to a great extent, 25% stated to a very great extent, 28% stated to an average extent and 7% to a low extent, 0% to a very low extent. The findings show that regulatory changes and political risk affect the development of the capital markets in Kenya.

## **5.4 Conclusions**

The result of the study insisted in shedding light on the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange. Institutional factors, macroeconomic factors and regulatory changes and political risk have all been shown to play a major effect on the development of the capital markets in Kenya.

The effect of Institutional factors, macroeconomic factors and regulatory changes and political risk on capital markets development was clearly shown by the response as depicted in the previous chapter. It was thus concluded that the variables affect the development of the Capital markets in Kenya. However to be noted was that the Capital Markets Authority would have to make some changes in its operations to enable it to aid in the development of the Capital markets as suggested by the respondents.

## **5.5 Recommendations**

Based on the findings of the study, the following recommendations are made:

On institutional factors the study recommends demutualization, creation of a capital markets fraud unit, heavy fines to those who break rules, setting up of a capital market tribunal, creation of a free and capitalist market, encouraging openness of companies to declare profits, good corporate governance and transparent trading.

On macro-economic factors, the study suggests the establish policies that favor private organizations, formulation of mechanisms to fight inflations, stabilization of interest rates, implementation of the new constitution, legal, land and business registration reforms, limit

directorships for quoted companies, separation of owners from the management of companies and regulation of interest rates on loans to encourage people to obtain loans to do investments.

On regulatory changes and political risk the study recommends closer monitoring of investment banks and brokers, government to ensure political stability, institutions to follow up on internal control, wide consultations with stakeholders on regulations and ensuring political risk, training both players and investors to mitigate against risks, free market without government intervention, introduce insurance policies against loss of shares and enhancement of policies that enhance company growth.

### **5.6 Suggestion for further research**

The study only focused on listed companies to find out the determinants of the capital markets development in Kenya, a case study of the Nairobi Stock Exchange. Further research should be done on the other unlisted companies in the same market, on the topic of the study and on the challenges they face that have not made it possible for them to be listed. This will widen the scope of information collected on the topic of the study.

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## APPENDIX I

### BUDGET PLAN

S/No.	Item description	Amount Kshs.
1)	Proposal writing (Consultative meetings with supervisors & Stationery, computer, photocopy, printing and bidding	10,000
2)	Secondary Data collection, research and assistant phone calls	5,000
3)	Data management and analysis	6,500
4)	Project preparation, computer services, stationery,	15,000
5)	Final report printing & photocopy and bidding	30,500
6)	Travel & Accommodation	15,000
7)	Miscellaneous	<u>10,000</u>
	<b>Grand Total</b>	<b><u>92,000</u></b>

## APPENDIX II

### LISTED COMPANIES

#### Agriculture

1. Rea Vipingo Ltd.
2. Sasini Tea & Coffee Ltd.
3. Kakuzi Ltd.

#### Commercial and Services

1. Access Kenya Group
2. Marshalls E. A. Ltd.
3. Car & General Ltd.
4. Hutchings Biemer Ltd. **Suspended**
5. Kenya Airways Ltd.
6. CMC Holdings Ltd.
7. Uchumi Supermarkets Ltd. **Suspended**
8. Nation Media Group Ltd.
9. TPS (Serena) Ltd.
10. ScanGroup Ltd.
11. Standard Group Ltd.
12. Safaricom Ltd.

#### Finance and Investment

1. Barclays Bank of Kenya Ltd.
2. CFC Stanbic Bank Ltd.
3. Housing Finance Ltd.
4. Centum Investment Ltd.
5. Kenya Commercial Bank Ltd.
6. National Bank of Kenya Ltd.
7. Pan Africa Insurance Holdings Co. Ltd
8. Diamond Trust Bank of Kenya Ltd.
9. Jubilee Insurance Co. Ltd
10. Standard Chartered Bank Ltd.
11. NIC Bank Ltd.
12. Equity Bank Ltd.
13. Olympia Capital Holdings Ltd
14. The Co-operative Bank of Kenya Ltd.
15. Kenya Re-Insurance Ltd.

**Industrial and Allied**

1. Athi River Mining Ltd.
2. BOC Kenya Ltd.
3. British American Tobacco Kenya Ltd.
4. Carbacid Investments Ltd. .
5. E.A. Cables Ltd.
6. E.A. Breweries Ltd.
7. Sameer Africa Ltd.
8. Kenya Oil Ltd.
9. Mumias Sugar Company Ltd.
10. Unga Group Ltd.
11. Bamburi Cement Ltd.
12. Crown berger (K) Ltd.
13. E.A Portland Cement Co. Ltd.
14. Kenya Power & Lighting Co. Ltd.
15. Total Kenya Ltd.
16. Eveready East Africa Ltd.
17. KenGen Ltd

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### APPENDIX III

#### LIST OF MEMBER FIRMS OF THE NAIROBI STOCK EXCHANGE

<p><b>Drummond Investment Bank Limited</b> Hughes Building, 2nd floor, P.O. Box 45465, Nairobi. Tel: 318690/318689 Fax.223061 E-mail: <a href="mailto:info@francisdrummond.com">info@francisdrummond.com</a> Web: <a href="http://www.francisdrummond.com">www.francisdrummond.com</a></p>	<p><b>Dyer &amp; Blair Investment Bank Ltd</b> Loita House,10th floor, P.O. Box 45396 Nairobi Tel. 3240000/227803/4/5 Fax.218633 E-mail: <a href="mailto:shares@dyerandblair.com">shares@dyerandblair.com</a> Web: <a href="http://www.dyerandblair.com">www.dyerandblair.com</a></p>	<p><b>Francis Thuo &amp; Partners Ltd. (under statutory management)</b> Statutory Manager, Nairobi Stock Exchange Ltd Kimathi Street, Nation Centre, 1st Floor. P. O. Box 43633 Nairobi Tel.283100/Fax.224200 E-mail: <a href="mailto:fstatutorymanager@nse.co.ke">fstatutorymanager@nse.co.ke</a></p>
<p><b>Nyaga Stockbrokers Ltd.</b> Nation Centre, 12th Floor, P.O. Box 41868, Nairobi Tel.315748/ 315628/9 Fax.315630 E-mail: <a href="mailto:info@nyagastockbrokersltd.com">info@nyagastockbrokersltd.com</a></p>	<p><b>Ngenye Kariuki &amp; Co. Ltd.</b> Corner House, 8th floor, P. O. Box 12185-00400 Nairobi Tel.224333/220052/220141 Fax.217199/241825 E-mail: <a href="mailto:ngenyekari@wananchi.com">ngenyekari@wananchi.com</a></p>	<p><b>Suntra Investment Bank Ltd</b> Nation Centre,10th Floor, P.O. Box 74016-00200 Nairobi Tel. 2870000/247530/223330/211846 0724- 257024, 0733-222216 / Fax.224327 E-mail: <a href="mailto:info@suntra.co.ke">info@suntra.co.ke</a> / Web: <a href="http://www.suntra.co.ke">www.suntra.co.ke</a></p>
<p><b>Reliable Securities Ltd.</b> IPS Building, 6th Floor P. O. Box 50338- 00200 Nairobi Tel.241350/4/79 Fax.241392 E-mail: <a href="mailto:info@reliablesecurities.co.ke">info@reliablesecurities.co.ke</a></p>	<p><b>CFC Financial Services – Stock broking Division</b> Corner House, Ground floor, P.O. Box 47198 – 00100 Nairobi Tel: 221452/3 /Fax.218813 E-mail: <a href="mailto:cfcfs@cfcgroup.co.ke">cfcfs@cfcgroup.co.ke</a>. Web: <a href="http://www.cfcbank.co.ke">www.cfcbank.co.ke</a></p>	<p><b>Bob Mathews Stockbrokers Ltd</b> Pan Africa Hse,3rd floor P.O. Box 73253 – 00200 Tel 311898/313492/310540 Fax: 210279 Telefax: 341867 Cell: 0724-957345/0733-371629 E-Mail: <a href="mailto:bobmathews@bobmathewstocks.com">bobmathews@bobmathewstocks.com</a> Website: <a href="http://www.bobmathewstocks.com">www.bobmathewstocks.com</a></p>
<p><b>Ashbhu Securities Ltd</b> Finance House, 13th Floor P.O. Box 41684-00100 Nairobi Tel: 210178/212989 Fax: 210500 E-mail: <a href="mailto:ashbhu@ashbhu.com">ashbhu@ashbhu.com</a></p>	<p><b>Crossfield Securities Ltd</b> IPS Building, 5th floor P.O. Box 34137-00100 Nairobi Tel: 246036/245971 Fax: 245971 E-mail: <a href="mailto:crossfield@wananchi.com">crossfield@wananchi.com</a></p>	<p><b>Sterling Securities Ltd</b> Finance House, 11th Floor P.O. Box 45080- 00100 Nairobi Tel.213914/244077/ 0723153219/0734219146 Fax.218261 E-mail: <a href="mailto:info@sterlingstocks.com">info@sterlingstocks.com</a> Web: <a href="http://www.sterlingstocks.com">www.sterlingstocks.com</a></p>
<p><b>ApexAfrica Investment Bank Ltd</b> Rehani House, 4th Floor P.O. Box 43676- 00100 Nairobi Tel: 242170/220517 Fax: 215554 E-mail: <a href="mailto:invest@apexafrica.com">invest@apexafrica.com</a> Web: <a href="http://www.apexafrica.com">www.apexafrica.com</a></p>	<p><b>Faida Securities Ltd.</b> Windsor House, 1st floor, P. O. Box 45236-00100 Nairobi Tel.243811/2/3 Fax.243814 E-mail: <a href="mailto:faidastocks@wananchi.com">faidastocks@wananchi.com</a> Web: <a href="http://www.faidastocks.com">www.faidastocks.com</a></p>	<p><b>Solid Investment Securities Ltd.</b> Kimathi House, 1st Floor P.O. Box 63046-00200 Nairobi Tel.2016482/3 244272/9 Mobile: 0736-850516/0724-951703 Fax.244280 E-mail: <a href="mailto:info@solid-kenya.com">info@solid-kenya.com</a> Web: <a href="http://www.solidkenya.com">www.solidkenya.com</a></p>
<p><b>Standard Investment Bank Ltd</b> ICEA, 16th floor, P. O. Box 13714- 00800 Nairobi Tel. 220225/240296/227004 Fax. 240297 E-mail: <a href="mailto:info@standardstocks.com">info@standardstocks.com</a> Web: <a href="http://www.standardstocks.com">www.standardstocks.com</a></p>	<p><b>Kestrel Capital (EA) Limited</b> ICEA Building, 5th floor, P.O. Box 40005-00100 Nairobi Tel.251758/251893,251815,250082 Fax.243264 E-mail: <a href="mailto:info@kestrelcapital.com">info@kestrelcapital.com</a> Web: <a href="http://www.kestrelcapital.com">www.kestrelcapital.com</a></p>	<p><b>Discount Securities Ltd.</b> International House, Mezzanine, P O Box 42489-00100 Nairobi Tel. 219552/38 Fax. 230987 E-mail: <a href="mailto:discount@dsl.co.ke">discount@dsl.co.ke</a></p>
<p><b>African Alliance Kenya Securities.</b> Ground Floor, Kenya Re Towers, Upper Hill P.O. Box 27639 - 00506 Nairobi Tel. 2735013/2735154/2735138 Fax. 2731162 E-mail: <a href="mailto:otienol@africanalliance.co.ke">otienol@africanalliance.co.ke</a></p>		

**APPENDIX IV**  
**QUESTIONNAIRE**

**SECTION A**  
**INTRODUCTION**

1. Gender

- (A) Male                    (B) Female

2. Organization .....

3. Experience in the industry

- (A) 0-5    (B) 6- 10    (C) 11-15    (D) over 15 years (Cross the appropriate answer)

4. Highest Education Level

- (A) Primary  
(B) Secondary  
(C) College  
(D) Degree  
(E) Postgraduate degree  
(F) Others (Specify).....

**SECTION B**  
**CAPITAL MARKETS DEVELOPMENT**

1. Do you think the NSE plays its role in the development of the capital markets in Kenya?

Yes

No

2. Please explain your answer above?

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3. If yes, to what extent?

V.Great

Great

Moderate

Low

V.low

4. What do you think influences the development of the capital markets in Kenya?

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5. What can be done to enhance the development of Capital Markets in Kenya?

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**SECTION C**  
**INSTITUTIONAL FACTORS**

6. In your opinion are the institutions that are listed in the NSE efficient and accountable enough to bring appeal and confidence to investors?

Yes

No

7. Please explain your answer

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.....

8. Do institutional factors affect the development of capital markets development in Kenya?

Yes

No

9. If yes, to what extent?

V.Great

Great

Moderate

Low

V.low

10. What can be done with regard to institutional factors to enhance the development of Capital markets in Kenya?

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**SECTION D**  
**MACRO-ECONOMIC FACTORS**

11. In your opinion is the macro-economic environment in Kenya stable?

- Yes
- No

12. Please explain your answer above

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13. Do you think macro-economic factors affect the development of capital markets in Kenya?

- Yes
- No

14. If yes, to what extent

- V.Great
- Great
- Moderate
- Low
- V.low

15. What can be done on macro-economic factors to improve the development of capital markets in Kenya?

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.....

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**SECTION E**

**REGULATORY CHANGES AND POLITICAL RISK**

16. Have there been any significant regulatory and political changes relating to the capital markets that have occurred in the recent past?

- Yes
- No

17. Please explain your answer above

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.....

.....

18 Do you think regulatory changes and political risk affect the development of capital markets in Kenya?

- Yes
- No

19. If yes, to what extent?

- V.Great
- Great
- Moderate
- Low
- V.low

20. What can further be done on regulatory changes and political risk to enhance the development of capital markets in Kenya?

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