This study was undertaken for FSD Kenya's GrowthFin programme by:

In collaboration with Simba & Simba Advocates

The report was commissioned by FSD Kenya. The findings, interpretations and conclusions are those of the authors and do not necessarily represent those of FSD Kenya, its Trustees and partner development agencies.

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## Acronyms

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<tr>
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<th>Description</th>
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<tbody>
<tr>
<td>AKI</td>
<td>Association of Kenya Insurers</td>
</tr>
<tr>
<td>CEDA</td>
<td>Citizen Entrepreneurial Development Agency</td>
</tr>
<tr>
<td>CEDA-VCF</td>
<td>Citizen Entrepreneurial Development Agency-Venture Capital Fund</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<tr>
<td>CIS</td>
<td>Collective Investments Schemes</td>
</tr>
<tr>
<td>CMA</td>
<td>Capital Markets Authority</td>
</tr>
<tr>
<td>DPO</td>
<td>Direct Public Offering</td>
</tr>
<tr>
<td>EAC</td>
<td>East African Community</td>
</tr>
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<td>EADB</td>
<td>East African Development Bank</td>
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<tr>
<td>FSD Kenya</td>
<td>Financial Sector Deepening Kenya</td>
</tr>
<tr>
<td>GOK</td>
<td>Government of Kenya</td>
</tr>
<tr>
<td>ICDC</td>
<td>Industrial and Commercial Development Corporation</td>
</tr>
<tr>
<td>ICEA</td>
<td>Insurance Company of East Africa</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>KEM</td>
<td>Kenya Equity Management</td>
</tr>
<tr>
<td>KES</td>
<td>Kenya Shilling</td>
</tr>
<tr>
<td>Ltd</td>
<td>Limited</td>
</tr>
<tr>
<td>M</td>
<td>Million</td>
</tr>
<tr>
<td>NZVIF</td>
<td>New Zealand Venture Investment Fund Limited (NZVIF)</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the Counter</td>
</tr>
<tr>
<td>RBA</td>
<td>Retirement Benefits Authority</td>
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<td>RBI</td>
<td>Retirement Benefits (Individual Retirement Benefits Scheme) Regulations, 2000</td>
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<td>RBMC</td>
<td>Retirement Benefits (Managers and Custodian) Regulations, 2000</td>
</tr>
<tr>
<td>RBO</td>
<td>Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000</td>
</tr>
<tr>
<td>RBS</td>
<td>Retirement Benefits Schemes</td>
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<tr>
<td>SBA</td>
<td>Small Business Administration</td>
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<td>SBIC</td>
<td>Small Business Investment Companies</td>
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<td>SME</td>
<td>Small and Medium Sized Enterprises</td>
</tr>
<tr>
<td>SMEEIS</td>
<td>Small and Medium Enterprises Equity Investment Scheme</td>
</tr>
<tr>
<td>UNDP</td>
<td>United Nations Development Program</td>
</tr>
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<td>United Kingdom</td>
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<td>USA</td>
<td>United States of America</td>
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<td>Venture Capital</td>
</tr>
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<td>World Bank</td>
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ACKNOWLEDGEMENTS

In order to effectively undertake this study, coordination from key players and consultation with a wide range of industry practitioners was required. The study team would like to thank the Financial Sector Deepening Trust for conceptualizing and providing funding for this important study. James Kashangaki, the Head of Growthfin, in particular has been very helpful in providing valuable comments on the report and methodology throughout the study, in addition to co-ordinating various aspects of the work.

The study would not have been possible without the people and organizations we interviewed who gave their valuable time to allow us to probe deeply and develop an assessment of the situation. We are most grateful to all the insurance companies, pension fund managers, venture capital funds and other key players for their insight and observations on the market.

We would also like to acknowledge and thank representatives from the Government of Kenya who provided input into the study, particularly the former (retired) Chief Executive of the Capital Markets Authority and representatives from the Retirement Benefits Authority. Their enthusiasm and support for the initiative will be important for implementation of the recommendations going forward.

Finally, we would like to thank all those who attended the stakeholder workshop and gave their comments on the report. While we acknowledge receipt of inputs from a wide range of sources, the consultants accept full responsibility for the contents therein.

John Kashangaki  Team Leader, Strategic Business Advisers Ltd.
John Simba  Legal Expert, Simba and Simba Advocates
EXECUTIVE SUMMARY

BACKGROUND

Overview and objectives

This report provides a profile of institutional investors in Kenya and an assessment of their attitude and appetite for investment in early-stage investment funds targeting small and medium-sized enterprises (SMEs). The report was commissioned by GrowthFin, a programme of the Financial Sector Deepening (FSD) Trust that works with policy makers, donors, industry associations and financial institutions to identify and overcome impediments to the provision of financial services to SMEs.

The key objective of the study is to provide a systematic documentation of the following:

(i) The legal and regulatory framework pertaining to the use of long-term funding for risk investment;
(ii) A census of the availability of long-term funds in Kenya; and
(iii) A representative survey of the attitudes of holders of these funds to risk investment in particular with respect to SMEs.

KEY FINDINGS

Literature review

Based on a review of the relevant literature, the following conclusions can be drawn:

• Kenya’s risk capital market is still in the early stages of development, both on the demand and supply side.
• On the demand side, SMEs largely rely on internal and bank financing to finance operations.
• On the supply side, very few funds operate in Kenya to date, although the number is increasing. Total venture capital (VC) currently available amounts to about USD200m. Of this, about USD40m target early-stage SMEs, compared to over USD2.5 billion in the USA.
• The pension fund and insurance industry contribute less than 10% of total funding for venture capital in the country, compared to above 30% in some developed countries.

Legal review

• Although somewhat restrictive, the Retirement Benefits Authority (RBA) Act and the Insurance Act both provide for investment in “other asset” classes for which early-stage SME funds qualify.
• As the legal review showed, in an emerging market, the issue whether or not the RBA Act is restrictive or whether the provisions of that Act are only prudential in its intentions is open to interpretation and there will be grey areas where the regulators will face challenges in their decision-making processes.
• The fact that the investment industry in Kenya is still fairly young made it necessary to impose restrictions on investment activities of trustees, but this makes them risk averse and makes it even more difficult to “secure market rates of return” as envisaged under the regulations. It therefore remains a challenge to the regulators how to draw the line between prudential and restrictive regulations especially as the industry matures.

Empirical work

The view from all managers of pension funds interviewed was that they had excess cash that they were willing to invest in any new well-structured risk product. However, they raised various concerns that needed to be addressed before they could commit to any long-term risk capital product. There was also consensus that there were too few well-structured vehicles available in the market at present. Indeed, all fund managers interviewed noted that their investments in private equity represented less than 0.5% of the pension funds under their management, compared to the legally allowed limit of 5%. All fund managers, however, expressed an interest in investing in risk capital instruments.

On the other hand, most managers of insurance funds interviewed for this study were more sceptical of the feasibility of using policy holders’ funds under their care for investment in long-term risk capital products. However, they noted that there was a possibility of investing shareholder cash in an appropriate product.

1For purposes of this study, SMEs are defined as those enterprises that have transactions too large and complex for microfinance, but too risky for conventional financial institutions. Other definitions typically focus e.g. on the number of employees (small: 11-50, medium: 50-100) or turnover (KES5m-KES300m per annum).
KEY CONSTRAINTS AND OPPORTUNITIES

Based on the report's assessment, the following key constraints and opportunities were identified:

Key constraints

- Conservative nature of pension fund trustees;
- Limited incentive to diversify investments;
- Cumbersome procedures imposed by regulations;
- Extremely conservative nature of insurance companies' investment committees;
- Credibility of managers of the venture capital funds;
- Limited knowledge of the market potential and need for high returns;
- Lack of an appropriate regulatory framework;
- Exit strategies in the funds offered so far are not particularly clear; and
- The required level of disclosure from SME fund managers is usually not forthcoming.

Key opportunities identified

- The need for diversification will be a driving force for future investment;
- There is excess liquidity in the market;
- Customer/demand-side education is necessary;
- Trustee education is important;
- There is need for an element of guarantee in the early stages;
- Key regulatory institutions are supportive;
- Investment clubs are an untapped opportunity;
- Commercialisation of universities' research offers opportunities;
- The demand side of the market is growing

KEY RECOMMENDATIONS

Based on the findings above, the following key recommendations were made:

- Support the development of a separate investment class for venture capital under the Retirement Benefits Authority (RBA) guidelines: FSD should work with the RBA and other stakeholders to develop proposals to include venture capital or private equity as a separate allowable investment class. This will make it much easier for prospective institutional investors to make investments in early-stage funds;
- Undertake a best-practice review of the existing regulatory and tax regime for venture capital funds: FSD should provide assistance to the Capital Markets Authority (CMA) to examine further the environment for the establishment of venture capital funds in Kenya. This will entail an additional best-practice review of the existing rules as well as a broader examination of the incentive structure for establishing funds in Kenya vis-à-vis other destinations. Of particular concern is that most funds prefer to register offshore, typically in Mauritius, for tax and other reasons. Another concern is the time it takes to register funds. So it should be investigated whether CMA can be supported to speed up the due diligence process.
- Work with the Government of Kenya (GOK) to develop an appropriate framework that will support the growth of the venture capital industry: FSD should undertake additional research to identify the scope and potential for establishing a structure similar to the US Small Business Administration (SBA) and their Small Business Investment Companies (SBIC) that can finance growth and development of early-stage funds for SMEs. This would entail exploring further the existing fund of funds at the Ministry of Trade and Industry to see whether it can be expanded appropriately. This review would also look into the scope for other instruments like guarantees etc.
- Support the development of an over-the-counter (OTC) market for SMEs: This would help to improve the exit options for venture funds.
- Establish market size and share of investment clubs in venture capital: Undertake additional research on the investment club industry in Kenya with a view towards understanding its size and potential to act as a catalyst for investment in early-stage venture capital. This work can be done through the Kenya Association of Investment Groups.
- Support additional education of trustees: Provide support through fund managers and the RBA for the education of trustees on the merits of diversification.
- Support financial education of SMEs: As highlighted, many SMEs are not aware of the benefits of different forms of financing and will need to receive education in this area. The newly formed Venture Capital Association could take up this initiative.
- Institute a self-regulatory mechanism for existing venture capital funds: In order to instill confidence in this new industry in Kenya, the Venture Capital Association could develop a vetting process and standards for members to instil confidence in potential investors.
- Support capacity building of existing funds: Provide support to the existing funds to build a credible track record and structure that appeal to institutional investors.
Chapter 1

INTRODUCTION

1.1 OVERVIEW

This report provides a profile of institutional investors in Kenya and an assessment of their attitude to, and appetite for, investment in early-stage investment funds targeting small and medium sized enterprises (SMEs). The report was commissioned by GrowthFin, a programme of the Financial Sector Deepening (FSD) Trust that works with policy makers, donors, industry associations and financial institutions to identify and overcome impediments to the provision of financial services to SMEs.

1.2 BACKGROUND

Surveys of enterprises in Kenya and other East African countries show that enterprises and particularly SMEs have traditionally lacked access to long-term capital. With the exception of family and friends, there are very few long-term financing vehicles in the country. Governments and donors alike have attempted to address this issue through various means. In the early 1990s, USAID and the European Union were particularly active in supporting venture capital funds, amongst others Kenya Equity Management (KEM) and Rehabilitation Advisory Services Ltd. Both funds closed down without having had a significant methodological impact nor were they able to act as a catalyst for the provision of long-term funds to SMEs in Kenya. The experience was similar in Tanzania and Uganda.

Efforts by the Government of Kenya have also yielded mixed results. In the 1960s and 1970s, the government promoted several investment companies with the specific objective of investing in indigenous enterprise growth, most notably the Industrial and Commercial Development Corporation (ICDC). In addition, the government promoted development finance institutions to provide long-term debt capital to SMEs. While showing initial promise, many of these schemes collapsed in the 1980s and 1990s due to poor management and lack of resources, among other reasons.

More recently the government has concentrated on developing a legal and regulatory framework to encourage long-term savings in the country. The enactment of the Retirement Benefits Act has resulted in significant growth of savings mobilisation in the country and created a pool of long-term investment capital. The legal and regulatory framework to encourage the establishment of locally funded investment vehicles has, however, not developed holistically. The fragmented nature of the current regulatory framework has left potential fund managers and investors unclear as to the implications of attempts to mobilise the growing pool of long-term funds in, among others, retirement benefit schemes and life insurance funds.

This profile of institutional investors will be very useful to all of GrowthFin’s target market segments and will help to develop a more comprehensive legal and regulatory framework that will enable innovative fund managers to mobilise local capital and invest in deserving SMEs with strong growth potential.

1.3 OBJECTIVES OF THE STUDY

The key objective of the study is to provide a systematic documentation of

- The legal and regulatory framework pertaining to the use of long-term funding for risk investment;
- A census of the availability of long-term funds in Kenya; and
- A representative survey of the attitudes of holders of these funds to risk investment in particular with respect to SMEs.

The key output is a comprehensive report that provides a well thought through and accurate representation of the potential market for long-term funds and the impediments to substantial investments in risk funds by this market.

1.4 METHODOLOGICAL APPROACH AND WORK PLAN

The assignment was conducted in five basic stages as outlined in Table 1.

1.4.1 Literature Review

The literature review covered three main aspects:

- Review of legal documentation;
- Review of other documents to estimate market size; and
- Review of international best practice literature.

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2 For purposes of this study, SMEs are defined as those enterprises that have transactions too large and complex for microfinance but too risky for conventional financial institutions. Other definitions typically focus on the number of employees (small: 11-50, medium: 50-100) or turnover (KES5m-KES300m per annum).
In order to inform the analysis, the following key pieces of legislation were reviewed:

- The Capital Markets Authority (CMA) Act: The purpose of this act is to promote, regulate and facilitate the development of capital markets in Kenya. The act contains regulations that govern the operations of fund managers (licensing etc.), collective investment schemes etc. Recently gazetted regulations provide guidelines on the operations of venture capital funds.

- The Retirement Benefits Authority (RBA) Act: This governs the overall framework for retirement benefit schemes, including their management, types of investment etc.

- The Insurance Act provides the overall framework for the operations of insurance companies.

In addition, the team reviewed several other pieces of legislation including the Companies Act and the Banking Act. A key element of the review was to document the obstacles and opportunities of the overall framework. Where possible, an attempt was made to compare the existing framework to international best practices. Some of the key areas examined include:

- Specific opportunities outlined in various acts and regulations;
- Legal restrictions on long-term investments, particularly risk-based types of investment;
- Specific regulatory requirements that hinder long-term investment;
- Other licensing and institutional hindrances for investing in risk capital.

### 1.4.1.2 Market Size Assessment

In order to determine the availability of long-term funds, information was obtained from the sources outlined in Table 2.

A key output is an estimate of the size of the total market together with a market share analysis for key players.
Chapter 2
MARKET ASSESSMENT

This section provides an assessment of the market for investment in early-stage investment funds targeting small and medium enterprises in Kenya. First we provide an overall conceptual framework for the assessment followed by a review of the demand and supply characteristics of the existing market in Kenya. This is then compared with some international markets.

2.1 CONCEPTUAL FRAMEWORK

SMEs in different industries progress along different “financing paths”. For example, a biotechnology firm may progress along a path that leads from research to development, clinical trials, and then an initial public offering (IPO) or private placement, while a manufacturing start-up may move on from research to development, pilot production, scale up, and then an IPO. In both cases, financing options become more readily available in the latter stages when products or services are closer to becoming a commercial reality and/or when positive earnings are evident. The following generic model represents the most usual circumstances for an SME seeking equity financing. It allows for the classification of the different forms of equity financing as well as the different facilitators, programmes, regulations, and policies that affect investment decisions at different stages in an SME’s growth cycle.

2.1.1 Stage 1: Seed

All businesses start with an idea. The germination of these ideas into a comprehensive vision of a viable company is called the seed stage of a business. During this stage, prototypes are built, market opportunities are assessed, ideas are exchanged between trusted friends and family, and the entrepreneur takes a final decision as to whether or not he will dedicate most of his time towards developing the new venture.

Seed-stage equity financing primarily comes from the entrepreneur, family, and friends — type I private investors. This type of financing is often called “love money”, as it is seldom invested based just on the idea itself, but on the relationship the investor has with the entrepreneur. During the seed stage, the majority of expenses will be incurred for developing prototypes and conducting market research. However, there are many situations in which seed-stage financing requirements are well beyond the means of an entrepreneur and his local network. In these situations, the most likely option for equity investment comes from angels and type II private investors, which include past business acquaintances, friends of friends, and others. While both type II private investors and angels will likely be wealthy individuals or business owners with the means to invest in the new venture, angels are different in that they actively seek equity investment opportunities. In fact, with the widespread use of

Fig 1: Framework for review: The flow of Equity Financing for SME’s

information technology, angels are becoming more like venture capital firms. The advent of online screening functions, angel networks and the proactive search for high-quality investments are three key factors that separate angels from type II private investors. Regardless of the type of investor targeted, at this point the entrepreneur will need to have some form of a business plan prepared along with financial projections for the business. Investors outside of the immediate circle of family and friends will require information regarding market size, trends, details of the technology, identification of customers, etc. Most angels will require a comprehensive business plan and executive summary. In addition to a written plan, the entrepreneurs will have to possess excellent verbal skills in order to communicate their vision to potential investors.

2.1.2 Stage 2: Start-up

Once the initial research, idea formulation, and prototypes have been completed, it is time to start the business. During this stage, the entrepreneur’s vision will become a functioning organisation. The entrepreneur will have to find a home for the business, hire employees (and possibly additional management), order inventories, secure suppliers, commence marketing efforts and so on. For most entrepreneurs, securing equity financing during this stage is still quite difficult. The company does not yet have a customer base and has not yet earned any profits. It is a very risky time for a new venture. Similar to the seed stage of growth, angels and private investors will be targets for investment funds. However, another group of investors, venture capitalists, can now be considered. It becomes more important than ever to have a well developed business plan. In addition, the entrepreneur will likely need the services of an experienced lawyer and an accountant, especially when attempting to the value the company in order to acquire equity financing.

2.1.3 Stage 3: First Expansion

In this model the first expansion occurs due to the company’s rapid growth. The entrepreneur needs additional working capital and/or capital investment to address growing sales of the company. Additional employees are hired, the production process is enlarged and new markets beyond the local setting are targeted. Average investments range from USD3m to USD5m, although in developing countries like Kenya, the amount will be significantly lower for SMEs. If the entrepreneur can show positive earnings and an established customer base, the chances to obtain private, angel and venture capital equity investment will be increased dramatically.

2.1.4 Stage 4: Second Expansion

Second expansion usually involves a company growing at an extremely rapid pace with a robust technology and a rapidly growing potential market. Although not always the case, the entrepreneur may envision transforming the business from a small concern to a large corporation. Additional funds are required to develop new products and/or enter new international markets. Again, production facilities, marketing budgets and other areas of the business may need to be enlarged in order to address the firm’s high growth potential. Second expansion investments range from USD5 to USD20m. With a successful history and high potential for the future, equity financing options will begin to increase. Banks and corporate investors will also become targets for additional funds.

2.1.5 Stage 5: Initial Public Offering or Acquisition

A successful SME (although it may no longer be an SME) can finance its growth by acquiring funds from the public through an IPO. However, many companies decide not to progress to this stage of growth: the numerous regulations and procedures that must be followed are often not appealing to an entrepreneur. Although business owners will have an opportunity to cash in some of their equity in the secondary markets, they must also be ready to give up some control of the business. Periodic reports of business activities have to be supplied to shareholders, which may affect any perceived competitive advantage associated with the company’s private information. Also, other activities such as sales of stock by executives must be reported to a securities exchange commission. The size of the investment may range from USD5m to well over USD100m. In the United States, there are alternatives to going public with regard to attracting equity investments from the public. Small businesses can access public capital by selling state-registered securities to the general public. This process is called a direct public offering (DPO). Acquisition: In many cases successful SMEs in high-growth industries are acquired by larger companies. While this provides growth capital and an exit strategy for an entrepreneur, in most circumstances the company will cease to be an SME.

For purposes of this report, the focus will be on funds that target largely early-stage investments in SMEs — seed, start-up and first stage expansion. As mentioned above, these are the most risky types of investments as the performance of the firm is not yet assured and returns are minimal in the initial stages. They are important, however, as they encourage innovation and risk taking, both of which are essential to the development of a modern enterprise sector.
2.2 SUPPLY OF FUNDS

2.2.1 Overview

The market for risk funds in Kenya is dominated by two main sectors: the pension fund sector and the insurance industry. Both industries are intertwined as both are involved in the investment of retirement benefit funds. The law requires that retirement benefit scheme funds be invested by an investment manager registered with the Retirement Benefits Authority (RBA). There are two types of investment managers:

- Insurance companies; and
- Asset management companies.

Insurance companies operate deposit administration schemes in which the funds of many schemes are pooled together and invested in the name of the insurance company. Asset management companies, on the other hand, invest scheme funds in the name of the scheme and not in the name of the asset management company. The scheme fund is segregated from other funds.

2.2.2 Structure and Size of the Insurance Industry’s Market

As investors normally seek to match the maturity of their funding sources with their investments, long-term funds available to the insurance industry will most likely come from their main long-term product, life insurance. There are eight registered life insurance companies in Kenya: Apollo Life Assurance Company, CFC Life Assurance Company, Old Mutual Life Assurance Company, Pan Africa Life Assurance Company, Pioneer Life Assurance Company and Trinity Life Assurance Company.

These companies, however, are not the only potential source of risk capital in the Kenyan insurance industry: Since 2006, almost all registered Kenyan insurance companies had some element of life insurance business. The main insurance companies with the capacity for long-term risk capital are summarised in the table below. Funds available for investment in risk capital are also presented in the table below. The life element of insurance companies that is available for long-term risk investment is relatively small compared to the pension funds. By 31 December 2006, the long-term funds currently under management by insurance companies stood at KES23.97 billion. Insurance companies are allowed to invest up to 5% of these funds, i.e. the equivalent to around KES1.25 billion (see table on market share below) in unlisted equities.

In addition to funds directly available to insurance companies, many have funds available through shareholders funds or holding companies that could be placed in risk capital. While it is difficult to estimate the magnitude of these funds, they are likely to be at least KES500m.

2.2.3 The Pension Fund Sector

2.2.3.1 Key Players

The pension fund sector is, by its very nature, an ideal potential source of long-term risk capital. As noted above, the legislation governing pension schemes has assigned the duty of managing the pension fund investments to registered professional fund managers. Table 4 lists the companies that are duly registered with the RBA to manage pension funds.

Table 3: Long-Term Insurance Gross Premium
(Market Share 2006)

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>AMOUNT</th>
<th>%</th>
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<tr>
<td>British American</td>
<td>239</td>
<td>519</td>
</tr>
<tr>
<td>Pan Africa Life</td>
<td>216</td>
<td>117.3</td>
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<td>ICEA</td>
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<td>11.0</td>
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<td>CFC Life</td>
<td>113</td>
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<td>Co-operative</td>
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<td>Madison</td>
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<td>6.9</td>
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<td>Old Mutual</td>
<td>70</td>
<td>5.6</td>
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<tr>
<td>Jubilee</td>
<td>71</td>
<td>5.7</td>
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<tr>
<td>Others</td>
<td>221</td>
<td>17.7</td>
</tr>
<tr>
<td>Total</td>
<td>1,250</td>
<td>100%</td>
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Source: Association of Kenya Insurers

Table 4: RBA Registered Managers

<table>
<thead>
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<th>No.</th>
<th>COMPANY NAME</th>
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<tr>
<td>1.</td>
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<td>2.</td>
<td>Genesis Kenya Investment Management Limited</td>
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<td>3.</td>
<td>AIG Global Investment Company (East Africa) Limited</td>
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<td>5.</td>
<td>ICEA Investment Services Limited</td>
</tr>
<tr>
<td>6.</td>
<td>Co-op Trust Investment Services Limited</td>
</tr>
<tr>
<td>7.</td>
<td>Old Mutual Asset Managers (E. A.) Ltd</td>
</tr>
<tr>
<td>8.</td>
<td>African Alliance Kenya Limited</td>
</tr>
<tr>
<td>9.</td>
<td>Kerindia Asset Management Company Limited</td>
</tr>
<tr>
<td>10.</td>
<td>CFC Financial Services Ltd.</td>
</tr>
<tr>
<td>11.</td>
<td>Jubilee Financial Services Ltd.</td>
</tr>
<tr>
<td>12.</td>
<td>Royal Investment Management Services Limited</td>
</tr>
<tr>
<td>13.</td>
<td>Madison Asset Management Services Limited</td>
</tr>
</tbody>
</table>

Source: Retirement Benefits Authority (RBA)
As the list shows, most of the companies registered by the RBA to manage pension funds are subsidiaries of or associated with insurance companies, as historically insurance companies managed most pension funds in-house to maintain control of the investment decision process. However, some insurance firms now outsource this work to the subsidiaries they formed to manage pension funds.

The companies listed in Table 4 that are in bold are also registered with the CMA as fund managers and can therefore manage funds sourced directly or indirectly from the public through various products like unit trusts or equity funds. The list is thus representative of the main players in the fund management sector.

Table 5: Investment Portfolio of Retirement Benefit Schemes

<table>
<thead>
<tr>
<th>No.</th>
<th>MANAGER</th>
<th>No. of Schemes</th>
<th>Total Portfolio (in KES million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>African Alliance</td>
<td>13</td>
<td>367</td>
</tr>
<tr>
<td>2</td>
<td>AVG</td>
<td>120</td>
<td>37,317</td>
</tr>
<tr>
<td>3</td>
<td>CFC Investment Management</td>
<td>58</td>
<td>4,574</td>
</tr>
<tr>
<td>4</td>
<td>Co-operative Bank</td>
<td>98</td>
<td>9,981</td>
</tr>
<tr>
<td>5</td>
<td>Genesis</td>
<td>51</td>
<td>21,510</td>
</tr>
<tr>
<td>6</td>
<td>ICEA</td>
<td>300</td>
<td>12,828</td>
</tr>
<tr>
<td>7</td>
<td>Jubilee Insurance</td>
<td>111</td>
<td>3,874</td>
</tr>
<tr>
<td>8</td>
<td>Kenindia Insurance</td>
<td>108</td>
<td>3,024</td>
</tr>
<tr>
<td>9</td>
<td>Madison Insurance</td>
<td>31</td>
<td>505</td>
</tr>
<tr>
<td>10</td>
<td>Old Mutual East Africa</td>
<td>128</td>
<td>44,205</td>
</tr>
<tr>
<td>11</td>
<td>Old Mutual Kenya</td>
<td>5</td>
<td>10,142</td>
</tr>
<tr>
<td>12</td>
<td>Stanbic Investment Management</td>
<td>74</td>
<td>11,228</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1,097</td>
<td>159,957</td>
</tr>
</tbody>
</table>

Source: Retirements Benefits Authority (RBA), March 2007

2.2.3.2 Size and Market Share

By March 2007, the value of private pension funds in Kenya stood at KES159.957 billion.4 The RBA Act limits the maximum funds available from pension funds for investment as long-term risk capital at 5% of the total funds under management, so the amount of long-term capital available for risk capital investment in Kenya is approximately KES7.998 billion. It should be noted that this figure includes pension funds managed by insurance companies. Table 7 provides the latest data on market share from the RBA. At present, only KES384m (0.24%) of total funds are invested in unquoted equity.5

2.2.4 Risk Capital Funds

Traditional venture capital funds, many of which are in their infancy in the Kenyan market, are an important source of capital for private equity transactions. The main risk capital funds in Kenya are presented in the Table 6.

In addition to the funds mentioned above, there are several very new small funds that have recently been established or are currently in formation whose details were not available. Some of these funds are administered by international managers, others are run by Kenyan professionals. As can be seen from the table, most funds, particularly those targeting SMEs, are newly established in Kenya and thus do not yet have a significant track record. Funding is largely provided by social investors who, while seeking a return, also have developmental objectives. These include the World Bank Group’s International Finance Corporation (IFC) and various European development banks like DEG. It is encouraging, though, that there are increasing numbers of funds interested in the Kenyan market. The

Table 6: Risk Capital Funds in Kenya

<table>
<thead>
<tr>
<th>FUND</th>
<th>Year of Establishment</th>
<th>Sources of Funding</th>
<th>Key Areas of Focus</th>
<th>Funding Levels (in USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Actis Africa Agribusiness Fund</td>
<td>2006</td>
<td>70% social investors; 30% institutional investors (estimate)</td>
<td>Agribusiness – large size transactions</td>
<td>100m</td>
</tr>
<tr>
<td>2 Acumen Fund</td>
<td>2001</td>
<td>100% social investors</td>
<td>Health, housing, energy and water</td>
<td>20m</td>
</tr>
<tr>
<td>3 Aureos East Africa Fund</td>
<td>2003</td>
<td>70% social investors; 30% institutional investors (estimate)</td>
<td>Banking, agribusiness, telecom, other</td>
<td>40m</td>
</tr>
<tr>
<td>4 BP Kenya</td>
<td>2006</td>
<td>100% social investors</td>
<td>SME</td>
<td>14m</td>
</tr>
<tr>
<td>5 Grofin East Africa fund</td>
<td>2006</td>
<td>100% social investors</td>
<td>SME</td>
<td>25m</td>
</tr>
<tr>
<td>6 Bridgeworks Africa Fund</td>
<td>2006</td>
<td></td>
<td>Agribusiness</td>
<td>in formation</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>199m</td>
</tr>
</tbody>
</table>

Source: International Finance Corporations (IFC) review of venture capital funds; Strategic Business Advisors (SBA) interviews

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5 See detailed data in the annex.
majority of funds combine both debt and equity, and the SME funds in particular rely more on debt/royalty financing rather than pure equity. Most of the funds focus on expansions, but a few like BP Kenya also fund start-ups. More recently, a technical assistance fund has been established by the Government of Kenya with funding from the World Bank’s Micro and Small Enterprise Competitiveness Project. The fund seeks to capitalise and provide technical assistance to eligible SME risk capital funds.

2.2.5 Other Potential Investors

In addition to traditional venture capital funds, an increasingly important source of capital for private equity transactions in Kenya is believed to come from the myriad investment groups scattered across the country. There are no official data on the number of these groups, but they are estimated to be in the thousands. Although no detailed research on the sector has been done, estimates of the funds available range from KES20 billion to KES30 billion. It is unlikely that more than 5% to 10% of these funds are available for investment in early-stage funds/enterprises. The best known and largest group, Trans Century Ltd., has a net worth of at least KES8 billion and often serves as a model to other investment groups. This group is an active investor in early-stage funds with investments in Business Partners International and Aureos among others. The group has also made its own investments in seed and start-up technology companies like Wananchi Online and Seven Seas Technologies.

Business angels also exist in Kenya and have participated in a number of private equity transactions. Data on business angel funding of early-stage venture capital are, however, difficult to obtain so estimates are not possible.

2.2.6 Estimated Total Market Size of Kenyan Risk Funds

Table 7 below summarises the information presented on the pension, insurance and investment group/business angel sources of private equity for early stage funding, providing an estimate of the Kenyan risk fund sector.

Funds currently invested are approximately KES5.9 billion with an estimated growth potential of about KES20.2 billion, if all currently available funds were invested in early-stage funds or enterprises. Much of this growth could stem from the pension fund sector that

Table 7: Estimated Kenyan Market Size

<table>
<thead>
<tr>
<th>RISK FUND SECTORS</th>
<th>Estimate of Currently Invested Funds (in KES million)</th>
<th>%</th>
<th>Estimate of Available</th>
<th>%</th>
<th>How Estimates Were Derived</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension Funds</td>
<td>384</td>
<td>6.5</td>
<td>7,998</td>
<td>30</td>
<td>Private pension funds are valued at KES 160bn. Of this, 5% or KES 7.998bn, can be invested in risk capital. To date, 0.24% or KES 384m, of the KES 160 billion are invested in unlisted equities. Source: RBA</td>
</tr>
<tr>
<td>Insurance Funds</td>
<td>480</td>
<td>8.1</td>
<td>1,250</td>
<td>5</td>
<td>Long-term funds under management are KES 23.97 billion, of which 2% or KES 480m, are invested in unlisted equities. Source: SBA estimate</td>
</tr>
<tr>
<td>Insurance - other Funds</td>
<td>500</td>
<td>8.5</td>
<td>1,000</td>
<td>4</td>
<td>Funds available through shareholders funds or holding companies that could be placed in risk capital. Source: SBA estimate</td>
</tr>
<tr>
<td>Venture Capital Funds</td>
<td>2,535</td>
<td>43</td>
<td>12,935</td>
<td>49</td>
<td>See Table 6: The approx venture funds size is USD 199m, KES 12.9 billion (USD 1: KES 65), of this, USD 39m or KES 2.535 billion specialise in SME</td>
</tr>
<tr>
<td>Business Angel / Investment Clubs</td>
<td>2,000</td>
<td>34</td>
<td>3,000</td>
<td>11</td>
<td>Estimates of funds available approx KES 20 - 30 billion, of which 5 - 10% would be available to easily stage funds/enterprises. Source: Investment Club Association of Kenya</td>
</tr>
</tbody>
</table>

Estimated Total Market Size 5,899 100 26,183 100
Total Market Size in USD 90.29 390.51

Source: Extrapolation by SBA using various data sources quoted in comments section of Table 7
Exchange rate: US dollars/Ksh = $1/Ksh 65
has around KES384m invested in this sector while regulations allow for KES8 billion. Existing venture capital funds and investment clubs/business angels are also an important source. In the estimates in Table 6, it should be noted that the figures for pension funds also include insurance companies that manage pension funds. It is important to recognise that the data provided are estimates that in some cases will need further investigation or verification, especially regarding investment clubs and business angels.

2.3 DEMAND FOR FUNDS

The market for private equity and/or long-term risk investment in Kenya is in an early development stage with few players taking part in the market. As can be seen from Chart 1, the main source of financing for Kenya’s SMEs is internal financing followed by banks. Kenyan SMEs do not use credit cards or leasing as a source of finance. Only 0.58% of SMEs surveyed used equity finance.

2.4 COMPARISON TO INTERNATIONAL MARKETS

The following section compares Kenya’s sources of funds and market size with those of the US and UK.

2.4.1 SME Sources of Funds

Table 8 below provides data for several markets. Data for the US market are based on a 2003 US Federal Reserve report\(^8\) that summarised the use of finance by SMEs. For the UK market data, they are drawn from a report on the 2004 UK Survey\(^8\) of SME Finances and for the Kenyan market from the World Bank’s Investment Climate Surveys compiled in 2002-2003, covering small firms with no more than twenty to fifty fulltime workers.

The UK data are very similar to the US data, showing in particular SMEs’ strong use of credit cards and the relatively limited use of equity finance. Bank financing, while higher in the UK and the US, is

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also quite high for Kenyan SMEs. Both leasing and the use of credit cards are still very limited for Kenyan SMEs compared to more developed countries. Equity financing forms only a small portion of SME finance in the UK and though data was not available for the US, it is likely to be similar. In Kenya, informal (internal) sources form the bulk of funding (50%) for SMEs, suggesting the high potential for increased financing from both debt and equity sources in Kenya.

### 2.4.2 Size of the Kenyan Market Compared to International Markets

The number of venture capital funds in Kenya is very small compared to that in developed markets. Based on the data presented in Table 9 below, it is clear that the US has the largest number of funds and UK has the largest size of funds under management. Compared to these, Kenya has least number of funds and a comparable fund size to India, South Africa and the UK.

#### Table 9: Comparative Fund Sizes Internationally

<table>
<thead>
<tr>
<th>Country</th>
<th>Funds under Management (in USD)</th>
<th>No. of VC Funds</th>
<th>No. of Deals</th>
<th>Average Fund Size (in USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>26.3 billion</td>
<td>646</td>
<td>2,454</td>
<td>40m</td>
</tr>
<tr>
<td>UK</td>
<td>32.2 billion</td>
<td>140</td>
<td>256</td>
<td>230m</td>
</tr>
<tr>
<td>Canada</td>
<td>21.1 billion</td>
<td>132</td>
<td>160</td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>8.2 billion</td>
<td>71</td>
<td>299</td>
<td>115m</td>
</tr>
<tr>
<td>India</td>
<td>7.5 billion</td>
<td>150</td>
<td>299</td>
<td>50m</td>
</tr>
<tr>
<td>Australia</td>
<td>2.3 billion</td>
<td>–</td>
<td>174</td>
<td>–</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1.2 billion</td>
<td>7</td>
<td>122</td>
<td>171m</td>
</tr>
<tr>
<td>Kenya</td>
<td>90 million</td>
<td>6</td>
<td>–</td>
<td>15m</td>
</tr>
</tbody>
</table>

Source: SBA extrapolation; PriceWaterHouseCoopers-National Venture Capital Association-Money Tree Report 2007; Canadian Private Equity Report 2006; European, South Africa, India, New Zealand Venture Capital Association

In the UK, approximately USD32 billion were under management by fund managers at the end of December 2006. In the US market, this figure stood at USD26.347 billion at the end of the same year, according to the PricewaterhouseCoopers/National Venture Capital Association Money Tree Report 2007. According to the Private Equity 2006 report, the Canadian Market stood at USD22.1 billion. The figures are for venture capital funds exclusively, and the Kenyan figures are an estimate by Strategic Business Advisors (see Table 7 for market size estimates).

As can be seen from Table 10, the Kenyan private equity and venture capital industry is small both in absolute and relative terms when compared to these other markets. South Africa’s total funds under management relative to the country’s GDP are 1.7%, compared to 1.5% in Europe and 0.9% in Asia Pacific. Kenya’s are at 0.36%, which is a third of Asia Pacific.

#### Table 10: International Private Equity and Venture Capital Markets in Relation to GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Private Equity and Venture Capital Investment (in USD billion)</th>
<th>Private Equity and Venture Capital Investment as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>379.9</td>
<td>2.8%</td>
</tr>
<tr>
<td>Europe</td>
<td>205.8</td>
<td>1.5%</td>
</tr>
<tr>
<td>UK</td>
<td>79.4</td>
<td>3.7%</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>72.6</td>
<td>0.9%</td>
</tr>
<tr>
<td>South Africa</td>
<td>43</td>
<td>1.7%</td>
</tr>
<tr>
<td>Israel</td>
<td>43</td>
<td>3.4%</td>
</tr>
<tr>
<td>Kenya</td>
<td>0.1</td>
<td>0.4%</td>
</tr>
</tbody>
</table>


#### 2.4.3 Contribution of Pension Fund and Insurance Industry to Venture Capital

Table 11 provides an outline of the sources of funds for the venture capital industry in various countries. The US and the UK are structurally similar as more than 40% of venture capital funds get their funding from pension funds and insurance companies. In Japan and Germany, the financial sector is very bank oriented and venture capital funds rely a lot on banks for their funding. In Canada, individuals and government play a key role in addition to pension funds.

During 2006 in Kenya, pension funds and insurance companies invested about 23.5% of their funds in unlisted equities (see Table 7 above). A significantly lower percentage, probably less than 5%, is likely to have been invested in venture capital funds. In addition, compared to developed markets, the absolute values are still very small. Based on the comparative data presented, there is still considerable scope for pension funds, insurance companies and other corporate sources to fund risk capital in Kenya. For early-stage funds, other sources like the government and donors are also likely to remain important players in the medium term.
The venture capital market industry in Kenya is still in its infancy, so the majority of investors tend to be international social investors and quasi-government investors. Most large funds raise their funds from external sources and only a few locally. In South Africa, based on 2006 data, 50% of funds raised were from the US, 5% from Europe and 45% from South African sources. In Canada, foreign participation in venture capital funds was approximately 32% of the total in 2006, coming largely from the US. As the Kenyan market continues to grow, more funds will be raised locally. Foreign participation, however, will remain heavy if the country follows the trend of other markets such as South Africa or Canada.

**2.4.4 Venture Capital Source of Finance and Stage of Company Development**

Various studies on the venture capital industry have found that venture capital fund activities are not independent of their sources of finance. Key sources of finance fall into the following four broad categories: banks, pension and insurance funds, individuals and corporations, and government. These sources of finance are strongly correlated to the following factors:

- **Company stage:** seed, early, expansion, late;
- **Sector:** low technology, e.g. manufacturing and services, or high technology, e.g. new technologies, IT and electronics.

The source of funding is also loosely correlated to geography, whether domestic or international (Mayer, Schoors, Yafeh, 2003). These relationships and the outcomes of their study of venture capital firms in UK, Japan, Germany and Israel are summed up in Table 12. Based on the data presented, it is unlikely that early-stage funds will receive significant resources from pension funds or banks. Most funds will come from individuals, corporations and governments. The situation in Kenya appears to be similar: Existing funding for venture capital comes largely from donors/government or quasi-public entities with a small portion of funds coming from the corporate sector. Investment in early-stage investments targeting SMEs could increase in Kenya with a government backed venture capital programme and a system to guarantee loans, similar to the US Small Business Investment Companies (SBIC) programme and Small Business Administration (SBA) programme. These are described in more detail below.

**Table 11: Sources of Funding for Venture Capital**

<table>
<thead>
<tr>
<th>Sources of Financing</th>
<th>Canada</th>
<th>US</th>
<th>UK</th>
<th>Japan</th>
<th>Germany</th>
<th>New Zealand</th>
<th>South Africa</th>
<th>Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension</td>
<td>13%</td>
<td>23%</td>
<td>28%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>30%</td>
<td>7%</td>
</tr>
<tr>
<td>Banks</td>
<td>-</td>
<td>-</td>
<td>25%</td>
<td>40%</td>
<td>-</td>
<td>21%</td>
<td>3%</td>
<td>-</td>
</tr>
<tr>
<td>Insurance</td>
<td>-</td>
<td>13%</td>
<td>27%</td>
<td>13%</td>
<td>-</td>
<td>-</td>
<td>19%</td>
<td>17%</td>
</tr>
<tr>
<td>Individuals</td>
<td>58%</td>
<td>22%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>22%</td>
<td>3%</td>
<td>-</td>
</tr>
<tr>
<td>Corporate</td>
<td>9%</td>
<td>15%</td>
<td>-</td>
<td>48%</td>
<td>-</td>
<td>36%</td>
<td>6%</td>
<td>-</td>
</tr>
<tr>
<td>Government</td>
<td>7%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>25%</td>
<td>22%</td>
<td>-</td>
</tr>
<tr>
<td>Foreign sources</td>
<td>10%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>7%</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>3%</td>
<td>30%</td>
<td>45%</td>
<td>14%</td>
<td>60%</td>
<td>-</td>
<td>10%</td>
<td>86%</td>
</tr>
</tbody>
</table>


**Table 12: Comparative analysis; Source of funds/ stage/ sector/ geographical focus**

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Stage</th>
<th>Sector</th>
<th>Geographical Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>late</td>
<td>low tech</td>
<td>domestic</td>
</tr>
<tr>
<td>Pension funds</td>
<td>late</td>
<td>low tech</td>
<td>domestic</td>
</tr>
<tr>
<td>Insurance funds</td>
<td>early</td>
<td>low tech</td>
<td>international</td>
</tr>
<tr>
<td>Individual and corporations</td>
<td>early</td>
<td>high tech</td>
<td>international</td>
</tr>
</tbody>
</table>

Source: Mayer, Schoors, Yafeh, 2003

**2.4.5 Example of Support Funding for Venture Capital in International Markets**

Various countries have instituted government initiatives to support the venture capital market with a specific focus on SMEs. Examples include:

- **New Zealand:** The New Zealand Venture Investment Fund Limited (NZVIF) was incorporated in June 2002 to foster the growth of the country’s angel and venture capital investment industry and provide capital and technical assistance to companies. The Venture Capital Fund of Funds is NZD160m in size. To date the fund has invested in 47 companies, six venture capital funds and four seed fund co-investment partnerships. To date, 36 early-stage companies have received investment through the venture capital programme, with a total of NZD118m invested through the programme by NZVIF and private investors.
• **Ghana:** The Venture Capital Trust Fund was established in November 2004 to finance SMEs and promote growth of the venture capital industry in Ghana. The trust has USD30m in funds, comprising a government endowment of USD18m and an additional USD12m from the private sector. The trust funds venture capital companies via debt or equity arrangements. The venture capital companies can borrow monies from the trust at below market rates to invest in SMEs, or the trust forms partnerships with the private sector. By December 2006, two venture capital company partnerships have been formed with USD2.5m for investment in SMEs.

• **Botswana:** The Citizen Entrepreneurial Development Agency (CEDA) loans funds to citizen-owned SMEs at low interest rate to be paid over a period of between five and seven years. In 2002, it established its own venture capital fund, the CEDA-VCF, to finance start-ups owned by Botswana citizens and joint ventures between citizens and foreigners.

• **Nigeria:** The Small and Medium Enterprises Equity Investment Scheme (SMEEIS) provides funds for equity in SMEs. As of 2005, USD200m had been set aside for investment, with USD71m invested in over 200 SMEs. Funds are implemented through participating banks that contribute 10% to the scheme through bank subsidiaries and fund managers.

The programmes instituted by the various countries mentioned above are modelled on the US Small Business Investment Companies (SBIC) programme, widely considered one of the world’s most successful funding support mechanisms for SMEs. It was established in 1958 by the US federal government and channels public venture capital to privately-owned venture capital companies. During the past 40 years, SBICs have provided USD20 billion in funding to small businesses, including such household names as Intel, America Online, Staples, Apple Computer and Federal Express. It is described in more detail in the following section.

### 2.4.5.1 Small Business Investment Companies (SBIC) Programme

SBICs provide equity capital, long-term loans and management consulting to eligible small businesses. Through a US Federal Government programme, they are able to leverage their capital base by 300%. The SBICs are regulated by the Small Business Administration (SBA). In addition, an SBIC with at least 50% of its "total funds available for investment" invested or committed in "venture capital" can leverage their position by as much as 400% of the value of private capital available, not to exceed USD90m.

A private capital investment of USD5m is required for most SBICs, while USD10m are required if an SBIC intends to use securities for its capital base. In some cases SBICs issue debentures guaranteed by the SBA. Pools of these debentures are formed and sold to investors through a public offering. SBA-guaranteed participation certificates representing an undivided interest in the pools are provided to investors.

SBICs are basically government regulated and leveraged venture capital funds. As at the end of 2003, the SBA had USD5.5 billion invested in 435 funds and USD3.7 billion available in commitments together with USD12 billion in private equity capital.

### 2.4.5.2 Small Business Administration (SBA) 7(a) Loan Guarantee Programme

This provides participating lenders with a credit-enhancing mechanism in the form of a loan guarantee for extending credit to small businesses unable to secure conventional financing. By lending to borrowers that meet the agency’s underwriting and eligibility criteria, the risk to lenders is significantly reduced. At least 75% of a qualified loan is covered by the SBA guarantee. In 2001, almost 43,000 SBA 7(a) guaranteed loans amounting to nearly USD10 billion were made.
Chapter 3

LEGAL AND REGULATORY FRAMEWORK

3.1 INTRODUCTION

This section reviews the main legislation governing the operations of key players in the provision of long-term capital in Kenya:

- The Retirement Benefits Act together with other subsidiary legislation;
- The Insurance Act Chapter 487;
- The Capital Markets Act Chapter 485A;
- The Trustee Act Chapter 167;
- The Companies Act.

A brief discussion of the relevant pieces of legislation is presented below.

3.2 THE RETIREMENT BENEFITS ACT, ACT NO. 3 OF 1997

The Retirement Benefits Act was enacted in 1997 to establish the Retirement Benefits Authority (RBA) that would regulate, supervise and promote retirement benefits schemes (RBS) and develop the retirement benefits sector in Kenya. The act was an important milestone for Kenya as prior to that time, management of the various schemes was largely left to employers and insurance companies. The governance provisions were scattered across different pieces of legislation. The passing of the act in 1997 has brought uniformity to the sector and greatly improved the management and governance of the industry. Key provisions of the act are presented below.

3.2.1 Regulatory Oversight

The act creates the RBA whose objectives and functions are contained under section 5 of the act and include:

- To regulate and subsequently establish the management of retirement benefits schemes;
- To protect the interests of members and sponsors of the retirement benefits sector; and
- To promote the development of the retirement benefits sector, among other functions.

As will be discussed later in this section, the RBA has been granted significant oversight powers for the industry in Kenya which, if used well, can benefit its growth and development.

3.2.2 Establishment of Retirement Benefits Schemes

The RBA Act enables the establishment of RBS, commonly also referred to as pension schemes. These may be set up as an umbrella scheme that brings together self-employed individuals or people working in different organisations who wish to provide for their financial security in their retirement. The Retirement Benefits Individual Schemes Regulation 2000 (RBI) regulates the setting up and management of such schemes. Employers who wish to attract and retain qualified human resources may sponsor the establishment of an RBS for their employees. The Retirement Benefits Occupation Scheme Regulation 2000 (RBO) deals with the establishment and management of occupational retirement benefits schemes.

3.2.2.1 Registration

Section 23 of the act provides for the registration of the RBS, whether established under RBI or RBO. As the regulator of the retirement benefits sector, the RBA will consider applications by any person wishing to establish a RBS. After registration, the RBA supervises and maintains records and information on all such schemes.

RBA will not register an RBS unless it is established under an irrevocable trust and the scheme rules adequately protect the rights and interests of the sponsor and the members. An application for registration must include a trust deed and scheme rules. For income tax purposes, the scheme should also be registered under the Income Tax Act.

3.2.2.2 Establishing of a Scheme Fund

Every registered RBS is expected to establish and maintain a scheme fund that receives all contributions from members (normally from both the sponsor and the employee in case of occupational schemes), and also investment earnings, income and other monies payable into the scheme fund under the scheme rules or the provisions of the RBA Act. The scheme funds together with all movable and immovable properties owned by the fund are vested in the trustees.

3.2.2.3 Management of the Scheme Fund

Every registered RBS, whether individual or occupational, is managed by a board of trustees. Membership of the board of trustees includes nominees by the scheme members to represent their interests as well as representatives of the scheme sponsor. The law requires that each RBS should not have more than nine or less than three trustees.
In the management of the scheme, particularly in the exercise of their powers and duties, the trustees are guided by the provisions of the RBA Act, the Trust Deed and Scheme Rules, the Trustee Act and the normal law of trusts. The duties of trustees include:

- A fundamental duty to administer the scheme in line with the trust deed and rules that are in line with the provisions of the Retirement Benefits Act;
- To keep proper books of account and allow the beneficiary and sponsor to inspect them and any other information related to investments and trust property;
- To liaise with service providers who are important players in the running of the scheme;
- To assume the duties of a trustee for as long as is the period of the trusteeship. According to the RBA, the law does not fully distinguish between active and passive trustees. A trustee is fully liable to the beneficiaries for any loss that occurs even where the management has been delegated to a third party.
- To be bound by the decisions of the trust. Unless stated otherwise in the trust deed, all decisions of the trustees must be made by all of them. If the rules provide for a majority decision, that decision binds the minority.
- To be jointly and severally liable for the decisions of the trust. An aggrieved party may elect to sue one, several or all of the trustees for redress.

3.2.2.4 Investment of the Scheme Funds

The Retirement Benefits Act sets out how the scheme funds shall be dealt with and invested by the trustees. Section 37 as it applies to investment of scheme funds states the following (our emphasis):

"37.1, Every Scheme shall have a prudent investment policy on the investment of the funds of the scheme so as to maintain the capital funds of the scheme and generally to secure market rates of return on such investment. Provided that a Scheme with a Fund Value of 5 Million Kenya Shillings or less may invest up to 100 per centum of its Scheme Funds in Government Securities. ...........”

Table 13 of the act reproduced below defines various investment classes and the maximum percentage of the aggregate market value of total assets of the scheme fund that may be invested in those classes.

Of particular interest to the current assessment is the provision that 5% of the scheme assets may be invested in either the unquoted shares of companies incorporated in Kenya or collective investment schemes incorporated in Kenya and approved by the CMA. In addition, the act allows for investment in any other assets.

### Table 13: Table G – Asset Class/Maximum

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>MAXIMUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5%</td>
</tr>
<tr>
<td>Deposits</td>
<td>30%</td>
</tr>
<tr>
<td>Commercial paper and corporate company</td>
<td>30%</td>
</tr>
<tr>
<td>Equities</td>
<td>70%</td>
</tr>
<tr>
<td>Quoted equity in any one company</td>
<td>30%</td>
</tr>
<tr>
<td>Guaranteed funds</td>
<td>100%</td>
</tr>
<tr>
<td>Foreign investments</td>
<td>15%</td>
</tr>
<tr>
<td>Property</td>
<td>30%</td>
</tr>
<tr>
<td>Government securities</td>
<td>70%</td>
</tr>
<tr>
<td>Schemes with up to KES 5m</td>
<td>100%</td>
</tr>
<tr>
<td>Unlisted securities and collective investment schemes</td>
<td>5%</td>
</tr>
<tr>
<td>Any other assets</td>
<td>5%</td>
</tr>
</tbody>
</table>

Before investing scheme funds, every RBS board of trustees is expected to develop an investment policy (discussed below) subject to the provisions of the act that guides all its investment decisions. This policy is expected to maintain the capital funds of the scheme, but also to earn market rates of return for the members. Although the law requires the trustees to generally secure market rates of return for scheme members, the authority has nonetheless issued certain investment guidelines that trustees and the fund managers who advise them are expected to adhere to.

Scheme trustees are expected to submit the statements of all investments to the chief executive officer (CEO) of the CMA in such form, manner and intervals as may be prescribed. They are also required to get written approval from the CEO of the RBA to invest in unlisted securities, collective investment schemes or any other assets.

3.2.2.5 Appointment of Fund Managers

To assist with the implementation of the scheme’s investment policy, the trustees are required by law to appoint a fund manager who must be registered with the RBA. The functions of the fund manager as provided for under the provisions of the Retirement Benefits (Managers and Custodian) Regulations, 2000 (RBMC) include:

- Advising the trustees on the asset classes that are available for investment;
- Assisting the trustees in formulating a prudent investment policy;
In carrying out their investments duties, the trustees are further expected to observe investment guidelines issued by the RBA. These guidelines contain one other important principle, stipulating the need to diversify as outlined in Table 13 above. The guidelines only lay down the maximum permissible investments levels within an asset class while the decision on the suitability and amounts involved is left to the collective wisdom of the trustees.

To guide their investment decisions, the trustees are expected to develop an investment policy as outlined above. The policy should cover, inter alia, the following areas:

- The policy of the scheme in compliance with the issued investment guidelines;
- A category of the investment to be held;
- The risks involved.
- Realisation of investment and any other matters that the RBA may prescribe from time to time.

As much as the areas covered by the policy may seem to lend a free hand to the trustees, the guidelines as contained under Regulation 38 of the RBO sets maximum investment levels for each category of investments:

- Maximum investment in the quoted equity of any one company should not exceed 30% of the aggregate market value of the total assets of the scheme fund (within this class, a scheme fund can invest only up to 70% of the aggregate market value of the total assets of the scheme fund);
- Unquoted equity, commercial paper loan, stock and debentures issued by a company controlled by or related company of the sponsor shall be 3% of the aggregate market value of the total assets of the scheme fund.

Although the investment guidelines give trustees of the scheme fund powers to invest in 5% of the aggregate market value of total assets of the scheme fund in “any other asset”, this is restricted by the obligation to obtain written approval from the authority.

Section 39 of the RBA Act gives unrestricted powers to the CEO of the RBA to restrict trustees or managers of a scheme fund from pursuing what is referred to as “unsafe and unsound practice.” However, the act does not define what this implies. This gives the RBA’s CEO the power to determine what he considers to be unsafe and unsound practice both in terms of assets and levels of exposure, imposing restrictions on the trustees to freely exercise their powers of investment.

As part of the segregation of functions relating to the management of scheme funds and in order to assist in the investment of those funds, the act requires the trustees to appoint:
A fund manager who will, as stated above, advise them and exercise professional judgment in making investment decisions. It should be noted, however, that the same investment guidelines and restrictions applicable to trustees are also applicable to fund managers.

A custodian whose functions include receiving and keeping in safe custody the title documents, security and cash of the scheme fund, opening a bank account or accounts on behalf of the scheme and keep or cause to be kept all appropriate records of the entire fund together with transactions associated therewith. Custodians have generally been institutions registered under the Banking Act.

Other professionals may be appointed as necessary.

It is important to note that scheme funds may either be segregated, part of a pooled fund or invested in a guaranteed fund.

3.2.3 Conclusion

Although the regulated pensions industry in Kenya is relatively new, with the RBA only established in 1997, the total scheme funds and inflows from RBS now amount to billions of Kenya shillings. Given that this is a growth industry, the relatively stable and predictable character of contribution inflows and pension outflows combined potentially give trustees of scheme funds a very wide choice of investment strategies, despite the restrictions noted above. The predictability of the inflows stems from the fact that contributions in occupational retirement schemes arise from a relationship embedded in an employment contract. When the age profile of scheme members is factored into this equation, it means that contributions will be received in the long term. As a result, fund managers will need to look for new investment opportunities beyond the traditional ones. Opportunities for innovative investment products abound but they must be such that trustees together with their fund managers and the RBA have confidence in them. To deliver market returns on scheme funds, trustees will have to develop alternative investment strategies. Some of these strategies will include investing in other classes of investment like venture capital funds and real estate funds, among others.

3.3 THE INSURANCE ACT

3.3.1 Introduction

All insurance companies in Kenya are regulated by the Insurance Act, chapter 487 (d) of the laws of Kenya. The act regulates all aspects of the operations of insurance companies. For the purposes of this report, we will focus on those areas that relate directly to the scope for investments under the act.

3.3.2 Powers of the Commissioner

The Insurance (Amendment) Act, 2006, created the office of the Commissioner of Insurance who has been granted autonomy, compared to its previous state when it was a department of the Ministry of Finance. The Commissioner of Insurance is the appointed regulator for all insurance companies in Kenya.

Simultaneously the Act provided for creation of the Insurance Regulatory Authority which has as its main objectives:

- Ensuring the effective administration, supervision, regulation and control of insurance and reinsurance business in Kenya;
- Formulating and enforce standards for the conduct of insurance and reinsurance business in Kenya;
- Licensing all persons involved in or connected with insurance business, including insurance and reinsurance companies, insurance and reinsurance intermediaries, loss adjusters and assessors, risk surveyors and valuers;
- Protecting the interests of insurance policy holders and insurance beneficiaries in any insurance contract;
- Promoting the development of the insurance sector;
- Advising the government on the national policy to be followed to ensure adequate insurance protection and security for national properties; and
- Undertaking such other functions as may be conferred on it by this act or by any other written law.

3.3.3 Admitted Assets

An admitted asset is the form in which an insurance company in Kenya may hold assets as prescribed by this Act and the Commissioner of Insurance.

Under Section 42 of the Insurance Act, admitted assets include any property, security, item or interest of a person approved by the commissioner. The section also specifies what assets are not admitted, including:

- An unsecured or, in the opinion of the commissioner, inadequately secured loan;
- An intangible asset;
- Unsecured loans to intermediaries; and
- A loan to, debenture of, or share in any insurer who is related to such a person.
3.3.4 Investment of Assets

Section 48 of the Insurance Act states that subject to any restrictions that an insurer may impose through their own articles of association or other rules of the insurer, “the assets of an insurer shall, with sufficient regard to consideration of security, liquidity and income, be invested in Kenya in such a manner as the insurer thinks fit.”

Section 48 also gives the Commissioner power to authorise investments outside Kenya, but only after considering the above parameters including the need for the insurer to diversify investments. The Commissioner may also impose any other conditions. If, in the opinion of the Commissioner, an insurer has invested assets in unsuitable or undesirable investments, he may give notice to the insurer to show cause why the investment should not be realised.

The Act does not define what may constitute unsuitable or undesirable investments, leaving the Commissioner with some latitude in exercising his powers. Once the Commissioner has made his decision, the insurer has no option but to comply with the directions of the Commissioner.

The admitted assets of an insurer in long-term business in Kenya are, pursuant to section 50 of the Insurance Act, expected to be invested in assets specified in that section. These investments include 20% of the total admitted assets in one or more of the following securities:

- Government;
- Prescribed statutory bodies;
- Local authority;
- Any other prescribed organisation.

At least 50% of the securities in which the insurer may wish to invest long term insurance funds should be securities of the Kenya government of a duration of two years or more.

A further proportion amounting to not less than 65% should be invested in one or more of the following:

- Securities described above;
- Mortgages on unencumbered immovable property in Kenya;
- Debentures, commercial paper, preference shares or ordinary shares of public companies whose shares are quoted on the stock exchange in Kenya;
- Instruments of title to immovable property in Kenya.
- Loans on life assurance policies, as these constitute a liability on Kenyan business within their share value.

- Deposits in banks or financial institutions under the Banking Act. A 5% ceiling is set for investment in any one bank or financial institution. An insurer may deposit a maximum of 5% of the value of the assets of the insured relating to that business in any one bank.
- Any other prescribed securities.
- Promissory notes, bills of exchange or other instruments issued by a company incorporated under the Companies Act. However such promissory notes, bills etc should be guaranteed by a bank.

Under the Insurance Act, insurance companies have restrictions on where they may invest the funds that they are holding. Furthermore, in any class of investments there are restrictions on the amounts that may be invested in any one institution or class of admitted assets. The insurer is, however, free to invest some 15% of the value of the admitted assets as he thinks fit, with due consideration given to security, liquidity and income. However, these 15% should be invested in Kenya.

For an insurer in general business, the conditions will be as indicated above, but given the nature of the short-term or general insurance, the percentage invested in specified investments is lower; i.e. 10% in the following securities: government, prescribed statutory bodies, local authority or any other prescribed organisation.; and only 30% in securities of the Kenya government of a duration of two years or more. This leaves the insurer with discretion over how to invest the remaining 60% of funds.

In most cases, insurance companies have engaged the services of fund managers to manage the funds on their behalf, but normally they follow the insurance guidelines and funds are hardly used for speculative purposes. Again, given the nature of insurance business, any investment must seek to match risks with assets.

3.3.5 Summary and Conclusions

Regarding the investment of resources in the hands of the insurance company, the Insurance Act stipulates the following:

- Admitted assets are defined mainly by reference to what they are not;
- Subject to the act, the insurer may invest funds in the best way he deems fit;
- The insurer must give due consideration to an asset’s security, liquidity and income before investing;
- The Commissioner of Insurance has the power to authorise investments outside Kenya with the additional proviso that he may impose any conditions he deems necessary;
The Commissioner of Insurance has the power to instruct an insurer to show cause as to why any invested assets should not be realised if, in his opinion, the investments are unsuitable or undesirable.

Insurance companies have restrictions as to where they may invest their funds and restrictions as to the amount that they can invest in any one category.

Insurance companies are, however, free to invest 15% of the admitted funds in Kenya as they think fit after due consideration of security, liquidity and income.

In most cases, insurance companies engage the services of fund managers to manage the fund on their behalf.

3.4 THE CAPITAL MARKETS ACT

3.4.1 Introduction

The Capital Markets Authority (CMA) Act was enacted for the purpose of promoting, regulating and facilitating the development of an orderly, fair and efficient capital market in Kenya. This section will highlight the key provisions of the act as it relates to the operations of fund managers, collective investment vehicles and venture capital firms.

3.4.2 Regulation – The Capital Markets Authority (CMA)

The CMA was established under Section 5 of the act to provide overall regulatory oversight to the industry. The authority regulates the Stock Exchange on which securities are traded, it licenses, registers and regulates fund managers and collective investment schemes, and registers venture capital funds and investment banks who advise on offers of securities to the public.

The objectives of the CMA as outlined in Section 11 of the act include the following:

- To develop all aspects of the capital markets with particular emphasis on the removal of impediments to and the creation of incentives for longer-term investments in productive enterprises;
- To facilitate the existence of a nationwide system of stock markets and brokerage services to enable wider participation of the general public in the stock market; and
- To protect investor interests.

3.4.3 Powers of the Regulator

In order to undertake its duties and meet the objectives above, the authority has been vested with extensive powers and duties under section 11 of the act. Powers and duties relevant to this study include:

- Issuing licenses to operate as an investment adviser, fund manager or investment bank and ensuring the proper conduct of that business;
- Granting approval to operate as a registered venture capital fund;
- The registration, approval and regulation of collective investment schemes;
- The appointment of an auditor to carry out specific audits of the financial expenditures of a collective investment scheme or a public company, the securities of which are traded in an approved securities exchange;
- Reviewing and overseeing the issue and subsequent trading, both in primary and secondary markets, of any capital market instrument.

In addition to the duties mentioned above, the authority is also empowered to formulate rules, regulations and guidelines that may be required for effective operations of the industry after consultations with the Minister for Finance.

Some of the regulations the CMA has formulated include:

- Capital Markets (Collective Investment Schemes) Regulations 2001;
- Capital Markets (Licensing Requirements) (General) Regulations 2002; and
- The Capital Markets (Registered Venture Capital Companies) Regulations 2006, gazetted recently.

When developing rules, regulations and guidelines, the authority is required to share them with relevant stakeholders for comments for a period of no less than 30 days.

3.4.4 Licensing Requirements

Under the provisions of Section 23 of the CMA Act, any person who wishes to engage in the business of investment adviser, fund manager, investment bank, authorised securities dealer, stock broker etc is expected to obtain a license from the authority before commencing business. The application for a license has to be made in the prescribed form, and be accompanied by the prescribed fee.

The authority may require any other information it considers critical before granting the license. Any condition that the applicant is expected to meet when a license is granted is a continuing obligation that the licensee must comply with as long as he remains in this business. Presented below are specific requirements for fund managers and venture capital firms.
3.4.4.1 Licensing Requirements for Fund Managers

The specific licensing requirements for fund managers include the following:

- The applicant has to be registered under the Companies Act and must submit the certificate of incorporation together with a copy of its memorandum and articles of association to the authority.
- The paid-up capital is KES2.5m for an investment advisor and KES10m for a fund manager.
- The level of shareholders’ funds shall not be less than KES2.5m for an investment advisor and KES10m for a fund manager for as long as the license is in force and the licensee is in business.

3.4.4.2 Licensing Requirements for Venture Capital Firms

The regulations that are supposed to regulate the registration and management of venture capital companies have only recently been gazetted. Some of the key licensing provisions include the following:

- The company must be incorporated in Kenya under the Companies Act;
- The minimum share capital is KES300m;
- The company must have a demonstrated track record of at least three years or the directors must have an equal demonstrable experience in the management of venture capital funds;
- The company must engage a fund manager who must be licensed by the CMA.

In addition to these basic requirements, under regulation 11, venture capital firms cannot invest more than 25% of the fund value in one company.

3.4.4.3 Collective Investment Schemes

Collective Investment Schemes are regulated under the Capital Markets (Collective Investment Schemes) Regulations 2006.

(a) Application for consent

An application for consent to register a collective investment scheme is submitted to the authority by the promoter of a proposed collective investment scheme, and should be accompanied by:

- The prescribed application fee;
- The documents specified in the regulations outlined below; and
- Any other documents that may be required by the authority.

(b) Documents to accompany the application

- Draft incorporation documents of the collective investment scheme;
- Memorandum and articles of association of the promoter;
- Memorandum and articles of association of the proposed fund manager;
- Business plan;
- One bank reference, and
- Two professional or business references

Consent granted for the registration of collective investment scheme shall lapse after three months.

(c) Application for registration of a collective investment scheme

An application for registration of a collective investment scheme should be made to the authority by a promoter, within three months after consent was granted, accompanied by the following:

- The incorporation documents;
- The information memorandum;
- Audited reports for the preceding three years of the proposed fund manager where applicable;
- Audited report for the preceding three years of the proposed custodian;
- A letter of consent to act as a fund manager;
- A letter of consent to act as a trustee;
- Letter of consent to act as a custodian; and
- The prescribed registration fee.

Licensing requirements for both the fund manager and the custodian of CISs are the same as those indicated above in the regulations relating to general licensing requirement. The duties of the fund manager are broader under the CISs.

One other issue to note in respect to collective investment schemes is that they may be set up under a trust deed and that the trustees of the trust have the same duties and functions to comply with.

3.4.5 Conclusion/Assessment

The CMA Act is crucial for the orderly development of the capital markets in Kenya. This is particularly the case in early-stage markets like Kenya where the necessity for prudential regulation cannot be
overemphasised. This is important to instil confidence in the investing public that the institutions they are dealing with have been properly vetted and that the possibilities of the investors losing money (except through ordinary business risks associated with the investment) is significantly minimised or eliminated altogether through effective vetting and regulatory oversight. However, the period of time it takes to process registrations or indeed identify and deal with possible breaches of regulations may itself discourage the entry of significant players who can identify opportunities for investors in the capital markets industry.

It is therefore important that the regulator — as much as any other authority in this market has the human, financial, technological and other resources for rapid responses and decision making whenever queries, concerns or applications are placed before it.

CMA has extensive powers to regulate the institutions and persons that are involved in advising investors, both institutional and retail, and influences all aspects of the evolution of the capital markets. Consequently, the CMA has a critical role to play in helping shape the inputs that these professionals and other players can give in the development of innovative instruments that may help attract long-term funds for the productive sectors. Funds such as those under the control of pension fund trustees or insurance companies would be an immediate target. The degree of sophistication with which the CMA implements its mandate may either facilitate or hinder the orderly development of capital markets and in particularly the risk capital industry in Kenya.

3.5 THE TRUSTEE ACT

This act applies to trusts. It also regulates where trustees, i.e. persons in whom property has been vested to hold on behalf of beneficiaries, may invest trust funds. As seen above, trustees of retirement benefit schemes are subject to the provisions of this act in addition to or as modified by the investment requirements under the Retirement Benefits Act. A key provision of the act is the requirement that trustees exercise their full fiduciary responsibility to ensure the property they are holding in trust is managed to the best interests and maximum benefits of the beneficiaries. This responsibility tends to drive trustees to be more conservative in their approach to investments.

3.6 THE COMPANIES ACT

The Companies Act deals with the incorporation, regulation and winding up of companies and other associations, and makes provisions for other matters relating thereto and connected therewith.

Two or more persons where a company is to be private, or seven or more persons where a company is to be public, may by subscribing their names to a memorandum of association seek registration under the act as an incorporated company. In addition, the subscribers are expected to submit the company's articles of association setting out how the company is to be managed.

Most corporate bodies, carrying on business in Kenya are registered under the Companies Act. As indicated above, to be licensed as a fund manager by the CMA, the applicant is expected to present a certificate of incorporation together with the memorandum and the articles of association. This implies that the applicant must be an entity registered under the Companies Act and must comply with the provisions in the act.
ASSESSMENT OF THE ATTITUDE AND APPETITE FOR RISK INVESTMENTS

4.1 INTRODUCTION
This section provides an assessment of the attitude to and appetite for risk investment by key players in the fund management and insurance industry. The assessment is based on detailed discussions and interviews with insurance and fund management companies as well as regulators and venture capital firms. First we review the key issues raised by insurance and fund management companies, followed by our assessment of the constraints and opportunities identified.

4.2 INSURANCE COMPANIES
Based on interviews with several insurance companies, the key findings include the following:

- **Current laws are not a binding constraint**: All firms interviewed confirmed that the existing legislative regime did not restrict insurance companies from investing in riskier assets like SME funds. As long as the insurance companies meet the liquidity requirements under the act, they are free to invest discretionary funds as they pleased.

- **Insurance companies are conservative in their approach**: In spite of the lack of legal constraints, very few insurance companies expressed willingness to invest policyholders’ funds in risky assets. At present, most insurance companies adopt a conservative approach to investments and keep their funds in three investment classes: government treasury bills, blue-chip stocks and corporate bonds.

- **Appropriate products required**: Insurance companies felt that funds for investment in SME funds are more likely to come from shareholder funds as opposed to policyholder funds. Those that expressed an interest in investing in SME funds felt that a credible structure or product would need to be put in place to attract investment. Key elements of such an appropriate product would include:
  - Ease of entry/exit;
  - Fund size should not be too large;
  - Specific nature of investments;
  - Management — experience of the promoter is crucial;
  - Premium over other investment classes.

- **Special approval required for offshore investments**: A key constraint identified with existing funds in the market is that most are registered offshore. Insurance companies investing in these funds would be considered to invest offshore, i.e. would require specific approval of the Commissioner of Insurance.

4.3 FUND MANAGERS
Based on interviews with several fund management companies, key findings include the following:

- **Legal framework not a major obstacle**: At present, the legal framework is not a major obstacle to investment in early-stage SME funds, i.e. with the right structure, it would be possible for fund managers to invest;

- **Limited investment at present in venture capital**: Very few fund managers are currently investing in private equity or other forms of risk capital. Reasons for this include:
  - Lack of incentives to invest as there is no pressure from trustees or beneficiaries to diversify;
  - Generally conservative nature of trustees;
  - Perception that regulatory approval is required to invest in venture capital; and
  - Limited knowledge of credible investment opportunities.

- **Increasing/Excess liquidity will drive demand for new products**: Most fund managers confirmed that the size of funds under management is growing and as liquidity increases, there will be a need to diversify into other investments.

- **Need for appropriate structure**: Those expressing willingness to invest highlighted the importance of an appropriate structure that will be attractive to investors. The key elements of the structure are similar to those mentioned by insurance companies.

4.4 KEY CONSTRAINTS AND OPPORTUNITIES
Based on the assessment provided, the key constraints and opportunities identified are presented below.

4.4.1 Key Constraints

- **Conservative nature of pension fund trustees**: This is partly because of their fiduciary responsibility under the RBA Act, but it is exacerbated by the fact that many trustees have limited expertise in investment analysis or appraisal.
4.4.2 Key Opportunities Identified

- **The need for diversification will be a driving force for future investment:** The scope for diversification through these types of funds was appealing to all interviewees. As the market increasingly demand higher returns, fund managers will need to look for alternative vehicles to diversify investments.

- **Excess liquidity in the market:** Interviewees, especially pension fund managers, noted that there was excess liquidity in the market and if well structured funds or products were marketed to them, they would be willing to invest.

- **Importance of trustee education:** Pension fund managers also noted that trustee education about the benefits of these funds would reduce their reluctance towards these asset classes.

- **Customer/demand-side education:** Often the demand side does not know the appropriate kind of money they need and what the alternatives are to banks for raising capital. There is need for financial education from the supply side to the demand side on the availability, the variety and advantages of different capital development instruments.

- **The need for a guarantee element in the early stages:** Because it is a relatively new industry with a limited track record, fund managers all noted that some element of capital guarantee of the funds would make marketing it to their trustees easier.

- **Support from key regulatory institutions:** Both the RBA and the CMA are willing to support the development of this segment of the market. Both institutions, however, will require assistance in moving forward.

- **Investment clubs are an untapped opportunity:** The investment club community in Kenya is a large latent source of capital for investment in early-stage funds. There is a need to properly understand how to tap into this source effectively.

- **Universities, research and commercialisation:** The commercialisation of universities’ research results can help to start enterprise development. In New Zealand, the market capitalisation of companies founded using intellectual property developed by New Zealand universities grew from USD76m to over USD430m between 2003 and 2005. During the same period, the universities’ commercialisation organisations raised...
over USD100m in capital for spin-out companies (New Zealand Venture Capital Association, Ernst & Young, 2006). Many well known companies around the world, such as Google, are the products of university research commercialisation. This is a model that can be adopted by Kenyan universities and venture capital funds.

- **The demand side of the market is growing**: Several funds now operating in Kenya are building a track record and understanding of early-stage SMEs. In the next few years, as they look to raise additional capital, there will be a need to have a conducive environment for domestic institutional investors to invest.
Chapter 5

CONCLUSIONS AND RECOMMENDATIONS

5.1 OVERALL ASSESSMENT

5.1.1 Literature Review

Based on a review of the relevant literature, one can conclude the following:

- Kenya’s market is still in the early stages of development both on the demand and supply side;
- On the demand side, SMEs rely largely on internal and bank financing to finance operations;
- On the supply side, very few funds operate in Kenya, although the number is increasing;
- The pension fund and insurance industry contribute less than 10% of total funding for venture capital in the country, compared to above 30% in some developed countries.
- Although somewhat restrictive, the RBA Act and the Insurance Act both provide for investment in “other asset” classes for which early-stage SME funds could qualify.

5.1.2 Legal Review

Although somewhat restrictive, the Retirement Benefits Authority (RBA) Act and the Insurance Act both provide for investment in “other asset” classes for which early-stage SME funds qualify.

As the above legal review showed, in an emerging market, the issue of whether or not the RBA Act is restrictive or whether the provisions of that act only prudent in its intentions is open to interpretations and there will be grey areas where the regulators will face challenges in their decision-making processes. It is important to look at the legislation in its totality: for instance, trustees could be left free to invest but provide information to the regulator on a regular basis. This reporting period could be shortened to ensure closer supervision, with heavier penalties for those who were reckless with scheme funds. However, this would also increase supervisory costs. In addition, the appointment of trustees of schemes could be vetted more vigorously than they are now. The fact that the investment industry in Kenya is still fairly young made it necessary to impose restrictions on investment activities of trustees, but this makes them risk averse and makes it even more difficult to “secure market rates of return” as envisaged under the regulations.

5.1.3 Field Work

The lack of maturity in the industry translates into the challenge for the regulator and other players in the industry to achieve a balance between freedom to invest and the requirements of good governance and prudential guidelines, and to adapt to growing maturity of systems and structures. As regards other legislation, the Pensions Act 1995 of the UK conferred upon trustees powers to “make an investment of any kind as if they were absolutely entitled to the assets of the scheme”. In the 2004 Pensions Act of the UK trustees were required to prepare and make a statement of investment principles specifying the strategic objectives of the pension fund in respect to investments. In the UK, the latitude to invest given to trustees is somewhat broader than in Kenya, reflecting the maturity of the structures and systems of that economy.

With regard to the Insurance Act, the same assessment applies, as the demarcation between a restriction on investments and a prudential guideline can be debated. For instance, insurance companies are free to invest 15% of their admitted assets in Kenya as they deem fit with consideration only of security, liquidity and income. This requirement of the Insurance Act could be interpreted to be a prudential guideline, but subsidiary regulations also stipulates a category and an amount, making it more restrictive.

The view from all managers of pension funds interviewed was that they had excess cash that they were willing to invest in any new well-structured risk product. They raised various concerns, however, that need to be addressed before they could invest in any long-term risk capital product. There was also consensus that there are too few well-structured vehicles available in the market at present. Indeed, all fund managers interviewed noted that their investments in private equity represented less than 0.5% of their pension funds under management, compared to the legally allowed limit of 5%. However, all fund managers expressed an interest in investing in risk capital instruments.

In contrast, most managers of insurance funds interviewed were more sceptical of the viability of using policy holders’ funds in their care for investment in long-term risk capital products. Yet they did note that there was a possibility of investing shareholder cash in an appropriate product.
5.2 KEY RECOMMENDATIONS

- Support/facilitate the development of a separate investment class for venture capital under the RBA guidelines: FSD should work with the RBA and other stakeholders to develop proposals to include venture capital or private equity as a separate allowable investment class. This will make it much easier for prospective institutional investors to make investments in early stage funds.

- Undertake a best practice review of the existing regulatory and tax regime for venture capital funds: FSD should provide assistance to the CMA to examine further the environment for the establishment of venture capital funds in Kenya. This will entail an additional best-practice review of the existing rules as well as a broader examination of the incentive structure for establishing funds in Kenya vis-à-vis other destinations. Of particular concern is that most funds prefer to register offshore, typically in Mauritius, for tax and other reasons. Another concern is the time it takes to register funds and whether support can be provided to the CMA to allow for a speedier due diligence process.

- Work with the Government of Kenya to develop an appropriate framework that will support the growth of the venture capital industry: FSD should undertake additional research to assess the scope and potential for establishing a structure similar to the US SBA that can finance growth and development of early-stage funds for SMEs. This would entail exploring further the existing fund of funds at the Ministry of Trade and Industry to see whether it can be expanded appropriately. This review would also look into the scope for other instruments like guarantees etc.

- Support the development of an over-the-counter market (OTC) for SMEs: This would help to improve the exit options for venture capital funds.

- Establish market size and share of investment clubs in venture capital: FSD should undertake additional research on the investment club sector in Kenya with a view towards understanding its size and potential to act as a catalyst for investment in early-stage venture capital funds. This work can be done through the Kenya Association of Investment Groups.

- Support additional education of trustees: FSD should provide support through fund managers and the RBA for the education of trustees on the merits of diversification.

- Support financial education of SMEs: As highlighted, many SMEs are not aware of the benefits of different forms of financing and will need to receive education in this area. The newly formed Venture Capital Association could take up this initiative.

- Set up a self-regulation mechanism for existing venture capital funds: To instil confidence in this new industry in Kenya, the Venture Capital Association could develop a vetting process and standards for members to instil confidence in potential investors.

- Support capacity building of existing funds: Provide support to the existing funds to build a credible track record and structure that will be appealing to institutional investors.
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## ANNEX I: LIST OF PERSONS INTERVIEWED

<table>
<thead>
<tr>
<th>Company</th>
<th>First Name</th>
<th>Surname</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>RBA</td>
<td>Nzomo</td>
<td>Mutuku</td>
<td>Head, Research and Policy Analyst</td>
</tr>
<tr>
<td>Kenya Association of Investment Groups</td>
<td>Tabitha</td>
<td>Mwathi</td>
<td>Executive Officer</td>
</tr>
<tr>
<td>Madison Insurance</td>
<td>Joseph</td>
<td>Kahenya</td>
<td>Senior Accountant</td>
</tr>
<tr>
<td>Sanlam Investment Mgt</td>
<td>Rogers</td>
<td>Kinoti</td>
<td>Portfolio Manager</td>
</tr>
<tr>
<td>Sanlam Investment Mgt</td>
<td>Eric</td>
<td>Kibe</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>Genesis Kenya</td>
<td>Wangui</td>
<td>Okello</td>
<td>Fund Manager</td>
</tr>
<tr>
<td>Pan Africa Life</td>
<td>Andrew D.</td>
<td>Greenwood</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFC Financial Mgt</td>
<td>Paul</td>
<td>Orem</td>
<td>Portfolio Manager</td>
</tr>
<tr>
<td>Insurance Company Of East Africa</td>
<td>Tony</td>
<td>Muithiga</td>
<td>Portfolio Fund Manager</td>
</tr>
<tr>
<td>African Alliance</td>
<td>Barrack</td>
<td>Obatsa</td>
<td>Support Portfolio Fund Manager</td>
</tr>
<tr>
<td>Old Mutual</td>
<td>Rick</td>
<td>Ashley</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>RBA</td>
<td>Charles</td>
<td>Nyakundi</td>
<td>Chief Compliance Officer</td>
</tr>
<tr>
<td>Business Partners International</td>
<td>Sally</td>
<td>Gitonga</td>
<td>Country Manager</td>
</tr>
<tr>
<td>Trans-Century Group</td>
<td>Tony</td>
<td>Wainaina</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>Bridge Works Africa</td>
<td>Milton</td>
<td>Lore</td>
<td>Country Manager</td>
</tr>
<tr>
<td>Aureos Capital</td>
<td>Peter</td>
<td>Njoka</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>Grofin East Africa Fund</td>
<td>Kenneth</td>
<td>Oyando</td>
<td>Kenya Country Manager</td>
</tr>
<tr>
<td>Capital Markets Authority</td>
<td>Edward</td>
<td>Ntalami</td>
<td>Chief Executive Officer</td>
</tr>
</tbody>
</table>
Questions for Insurance Companies and Fund Managers.

1. Generally what type of investments do you make with your managed investment funds?
   a. Estimate percentage in various sectors;
   b. What is the time horizon for these investments?

2. What are your investment choices guided/restricted by?
   a. If legislation what legislation?
   b. Elaborate on any other answers.

3. What kind of companies do you consider to be SMEs?

4. What is your impression of the SME sector in Kenya?
   a. Prospects/future?
   b. Size?
   c. Is it a sector with any opportunities for investment?

5. Have you ever invested in the SME sector in any way (i.e. debt and or equity)?
   a. If yes, roughly describe the type of companies invested in and whether it was a successful venture.
   b. If not, why not and have you ever considered any such an investment?

6. Please describe any impediments to you making such an investment.
   ii. Are there any circumstances under which you would make such investments?
   iii. Any ideas on what needs be done to make this type of investment attractive/viable (Recommendations)?

Questions for Venture Capital Funds

1. What kind of companies do you consider to be SMEs for your investment choices?
   a. What is your general investment size for SMEs?
   b. What guides your choices to invest in a particular SME?

2. What is your impression of the SME sector in Kenya?
   a. Prospects/future?
   b. Size?

3. What is your impression of the ease of investment in SMEs in Kenya?

4. Are there any impediments to equity investments in SMEs in Kenya?

5. In your opinion what changes if any, need to be made in to improve the environment for investment in SMEs in Kenya?

Questions for Regulators

1. What kind of investments are your licensees allowed (legislatively) to make?

2. Are your licensees permitted to invest in SMEs? If so, to what extent, if not, why not?
3. What is your impression of the SME sector in Kenya?
   a. Prospects/future?
   b. Size?

4. Do you think investment in SMEs is advisable for your licensees?

5. Have you licensees made any requests for changes in the current legal regime to enable them invest in SMEs? Do you have any plans to change your licensees rules to enable them easily invest in SMEs?
1.0 INTRODUCTION

On 14 December 2007, representatives from Strategic Business Advisors (SBA) Ltd. presented their draft report, “Profiling of Local Institutional Investors with Potential to Invest in Early-Stage Investment Funds Targeting Small and Medium Sized Enterprises (SME)”, to key stakeholders in the venture capital (VC) industry.

1.1 REPORT OVERVIEW

The report presented to stakeholders provided a profile of institutional investors in Kenya and an assessment of their attitude to, and appetite for, investment in early stage investment funds targeting SMEs. The report was commissioned by GrowthFin, a programme of the Financial Sector Deepening (FSD) Trust that works with policy makers, donors, industry associations and financial institutions to identify and overcome impediments to the provision of financial services to SMEs.

1.2 OBJECTIVES OF THE STUDY

The key objective of the study is to provide a systematic documentation of:

(i) The legal and regulatory framework for the use of long-term funding for risk investments;
(ii) A census of the availability of long-term funds in Kenya; and
(iii) A representative survey of the attitudes of holders of these funds to risk investment in particular with respect to SMEs.

1.3 STAKEHOLDER WORKSHOP

The stakeholder workshop was held at Lenana House, Nairobi. The event had close to 20 participants who participated fully in the question and answer session. The attendees included representatives of pension funds, venture funds, various local banks, among others:

1.4 WORKSHOP METHODOLOGY

James Kashangaki, Head of Growthfin, FSD Trust, welcomed participants to the workshop. He provided an overview of the objectives and rationale for the study. He then invited SBA to give their presentation. SBA’s Mr. Kashangaki focused on the policy aspects and Mr. Simba focused on the legal aspects of the study. The presentation had four main elements:

• Introduction and overview of the methodology to the study;
• Assessment of the market for investment in early-stage SME funds;
• Review of the legal environment; and
• Key findings and recommendations.

Thereafter, feedback and opinions were sought from the delegates. Feedback from the industry was collated and will be used to firm up the final report.

1.5 WORKSHOP DISCUSSION

Below is a summary of the key issues?

• Universities’ research commercialisation: Some of the research by universities could be used to start commercial enterprises. It was suggested that pension funds for universities
could be a potential source of funding for such research with commercial potential. Mr. Simba informed the participants that the University of Nairobi previously did not have an intellectual property policy, therefore once research on inventions and processes had been completed, no revenue streams were created for investors or the university. However, the university has now developed an intellectual property policy and is creating strategic partnerships with the business community to promote and commercialise products developed through the university’s research arms. For instance, the university developed numerous soaps and detergents, yogurts and even computer systems and software.

- **Guarantee scheme:** A participant highlighted the report’s recommendation that the possibility for a guarantee scheme to support SMEs should be looked into. The participant felt that this was a good idea and should be explored further.

- **Over the counter (OTC) market:** A participant supported the report’s observation that a key constraint for risk funds in Kenya was appropriate exit mechanisms for investors. He suggested consideration of an OTC market to facilitate exit from SME funds. Mr. James Kashangaki informed participants that the FSD Trust was currently in talks with appropriate parties on the development of an OTC market.

- **Need for education:** A participant observed that one problem on the demand side was that the customer did not know the kind of money he needed and what the appropriate avenues for raising capital other than banks were. The participant observed that there was a need for financial education from the supply side on the availability, the variety and advantages of different financing instruments.

- **Venture capital association:** One of the participants informed the group that a venture capital association for Kenya was in formation and would be important to developing the venture capital market. It was agreed that some of the recommendations made in the consultants’ report could possibly be taken up by the new Kenya Venture Capital Association.

- **Sources of capital for venture funds:** A participant asked for more information on the sources of capital for existing funds, and the extent to which sources are social investors or purely commercial investors. In addition, information was sought on whether existing funds operate only in Kenya or regionally. The participant recommended that the report highlight possible sources of capital for venture funds.

- **Comparative data:** Several participants asked for more comparative data (where possible) on the regional and African market. Mr. Kashangaki of SBA noted that comparative data on regional markets were difficult to obtain but efforts would be made to include some in the final report.

- **Structure of the investment:** There was general agreement with the report that the structure of the investment was an important consideration for fund managers. One participant noted that key issues looked at by investors include:
  
  (i) Track record of the fund and the manager;
  
  (ii) Disclosure;
  
  (iii) Structure of returns; and
  
  (iv) Regularity of reporting of returns.

- **Sources of funding:** A participant highlighted the fact that Kenya’s venture capital industry was still in the early stages of development, so the majority of investors tended to be social investors and quasi-government investors. Most reasonably large funds source their monies from external sources. Few funds try to raise funds locally.

  - Legal and regulatory framework: It was observed that since the Capital Markets Authority (CMA) rules have been gazetted, the legal and regulatory structures should now be in place for the development of early-stage funds.

  - There was discussion among participants on the risks associated with SMEs and the lack of appropriate information on the sector. It was pointed out that although risks exist, there was still considerable potential to provide funding to this segment of the market. It was interesting to note that a few years back no-one would have imagined that an international investor would invest KES11 billion in a “mom and pop bank” called Equity Bank. What was needed was a venture capital fund to take this model and strive to become the Equity Bank equivalent of the venture capital industry.

  - It was agreed that regulation would be necessary in a country like Kenya to address investors’ risk perceptions, hence the importance of the CMA. It was also agreed as highlighted in the report that the CMA would require some level of capacity building to enhance its role as a regulator. In addition to the CMA, it was suggested that the venture capital association could be a source of investor confidence. The association could provide some sort of peer review, relay information on fund managers and develop a disciplinary or self-regulatory mechanism.

- **SME definition:** There was lively discussion on the definition of SMEs and the fact that different institutions define it differently. Some define it by number of employees, others define it by turnover. FSD felt strongly that definitions that focus only on turnover or number of employees was limiting. The institution supports a wider definition of an SME to be “a firm whose transactions and operations are too complex for microfinance and too risky for the mainstream lending industry”.

- **Enabling environment:** One participant noted that funds based in other countries but operating in Kenya are considered foreign funds. The benefit of incorporating funds offshore, e.g. in Mauritius, used to be avoidance of the capital gains tax. However, since this has been removed, fewer advantages remain. Some funds still prefer incorporation in Mauritius for tax reasons. If the fund is engaged in a lot of cross-border activity, it receives a tax credit from the Mauritian government, which is
not the case in Kenya. In addition, venture capital funds are not subject to taxation of dividends and capital gains. It was agreed that there was a need for a more in-depth review of the regulatory environment for funds to ensure that it was competitive with other countries like Mauritius.

1.6 WORKSHOP CONCLUSIONS

Presented below are the main points the workshop participants recommended to be included in the final report.

- Benchmarking: It was felt that the benchmarking done against developed countries (UK, US, Canada, Japan, Germany, Israel) in the draft report was somewhat remote and a regional context should be included as part of the final report. Suggested countries for comparison were South Africa, Nigeria, Botswana, possibly some Asian countries and New Zealand.

- Sources of funding for venture capital funds: In addition to the sources of funding presented in the draft report, it was suggested that if possible the final report could clarify generally whether funds are local or external and whether the funds are purely commercial investments or social investments.

- Other comments: There were various other comments, e.g. greater emphasis on the OTC market as an exit strategy, that were made during the interactive session presented in section 1.5 that will be included in the appropriate sections of the report.

1.7 SUMMARY

The consultants were thanked for their presentation and workshop participants for sharing their time and expressing their views. It is SBA’s intention to use the workshop data to address the gaps identified in the draft report during the workshop and incorporate them in the final report. Once received, FSD would share the report with stakeholders.