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FRAMING THE ISSUES

Developing Capital Markets in Rwanda

By Jacqueline Irving, John Schellhase, and Jim Woodsome

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Framing the Issues: Developing Capital Markets in Rwanda

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A summary report from the Milken Institute Center for Financial Markets based on the Rwanda Capital Market Authority's Strategic Planning Roundtable on Capital-Market Development held October 14-16, 2015, in Rubavu, Rwanda

Overview

On October 14-16, 2015, Rwanda's Capital Market Authority (CMA) and the Milken Institute Center for Financial Markets (CFM) hosted a working Strategic Planning Roundtable on Capital-Market Development in Rwanda. FSD Africa provided funding support to the CMA for the event, which convened capital-market players, private investors, capital-market regulatory authorities from the region, officials from development agencies and international financial institutions, and other capital-market experts. The roundtable's purpose was to inform the scope of work for a 10-year Capital-Market Master Plan (CMMP) for Rwanda. This document frames the issues and summarizes the important themes discussed for building capital markets in Rwanda's small, open economy. It aims to capture both the points of consensus and the divergent views of the range of academics and expert practitioners present.

The summary is divided into several sections. Sections III-VI conclude with a number of policy research questions generated during the roundtable discussions.

I. Supporting Conditions and Prerequisites for Capital-Market Development

II. Why Bother: The Value-Added of Capital Markets

III. Developing Institutional and Retail Investor Bases

IV. Boosting Supply: Developing the Equity Market

V. Developing Bond Markets

VI. Developing a Commodities Exchange

VII. Execution and Implementation: Lessons From Malaysia

VIII. Concluding Points and Next Steps

I. Supporting Conditions and Prerequisites for Capital-Market Development

Macroeconomic stability is the cornerstone of a national financial system that can provide sustainable and affordable long-term finance. The discussion during this session focused on how to move Rwanda's capital-market development agenda forward in the prevailing institutional and policy context, noting acknowledged prerequisites and supporting conditions for developing capital markets. Even when a sound policy framework and business-friendly environment are in place, as in Rwanda, regulators must rise to the challenge of striking the right balance in dual and sometimes conflicting oversight and market development roles.

Rwanda has made significant progress in establishing a sound macroeconomic policy framework, underpinned by prudent fiscal and monetary policies, as noted during the roundtable's opening remarks.[1] For more than a decade, its macroeconomic performance generally has exceeded that of other economies in the region. Inflation rates have been kept low and average annual economic growth has exceeded 8 percent over the past decade. Although risks to Rwanda's economic outlook have increased in the past several months due to lower global commodity prices and slower export growth prospects, the economy performed more strongly in 2015 than had been expected. Real GDP growth for 2015 is projected at a robust 7 percent and consumer price inflation is forecast to remain below 5 percent.

Participants noted that sound and stable macroeconomic policies—including disciplined fiscal policies to avoid crowding out of private capital—are essential to the proper functioning of financial markets. In the absence of macroeconomic stability, notably where inflation is high and-or volatile, there is a disincentive to save, because future earnings are uncertain in real terms. Likewise, when macroeconomic stability is lacking, financial markets will make available only short-term finance at variable rates. Infrastructure projects in particular require long-term finance at predictable interest rates. "We see banks do more business in frontier markets where interest rates have dropped and inflation is under control," summed up one roundtable participant from an investment firm active in Africa.

The empirical literature supports discussants' key points that sound macroeconomic policies are linked with financial-sector development. Aryeetey and Nissanke (1998) found that in the absence of macroeconomic stability, the impact of financial-sector reforms on financial deepening will be ineffective.[2] The literature also shows support for causality running both ways. A large body of literature examines how financial development leads to sustainable macroeconomic growth, one precondition of which is greater macroeconomic stability.[3]

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[1] "IMF Staff Completes Review Mission to Rwanda," Press Release No. 15/494, November 4, 2015.

[2] Aryeetey, Ernest, and Machiko Nissanke, 1998, *Financial Integration and Development, Liberalization, and Reform in Sub-Saharan Africa*. London: Routledge.

[3] See, in particular, Levine, Ross, and Sara Zervos, 1996, "Stock Market Development and Long-Run Growth," Policy Research Working Paper No. 1582 (Washington: World Bank). Examining the relationship between macroeconomic stability and capital-market development, Garcia and Liu (1999) found that the former, along with adequate national income and savings, was a

While participants agreed that Rwanda meets the prerequisite of having a relatively stable macroeconomic policy framework, some cautioned against foreign-currency-denominated borrowing on international capital markets. Several participants from outside the East African region argued that it was better to issue local-currency debt because of the associated foreign exchange risk and the prospect of higher debt servicing. However, a few local market participants defended moves to borrow in foreign currency by pointing out that local interest rates are so much higher. One participant noted that if the Kenyan government had borrowed locally when it issued its dollar bond, it would have paid less in the end in real terms, despite higher domestic interest rates.

Moving money from savers to borrowers

As fundamental as the macroeconomic policy environment is, the growth trajectory that underpins it requires domestic savings. Raising domestic savings and investment levels is also a critical step for Rwanda in maintaining its strong track record over the past decade on *inclusive* economic growth and poverty reduction.[4] The savings rate is an important macroeconomic indicator of an economy's ability to generate finance for infrastructure and socioeconomic development overall. Despite a rising savings rate, Rwanda's capital markets are underdeveloped, which impedes their ability to intermediate long-term finance effectively, moving money from savers to borrowers.[5]

A key step needed to address this will involve improving coordination of how East African Community (EAC) exchanges seek to attract investors across the region. (See Box 1 and Section III.) And there was strong agreement among roundtable participants that institutional investors played an important role in capital-market development. This long-term money can help catalyze investment from other sources to deepen and develop capital markets. One participant went so far as to stress that it "is absolutely essential that 'domestic' has to be East Africa in the context of institutional investors." Because Rwanda's local institutional investor base currently is small, a regional approach would help develop the institutional investor base. As another participant put it: How can the EAC be thought of as an asset class for institutional investors across member countries?

There also is a need to scale up small savers—the large number of people with relatively low earnings or even those employed in the informal sector—and advance financial inclusion across the EAC. There was broad consensus among participants that a related key question was how to motivate the many people in the informal sector with considerable cash on hand to begin to have a need for savings and investment instruments.

Predictable, business-friendly regulatory environment as the foundation

It also is important to look at capital-market development in the context of the enabling policy environment, business operating and regulatory environment, and the overall banking and financial

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prerequisite for development of capital markets in developing economies. See Garcia, Valeriano, and Lin Liu, 1999, "Macroeconomic Determinants of Stock Market Developments," *Journal of Applied Economics* 2: 29–59.

[4] See IMF, Country Report No. 14/343: 2014 Article IV Consultation.

[5] According to World Bank data, Rwanda's gross domestic savings rate was equivalent to an estimated 10.7 percent of GDP in 2014, up from 7.3 percent in 2010 and 2 percent in 2005. This put Rwanda's savings rate ahead of that of EAC member Kenya in 2014 (3.9 percent of GDP) but behind those of Tanzania (20.6 percent) and Uganda (19.6 percent).

system. Several roundtable participants underscored that, where large investments are at stake, long-term money needs some kind of certainty about how that investment will be treated over time.

Policies and regulatory reforms in Rwanda over the past decade have strongly emphasized institutional capacity building and a business-friendly environment, providing a solid foundation for developing capital markets. In fact, the World Bank's "Doing Business 2016" ranks Rwanda second among all countries it covers globally in terms of overall improvement in the past 12 years in the business environment.[6] As noted by one roundtable participant, Rwanda's approach to building capacity and institutional support should help create a solid bedrock on which strong financial and capital markets can be built.

Because of the still relatively small size of Rwanda's financial sector, regulators have a dual linchpin role to play: that of providing consistent oversight, but also of regulating the various subsectors in a way that fosters financial-sector development. In view of this dual role, however, there are concerns of overregulating and stifling market development. A few roundtable participants also cautioned against overregulating markets in ways that stifle innovation. One also warned against creating identical capital markets in the region and advised that an approach that instead defines unique, yet complementary, market niches could foster innovation. Participants discussed the successful take-up of mobile money services in Kenya as an example of regulators striking a good balance in meeting the dual mandate of regulating and providing a context that allows innovation to thrive and financial services to grow.

"In looking at how to develop a well-functioning, efficient commodity exchange, one of the important conditions is a minimum level of government intervention," explained one roundtable participant. "At the same time, I would also say that the markets need the government," he added, noting that there is a paradox situation whereby commodity exchanges will not be successful if not backed up by the government.

Achieving scale

A regional approach to capital-market development can bring several benefits. First, there are the economies-of-scale benefits: Sharing market infrastructure and intermediation services can reduce fixed costs and improve efficiency. Second, businesses and governments looking to raise funds are able to access a broader investor base, which may result in lower financing costs as well as improved liquidity and stability of funding. And this may have implications for financing private companies too, since private-equity investors will more readily invest when the exit strategy is clear. Third, investors are able to diversify their portfolios more easily, reducing their exposure to idiosyncratic risks.

Forging closer regional links across the EAC's capital markets may offer a way for Rwanda's capital markets to achieve needed scale. And more regionally integrated markets can facilitate the development of regional companies, such as Equity Bank Holdings, and regional infrastructure projects, such as the EAC's Northern Corridor.

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[6] Rwanda also implemented the largest number of business-friendly reforms in the African region in the past year. According to "Doing Business 2016," it currently takes 32 days for an entrepreneur in Rwanda to transfer property (less time than in Germany); a decade ago it would have taken 370 days.

Despite these potential benefits, there are several barriers. Not the least is national pride. “We continue to fragment and duplicate infrastructure across the region in the ambition of each having our own,” said one participant. Though competition has spurred countries in the EAC to develop better systems, the result is rampant duplication and a high degree of redundancy: “Each one of those systems could run the whole region,” remarked another participant. Part of the challenge is to shift policymakers’ focus from national ownership to national value. “National value will be much higher if we are using the best systems that can attract and consolidate the highest number of investors and deliver the highest level of efficiency,” observed the same participant. This is true not only for the smaller EAC members, such as Rwanda, but also for the larger members, whose markets are still small by international standards.

Likewise, institutional investors’ mandates often restrict their ability to invest abroad. If a major institutional investor in one EAC market is severely restricted in the amount of offshore investment it can make in other EAC markets, for example, the full benefits of regionalization won’t be realized. The smallest markets often harbor concerns that a move to forge closer links regionally with other capital markets carries the risk that they will essentially become “outposts of a regional exchange.” For the very smallest economies, it simply may not be commercially viable to have their own independent national stock exchanges. Where small markets can prosper, however, is by specializing to carve out unique niches, or becoming more nimble or efficient.

Constraints that intermediaries and investors face in operating across borders can pose another barrier. Local ownership laws shield brokerages and investment banks from competition, which can inhibit efficiency gains, learning, and innovation. Opening up these markets would result in some existing organizations gaining market share at the expense of others, and potentially spur an uptick in mergers-and-acquisitions activity, as intermediaries consolidate. It may also provide opportunities for upstarts: “When we talk about regionalization,” said one participant, “sometimes there’s a presumption that the existing service providers will be able to operate in all the other markets.” He urged a shift in that thinking, to instead asking: “Who are the new voices, the new perspectives that are going to be necessary to fully take advantage of that new opportunity and grow?”

Some participants made clear their impatience at the pace of integration. One private-sector participant pointed out that, with technology having made possible advances such as WhatsApp, M-Pesa, and the sale of bonds by SMS text messaging, setting up a platform to link brokers and markets should be relatively straightforward. Another participant cautioned against underestimating the operational problems, pointing to the difficulties that the Association of Southeast Asian Nations (ASEAN) has experienced over decades in harmonizing members’ rules, payment and settlement systems, legal and regulatory frameworks, and financial oversight regimes. She also emphasized that strengthening the domestic market is important, no matter what form regionalization takes. This participant suggested that EAC members approach regionalization by focusing first on “small but concrete wins,” such as bilateral agreements that open investor access to bond and equity markets. In other words, do not allow the perfect to become the enemy of the good.

BOX 1. How can EAC capital markets best leverage regionalization?

In discussions on taking a regional approach to capital-market development, the actual linking of exchanges is a frequent topic. However, a few roundtable participants suggested that any benefits from these linkages may be overemphasized, especially at early stages of capital-market development. At least one indicated that they could even be a distraction: “Several have been built over the years at considerable cost and, with one exception—the Hong Kong-Shanghai link—they’ve done absolutely no business.” In fact, too rapid a move to a fully integrated, regional stock market could merely create a large, illiquid market. Participants broadly agreed that what matters most is regulatory harmonization and mutual recognition to foster cross-border listings and investment. One private-sector participant noted that his firm operates in East Africa as one zone but has three licensing regimes, three audited financial statements, and three capital-market authorities (CMAs). “I should be able to have one license, so that I can operate in all three countries,” he said. Another participant pointed out that exchange linkages are most relevant to equity markets and less so to bond markets, which are bigger and arguably more beneficial to the region.

Other participants warned that in developing exchange linkages, it is important to not overbuild market infrastructure. One argued that the costs entailed were being overestimated, pointing to the successful linkage between the stock exchanges in South Africa and Mauritius despite different central securities depositories (CSDs). Instead of investing heavily in new market infrastructure, the Stock Exchange of Mauritius (SEM) established an efficient, cost-effective procedure for trading securities between its own central securities depository and that of the Johannesburg Stock Exchange (JSE). “The shares move seamlessly between the two CSDs, because they communicate through book entry systems,” the participant noted, adding that this illustrates that sometimes there may be relatively simple solutions to problems that seem complex. The challenge, naturally, was protecting against creating duplicate securities. To this end, among other control procedures, the Mauritian process limits access to the registrar kept by both CSDs to authorized registrar and transfer agents of the securities issuers.

The following process[*] can be used by any Mauritian investor who wants to transfer securities from the Mauritian CSD to the South African CSD:

1. The investor sends a request for the transfer to the registrar and transfer agent in Mauritius.

2. The registrar and transfer agent in Mauritius sends written instructions to the Mauritian CSD to debit the account of the investor.

3. The Mauritian CSD debits the account of the investor after appropriate verification and sends a written confirmation to the registrar and transfer agent in Mauritius.

4. The registrar and transfer agent in Mauritius sends a written instruction to the registrar and transfer agent in South Africa regarding the transfer.

5. The registrar and transfer agent in South Africa sends an instruction to the South African CSD to credit the account of the investor.

6. The South African CSD credits the account of the investor and sends a confirmation to the South African registrar and transfer agent, who informs his Mauritian counterpart. This completes the transaction.

BOX 1 (*continued*)

Some roundtable participants suggested that the best way to regionalize market infrastructure is to have the public sector step back and allow the private sector to lead. Both the Nairobi Stock Exchange and the Rwanda Stock Exchange have demutualized, and the Dar es Salaam Stock Exchange in Tanzania is in the process of doing so. According to this line of reasoning, as investor-owned, for-profit corporations, these exchanges will approach decisions that link EAC market infrastructure as a straightforward business matter.

**Special thanks is owed to Vipin Y.S. Mahabirsingh, managing director of Central Depository & Settlement Co. Ltd., for providing the details of the process for trading securities between the SEM CSD and that of the JSE.*

II. Why Bother: The Value-Added of Capital Markets

Roundtable discussions on the theme of the value-added of capital markets highlighted the importance of sequencing in developing capital markets, while also underscoring that capital markets should complement rather than compete with the banking sector. Participants also discussed the key role that well-functioning capital markets play in providing information on how market participants value firms. Much of this part of the discussion hinged on the fact that capital markets both provide and need the right information environment.

Banking finance is not sufficient for Rwanda

Financial-market development must begin with a sound banking sector, and the banking sector has been growing steadily in Rwanda.[7] Businesses, however, cannot rely only on bank loans for their financing needs and require a range of financial products throughout their life cycles. Rwanda's large businesses as well as its small and medium-sized enterprises (SMEs) with high-growth potential need access to longer-term financing that banks may not provide at reasonable rates, if at all. As found in the CMA-Milken Institute survey of Rwandan businesses, the most common source of finance for firms is bank term loans, used by two-thirds of surveyed companies. However, only 22 percent of the surveyed businesses successfully raise the finance they need, with 35 percent finding partial success and the remainder—more than a third—not at all successful in raising funds. For this last group, the most significant obstacle cited was insufficient collateral.

Ideally, as several roundtable participants noted, banks and capital markets ought to work as complements rather than competitors. Once large firms in a financial system can access local capital-market financing, banks will be forced to lend further down the credit spectrum to SMEs in need of financing.

Beyond the needs of Rwandan businesses, participants noted that bank financing alone is also inadequate for other important foundational aspects of the nation's growth story. First, Rwanda needs to make long-term investments in infrastructure that require mobilizing long-term capital, which banks are not as well-suited to provide. On the savings side, the growth of Rwandan and regional institutional

[7] According to Global Findex data, between 2000 and 2014, total deposits have grown from $225 million to $1.6 billion. Today, 42 percent of Rwandan adults have a bank account.

investors means there is increasing appetite for long-term securities to match their investment horizons. The roundtable discussion of both of these points is presented below in Section III.

Strengthening the information environment for the benefit of all

The information environment in Rwanda is currently poor, a number of participants agreed. “The quality of financial data is neither adequate nor produced in a timely way,” remarked one who works in the local banking sector. “We sometimes see even audited financial records that cannot be relied upon,” he added. Another participant noted that the valuation of property can range wildly, sometimes as much as 300 percent between valuators.

A weak information environment can shift the financial sector heavily toward banking. When companies do not or cannot produce timely and accurate financial records, they become more dependent on relationship-based borrowing. As one participant said, “Banks specialize in developing long-term client relationships, and they excel in doing that in a bad information environment.” Capital-market investors, on the other hand, require detailed and up-to-date company data to assess risks associated with long-term debt or taking an ownership stake in a company.

Rwanda’s unreliable information climate has serious consequences for the economy. First, banks pass the uncertainty about valuation on to households and businesses through high collateral requirements. This leaves many firms unable to pledge the collateral needed to access bank financing.

The weak information environment also holds back capital-market development by complicating the work of regulators. As regulators from two countries in the region noted during the roundtable, companies lacking accurate accounts that plan to issue securities will require extra scrutiny, resulting in delays in the regulatory approval process. When regulators are forced to sift through poor-quality records, their response time and overall capital-market development are impeded.

The irony is that capital markets both provide and need the right information environment. In addition to providing an alternative to bank financing, capital markets serve the useful function of providing information on firms’ market value. In fact, as this session’s presenter emphasized, that function is probably more important than the function of generating finance, which can be relatively expensive. Through prices, markets reveal important information about the value of firms as well as the markets’ level of confidence in policymakers. As several participants noted, a strategy for developing the auditing industry is a critical short-term priority for improving the information environment. Standardizing and improving the accuracy of collateral valuation is also important.

In general, by providing important information on the value of firms, capital markets are able to provide several other functions. Capital markets are instrumental in mobilizing resources, allocating those resources to productive investments, monitoring the use of resources after their allocation, and improving business management through higher standards of corporate governance.

Preparing to list on an exchange—with all of the requisite disclosure requirements and governance restructuring—needs to be presented to firms as a value proposition. In preparing for a listing, firms

provide the information that markets need to assess their value—while also improving corporate governance and overall competitiveness, efficiency, and management. Several participants noted that there was a need for a change in mindset so that Rwandan corporates viewed listing on the stock exchange as a natural stage in the life cycle of a company. A few participants argued that targeting prospective firms for listing one by one, using financial education to address concerns that lead to reluctance to go public, could change this mindset and boost listings.

A few others flagged a role for targeted technical assistance in helping entrepreneurs develop a business plan, acquire financial reporting skills, and improve corporate governance and transparency. Participants disagreed, however, about whether market intermediaries, the RSE, or the government—through the CMA or other agencies—should be leading these efforts.

Cautionary comments

An important aim of capital-market development, as several participants emphasized, is to spur growth of a diversified private sector that creates decent jobs, improves living standards across the population, and supports inclusive sustainable macroeconomic growth. Throughout the roundtable, participants returned to the point that capital-market development "should not be done for its own sake." There was strong consensus that "efforts should focus holistically on developing financial markets that effectively intermediate capital to meet enterprises' real financing needs." This must be the overriding objective, rather than building a marketplace and using the market infrastructure created, which may or may not be useful and appropriate.

A few participants cautioned that capital-market development should not necessarily be a high priority for Rwanda right now. "There is not necessarily a one-type-fits-all approach for how you evolve from what is largely bank funding," said one participant. "How can you use capital markets as a tool? Crowding in more funding doesn't necessarily mean that you need to go directly to issuing bonds on the market." Another participant, noting that the average age of Rwandan firms is seven years, said flatly, "The average seven-year-old firm does not access the capital markets. It's when firms get much older and larger that they access the capital markets, even in the most advanced capital markets in the world."

As one participant noted, it is not essential that the full range of financial services be provided by domestic institutions. With Rwanda's membership in the EAC, capital-market stakeholders in the region have an important opportunity to leverage regionalization in encouraging new issuers on capital markets, developing buy side, and developing the supporting market infrastructure. This same participant drew an analogy between capital markets and airlines. Not all economies need their own national airline, but they all need national government to ensure safe and effective operation of local runways and air traffic control. In other words, Rwanda may be able to find more cost-effective routes to market development by promoting access to services already provided by other EAC members.

Capital-market development takes time. As one participant said, developing a stock market is "a long and slow process and it is difficult to take quantum leaps." Therefore, appropriate sequencing is key. While the 10-year plan to develop Rwanda's capital markets will focus on developing formal bond and

equity markets, it will also be important to simultaneously develop a range of other financing mechanisms for enterprises. Naturally, a well-functioning banking sector lays an essential foundation for capital-market development. However, alternative financing sources such as private equity, financial leasing, invoice discounting, and factoring may be more appropriate for certain enterprises, depending on their size and life-cycle stage, as well as their particular financing needs.

III. Developing Institutional and Retail Investor Bases

The roundtable discussions on developing institutional and retail investor bases focused on several critical considerations for the role these investors should play in capital-market development. First, participants debated the "dual mandate" of institutional investors in both financing local economic growth, as some of the largest local pools of capital available, and in prudentially managing the savings with which they have been entrusted. Second, participants explored ways of matching Rwandan and EAC institutional investor appetite to domestic and regional infrastructure projects. Third, they discussed the importance of Rwanda attracting investment from institutional investors in other EAC member states, particularly Kenya. In addition to the discussion on institutional investors, participants also emphasized the importance of developing a retail investor base. That discussion, which centered primarily on the development of unit trusts (mutual funds), is also summarized below.

Roundtable participants agreed that the expansion of capital mobilized through pension and insurance schemes will be a key driver of capital-market development in East Africa. As one noted, "As institutional investors become the big sources of savings in Rwanda, the banking sector will not be a suitable channel for those savings. Investment instead will be made through capital market channels of one form or another." These investors have a sustained appetite for long-term, capital-market securities to match their long-term obligations.

Indeed, in recent years, the growth of institutional assets has accelerated across the EAC. This is true particularly in the Kenyan pension industry. As noted in the presentation of one roundtable participant, with Rwanda's institutional investor base still relatively small, there is likely to be a tendency for these investors to come from Kenya and for the market to be dominated by Kenya for the foreseeable future.[8]

Debate over institutional investors' 'dual mandate'

In Rwanda, as in many countries, pension funds and insurance companies represent the largest pools of private capital available for productive investment outside the banking system. For this reason, several roundtable participants argued that these institutional investors have an important responsibility to finance the domestic, private-sector growth story through investments in public equities, public and

[8]Assets under management in the Kenyan pension industry have increased from less than US$500 million in 2000 to about US$8 billion today. In Rwanda, the domestic institutional investor base was estimated at just over US$1 billion at the end of 2014 (13 percent of GDP). Some 400,000 people currently participate in Rwanda's pension system. Potential for future growth of the pension industry in EAC countries is strong, particularly given the proportionately high populations of youth. While the Rwanda Social Security Board (RSSB) is by far the predominant local institutional investor, private pension and insurance funds have been growing rapidly in recent years, according to the World Bank. Fifty-three defined-contribution pension schemes operated in Rwanda as of year-end 2014, alongside the RSSB, as a defined-benefit scheme. Twelve regulated insurance firms manage over US$300 million in assets in Rwanda.

private placements of corporate debt, and private equity. As one participant noted, “Money follows money,” and so pension funds in Rwanda and other EAC members could act as important trailblazers for crowding in further investment from abroad.

In Rwanda, however, the amount of assets allocated to equities and corporate or project bonds has remained small. The Rwanda Social Security Board, for example, has allocated more than 60 percent of its assets to bank deposits, government debt, and real estate.[9] Several participants worried that, throughout the EAC, pension funds have become “a captive market for government bond issues.” A few advocated for a policy intervention that would push, in one way or another, pension funds to more actively allocate assets to infrastructure and private equity as catalytic investments for driving economic growth. As one said, “There needs to be some policy deliberation as to how the governments are making critical decisions on directing components of the national insurance or pension funds to go into supporting early-stage funding.”

Other participants, however, cautioned against such an activist approach by East African governments, for two main reasons.

First, they noted that institutional investors have a dual mandate. In developing countries in particular, where capital is scarce, pension funds and insurance companies have a role to play in investing in the local economy. However, they also have a mandate to judiciously invest the savings of others. Several participants noted that protecting pensioners’ retirement money is a first-order priority. This second part of the mandate would perhaps guide pension funds away from early-stage funding, where failure rates are especially high. A few participants argued for taking into consideration the “social impact of these risk issues.”

A second and related point raised during the roundtable was that funds need to diversify risk beyond their own country’s economic growth story. Participants arguing this point noted that some East African governments already place strict limits on how much their institutional investors can invest abroad, even within the subregion. Government-prescribed local asset allocations could actually increase systemic risk in the local financial sector. If the job of the pension funds and insurance companies is to safeguard returns for pensioners and shareholders, then they need to diversify risk through investments abroad. As one participant said, “Institutional investors need to be the source of funds for capital-market development, but the smaller the economy, the less *local* institutional investors should be providing those funds.”

Finally, a few participants believed that the reason pension funds have not diversified much beyond bank deposits, government debt, and real estate is simply due to a lack of product. (See also Section III.) As one noted, they buy and hold because they don’t have alternatives. “If they have only three stocks to buy and they sell, where are they going to put the money?” he asked.

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[9] EAC Secretariat, *EAC Pension Statistics*, December 2014.

Crowding in more infrastructure financing

Much of the roundtable discussion about institutional investors focused on their role in funding long-term infrastructure projects. Naturally, this is part of their mandate as essential pools of capital for financing investments in local economic growth. Pension funds tend to be better suited than banks to financing long-term infrastructure projects because their liabilities typically better match the longer terms of infrastructure projects. One participant remarked on a role for infrastructure bonds issued on local capital markets as a vehicle that may attract pension fund investments, more so than direct investment in infrastructure projects.

Participants discussed ideas for developing additional long-term financing options, including for funding infrastructure. Much of this discussion centered on the lack of investment vehicles and other financial instruments. As underscored by one participant, a main impediment to accessing more private finance is a shortage of well-prepared projects.[10] Several participants pointed to a lack of "fundable" projects—rather than a lack of investment—as the biggest impediment to capital-market development. "Developing quality projects and preparing that pipeline is perhaps more important than focusing too much on development of the market itself," argued one participant. Another noted that it was important to remain mindful that, as a frontier market, "Rwanda's capital market is very much a growth market, so you've got to create that pipeline."

According to findings from a study by McKinsey, an estimated US$15 billion annually in international private finance could be tapped for investment in Africa's energy sector alone. Project preparation can be costly, time-consuming, and risky, however. And the process of preparing projects can be further impeded by technical capacity and budget constraints.[11] "When a country has infrastructure projects, which are essentially public-sector-led, and they are trying to bring in private-sector finance, getting the public-private-partnership (PPP) structure right can be complicated," remarked one participant. The process of actually procuring infrastructure investments can be lengthy as well as complicated, another noted.

One participant noted, more optimistically, that PPPs can provide impetus for crowding in private capital. PPPs can bridge the fiscal gap where governments are not able to provide all of the funding. "Adding private capital can actually improve timelines for delivering goods and services, and therefore generate value for money," he added. At the same time, participants agreed that it was important to strike a balance between the commercial interest in growing the venture and any direct, long-term impact on the public. All of the components involved in financing long-term national infrastructure need to be examined in the context of the wider ecosystem. "No one platform is a solution to all problems," one participant observed. And crowding in more funding doesn't necessarily mean issuing securities directly on the market, as another pointed out.

There may be a role for unlisted products such as private placements and unlisted infrastructure funds and co-investment instruments. To this end, participants believed there might be an important role for

[10] McKinsey, 2013, "Infrastructure Productivity: How to Save $1 trillion a Year."

[11] In 2011, the G-20 flagged insufficient resources for project preparation as a major impediment to large-scale infrastructure projects in developing countries.

donors to play in providing insurance wrappers and other credit-enhancement products to lower the risks these projects pose to investors. As an example of partially de-risking long-term infrastructure projects, one participant referenced Israel's experience of having a government-owned insurance company provide a credit guarantee. A similar idea for product development would be municipal or national development bonds with a credit wrap sold to institutional investors by the issuing agency.

Another attractive idea that emerged from this part of the discussion was the creation of a regional infrastructure fund seeded by a variety of funds throughout the EAC. Through such a pooled fund, risks would be spread across multiple projects and shared by multiple investors. Again, participants suggested that donors could assist in the creation of such a fund and provide some first-loss guarantees to encourage participation.

The challenge of attracting investment from regional institutional investors

Roundtable participants were in agreement that Rwanda's domestic institutional base is inadequate to meet the investment demands of the economy. As one local participant stated, "Rwanda currently does not have enough institutional investors domestically." Participants believed that a crucial step for capital-market development in Rwanda would be tapping the nearly US$15 billion of assets under management by institutional investors in neighboring EAC countries. (See also Section I.)

Participants identified four main obstacles that stand in the way, however. As expanded on immediately below, these obstacles are: high returns on government debt, the difficulty in investing across borders, mandates that restrict cross-border investment, and exchange rate risk.

1. **CAPTIVE TO GOVERNMENT DEBT MARKETS**. As several participants noted, many pension funds in the EAC have become comfortable buying and holding government debt. If Kenyan investors can earn 15 percent on safe government assets, they are not incentivized to invest in Rwandan government or private-sector securities.

2. **COSTLY REGIONAL INVESTING PROCESSES**. The process of investing in securities across borders within the EAC is overly cumbersome, several roundtable participants said. Participants strongly recommended shifting to a system where, when a security is listed on one EAC exchange, it automatically can be traded on all EAC exchanges. While some participants expressed concern that this would involve additional costly investment in market infrastructure, others suggested there could be low-tech, low-cost alternatives. For example, one cited the simple book-entry system that links the Stock Exchange of Mauritius with the Johannesburg Stock Exchange, allowing for the dual listing of shares without expensive new market technology. Similarly, several participants urged that an "EAC passport" be made available for intermediaries to eliminate redundant approval processes and trading fees that could curtail cross-border activity.

3. **RESTRICTIVE MANDATES**. Some EAC institutional investors are required to allocate large shares of their assets to domestic projects or have relatively low ceilings on how much they can

invest in foreign securities—even those issued within the EAC. One of the strongest consensus recommendations coming out of the roundtable was that securities issued by entities in other EAC member states should be subject to the same investment guidelines as those issued by domestic entities. In Rwanda, foreign investment—including from within the EAC—in securities issued on the stock exchange is limited to 30 percent. Raising this threshold for EAC-sourced investment could also help address buy-side constraints in Rwanda.

4. EXCHANGE RATE RISK. One East African regulator pointed out the difficulty in trading across borders seamlessly with different currencies. “As soon as you start trading, you’re going to be losing 5 percent just in currency conversion,” he said. Several participants argued that establishing a financial derivatives market that allows investors to hedge their currency risk would catalyze further financial-market development in Rwanda. “Creating an enabling environment for currency forwards so there are no settlement issues for international investors would be an enabling product for capital-market development,” said one. Developing FX hedging products would allow Rwanda not only to more fully attract EAC institutional capital, but flows from beyond the region as well.

Cultivating a retail investor base

There was consensus among roundtable participants that there is a role for retail investors, although some participants described them as “the third tier” in developing buy side. Others agreed that involving a wider number of retail investors in the equity market should likely be included as a medium-term goal for capital-market development. With very few people contributing to pension schemes, an important challenge is determining how best to mobilize funds from small-scale savers—the large number of people with relatively low earnings or even those employed in the informal sector.

Low combined EAC savings impede the ability to attract large numbers of small savers to unit trust (mutual fund) products, even intraregionally. Cooperation among EAC exchanges in developing innovative financial instruments could improve the ability to attract small-scale investment from across the region. A few roundtable participants recommended that capital-market players across the EAC explore setting up a regional fund employing mobile technology to directly access retail investors and even very small-scale savers throughout the EAC.

With the goal of encouraging the development of a unit trust industry to help increase savings rates, including among low-income populations, the Rwandan government recently created the Rwandan National Investment Trust. The RNIT is an open-ended fund that invests only in listed securities and money market securities. Investment targets are 30 percent in equity and 70 percent to 100 percent in debt. The trust has an initial aim of reaching 5,000 investors, targeting institutional and retail investors. It also intends to reach 100,000 small-scale savers and will sell shares in the trust for amounts as small as RWF2,000 (approximately US$2.70).

Well-targeted financial education will be a key supporting step in scaling up underbanked savers. Several roundtable participants argued that intermediaries need to play a greater role in leading educational

efforts. As one participant said, “It is not only the exchange regulators’ responsibility to get into public education … intermediaries have an equally important role to play.” By taking up this role, intermediaries will draw in new clients and grow their businesses. There was disagreement about the extent to which intermediaries should take on this role, however. One participant pointed out that cost considerations make it impossible for trading participants or intermediaries to carry out this task alone. He underscored that government was needed “to provide leadership as the market grows.”

KEY QUESTIONS:

- What do institutional investors require from capital markets to invest more in longer-term assets and projects (a challenge not restricted to Rwanda and other developing markets)?
- What are institutional investors’ minimum liquidity needs?
- What are the best ways to leverage regionalization and attract long-term capital from investors based in other EAC members?
- What types of mutual fund (unit trust) investment vehicles are needed?
- Are there investment products that can attract and scale up savings from the smallest-scale savers (people in the informal sector)?

IV. Boosting Supply: Developing the Equity Market

The roundtable’s third and fourth sessions were devoted to an exploration of how best to connect firms to capital markets and boost the supply of new issues on Rwanda’s equity markets. The discussion centered on several main, interconnected themes: How to increase “product” by increasing fundable projects and attracting more firms to list on the RSE’s main board; whether the RSE should target SMEs for listings at all; and, if not, the alternative forms of finance these firms could access to best meet their needs. In discussing the first theme, several participants called for a regional approach. Several recommended targeting firms from within the EAC seeking to expand their businesses regionally as a key part of a campaign to attract new listings.

In addition to providing access to long-term finance, a listing on public equity markets can bring benefits of improved financial reporting and transparency, related efficiency improvements, diversification of the shareholder base, and price discovery and a basis for company valuation. It also can provide companies with an opportunity to raise their market profile, which can help in expanding market share and building the business. The stock exchange also can be appealing as a way for firms from within the region to raise capital to fund regional expansion. Observing this phenomenon at work in Southern Africa, one participant noted that a number of well-established, large, and profitable firms in that subregion have good business models that are transferrable to other countries in the subregion. “These firms are doing rights issues that are being used to finance their regional expansion programs,” he added.
But outreach is required to make firms aware of the benefits of listing on public equity markets. And to enable firms to access these markets, listing cannot be too costly or too onerous.

Targeted outreach to attract listings—domestically and within the region

One step that could help increase main board listings is outreach to boost companies’ awareness of a stock exchange listing as a vehicle for raising finance. There was broad agreement among roundtable

discussants that these efforts are most effective when they are carefully targeted. To attract listings, other countries' financial market authorities and intermediaries have targeted individual companies they identified as listing candidates. "We assembled a list of about 30 to 40 companies that were of a large enough size, and went round and talked to them one by one to try to convince them of the benefits of listing," recounted one African capital-market expert. "Targeted education rather than scatter-gun education typically is more effective," he added. "We should identify those firms that are relatively big and would attract interest from both local and international investors," echoed another participant.

Taking a regional approach to a targeted campaign to attract listings also could have merits. This is not a new idea, but efforts could be stepped up and more closely coordinated. As long as a decade ago, the Nairobi Stock Exchange proposed that the EAC exchanges jointly conduct a regional public awareness and educational campaign, reaching out to a list of potential issuers across the EAC, compiled periodically on a regional basis. To increase the amount and range of "product," one African stock market head proposed that EAC regulators and exchanges go so far as to agree that whatever was listed in Kenya simultaneously be made available for trading in Rwanda, and vice versa.

Developing capacity is also important. Several participants commented that the private sector typically does not lead in capacity building and education, but rather relies on government investment in these areas. At the same time, intermediaries have a role to play in improving the way financial markets intermediate capital by investing in public education, as well as selling the products that are on the market to prospective investors. "It is not just the regulators' responsibility to get into public education," said one participant. At the same time, several participants commented that the private sector relies on government investment and leadership in this area.

Reducing listing costs and complexity to encourage more issuers

In addition to the listing fee itself, there are other costs associated with getting and maintaining a stock exchange listing. Raising capital on a stock exchange through an initial public offering can be expensive because of the larger costs such as advisors' fees, reorganization costs, and costs associated with auditing and compliance with financial reporting standards. In fact, for a main board listing, the actual listing fee is trivial relative to advisors' charges and other costs. Citing findings from a World Bank study, one participant reported that "the direct costs were not necessarily very high, but most of the issuers found the indirect costs to be prohibitively costly." These indirect costs include the time it takes to get a listing approved.

Other participants pointed out that while listing costs may seem high in absolute terms, when expressed in terms relative to the amount of finance actually raised, they may not seem so high. "The issue is really more so how to reduce the complexity of accessing capital markets—and how to make it faster to access the markets," said one participant.

One well-known factor on the ground is that potential issuers—especially SMEs—fear the disclosure needed for a listing. "They look at themselves and assume they don't have the capacity to open up to go public," explained a participant in regular contact with Rwandan enterprises.

A few participants suggested a possible role for technical assistance in improving the time and process associated with a main board listing. “Technical assistance for first-time issuers could help them with ratings, legal issues, etc. to incentivize these first movers who could be otherwise a bit apprehensive,” said one.

Participants discussed whether tax incentives were effective as a way to encourage listings. According to a key stakeholder in developing Botswana’s stock exchange, during the five years that tax incentives were in effect to attract new listings, they did help build a critical mass of listed companies. However, he cautioned that although this tactic can work to attract listings, it can also be costly. “If used at all, tax incentives should only be used for a limited period of time, perhaps five years,” he recommended, citing the experience of Botswana. “Eventually government realized this was a very expensive way to get companies to list, and after a while they withdrew this incentive,” he added.

The head of the Mauritius stock exchange explained his market’s relatively unconventional approach to building new listings and a secondary market. “Rather than creating the platform and then looking for companies, we created an unregulated platform,” he explained. By offering the exchange’s trading and settlement platform to these companies on an unregulated basis, the exchange gained the ability to test market appetite. “It was only when a subset of the firms had reached a certain size that we asked them to join and they signed off—and then, of course, we formally launched the regulated market.” In other words, before it launched the actual platform, the exchange first took the approach of asking firms whether they wanted access to a platform providing a market price and more transparent way to trade their securities. And this approach also provided a way to help develop a secondary market. “We approached top management of, say, about 80 companies whose shares were trading regularly on that unregulated platform,” the participant explained, pointing out the statistics showing number of shareholders and trading levels, and then asking them to “graduate to the next level” and join the regulated market.

A similar point was made by the head of Uruguay’s stock exchange, who noted that if capital-market regulatory authorities provide the right incentives, firms on the over-the-counter market may move to the registered capital markets. This would help foster capital-market development. He also cautioned against overregulation that could stifle innovation, including on the part of stock market intermediaries.

Can privatization help kick-start main boards?

In terms of “getting product” on the main board, the government can have a positive role to play by privatizing state-owned firms and floating shares on the stock market. There was broad agreement that privatization could be a channel for developing the main board by providing a pipeline of IPOs. A few participants cited country cases in which privatizations had kick-started capital markets over the years. For example, Malaysia’s privatization master plan formed a key part of the effort in developing the local equities market. (See also Section VII, *Execution and Implementation: Lessons from Malaysia*.) Privatizations on capital markets also can bring benefits by leading to improvements in corporate governance, management, and overall transparency of the companies.

According to one participant, drawing on the Malaysia case, this "kick-start effect" can occur even with partial privatizations involving sell-offs of as small as 25 percent equity stakes. Some participants suggested the RSE and the Ministry of Finance could work together to steadily roll out partial privatizations over the next several years. This strategy could also generate revenues for the government, particularly when these state-owned enterprises go back to the market for subsequent offerings.

Targeting SMEs: Do SME boards make sense for small firms?

SMEs are the backbone of most of the world's economies, and Rwanda is no exception. "When we look at the realities in East Africa and other emerging markets, we have to be very conscious that the economic drivers of our economies are, in fact, SMEs," pointed out a senior manager with one of the region's capital-market regulatory authorities.

More than 80 percent of Rwandan firms recently surveyed jointly by the CMA and the Milken Institute have fewer than 100 employees. The findings showed that only 22 percent of the surveyed firms could access the right kind of capital—the capital they need. Among the biggest challenges is the lack of awareness of financing options, including the relaxed listing requirements for SMEs. Given that the RSE significantly relaxed listing requirements for SMEs in 2013, this finding is surprising. This seems to point to a need for capital-market stakeholders to engage in more private-sector outreach to boost awareness of public equity markets among SMEs in particular.

Over the past decade, an increasing number of exchanges across emerging and frontier markets have been setting up SME boards or segments. Roundtable participants discussed at length what it takes to make an SME segment effective—and whether such a segment is appropriate at all. "There's not one single example in the world today where a platform for SMEs has been hugely successful, even in the developed markets," argued one participant. Many other discussants noted that comprehensive evidence on how effective these SME segments have been in raising finance is lacking thus far. One pointed out that some country cases show targeting SMEs for listings that are in high-growth-potential, strategic sectors may be effective.[12] Another pointed out that, even in the world's largest capital markets, young, early-growth-phase firms typically do not list on stock exchanges.

There also was a call for capital-market or other financial market authorities to think more creatively about strategic engagements between the official and private sectors that could produce mechanisms that could support development of an SME board. A parallel was drawn with PPPs as an example of the official and private sectors working together to develop financing mechanisms. Identifying productive, high-growth sectors was seen as the first step in identifying SME candidates for listing.

[12] One recent study by the World Bank, drawing on experiences of seven SME exchanges across a range of countries, recommended that beneficial approaches may include outreach, public awareness campaigns, and training targeted to SMEs with a significant growth rate. See Harwood, Alison and Tanya Konidaris, "SME Exchanges in Emerging Market Economies: A Stocktaking of Development Practices," Policy Research Working Paper 7160, January 2015.

A few other participants similarly pointed out that SMEs cannot be viewed as a "homogenous group of companies." In fact, there was fairly broad agreement that SMEs cover a wide range of firms and that an SME segment may be appropriate only for the upper tier (if any) of these firms. "We have to identify the potentially listable companies within this universe of SMEs," urged one participant, distinguishing these from smaller firms that would have problems meeting listing criteria on an ongoing basis. But completely excluding the SME equation from the scope of the capital-market development agenda could diminish capital markets' potential role in driving economic transformation, warned another participant.

Although the RSE has relaxed SME listing requirements, many SMEs may have problems meeting these requirements on an ongoing basis. "An IPO involves fixed costs, prospectus costs, getting sponsoring brokers, etc., and I'm not sure it's really a cost-effective route for small enterprises to go down to raise funds," advised one participant.

"I don't think it's so much the complexity of capital markets, but also that investors would favor larger firms," said another. And there was some debate on whether an SME segment might be perceived as a "lower quality" listing tier that fails to attract investors. "At a time when the main market is struggling to get volume and liquidity in share trading, it would seem perverse to introduce a second-tier market where getting liquidity would be even more difficult," warned one participant. There also was concern that any investor disillusionment potentially could spread to the main board, giving developing capital markets a "bad reputation" overall.

BOX 2. Caution against overly costly market infrastructure

A few participants warned against the official sector building up costly infrastructure in financial systems that would be poorly suited at the current stage of the market's development. "The challenge is to have more productive market infrastructure that works to intermediate capital—and avoid a situation where you have extensive infrastructure doing very little," observed one participant. Overly costly infrastructure can lead to high fixed issuance costs.

There is a broadly acknowledged need for further cooperation on market infrastructure so as to move beyond the stumbling block of competitiveness among the EAC countries to get the "best" market infrastructure on a national basis. How can technology be employed to cross-link the EAC markets in four countries—Kenya, Rwanda, Tanzania and Uganda—to encourage more cross-listings as well as cross-border investment? At the same time, there is a need for more harmonization and mutual recognition of regulations, including for listing, trading, licensing of intermediaries across the EAC markets, and other aspects of regulatory oversight. There was a call for speedy national adoption of these standards, once finalized. A few participants urged reforms that facilitate the ability of brokers from one country to trade on another's market, for example. (See also *Developing Equity Buy Side*.)

Do private markets provide more appropriate SME financing alternatives?

Some participants argued that the RSE should not be focusing on SMEs at all and suggested closing the SME window and focusing solely on large, mature corporates. No consensus developed around this point, although there was broad agreement on the importance of focusing holistically on developing a

financial market with a range of financial institutions, which effectively intermediates capital to meet enterprises' real financing needs.

A few participants noted that alternatives to bank credit and capital markets may be more appropriate for the financing needs of many firms that lack adequate collateral and creditworthiness track records. In addition to diversifying the range of available financing sources, developing non-loan financing instruments can help reduce the risk of loan default. "It is worth considering how to increase availability of other forms of enterprise finance that aren't used much in Rwanda yet, such as private equity, leasing, invoice discounting, and factoring," a few participants noted. For example, factoring and financial leasing, with appropriate regulatory frameworks in place, can be well-suited to SMEs lacking collateral and creditworthiness track records required for traditional loans. New technology-enabled solutions such as crowdfunding may also provide more appropriate ways for smaller, young firms to raise finance, in the right regulatory context, and may play an "incubator" role for later equity listings. (See Box 3.)

According to a recent World Bank study, venture capital (VC) and private equity (PE) often may be a more suitable form of longer-term finance than a stock exchange listing for firms at an earlier stage of development because firms stand to benefit from growth-oriented strategic advice, technology, and support from VC or PE partners.[13] An early-stage firm may be able to draw on these benefits to strengthen its corporate governance and overall operations, preparing itself for a successful exchange listing at a later stage in its growth cycle.

A number of roundtable participants similarly argued that venture capital or private equity is most suited as early-stage finance for most SMEs and that, at a later stage, these vehicles could access the stock exchange as a platform for exit. One participant described the challenge as first focusing on how Rwanda can develop "good and strong companies" and then building on that for the next phase of private-sector development. "I don't think we should get sidetracked by focusing on SME funding through the capital markets in Rwanda," he argued. A capital-market development expert in Botswana shared his country's experience in introducing a venture capital board with less stringent listing requirements. "This did not take off—with the exception of one specific sector, the key mining sector," he recounted. A number of young mining companies in Botswana found this board attractive and sought later cross-listings on large exchanges in the United Kingdom, Canada, and Australia. A few other participants raised the idea of using incentives first to encourage SMEs to raise finance through private equity and, possibly, at a later stage of their development, also listings on the SME segment. (See below.)

[13] Harwood, Alison and Tanya Konidaris, "SME Exchanges in Emerging Market Economies: A Stocktaking of Development Practices," Policy Research Working Paper 7160, January 2015.

Private markets can create investment products for retail investors on the main market

Given the questions about the viability of an SME board on the RSE, roundtable participants discussed how to encourage venture capital and private equity investment in Rwanda. As several noted, VC/PE funds can be an appropriate vehicle for financing many SMEs. Institutional investors typically will not choose to assign an expensive analyst to cover small-cap SMEs. Furthermore, institutional investors must be prudent in allocating investment to early-stage financing, as failure rates are often very high. And retail investors, as several participants noted, should not be exposed to high amounts of risk associated with financing early-stage companies.

A possible solution for both institutional and retail investors would be to channel savings through VC/PE funds or a "fund of funds" that could be listed on the stock exchange. Such funds could pool risk by diversifying their portfolios across a large number of SMEs. Some participants believe that EAC institutional investors could themselves seed such a regional fund to focus on investing in SMEs across the region, perhaps with donors providing first-loss protection. Others suggested that government and donors could encourage development of these funds by offering technical assistance to improve SME financial reporting, help entrepreneurs develop business plans, and help fund managers identify investment targets. One participant recommended making available a list of registered Rwandan SMEs to potential VC/PE investors as one relatively easy step that would facilitate development of these funds.

The Rwandan government, through the Rwandan Development Board (RDB), is attempting to jump-start a VC/PE culture by seeding a new fund called the Angaza Fund. The government has seeded the fund with US$30 million and is seeking to catalyze another US$70 million in private investment. The fund will invest in early-stage, high-growth companies in strategic sectors, such as information technology, health, and finance.

BOX 3. Equity crowdfunding

In the right regulatory and business environments, equity crowdfunding and other alternative financing solutions have significant potential to narrow the SME finance gap—financing new entrepreneurs who have figured out their business model and product-market fit but whose financing options are typically limited to bank loans or family funding. By drawing on new business models and technologies, these new financing solutions can reduce information asymmetries in the early-stage investment space, mutualize risks across a broader investor base, and reduce transaction costs for investors while decreasing post-transaction overheads for SMEs.

Equity crowdfunding enables entrepreneurs to raise money from multiple investors through an online platform without having to go public. It also makes it possible for small investors to buy minority stakes in unlisted companies. Equity crowdfunding can be seen as akin to private equity in the same way that microfinance is akin to bank lending.

The online platform also potentially serves as a vehicle for facilitating entrepreneurs' compliance with regulatory requirements and oversight. Instead of registering their offerings directly with the local regulatory authority, entrepreneurs can apply to raise capital on a regulated crowd investment platform and, after satisfying due diligence requirements, issue a mini-prospectus to disclose information such as

BOX 3 (*continued)*

legal structure, debt schedule, and forecast cash flow. Even periodic shareholder meetings can be held online.

Because crowdfunding and other alternative financing solutions introduce new risks, however, it is essential that adequate investor protection and financial education be in place as cornerstones. Here again, the online platform can serve as a useful vehicle. Retail investors, for example, are required to pass a "suitability test" demonstrating their risk awareness before they can access investment opportunities.

Equity crowdfunding is not yet in use in East African or many other emerging markets, and there currently are no local regulatory frameworks. Looking ahead, however, equity crowdfunding could provide a partial solution to the SME financing gap, particularly for entrepreneurs whose business models do not fit standard bank credit-risk assessments. This represents a formidable opportunity for Rwandan and East African regulators to position themselves to possibly act as first movers and promote cost-effective local legal structures and fiscal incentives for early-stage investments. At present, European crowd investment platforms targeting East African SMEs still default to offshore structures in Mauritius. Onshoring these transactions to a price-competitive, investor-friendly destination such as Rwanda merits consideration.

Lastly, the data these platforms collect could be used to supplement SME credit registries and further address information asymmetries that contribute to the SME credit gap. Importantly, in building a thriving private sector, crowdfunding platforms could serve as incubators for companies that go on to list on SME exchanges or on the regular stock market. Creating such a pipeline of investable companies is equally critical in harnessing the large private equity funds entering the region.

KEY QUESTIONS:

- Would including concrete targets for number of listings in the Capital-Market Master Plan help provide an effective way to develop equity buy side?
- How can a regional approach best be employed to "develop product" by increasing new equity market listings? Would it be possible for the EAC region's regulators—and the exchanges—to agree that a firm listed in one country would simultaneously be available for trading on the other EAC markets?
- Should the focus be on incubating future listed companies or on trying to attract more listed companies now?
- Is venture capital or private equity funding more appropriate for many SMEs—where exchange platforms can be used for exit at a later point?
- Is there a role for technical assistance in guiding firms identified as listing targets through the process?
- What would be the best way to channel savings through VC/PE funds or a "fund of funds" that could be listed on the stock exchange?

V. Developing Bond Markets

The roundtable session on developing bond markets started off with a discussion on the motives and prerequisites for such a market. A central theme in these discussions was how best to encourage

corporate bond issuance and prepare firms to issue bonds. However, there was some disagreement on the priority that Rwanda currently should give to developing a corporate bond market. A heavily debated point concerned the role of foreign investors, including how and the degree to which bond issues should rely on this capital.

Rwanda is among a growing number of frontier market countries that have put development of local currency bond markets on the national policy agenda over the past decade or so. Participants listed a number of common motives driving this, including a desire to develop local capital markets to make available more flexible financing for local infrastructure and other medium-to-long-term projects that could improve socioeconomic development. A well-functioning government bond market can facilitate government debt management, providing access to a stable source of funds at desirable maturities and reasonable costs. Government bonds can serve as an investment alternative with relatively low or no risk of default. As government and corporate bond markets develop, they may give the banking sector a competitive spur to develop new financial instruments and intermediate finance more effectively, including by reaching further down the credit spectrum to credit-constrained smaller firms. However, the interest rate on longer-dated, local-currency bond issues may be higher in real terms than a corresponding issue on international capital markets.

Rwanda's bond market currently is illiquid and very small. So far, only one company, I&M Bank, has issued a corporate bond on Rwanda's capital markets: a 10-year, RWF1 billion issue. The International Finance Corporation issued a five-year bond in 2014 with the aim of deepening Rwanda's bond market. That year, the Rwandan government also began issuing bonds on a regular basis.

As several roundtable participants noted, further development of the bond market has been impeded by many of the same factors that have impeded securities markets in general, such as an underdeveloped investment base and prevalence of a "buy and hold" attitude among existing investors. Development of a corporate bond market also has been hindered by a continuing reluctance among many indigenous companies to issue securities, which can be due to some combination of wariness of the financial disclosure and related costs associated with issuance, insufficient resources, lack of experience, and general lack of awareness of the bond market as a financing option. Moreover, the vast majority of Rwanda's firms are SMEs, which lack the scale, resources, and capacity to issue a bond at this stage of their business life cycle.

Most discussion participants, however, saw developing a bond market as important if not essential. "I think there is really no alternative to building a deep local-currency bond market, both for government and nongovernment borrowing," said one participant, noting the danger of relying on international markets for bond financing. "When we try to convince our clients to borrow in local currency, it's often a hard sell, because when the market is calm, the interest rates in dollars just look so much cheaper. Then when the dollar appreciates against the local currency, suddenly all of our clients come to us for hedging solutions at precisely the moment when it's becoming prohibitively expensive." Another participant noted the role of a bond market in attracting long-term financing. "We have realized that the short-termism of bank funding is not able to fund long-term investments in Africa," he said.

Developing the government bond market

Developing and deepening a bond market is an interactive, sequenced process requiring as context sound, credible macroeconomic policies and a stable and predictable regulatory regime. Roundtable participants were in broad agreement as to the prerequisites that must be in place for a well-functioning, liquid bond market. These include a sound banking system and an active money market. The roundtable followed the discussion of the latter with a discussion of the importance of a deep government bond market, which is itself necessary to set the stage for a corporate bond market. By supporting secondary market activity, a resilient and efficient repurchase agreement (repo) market is fundamental to liquid bond markets. "The money market is the foundation of the bond market because it provides a way to recycle liquidity," noted one participant. Another warned that "without a functioning repo market, the sovereign bond market is not going to take off."

Deepening government bond markets in a sequenced, transparent manner is a critical step in developing a corporate bond market and well-functioning capital markets for several reasons. First, it raises the country's profile among investors. "A country's sovereign bond issuance is how investors get to know that country," said one participant. Another participant recalled that the IFC's offshore Rwandan-franc issue "generated lots of interest among international investors who, previously, could barely spell the name of the country."

Second, and relatedly, it supports the establishment of a benchmark yield curve for pricing corporate bond issues. "You need to have that benchmark in order for corporates to issue," explained one participant. "The sovereign pricing is always a guide for the corporate debt sector."

Third, the government bond market facilitates market participants' access to an adequate, continuous supply of liquidity and enables dealers, market makers, and other investors to plan their investment strategies. A reliable supply of safe assets is especially important to encouraging investors to enter other markets. If investors are going to hold risky assets, one participant pointed out, "they like to have that balanced off by holding safe assets, and government securities provide that safety."

To support the development of a government bond market, participants recommended that the government adhere to a regular and predictable issuance schedule, concentrate issuance on plain vanilla bonds with a limited number of maturities, and consider establishing a primary dealer system. A regular, predictable issuance program for benchmark government bonds also sends an important signal to investors. One participant who played an instrumental role in developing Malaysia's financial markets pointed to that market's experience in the 1980s and 1990s as a salutary lesson: "We started the market for government bonds quite early in the day, but it was always tied to the fiscal deficit," she recalled. She described how Malaysia's government discontinued issuing bonds once the budget went into surplus and was not in the market again for some 11 years. "When we re-entered, it was very tough, because the market no longer knew us and it was like starting all over again," she said. "The idea is to have regular issuances and be in the market all the time."

A few participants also pointed out that keeping the government bond market "as vanilla as possible" makes sense in the early stages of bond-market development for a frontier market such as Rwanda.

"Have as few government bond issues as possible, at this stage," advised one. "If you issue a new bond at every new auction, you may as well forget about secondary market liquidity," he added. Pointing to the case of Kenya, which is doing fewer new bond issues than in the past, he went on to advise that it may make more sense to "have five bonds and keep opening those bond markets."

A Rwandan government official acknowledged that from 2008 through 2011, "we were a bit dormant." However, since 2014, Rwanda has been taking steps toward deepening the government bond market and establishing a benchmark yield, by committing to issuing bonds on a quarterly basis and gradually increasing tenors. Participants generally praised the government's progress thus far in developing a bond market. One advised that, going forward, financial market authorities will have to ensure a free flow of information and effective coordination between the central bank and the Finance Ministry, which oversees the government bond market and the interbank market, and the CMA, which oversees the corporate bond market.

Setting up a well-functioning primary dealer (PD) system can be a key step in building the primary market infrastructure needed to develop a more liquid, deeper bond market. Essentially a network of financial intermediaries, primary dealers help ensure success of primary market issuance and help foster and maintain liquidity in the secondary market. "In moving to a primary dealer system, market infrastructure and electronic trading platforms become important," said one participant. He pointed out the need for a mechanism for monitoring the performance of PDs and making sure the right kinds of incentives are in place. A number of participants noted that the regulatory framework should explicitly identify the primary dealers as the financial intermediaries that can participate in the primary market for buying bonds. "In their role as market makers, they shouldn't be paying any fees, as a means of encouraging them to narrow the spreads between bid and ask," noted one.

In the secondary market, liquidity is partly an issue of scale. Addressing it will require patience. "Getting liquidity in the market is something that Rwanda can build towards and certainly will build towards," one participant remarked optimistically. "I think we'll get there within five years." Liquidity in the secondary market for government bonds helps ensure that the yield-curve is market-determined. Primary dealers can play a role in ensuring liquidity here as well.

Developing the corporate bond market

After these prerequisites for a corporate bond market are in place, developing an issuer base is the first priority, according to a number of participants. Institutional investors at the roundtable expressed their eagerness to allocate more of their portfolios to bonds, but the supply needs to be there first. "We realize the returns are better with bonds than with deposits," said a local institutional investor. "We would be glad to participate in this market, but it has to come from the other side."

What can be done to encourage more companies to issue a bond on the local market? "Make it faster, simpler, and cheaper," said at least a few roundtable participants familiar with Rwanda's nascent market. "One of the aspects of regulation that has haunted East African exchanges is that the costs of bond issuance are quite high," said one. "I think Rwanda's corporate bond market is actually pretty good in this respect, but reducing transaction costs is still something that can be improved," said another.

Disclosure requirements and issuance costs are not the only obstacles. In Rwanda, observed one participant, “what we found is that the direct costs are not necessarily very high, but most of the issuers found the indirect costs to be extremely prohibitive.” Time is one indirect cost. “If it’s going to take you two months to get an issue approved, then obviously you have an issue,” said another participant. “You are going to try to find an alternative source of financing.”

Another deterrent is the possibility of getting only a speculative grade rating, although Rwanda’s sovereign credit rating was upgraded this year to B+/B, reflecting a stable outlook for the political and macroeconomic context. And, similar to raising finance on equity markets, basic lack of knowledge—even among banks—about the benefits of raising finance on bond markets is another factor that has impeded the corporate bond market’s development.

And indirect costs flow from the need to obtain a credit rating prior to issuance. Many companies find that in order to secure a good credit rating, they need to reform their corporate governance or upgrade their accounting systems. At least one local company that recently considered a bond listing was, in the end, deterred by the prospect of incurring these costs. Although Rwanda has adopted international financial reporting standards (IFRS), most private businesses still are not in compliance with these, and making the transition represents a major barrier. “As yet, there is no regulation that requires companies, other than banks and perhaps insurance companies, to provide financials on a regular basis,” complained one private-sector participant. Another participant went so far as to propose that credit ratings become mandatory for companies above a certain size, in order to spur the necessary reforms and investments. Several others called for donor-sponsored technical assistance for first-time issuers.

Another issue related to the weak information environment is collateral. Because Rwandan banks cannot rely on financial statements, they mostly engage in asset-based lending, as opposed to cash-flow lending. Banks’ demand for high levels of collateral hinders companies’ ability to issue bonds. “The bond investors are in effect subordinated to bank creditors,” explained one participant, “because all this collateral has already been pledged to the banks.” Encouraging Rwandan firms to adopt IFRS would therefore have a second positive effect: to free up collateral for issuing secured bonds.

Participants debated the merits of credit enhancements and other forms of government support. One spoke positively of the credit-enhancement programs offered by pension funds such as the California State Teachers’ Retirement System, whereby the funds “lend out” their credit rating for a fee. Other participants were more cautious about this approach, noting that sometimes credit enhancement does not offer an offsetting benefit.

Beyond developing the issuer base for corporate bonds, a few participants pointed to some low-hanging fruit for the government to reduce transaction costs and entice more investors to enter the market. In particular, institutional investors at the roundtable complained about being forced to buy bonds through authorized banks, instead of being allowed to do so directly. The government should temper its expectations, though: Participants observed that even advanced-economy corporate bond markets are not typically characterized by ample liquidity.

BOX 4. Kenya's M-Akiba bond: Leveraging mobile technology to engage small investors
Participants discussed the prospective role of small investors in Rwanda's bond market and whether or how products should be designed to accommodate them. They also discussed how Rwanda might use new technologies to leapfrog older, more established capital markets. On both counts, Kenya may offer lessons for a way forward.

Kenya's National Treasury has recently partnered with Safaricom to launch M-Akiba, an innovative, tax-exempt government bond that can be bought in small denominations and traded directly through a mobile phone. M-Akiba will be sold on the newly developed Treasury Mobile Direct system, based on the M-Pesa platform. M-Akiba bonds will be fixed-rate and have a five-year duration, with a minimum investment amount as low as KES3,000 (about US$30). Investors will be allowed to buy up to 140,000 Kenyan shillings (about US$1,370) per day and can continue buying on subsequent days until the issue closes. An inaugural offering of US$5 billion to raise finance for domestic infrastructure was planned for October 2015, but was subsequently delayed.

The Kenyan government has three goals for M-Akiba:

- Lower the government's funding costs, with the M-Akiba bonds to be priced somewhat below the market interest rate
- Build the local investor base and reduce reliance on foreign investors
- Broaden public participation in local capital markets and make it easier for Kenyans to save (Kenya's savings rate is half that of its neighbors)

Individuals still represent just 2 percent of bond investors in Kenya. Foreign and domestic institutional investors comprise the other 98 percent. One major hurdle to attracting more retail investment was a registration process described by one roundtable participant as "very complex, cumbersome, time-consuming, and expensive." To invest directly in government bonds, investors had to register with the Central Bank of Kenya by visiting one of its four offices, providing several months' worth of bank statements and filling out numerous forms.

With M-Akiba, these barriers to entry have been reduced. There is no paperwork to fill out and registration, trading, and settlement will all be done directly by mobile phone. All that is required is a subscription to a mobile money service and a valid national ID. Interest will be paid to mobile wallets semiannually. Investors can also use their phones to check statements and engage in secondary trading.

The initiative hinges on the popularity of mobile money services in Kenya. Just 20 percent of Kenyans own bank accounts, but more than 75 percent own mobile phones and 60 percent make mobile payments.

Several roundtable participants spoke approvingly of the initiative and suggested that Rwanda should consider emulating it. "There's a real opportunity for a retail bond along the lines of the Kenyan shilling-style retail bond that allows for small-scale investment by mobile phone," said a participant with an investment management firm. "This could be a product to get the man on the street used to savings—and used to the whole idea of financial instruments."

KEY QUESTIONS:

- How can awareness be raised among Rwandan firms of the benefits that come from raising capital through bond issues?
- How can transaction costs associated with issuing corporate bonds be further reduced?
- What are the best ways to spur larger firms to meet the corporate governance and disclosure requirements needed to obtain a credit rating for issuing a bond?
- How can Rwanda strike the right balance in accessing needed foreign portfolio investment while guarding against the risks of overreliance on this investment?
- What are the best ways to increase bond market liquidity and address the problem of scale?

VI. Developing a Commodities Exchange

Commodities, especially agricultural commodities, are essential to the Rwandan economy. The agricultural sector accounts for one-third of GDP and employs more than 70 percent of the population. Rwanda's main exports are coffee, tea, and minerals. The roundtable discussion on developing a commodities exchange focused on the different ways spot and futures markets catalyze economic development, the regulatory challenges of supervising commodities exchanges, and the potential for commodities markets to drive regional economic integration, perhaps with Rwanda leading the way as the host of a high-powered East African Exchange.

Rwanda's agricultural sector is characterized by small-scale, subsistence farming with low productivity. Until recently, whatever surplus was produced was sold through informal networks of small traders. The illiquidity and opacity of these networks made it hard for farmers to obtain competitive prices for their harvests. This pointed to the need for a more organized market—one in which smallholder farmers could participate.

As one roundtable participant said, "A commodity exchange is as important as stock and bond markets, if not more so, because a commodity exchange actually affects the life of the average person." This is true for smallholder farmers who access markets to receive fair prices for their crops, and it is also true for Rwandan businesses operating in the agricultural sector, including the country's many agricultural exporters. Furthermore, the growth of these agricultural sectors, as well as efforts to exploit natural resources, motivates much of the need for investment in transport infrastructure in Rwanda and the EAC. In this context, one participant said, "East African capital markets are going to be developed on the back of developing commodities markets."

How spot and futures markets influence economic development

As a presenter during the commodities session explained, early commodities markets, such as the New York Mercantile Exchange, were essentially financial derivatives exchanges for trading futures contracts. They facilitated price risk management and price discovery for buyers and sellers of agricultural and extractive commodities. These futures markets were "monopolies by design," in that the contracts could originate and be sold only via the exchange itself. They were highly liquid markets that are relatively low-cost to set up and manage. The prime example of this kind of exchange in Africa is the South African Futures Exchange (Safex).

Unlike futures exchanges, this session's presenter said, spot exchanges are not monopolies: They compete directly with the open, informal markets where farmers sell their crops. As this dynamic suggests, spot markets take a step away from the financial sector and toward the physical trade of goods.

This is certainly true for the Ethiopia Commodity Exchange (ECX), the second-largest African commodities exchange (after Safex). As the same presenter said, "The ECX came up as a 100 percent spot exchange and works more like a trade institution than a financial institution, in that every single transaction processed on the exchange platform results in a physical delivery." He went on to note that, due to its linkages with the physical movement of goods, the arrival of a spot exchange brings with it a variety of economic activities and investment. "In any market where a spot exchange has emerged," he said, "there is also an emergence of infrastructure in terms of agricultural storage and quality certification. This is part of the business model." Without control over the warehousing and quality assurance processes, the spot exchange cannot make necessary guarantees about the volumes and quality of products being traded via the exchange. For this kind of exchange, it is also essential to widely distribute price information to as many farmers as possible, even those who are not actively selling through the exchange.

In 2014, Africa Exchange Holdings set up the East Africa Exchange (EAX) in Kigali, Rwanda's capital. Whereas the South African exchange is a purely private futures market and the ECX is a government-run spot market, the EAX is a private spot market with ambitions of developing a futures market in the coming years. (See Box 5.)

BOX 5. How does the EAX contribute to Rwanda's economy?
Since it was launched in 2014, the EAX has quickly risen to become the third-largest agricultural exchange in sub-Saharan Africa, after the South African Futures Exchange (Safex) and the Ethiopia Commodity Exchange (ECX). Today, the EAX functions as a spot exchange, facilitating auctions and offering transparent price discovery to Rwandan farmers growing maize, beans, soy, and rice. Designed as a hybrid exchange, the EAX will eventually trade both spot and futures transactions in a wider variety of agricultural and non-agricultural commodities. In partnership with the Rwanda Ministry of Agriculture and Animal Resources, the EAX also maintains a network of warehouses for cleaning, grading, certifying, bagging, and storage. A warehouse receipt system tracks inventory and ownership.

According to the roundtable discussion, the EAX currently is contributing to Rwandan economic expansion in three main ways. It benefits the Rwandan economy by improving efficiencies in the agricultural sector, expanding access to credit, and spurring investment and business activity in warehousing and quality assurance.

- **IMPROVING EFFICIENCES IN THE AGRICULTURAL SECTOR**. By centralizing trading, the exchange facilitates price discovery, enabling farmers to obtain fairer prices for their produce on commodities market. By disseminating market prices to traders through SMS text messages, its website, newspapers, and other media sources, the exchange produces an important public good. As with the ECX in Ethiopia, all market participants, even those who do not trade on the EAX, benefit from price transparency and have an opportunity for a stronger negotiating position. Through its grading and certification services, the EAX counters the adverse selection

BOX 5 (*continued*)

problem and enables greater product differentiation, enabling farmers with high-quality goods to command a premium. As one roundtable participant said, “Going through the exchange, farmers get a huge premium when they sell because the quality typically coming out of the exchange is much higher and buyers will pay more.”

- **EXPANDING ACCESS TO CREDIT**. Through the EAX, farmers in Rwanda can now use warehouse receipts as collateral, making it easier for them to obtain bank loans. Currently, farmers can take out loans for up to 70 percent of the value of their warehouse receipts. With a large majority of Rwanda’s population engaged in agriculture, loans collateralized by warehouse receipts can be a powerful tool for enhancing financial access and advancing financial inclusion.
- **SPURRING INVESTMENT AND ECONOMIC ACTIVITY**. As discussed above, spot exchanges are supported by a dense ecosystem of logistics, warehousing, and quality-assurance services. This has been true in Rwanda as well, where the EAX itself has invested heavily in warehousing facilities and value-added processing, such as cleaning, grading, certifying, bagging, and storage, for the commodities that trade on the exchange. These services were previously unavailable in Rwanda, and they are foundational to the functioning of the spot market. Furthermore, warehousing and other services have emerged as attractive revenue streams for the exchange as the market develops.

Regulatory challenges

In discussing the regulatory environment for commodities exchanges, roundtable participants highlighted two issues that the government must keep in mind. Striking the right balance between over- and underregulation is key. On the one hand, the government must provide a clear and predictable legal and regulatory environment. “The biggest thing that a commodity exchange trades is trust,” remarked one participant. “And trust comes from a conducive legal environment.” At the same time, the government must not stifle innovation. Exchanges have to innovate to be successful, and the government must be willing to draw a line and say, “This is where we stop.” Further, exchanges sometimes have to move quickly—quicker than government can—to take advantage of opportunities or fend off competitive pressures.

Roundtable participants pointed to experiences in Malawi and Ethiopia as cautionary extremes. In Malawi, international buyers refused to come to the exchange because it operated in a complete regulatory vacuum. The exchange and potential participants had to approach regulators and demand basic rules and protections for market participants. As one roundtable participant explained, such markets “need a regulatory environment and legal framework, because they give confidence to stakeholders.” In Ethiopia, on the other hand, the exchange suffered from overly intrusive regulation, as government officials intervened in details of exchange management as minute as the vacation time of employees.

As several roundtable participants noted, commodities exchanges must be innovative, coming up with new policies, new structures, and new products. According to several participants, regulators should allow room for exchanges to innovate and experiment, but when benefits and risks become clearer, the regulator has a responsibility to step in and establish standards and boundaries. A commodities

exchange would not be successful if not backed up by the government in this way.

One additional interesting concern about regulating commodities markets, as raised during the roundtable, is that exchanges, particularly spot exchanges, operate in a gray area between the financial and agricultural sectors. “There are aspects beyond the mandate of financial-sector regulators, like quality assurance, warehousing, and logistics,” one participant explained. “If not handled properly, this can lead to difficult situations.” Participants pointed to the collapse of India’s National Spot Exchange Ltd. (NSEL) as a cautionary lesson. There, ambiguity of regulatory responsibility allowed for massive fraud that destroyed the fundamental trust necessary for a thriving exchange. A consensus recommendation from the roundtable was that Rwanda’s CMA coordinate closely with the Ministry of Agriculture and Animal Resources to ensure proper supervision of all of the EAX’s activities.

Developing a regional commodities market across the EAC

As a few roundtable participants noted, the EAX may serve as an important driver of regional integration in the East African Community. For example, the development of the commodities exchange can help governments identify barriers delaying the cross-border delivery of physical goods, and the presence of the exchange further provides a politically weighty motivation for solving such problems.

Furthermore, the expansion of a vibrant commodities market can spur regional standard-setting and capacity-building projects. As one participant noted, the EAC Northern Corridor—comprising Rwanda, Kenya, and Uganda—is currently establishing regional quality standards and definitions for high-priority crops in the region. The Northern Corridor countries are also planning coordinated campaigns to improve financial market education among farmers growing key crops.

Finally, the EAX itself sees its future as a regional exchange. When establishing the exchange, the investors purchased Nasdaq OMX’s X-stream platform with the goal of being a trading platform for the entire EAC and other nearby Southern and East African countries. A few roundtable participants called the system “overkill,” and one local intermediary expressed concern that what some market participants view as prohibitively high trading costs on the EAX were the result of the expensive platform. Supporters of the decision, however, emphasized that the future of the Rwandan market is regional and that farmers and buyers will benefit from the economies of scale offered by a truly regional market.

Rwandan government officials and market participants hope to leverage the decision of the EAX to locate in Kigali as a distinct advantage going forward. As several roundtable participants said, their hope is that by capitalizing on the commodities exchange’s competitive advantages, including state-of-the art IT infrastructure and good governance, Kigali will become a regional center for trade in a number of economically important commodities.

KEY QUESTIONS:

- How can Rwanda strike the right balance in regulating the EAX?
- In responding to the need to remain innovative, what are the best new products, policies, and structures for the EAX?
- What should the next steps be in taking forward the EAX’s plans to establish its niche as the commodities exchange serving the EAC and beyond?

VII. Execution and Implementation: Lessons From Malaysia

As Rwanda embarks on the design and implementation of its Capital-Market Master Plan (CMMP), it is worthwhile to draw lessons from other countries' experiences. On the final day of the roundtable, participants examined Malaysia's experience in planning, coordinating, and implementing capital-market reform during the previous decade.

In the wake of the Asian financial crisis, Malaysia's Ministry of Finance tapped the Securities Commission (SC) to develop and strengthen the country's capital markets.[14] The ensuing 10-year CMMP, published in 2001, was a comprehensive reform plan. It contained 152 recommendations, organized under six objectives and 24 strategic initiatives. It focused on developing a more robust regulatory framework and on building up markets, institutions, instruments, and public- and private-sector leadership. By the end of the decade, the SC had implemented 95 percent of the plan's recommendations. It is now in the process of implementing the second plan (CMMP 2). This follow-up plan contains less explicit recommendations and more directional guidance, focused primarily on improving corporate governance and integrating with international markets.

The decision to draft the CMMP was motivated by two factors, one domestic and one foreign. The domestic impetus was to reduce the maturity mismatch in the domestic banking sector, by shifting long-term financing away from depositors and toward direct investors. The Asian financial crisis made clear the Malaysian economy's overreliance on bank financing, as well as the need to diversify its financial sector. The foreign impetus was to improve the competitiveness and resilience of the domestic financial sector in anticipation of further international liberalization, to which Malaysia was obligated as a signatory to the GATS Financial Services Annex.

As several roundtable participants cautioned, Malaysia's economy and financial sector were both more developed and diversified in 2001 than Rwanda's is now, which has to be taken into account. Nonetheless, while the scope of the work differs, as do many of the details, Malaysia's experience contains several overarching lessons for Rwanda and other countries at similar stages of development looking to diversify away from bank finance.

First, it is important to adopt a holistic and integrated approach. The CMMP was developed concurrently with a Financial Sector Masterplan (FSMP). The FSMP was overseen by the central bank, Bank Negara Malaysia (BNM), and covered banking, insurance, and domestic development financial institutions. Both the CMMP and the FSMP were formulated with reference to Malaysia's economic development goals, as outlined in the country's Vision 2020 plan and its five-year Outline Perspective Plans. It is important, noted one participant, "to make sure that the plans are implemented in a useful way that jibes with what the economy wants." A capital-market or financial-sector development plan that is not aligned with the economy's needs will not be effective or useful.

[14] In developing countries, financial-sector regulators are responsible not only for oversight, supervision, and stability, as they are in developed countries; often, they are also responsible for financial-sector development.

Second, and relatedly, the government needs to have a clear and realistic vision of what it is trying to achieve by developing its capital markets, as well as what success looks like. “You have to have a road map,” said one participant. “And you have to make sure that the roadmap is actually likely to lead to the outcomes you want.” In Malaysia, there was a general consensus among policymakers that the purpose of the financial sector was to be an *enabler* of growth, not a driver of it. The CMMP and the FSMP were developed with a clear view toward supporting the growth of the real sector and Malaysia’s transition to a fully industrialized and high-income economy. Further, policymakers had a clear vision of what capital markets capable of fulfilling this role would look like. Such markets would, above all, effectively facilitate fundraising and risk management. They would further be characterized by sufficient liquidity; efficient and robust infrastructure; a diversity of products, investors, and intermediaries; transparency; and, finally, effective oversight and regulations that met international standards.

Third, it should be recognized upfront that developing a CMMP is a major undertaking and requires commensurate resources. In Malaysia’s case, the process took more than a year and involved many consultative meetings with a variety of stakeholders, policymakers, and outside experts. The final plan ran nearly 300 pages, not including supporting documents. Countries developing a CMMP should ideally assemble a small, dedicated team (three to five people) to see the process through to completion. The team should be composed of the agency’s rising stars, and should include individuals with project management and project evaluation expertise; at least one person with direct market experience; and at least one person with legal expertise, since many CMMP recommendations will require new legislation and regulations or revisions to existing ones. Outside consultants are useful for communicating what has worked in other countries and for helping policymakers develop a coherent strategic approach. However, in one participant’s experience, they can have a harder time tailoring their recommendations to fit a country’s specific situation.

Fourth, effective stakeholder management is critical. It is important to reach out to relevant market participants and industry organizations early and often. This is not only to obtain their buy-in, but also to ensure that the ultimate plan accurately reflects market conditions and addresses real deficiencies. During the drafting of Malaysia’s CMMP, the team at the SC not only conducted regular meetings with various stakeholders, it was also overseen and supported by a strategic committee composed of public- and private-sector representatives. Prior to the finalization of many specific reform measures, the SC disseminated consultation papers for public comment and industry feedback. Further, implementation proceeded only with approval of the strategic committee. Legislators represent another key stakeholder group, given that their support is necessary to pass new laws. Effective policymakers must be attuned to politicians’ perceptions and concerns and be able to communicate why it is in their interest to support reform.

Fifth, interagency coordination must be managed effectively, and it depends crucially on the tone from the top. Financial regulatory authorities must coordinate to ensure that in the development and implementation of related plans, there are no overlaps or gaps in coverage. It is also important to know when it is acceptable to foster interagency competition and when cooperation is necessary. In Malaysia, the CMMP and the FSMP were drafted separately, but the legal authorities of the SC and the central

bank provided a clear demarcation of responsibilities and jurisdictions. During this stage, interagency competition could be channeled effectively toward motivating each planning team to do its best. Interagency coordination became more important during the implementation phase, particularly when it came time to liberalize international transactions.

Sixth, specific reform measures should be assigned targets and timelines. “A plan is meaningless until you put proper targets around it,” said one roundtable participant. It is also important to identify the “success factors” necessary to reach each target. “You list out the necessary and sufficient conditions that have to be in place,” explained one participant. “Usually, to achieve one measure you probably need to do 10 other measures. You have to create that positive environment to make sure your measures will actually work.” Policymakers should keep in mind that some targets are sequential, while others are interrelated and need to be developed concurrently.

Seventh, a CMMP should be thoughtfully sequenced (as opposed to taking a “big bang” approach), with the plan broken down into phases. (See Table 1.) Malaysia’s CMMP was divided into three phases. In the first, reforms focused on enhancing domestic capacity. In the second, they worked to intensify competition among domestic players. In the third phase, the markets were further opened to foreign competition.

TABLE 1. Sequencing framework

<table>
<tr><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>2005</th><th>2006</th><th>2007</th><th>2008</th><th>2009</th><th>2010</th></tr>
<tr><td colspan="3">Strengthen domestic capacity and develop strategic and nascent sectors.</td><td colspan="7"></td></tr>
<tr><td colspan="3"></td><td colspan="2">Further strengthen key sectors and gradually liberalize market access.</td><td colspan="5"></td></tr>
<tr><td colspan="5"></td><td colspan="5">Further expand and strengthen market processes and infrastructure toward becoming a fully developed capital market, and enhance international positioning in areas of comparative and competitive advantage.</td></tr>
<tr><td colspan="3">PHASE 1</td><td colspan="2">PHASE 2</td><td colspan="5">PHASE 3</td></tr>
</table>

Source: Securities Commission of Malaysia, *Capital Market Masterplan*, p. 272.

Eighth, during the implementation phase, adaptability is key. Before transitioning from one phase to another, it is important to make sure that targets have been met. If they have not, the transition should be delayed. Rushing to meet a timetable once implementation of the plan is out of sequence can compromise market integrity and invite financial instability. Malaysia’s Securities Commission was advised by a Capital-Market Advisory Council (CMAC) during the implementation phase; CMAC’s role was to independently assess implantation and progress and, when necessary, make recommendations for the plan to be adjusted. Beyond sequencing, adaptability is crucial for a broader reason: Markets will evolve over the course of implementing a long-term plan, and policymakers need to be continually asking themselves whether the reforms they are implementing are still relevant and useful.

VIII. Concluding Points and Next Steps

In framing the key challenges and opportunities that Rwanda faces in developing capital markets, this paper aims to provide a useful input to inform capital-market reforms going forward.

In concluding the roundtable, participants discussed proposed next steps for taking forward a 10-year Capital-Market Master Plan, including a market assessment drawing on main roundtable findings and more in-depth consultations held with key Rwandan capital-market stakeholders. This process will culminate in a list of recommended implementing actions and timelines for Rwanda's 10-year Capital-Market Master Plan.

In discussing capital-market reforms, roundtable participants underscored the importance of sequencing and developing capital markets to complement rather than compete with the banking sector. A key cross-cutting issue is the role of a regional approach in developing well-functioning capital markets that more effectively intermediate long-term capital. Reforms and measures that encourage more cross-border listings and cross-border investment across EAC securities exchanges could help overcome local capital markets' impediments such as illiquidity, low market capitalization, and small number of listings. Moreover, greater cooperation across EAC capital markets in developing and sharing market infrastructure and intermediation services would bring benefits, including economies-of-scale benefits of reduced fixed costs and greater efficiency.

Well-functioning, appropriately regulated local and intraregional institutional investors are keystones in developing the "buy side"—as long-term money that can help catalyze investment from other sources to deepen capital markets. The role of foreign investors was more heavily debated, however, particularly the degree to which bond issues should rely on this capital. Several participants flagged other buy-side priorities as the need to scale up small savers, including in the informal economy, which also would advance financial inclusion.

Roundtable participants strongly agreed that an immediate-term and ongoing priority for Rwanda's capital-market stakeholders is to develop a pipeline of prospective listings. Targeted outreach is critical to raising awareness of the benefits of a listing and boosting the supply of listed firms—on securities markets domestically and within the EAC region.

There was much less consensus on whether and how SMEs should be targeted for listings. The merits of SME boards is one particular issue that would benefit from further evidence-based research across developing regions. There was stronger agreement that cultivating a high-growth-potential, strategic-sector "corporate base" could provide an "incubator" for future stock market listings. Developing the venture capital and private equity markets, as well as other nonbank sources of SME finance such as invoice discounting and even crowdfunding, will be key steps in "incubating" firms for future listings.

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Strategic Planning Roundtable on Capital-Market Development
Hosted by Rwanda's Capital Market Authority and the
Milken Institute Center for Financial Markets
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