Economic Development Institute of The World Bank

"Developing Financial Markets in Sub-Saharan Africa"

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EDI WORKING PAPERS
FINANCE, INDUSTRY AND ENERGY DIVISION
Developing Financial Markets in Sub-Saharan Africa

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Abstract

This paper briefly reviews the role of financial markets in the development process, classifies the different types of markets and discusses the obstacles to and requirements for the development of these markets in the Sub-Saharan African region.

EDI Working Papers are intended to provide an informal means for the preliminary dissemination of ideas within the World Bank and among EDI's partner institutions and others interested in development issues. Copies are available from Edith A. Pena.

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Foreword

The focus of EDI's program on the financial sector is on the improvement of decision-making in seven important areas dealing with the structure, reform and development of financial systems in developing countries. The areas covered are:

- reforms of the structure of financial systems;
- policies and regulations to deal with insolvency and illiquidity of financial intermediaries;
- the development of markets for short- and long-term financial instruments;
- the role of institutional elements in the development of financial systems;
- the links between the financial sector and the real sectors, particularly in the case of restructuring financial and industrial institutions or enterprises;
- the dynamics of financial systems management in terms of stabilization and adjustment; and
- access to international financial markets.

The program is articulated around cycles of regional and worldwide roundtables and seminars. Policymakers and professionals are brought together to discuss agendas of specific issues and problems, often identified beforehand by the participants themselves. The papers circulated at these seminars are published in the EDI Working Papers series, to make them available to a broader audience than is possible within the framework of the seminars themselves.

This paper was presented at the Senior Policy Seminar on Financial Systems and Development in Africa, held in Nairobi, Kenya from January 29 to February 1, 1990. The author is Senior Financial Economist in the Industry and Energy Division of the Technical Department of the Africa Regional Office of The World Bank. The views presented in this paper, however, are entirely those of the author and do not necessarily reflect those of The World Bank.

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Introduction

There are several reasons for developing financial markets, all of which relate ultimately to improvement in financial intermediation which is a key factor to economic growth. Broadly, these reasons can be grouped into two categories, with different intermediate purposes and different time horizons. One category groups reasons primarily and directly related to improvement in mobilization and allocation of financial resources. The other category groups reasons indirectly related to this improvement through their direct aim of facilitating the management of liquidity and money in an economy.

Of course, from reasons of the first category to reasons of the second category and vice versa, the causality is reciprocal. Better management of liquidity and money offers greater potential to improve mobilization and allocation of financial resources. Better mobilization and allocation of financial resources offers a financial environment conducive to better management of liquidity and money.

The pursuit of both these objectives requires and leads to deepening financial markets.

The Importance of Developing Financial Markets

The ultimate function of financial markets is to increase the financial resources available to the economy and to enable a more efficient use of those resources, that is, to facilitate financial intermediation and its management, in order to stimulate and accelerate the process of economic growth. Hence, financial markets are essential for the efficiency and solvency of financial systems and for the effectiveness of management of liquidity and money in the economy.

Financial markets intermediate in both debt and risk capital finance. In essence, the supply of these two types of funds stems from two different functions: a lending function and a venture capital function. A lender has a different perception of risk and, therefore, different expectations with regard to the application, reimbursement and yield of its funds than a venture capitalist. The latter is ready to take more risks and losses in order to maximize profit.

Money markets deal in short-term debt instruments and securities markets deal in long-term debt and equity instruments.

While the general role of capital markets is also to mobilize savings and channel them into productive investments, their primary--though not unique--role is to provide long-term debt financing and risk capital, through issue of bonds and shares, for investment in long-term assets. In addition,
by providing access to risk capital and long term financing, securities markets help to strengthen the financial structure of corporations and improve the general solvency of the financial system.

By increasing the range of financial instruments available to savers and investors, financial markets contribute to increased competition in the financial system and help channel resources toward the highest return investments for a given degree of risk. This, in turn, stimulates economic growth and lowers financial intermediation costs.

Moreover, the level of development of financial markets is an important determinant of the flexibility and pace with which the financial system can adjust to internal and external change and absorb shocks. The simple reason is that money and securities markets represent the deep end of the financial system, and the deeper the system, the greater its stability and resilience. Many developing countries today are faced with difficult adjustment problems that can be considerably eased by a well developed and flexible financial system.

Finally, by developing financial markets, a domestic financial system can be linked to the international system, thereby enhancing capital flows and creating new opportunities for risk-reducing portfolio diversification.

Financial Markets Development

These general reasons apply in the countries of Sub-Saharan Africa where some of their aspects reflect specific features of the region's financial systems. One of these aspects is enhancing competition in the financial system through diversification. Another is providing an institutional framework for monetary management.

Enhancement of Financial Competition

Seen in perspective, the approach to the development of financial systems in Sub-Saharan Africa has, hitherto, tended to focus on the banking system, including for the purpose of this presentation, development finance institutions. As a result, the development of nonbank financial institutions and financial markets kept receiving lower priority. This approach reflects two factors. Firstly, it reflects the financial policy focus of most countries in Sub-Saharan Africa. No sector is more regulated than the banking sector. Nor is there a sector with such apparent abundance of financial resources ready to meet budgetary needs. Secondly, it reflects the urgency of existing problems, and there are many important and threatening problems in financial sectors in Sub-Saharan Africa. Probably the most pressing one today is the financial distress that plagues many financial systems.
Overfocus on the banking sector is, in a sense, a self-feeding process. The prevailing policy concentration and the problems' immediate urgency capture attention and resources and reinforce the focus on what is, and should be, only a part of the financial system. This process leads to the relative neglect of the nonbank part of the financial system. To the extent that, in the long term, the ultimate objective is to strengthen the financial system and make it more resilient to external shocks, this process is self-defeating.

Indeed, to achieve its objectives, the financial system must be efficient and solvent. Since efficiency is best promoted by competition, dilemmas arise when competition cannot be promoted to the same degree in all segments of financial markets. This is because in bank-centered financial systems, which are common in many countries of Sub-Saharan Africa, the main component, namely the commercial or deposit-taking banks, have exhibited, and perhaps may even have to exhibit, strong oligopolistic features in the interest of institutional stability and solvency.

But solvency and efficiency may be at odds and lead to a contradiction in promoting bank-centered financial systems: operational considerations tilt the policy toward fewer and larger units, but this diminishes real competition and therefore eases pressures for efficiency while intensifying the risk factor. There is another practical problem in achieving long-term competitive conditions in a bank-centered financial system. The process of competition itself is not necessarily a stable equilibrium; after a while, the strong institutions eliminate or absorb the weak and inefficient ones. This, then, results in sector concentration that may again have monopolistic overtones. Moreover, recent studies of modern banks have shown that larger unit size and fewer numbers do not necessarily lead to economies of scale.

Hence, it becomes necessary to find other, more meaningful sources of competitive pressure while preserving the solvency and restraining the risk concentration in the banking sector.

This is where development of money and capital markets can play a crucial role. The lower capital requirements and the greater importance of entrepreneurship in nonbank financial institutions mean that two out of three factors that make a market competitive are being introduced: greater number of participants and greater ease of entry (the third factor being transparency and information flow). Development of money and capital markets should lead to a higher degree of competition and, therefore, transparency.

Thus, in seeking to bring about efficiency through competition, the focus on competition within the banking sector may be misplaced. Rather, it may
be useful to redirect attention to intersectoral competition between deposit-taking banks on the one hand and nonbank financial institutions on the other. Public authorities could continue to promote safety, solvency, and possibly economies of scope through high capitalization, large units, and cautious liquidity and solvency policies, while at the same time prodding banks to be more efficient through competition from the money and capital markets, institutional investors, and specialized quasi-banking institutions such as leasing, venture capital companies, hire purchase, check discounting, and the like. Only a few countries have pursued such policies consciously and systematically: United States, Canada, Japan, Brazil, Malaysia, Thailand, and the Republic of Korea. In all these cases, the result has been healthy and viable markets.

Hence, one among reasons related to improvement in financial intermediation, particularly in Africa, is the introduction of competition in the financial system by removing the policy overfocus on the banking system.

*Developing an Institutional Framework for Monetary Management*

Effective management of liquidity and money, an essential function of monetary authorities, ultimately aimed at maintaining a stable level of prices and a situation of the balance of payments that is sustainable in the long term, requires relatively developed financial markets and in particular relatively developed money markets.

Monetary authorities use basically two ways to manage liquidity and money in an economy. The first is through the extension of direct controls. The second is by indirect ways and means aimed principally at influencing the levels of banks' reserves and, in some cases, of interest rates. Indirect monetary management is generally considered far superior to direct monetary management in terms of effectiveness and efficiency as well as in terms of unwanted or undesirable side effects which are fewer and less pronounced. In particular, indirect monetary policies and instruments are better and wider transmission mechanisms and affect liquidity conditions and interest rates in the economy at large. This is in contrast with direct monetary policy and instruments whose effect is predominantly restricted to the targeted financial institutions and whose undesirable side effects are numerous and pernicious to financial intermediation. Finally, indirect conduct of monetary policy permits monetary authorities to modulate this policy better, because it opens more policy options and permits the use of alternative monetary instruments. This is the reason why many developing countries are today striving to shift their monetary policies from control of liquidity and money through direct instruments toward management of liquidity and money through indirect, more market-oriented instruments.
Developing Financial Markets in Sub-Saharan Africa

There are several countries in Sub-Saharan Africa that have initiated or have been pursuing for some time this shift from direct to indirect ways and means to manage money. Among them are Ghana, Kenya, Madagascar, Malawi, Zaire, and several others.

But indirect monetary management, as mentioned earlier, requires a sufficient level of development of financial markets and in particular of money markets. Hence, the importance in Sub-Saharan Africa of developing them.

The Financial Market

In the broadest sense, a market is an institutional arrangement in which demand and supply meet to establish the exchange of goods or services at a price. A financial market comprises two distinct types of markets: a money market and a capital market. A money market—which frequently includes an interbank market—is for short-term debt instruments and serves to redistribute cash balances in accord with participants' liquidity needs. It also forms a basis for the management of liquidity and money in the economy by monetary authorities. A capital market is distinguished from a money market by the longer term of the financial instruments and dealings in equity. These instruments are issued and traded through institutions, the nature of which depend upon whether they deal in debt, equity, or combination of the two.

The Money Market

The role of the money market is twofold: (a) the objective of the money market is to provide the public and private sectors with means to raise short-term money and invest cash for short periods of time with the understanding that it can be quickly liquidated and, thereby, allocate the financial system, economic agents, and the Treasury to adjust their liquidity position frequently; and (b) by so doing provide a basis and a framework for the management of liquidity and money by the monetary authorities.

Money market instruments have four main characteristics:

- They have short-term maturity,
- They have good credit-worthiness, that is, they are created by institutions with good credit ratings,
- They are highly liquid,
- They are bought and sold in large denominations to reduce transaction costs.
The specific type of money market instruments employed and their quality level varies from country to country. In Sub-Saharan Africa, the main money market instruments employed are treasury bills, short-term draft, and in several countries, government securities.

It is important to note that there is an inextricable link between the money market and the capital market. In many instances, the same financial institutions will be actively involved in both markets and will use the money market to provide liquidity for their longer term investments. It has been observed that in the process of financial markets development, the development of a money market typically precedes development of a capital market.

The Capital Market

Within a capital market, a distinction can be made between securities and nonsecurities segments. The nonsecurities segment is characterized by institutions of a banking nature, including savings and loan institutions, housing finance institutions, and commercial banks. Typical instruments within the nonsecurities market are debt related, such as term loans and mortgage. In contrast, the financial instruments which form the basis of the securities side of the capital market are mostly equity or quasi-equity in nature, such as shares. The players in the market are also different. In addition to banking institutions, the securities market usually contains investment bankers, brokers, and venture capitalists.

Of the various types of markets hitherto mentioned, the securities market is the most difficult to create. In general terms its purpose is:

- to mobilize long-term savings to finance long-term investment;
- to provide risk capital in the form of equity or quasi-equity to entrepreneurs;
- to encourage broader ownership of productive assets; and
- to improve the efficiency of capital allocation through a competitive pricing mechanism.

Typically, the primary users of a securities market are new or expanding businesses. A firm will usually seek access to the primary market only on special occasions, while it takes care of its daily business through the commercial banks. Entry into the primary market may be made by selling securities directly to investors, but more likely the sale will be made through intermediaries. These intermediaries include brokers, dealers and investment merchant bankers, all of whom purchase securities from issues for resale to the public.
Primary and Secondary Markets

Secondary markets are necessary adjuncts to both the money market and the capital market. Primary markets are essentially those markets in which primary sales of financial instruments, short- and long-term are made; secondary markets are those in which these instruments are traded.

The ability of a public or private entity to use the primary market as a vehicle to raise short- or long-term funds is largely dependent upon the liquidity of the market. Lenders or investors do not want to be locked into a commitment for an indefinite period of time; rather, they want some means of exchanging their loans (sometimes securitized) or investments for cash. The secondary market, therefore is a critical adjunct to the primary market. The main function of a secondary market is to provide organized means of trading short- and long-term financial instruments to provide cash to lenders and investors. Trading in this market occurs through discount houses, dealers, and brokers who may or may not take positions in the instruments traded, merchant banks, and in either organized stock exchanges or over the counter.

Financial Markets' Depth and the "In-Between Market"

Financial markets' depth is usually measured by relating monetary and financial aggregates such as M1, M2, M3, and dcM4* to the GDP. But this measures masks qualitative features of financial markets development.

These features are the range and diversity of instruments and markets as well as the degree of markets integration. From this qualitative standpoint, it can be said that financial markets are deep when:

- They offer savers and investors a broad range of financial instruments different in terms of liquidity, yields, maturities, and degree of risk, including debt instruments, equity instruments and in between, quasi-equity instruments.
- They encompass a diversity of markets--or sub-markets trading in different financial instruments.
- These financial markets are linked through financial instruments and through financial institutions with functions of market makers and brokers.

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* The "dc" stands for "domestic currency."
When mature, domestic financial markets are integrated into the international financial market.

Hence, a mature financial market can be visualized as one market encompassing a number of submarkets trading in a number of financial instruments, with a market for very short-term debt maturities at one end and another for quasi-equity and equity finance at the other end, animated by a number of bank (at one end) and nonbank financial institutions (at the other end) including commercial banks, finance companies, discount houses, dealers, brokers, merchant banks, investment companies and mutual funds, venture capital companies, and stock exchanges.

The depth of the market is to a large extent determined by the markets, mechanism, instruments, and institutions that intermediate (in sequence) between the short and long-term of the market. To the executive manager of one of the largest stock exchanges of the world: "the strength of the market comes from the middle." This aphorism is germane to the situation of several countries of the region which have at one end a budding money market and at the other a stock exchange, with few component to ensure "in between trading and intermediation." That is the area where, ultimately, the main part of the endeavor of developing financial markets in Sub-Saharan Africa should focus.

As mentioned above, the next level of development for a mature market occurs when it integrates into the international financial market.

Development of Financial Markets

Evolutionary vs. Planned Approach to Developing Financial Markets

The role played by governments in the evolution of financial markets has been significant in most countries. One can generally find laws governing the structure of financial markets--banking acts, companies acts, securities acts--that have been implemented to structure and guide financial market activities. Monetary and fiscal policies have had an especially important bearing on the rate and course of development of financial markets. The predominant experience in money and capital markets development, however, has been an evolutionary one, and policy measures concerning them are often taken in a rather piecemeal way, at the expense of long-term objectives and consistency. Only a few countries have taken a more actively planned approach, such as the use of laws, regulations and other policy instruments to stimulate the development of capital markets in a specific direction. With hindsight, this actively planned approach to the development of money and capital markets has proved to be desirable and
beneficial. It has been shown to have a number of advantages leading to the strengthening of financial systems and financial deepening:

- A planned approach fosters the broadening of the range of market instruments and participants, allows the capital flowing through it to be priced rationally and, therefore, to finance the most productive opportunities. Concomitantly, it permits more rational planning of long-term industrial development, since long-term sources of funds--both debt and equity--can be tapped to match long-term investment commitments.

- It stimulates financial resource mobilization by offering to savers, investors, and borrowers more varied risk/return choices and a more efficient means to adjust their portfolios to meet changing circumstances. For institutional investors, the ability to adjust portfolios to liquid markets means a lower cash liquidity requirement and, thus, a lower intermediation cost.

- It forestalls the emergence of unofficial markets usually characterized by wide spreads, high risks, and tax evasion.

- It introduces immediately the right technology, adapted to local conditions.

Requirements and Ingredients

In the first place, both the development of money and capital markets is dependent upon the health of the economy, which implies that policies for efficient economic development have an important bearing on their future. Investors are very sensitive to political or economic uncertainty. Hence, a combination of macroeconomic and sector policies aimed at the maintenance of political stability, steady economic growth, and low inflation is necessary to foster an environment conducive to the harmonious development of money and capital markets. This also means that government policies must promote the efficient allocation of resources, in accordance with market forces rather than government directives, and allow enterprises and entrepreneurs to respond to undistorted market signals.

Some of the more commonly observed policies that distort market signals and discriminate against capital market development include the following:

- *Tax policies* that are more favorable to interest earned on bank deposits than on yields from stock and bonds.
- Credit policies that give priority of access to a certain sector or type of investment.

- Interest rate policies that hold interest rates below market levels, thus reducing the cost of borrowing and encouraging debt financing instead of equity financing.

Policies that interfere with market signals lead inevitably to distortions in the risk/return relationships of different investment choices. The effects of these distortions are to prevent resources from being channeled into the highest return investments and to reduce the supply and demand for securities, hence thwarting a balanced development of capital markets.

Promoting the Supply of and Demand for Financial Instruments

The following is a quick check list of the most common impediments to the increase in supply and demand for financial instruments in the field of finance that are meant to have rapid, punctual effects; policies for developing money and capital markets require a more long-term approach which consists of the systematic removal of impediments to their development as well as the establishment of an adequate framework of policies, laws, and regulations.

Obstacles to Larger Supply of Financial Instruments

Frequently, the main problem in securities market development is that companies do not raise finance through the securities market, but instead rely on internal funds, bank finance or other borrowing. In developing countries, companies' securities are usually "closely held," that is, held by individuals or groups closely aligned with one another. Therefore, a main step in financial markets development is to determine why businesses do not raise long-term finance through the securities market and formulate measures to encourage an increase in the use of these markets. The following are some of the main elements that experience has shown to limit the supply of securities:

- Government allocated or subsidized credit.

- Tax limitations. The tax environment in developing countries is almost always biased against financial markets development. One common impediment to an increased supply of securities is the tax advantage given to debt financing as opposed to equity financing. Interest on debt is tax deductible. Dividends are not tax deductible and are taxed twice—once at the company level and once at the shareholder
level. Moreover, the capital gains shareholders obtain upon sale of securities may be subject to excessive taxation, encouraging them to retain their shares and take out profits in dividends and various undeclared payments.

- **Blanket insurance of bank deposits.**

- **Fixing of issue price.** A major impediment to public issues is the arbitrary determination by the authorities of the price at which an issue can be offered in the market.

- **Fixing of brokerage and underwriting commissions.**

- **Queuing.** Companies that plan public offerings are subjected to government enforced share-offering procedures which favor government and not market priorities.

- **Explicit or implicit limitations on types of securities,** such as bonds, convertibles, or negotiable commercial paper.

- **Approval requirements** for the issuance of securities.

- **Listing requirements** that are excessively constraining.

- **Excessive limitations on foreign shareholding.**

- **Preemptive rights.** The practice of granting preemptive rights to existing shareholders to purchase all new shares--and sometimes debentures and bonds--issued by a company is another serious constraint to the supply of securities.

- **Inadequate understanding on behalf of the entrepreneurs** of corporate financing techniques.

- **Investment incentives.**

- **General government interference in business.**

There are fewer obstacles to the development of short-term financial instruments that can be strongly promoted through the introduction of treasury bills and other government short-term paper.
Obstacles to a Greater Demand for Financial Instruments

If one of the main problems in financial markets development is impediments to the increase in supply of short-, medium- and long-term financial instruments, countries with underdeveloped markets can also suffer from limited demand for such instruments. The main reasons are again tax laws, lack of transparency and information, lack of adequate mechanisms to finance securities transactions, lack of a secondary market ensuring an adequate degree of liquidity, constraints on foreign exchange convertibility and repatriation of dividends and capital, poor market performance, lack of adequate accounting and auditing standards, weaknesses in the legal system and in the mechanisms available to enforce contracts, together with lack of confidence in the markets' institutions and operations.

Developing a Critical Mass of Regulations, Institutions, Markets, and Skills

Finally, in addition to the general economic environment and the existence of a sufficient supply and demand of short-, medium- and long-term financial instruments, there are other legal and institutional factors that are critical to the successful development of capital markets. These include:

- The existence of a sufficient number of market intermediaries such as brokers, dealers and underwriters.

- Reasonably well developed accounting, auditing and disclosure standards, so that financial information is available, transparent and accurate.

- Establishment and vigorous enforcement of rational and comprehensive legal and regulatory frameworks, so that abuses are prevented and investors protected. This is extremely important for maintaining the integrity of the financial system and sustaining investor confidence.

A sound and rational development of capital markets requires, therefore, not only favorable policies, but also the establishment of the legal and institutional infrastructure to support the operation of such markets.

Translating the Theoretical Objective Into Institutional Reality

Enhancing the efficiency of financial intermediation and deepening financial markets are interrelated objectives. Other things being equal, the
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Deeper the financial markets are, the more potential they offer for the efficiency of financial intermediation. This is because, as financial markets deepen, they offer savers and investors increasingly diversified financial instruments not only in terms of maturity and liquidity but also in terms of risk factor; fully developed financial markets offer both debt and risk capital finance.

As mentioned earlier, the supply of these two types of funds stems from two different functions: a lending function and a venture capital function. This differentiation between the lending and the venture capital function has several implications, some of which are more pertinent to developing financial markets.

One of these implications is that most of the financial institutions found in developing financial markets are specialized in one or two functions. This early specialization is a feature that has been observed frequently in the process of financial markets development. There are several reasons for this. A unique learning curve is easier to follow than a multiple one. Scarcity of skills and techniques call for utilizing them more narrowly than when these are abundant. Finally, less developed financial markets offer a pattern of financial operations that induces specialization. As financial markets develop and their markets begin to overlap, financial instruments to bridge markets multiply, and term transformation diversifies, there is more scope for "universalization" of financial institutions. This may happen in particular if the regulatory framework is conducive to such a development.

Specialized institutions in developing financial markets seek to maximize returns on a limited range of operations and instruments thereby concentrating their resources and skills or well-defined objectives. To the contrary, universal institutions in developing financial markets are likely to be unable to pursue all different opportunities open to their financial operations with equal vigor and determination. By virtue of the development process they are likely to concentrate on operations in which the skills and technology they command provides them with a tangible comparative advantage, leaving other opportunities only marginally exploited.

Although this point is still debated by scholars and experts, there are indications that there may be economies of scope, if not of scale in financial institutions specialization in earlier stages of financial development. An additional argument for cautiously promoting such a specialization, is that supervision and regulation of specialized institutions is considerably simpler and easier than that of universal ones.

Hence, a possibly desirable strategy of financial development and market deepening in most countries of Sub-Saharan Africa is to encourage
specialization. Conversely, financial functions that do not correspond to their main specializations should not be imposed on financial institutions. For instance, commercial banks are geared for short- to medium-term depositing and lending, the latter with collateral. This is the fundamental nature of their operations dictated by the maturity structure of their liabilities. They are not financial development institutions or market makers. This function belongs to merchant banks and brokers. Merchant banks and brokers, in turn, are not venture capitalists. This function belongs to venture capital funds. A strategy of development of financial markets should take these specificities into account.

**Development of Money Markets**

The development of money markets most of the time precedes the development of a securities market. Skills, techniques, instruments and institutions emerge and develop more easily at the shorter term end of the financial markets. They later expand and diversify toward the securities and stock markets. Hence, a strategy of financial markets development in countries of Sub-Saharan Africa should concentrate on fostering first primary and secondary money markets and related instruments and institutions.

**Toward the Emergence of a Capital Market**

The development of a capital market usually follows and builds upon the development of primary and secondary money markets. There are few, if any shortcuts to collapse this time sequence. Most developing countries have leasing companies and development finance institutions that supply long-term finance and some risk capital. Without active financial markets surrounding and supporting them, however, these institutions' financial contribution to intermediation is, by necessity, limited. They stand like isolated bridgeheads waiting for the capital markets to develop around them.

But, as mentioned earlier, development of a capital market calls for a number of prerequisites which are worth repeating:

- sufficient supply of securities;
- sufficient demand for securities;
- tax neutrality toward financial instruments;
- a critical mass of merchant banks, brokers and other market makers;
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- adequate information standards including proper auditing capacity and adequate information flows; and

- a minimum population of enlightened investors.

It follows that a strategy most countries of Sub-Saharan Africa might consider in order to develop a capital market is, in a first stage, strengthen and expand these money markets' trading and market making functions and activities that are easily transferable into capital markets operations. On the way toward developing these markets, some mechanisms and institutions could be added, while the prerequisites mentioned in the preceding paragraph develop.

**Strengthening and Expanding the Market-Making Function**

Functions that are essential to the operation and development of capital markets and that can be transferred without too much change to securities and capital markets are those involving market making and in particular those leading to provision of liquidity and term transformation and matching of supply of and demand for various financial instruments. The promotion of these functions toward dealing in longer term instruments should be actively pursued. In particular the matching and trading functions can gradually be extended toward private placement of shares. This operation, the first one that usually appears in the process of capital markets development, consists in the sale of shares to a pre-identified group of purchasers such as institutional investors. In general, a private placement does not require a prospectus to be issued because the purchasers have sufficient information on which to base their investment.

**Extending the Maturity of Financial Instruments**

To create a demonstration effect and introduce trading in longer maturities, the government may issue longer term bonds. To ensure their liquidity, the central bank may accept them for rediscounting. Another option is that the central bank backs a discount house that, with or without a government deposit would act as a lender of first resort.

**Promoting Venture Capital Companies**

This is where development of a capital market is steered toward supply of risk capital. The difference between a lending and a venture capital function has been mentioned earlier. Venture capital companies are institutions the specialize in the latter function. There are many different types of venture capital companies some catering for large ventures, some fostering small entrepreneurs. In developed countries they tend to specialize by sector,
products, technologies or clientele. Experience with venture capital companies operating in developing countries is emerging only now. Perhaps the main difference with those in developed countries is the degree of involvement of the venture capital company in the implementation of the project. Without getting into sweeping generalizations, it can be noted that in developed and developing countries alike, the decision to invest in a project is taken according to a number of criteria, including the quality of the technology, of the management, the market potential, and other similar elements. But once the project is approved in developed countries, it is left to itself to start and mature.

In contrast, in developing countries, it appears that successful venture capital companies are those that assume most of the functions needed to design, start, and bring the project to maturity, until such time as these functions are developed within the project and can be taken from the venture capital company. It is a formula that is close to the financing project activity and project support that many development financial institutions carry out already in developing countries. It is also a formula suitable for the development of medium and small enterprises. The difference is, of course, the degree of risk taking and the provision of risk capital. It is also very much the willingness of the venture company's management to take losses.

Usually an over-the-counter market is needed for venture capital companies to sell shares in successful companies it financed, so as to recycle its capital and take its profit. Until an over-the-counter market emerges, this trading function can take place, first, on a private placement basis.

Finally, the establishment of venture capital companies may require specific legal provisions. Two of them are essential: tax deductibility of capital losses and nontaxation of capital gains.

There are financial institutions in countries of Sub-Saharan Africa that could almost immediately or in the near future assume a venture capital function independently or within a merchant banking function, drawing on their experience with project financing or their contacts with entrepreneurs from the sector of medium and small enterprises.

**Formalizing Investment Finance and Trading**

Once private placement has led the way to over-the-counter trading there is room for merchant banks and other market making financial institutions to establish investment funds and unit trusts. Gradual formalization of these institutions mechanisms and investment vehicles will pave the way for the establishment of a stock exchange on which all types of securities should be traded.
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Developing an Adequate Regulatory and Prudential Framework

Early in the process of fostering the development of money and capital market the authorities may give due consideration to the formulation and adoption of a comprehensive securities market law. This would ensure the necessary degree of uniformity of regulations for the closely interrelated primary-issue and secondary-trading markets. It is of utmost importance that the development of a regulatory, supervisory and prudential framework remains a few steps ahead of the development of the markets themselves. This will prevent insider trading, other irregularities and "bust-and-boom" cycles—all adverse developments that, because of their deleterious impact on public confidence, set the development of financial markets back not by months but by years.
OPTIONS FOR CAPITAL MARKET DEVELOPMENT

Overview

There is no ready-made blueprint for developing financial markets. There are, however, certain key features which will determine the strategy adopted, including:

- the need for market makers who undertake to buy and sell specified securities to maintain an orderly and relatively stable market;
- the need for a financial intermediaries to buy, sell and manage securities on behalf of customers;
- the need for secondary markets to buy and sell financial instruments to create liquidity for savers and investors; and
- the need for a fiscal, legal, and regulatory environment which permits a reasonable return on investment.

Although in theory, there are a number of ways of developing this institutional framework, in practice there are relatively few viable approaches which can be implemented due to the institutional capacity currently in place in countries of Sub-Saharan Africa. The following section analyses a range of investment mechanisms that are suitable for the region. For each, a brief definition of the investment mechanism or intermediary is provided, followed by a discussion of the structure and operations and of the advantages and disadvantages in establishing or using the mechanisms.

Investment Mechanisms and Intermediaries

Private Placement

A private placement is the sale of shares to a pre-identified group of purchasers, such as institutional investors. In general, a private placement does not require a prospectus (a legal document prepared in connection with a public offer disclosing all material information about a security to be issued) because the purchasers have sufficient information on which to base their investments.
The mechanics of this transaction are similar to that of a direct investment except that two or more passive investors are to be involved. The motivation for investment is capital growth and income without management and operational responsibilities. The mechanics of selling shares through this vehicle are flexible; a formal solicitation of bids from prospective investors can be sought or direct negotiation with preselected buyers can be conducted.

Institutions such as pension funds and insurance companies constitute the target market for a private placement. These institutions usually have relatively large sums of money available for investment. Purchasing shares through private placements provides an opportunity to invest in equities without assuming the administrative costs associated with direct management responsibilities. Few individual investors are likely to participate directly in such transactions since typically there are not many individuals with sufficient funds available to purchase and retain large blocks of shares.

The transaction costs for a private placement include preparation of an offering document. This is normally assumed by the seller and recovered through the sale of the shares. Recurrent operating expenses would only be incurred if the purchasers desired external management of the portfolio.

As mentioned above, this investment mechanism usually does not enable the independent investor to participate because the financing requirements are often excessive at the individual level. In addition, the use of private placement may result in concentration of wealth within the economy. The objective of mobilizing savings is, therefore, only partially achieved. A private placement also exposes the individual or group of investors to the risks of the financial performance of a small number of companies. Therefore, this investment mechanism is to be used at the beginning of the development of financial markets and only as a transitory mechanism until such time as alternative mechanisms that are better able to spread ownership and risk emerge.

**Investment Company**

An investment company is a privately held company (most likely a limited liability company) which invests in a broad range of securities. The investment company could be a passive investor or could take an active role in the management and operation of its investments.

The main objective of an investment company is to realize capital growth from the underlying investments. Securities are generally held for an extended period of time and not traded on a frequent basis. Accordingly, a
Developing Financial Markets in Sub-Saharan Africa

typical investment company must have access to long-term sources of funds and will have little need for liquidity.

The terms and conditions of buying or selling shares in an individual corporation by an investment company are normally determined through a process of negotiation. Often, the shareholders of the investment company will develop criteria for new investments and disinvestment. In some instances, the articles of association may specify priority sectors for investment and the conditions of shares acquisition or disposal.

The participants in an investment company could include institutional investors and/or possibly a few select individuals. At inception, long-term funds to purchase the initial shares in the company would have to be sought with the understanding that the ability to liquidate the investment is limited. Moreover, the company must have access to additional long-term funds for future investment.

In addition to those costs normally associated with the establishment of a corporate entity, the investment company would also incur duty on authorized share capital and often stamp duty on all transactions in shares. On-going operating expenses would include that of a general manager, as well as professional, support and administrative staff.

The advantages and disadvantages of an investment company are broadly similar to that of private placement. This mechanism neither contributes to promoting wider share ownership of assets nor mobilizes all available saving for productive investment. In addition, an investment company is not typically geared to liquidate holdings rapidly when and if the need arises. Because of this lack of liquidity, it is unlikely that, as mentioned earlier an investment company would fulfill its objectives unless there is some public sector involvement or a well-developed secondary market.

An investment company, however, would likely involve significant public sector participation. Similar to the current institutions involved in the capital market, the investment company would suffer from inability to liquidate holdings as and when the need arises. Because of this lack of liquidity, it is unlikely that the company would fulfill its objectives without some public sector involvement and contribution.

**Unit Trust**

A unit trust is an investment mechanism that provides a large number of investors with a means to participate in a diversified portfolio of investments. The basic idea is simple: a large number of investors pool their money to obtain a range and spread of professionally managed investments that they could not obtain individually. The advantage is that
the investor in a unit trust is taking much less of a risk than a direct equity investor, because the diversity and breadth of the portfolio reduce the effect that any one share can have on its overall performance.

A unit trust is divided into equal portions called units with each unit being worth the same amount. The price of units is calculated regularly by the managers and is governed by the value of the underlying securities. Generally, two prices are quoted, the higher (offer) price being the price the investor pays to buy units and the lower (bid) price being the price he or she will receive for units sold back to the managers. The spread between bid and offer prices is dependent upon market conditions. In the United Kingdom, for instance, it is typically on the order of 5 to 6 percent.

Unit trusts have different investment objectives; for some the dominant objective is capital growth, that is reflected principally in an increase in the unit price. For others, it is regular income for the unit holders, that is, dividends. The income generated by the underlying investments is usually distributed twice yearly on specified dates. The income is distributed after the deduction of the annual management fee and net of the basic tax rate.

A unit trust is set up by a trust deed, which is an agreement between the Trustees and the Managers, and covers the main aspects of the running of the trust. The essential characteristics of the deed are that it states the rights and responsibilities of all concerned, the provisions enabling new members to join, the charges that can be made by the managers for administering the funds, and provision for calculating the buying and selling prices of units.

The unit trust management makes the day-to-day investment decisions necessary to the running of the trust and deals in units with the public. The trustee is an independent party whose job it is to hold the actual cash and securities belonging to the trust and also to ensure that the management is running the trust properly, that is, in accordance with the trust deed. The trustee is often a major bank or insurance company. Because of the trust structure of the investment and the fact that the management does not actually hold the money or stocks which make up the fund, there is no risk to the investor in the event of a management group's collapse.

One of the most important functions of the trustee is to act as custodian of all the cash and securities in the trust. All the assets of the trust are held in the trustee's name and it is the trustee who issues certificates to the unitholder, not to the managers. Similarly, before any proceeds are released to meet the sale of the units, the trustee has to receive the relevant cancelled units. Supervising the register of unitholders, settling all investment transactions, and collecting and distributing the income of the trust are just some of the tasks performed by the trustee which are essential to the running of a trust. By becoming so involved in the day-to-day operations
of the trust, the trustee serves to protect unitholders and the public from any possibility of fraud on the part of the management.

The other main duty of the trustee is to ensure that the trust is managed within the terms of the trust deed. From the unitholder's point of view, the most important aspect of the deed is the investment aim of the trust. It is the task of the trustee to ensure that the investment aim is adhered to.

The majority of unit trusts issue interim, as well as final, reports of their funds. This means that the investor will receive a regular, six-month update on how his or her investment is progressing. All reports give details of the directors of the unit trust company, the auditors, investment managers, and trustees.

In most countries, investors in unit trusts are individuals who have neither the time, money, or perhaps the expertise successfully to undertake direct investment in equities. In theory, a unit trust can reach and accommodate a broad range of investors including pension funds and insurance companies, corporations, and individuals. Although the structure of a unit trust can easily accommodate the small investor, it is likely that in Sub-Saharan Africa, at least initially, individuals will purchase only a small percentage of the units in the trust. Not only are individual savings in the region relatively limited, but mobilizing this source of investment requires development of confidence in the market. At the beginning therefore, the primary source of investment is likely to be institutions.

Development of a unit trust involves a number of up-front costs including, but not limited to, the preparation of a trust deed. These initial costs can be recovered through either an initial front-end charge added to the price of a unit or recovered through annual fees. The initial charge is often waived or reduced for large investors. In addition, an annual management charge is also incurred. This annual charge is normally taken out of the income of the trust fund and used to pay the managers as well as the trustees.

In the U.K. and the United States, there is no statutory limit on the unit trust charges, though the trust deed itself will normally state the maximum levels the managers are permitted to charge. Common rates are 5 percent for the initial charge and 0.75 to 1 percent for the annual charge.

**Investment Trust**

An investment trust is a limited liability company usually set up under and subject to the provisions of the Companies Act. An investment trust has a fixed-share capital base and its shares are normally traded on stock exchanges. It is, thus, a "closed-ended" investment vehicle as opposed to
"open-ended" such as unit trusts (although there exist closed-ended unit trusts). There are only a fixed number of shares in each investment trust available, although companies can increase their authorized and issued share capital just as any other limited liability company. The managers of unit trusts, on the other hand, can simply create or cancel units according to public demand.

With regard to objectives, investment trusts have many similarities with unit trusts. In terms of operation, however, they are two very different investment mechanisms. Investment trusts, in fact, preceded unit trusts into the world by more than 50 years. The first investment trust was established in 1896 with the aim of providing investors with moderate means, the same range of investments which were previously only available, by direct investment, to investors of greater wealth. Would-be capitalists of limited resources could pool their funds, achieve a spread of investments and, it was hoped, benefit from professional investment management at low cost.

The differences between an investment trust and a unit trust are many. First, an investment trust is not, in fact, a trust at all. It is a public limited liability company which invests its own share capital supplemented by borrowings if required. The so-called "trust" feature arises from the normal requirement that all income be distributed by way of dividends to the shareholders rather than being partly retained to finance growth. Profits arising from investment switches, however, are generally retained.

A second, and perhaps the most important difference is the closed-ended nature of an investment trust. There are only a fixed number of shares in each investment trust available, although companies can increase their authorized and issued share capital as any other limited liability company can. Moreover, it would be extremely difficult to reduce share capital in an investment trust should the demand for shares decline dramatically. The managers of a unit trust, on the other hand, can simply create or cancel units according to public demand.

A third key difference is the manner in which shares in an investment trust are valued. Investment trust shares are normally bought and sold on a stock exchange, but the quoted price does not necessarily equal the underlying asset value. The actual price per share is the equilibrium price equating supply of and demand for shares: when demand exceeds supply, the price will tend to rise and the discount will narrow and when demand is weak prices will fall and the discount might widen. This sharply contrasts with the way in which units are valued in a unit trust, a method whereby the price faithfully mirrors movements in the prices of the underlying investments.
In principle, investment trusts, in contrast with unit trusts require the existence of operating stock exchanges. Without these, transactions in shares and their valuation is cumbersome. In the absence of a stock exchange, any intending seller would have to seek out a buyer for his or her stake. Valuations would then be based on the overall demand for equities as well as the underlying value of the investments.

Finally, management discretion in a unit trust is much more restricted. Investment trust managers can be more entrepreneurial in their investment decisions because they are not governed by trust deeds which limit the size of stakes that can be taken in individual companies relative to the size of the trust. They are only bound by their own memoranda and articles of association plus the prudence of the management team. Unit trusts tend to be limited to modest stakes, and there is little or no opportunity for the unit trust managers to exert the sort of influence over the development of companies which investment trust managers are generally afforded.

Shares in an investment trust can be purchased by anyone, including institutional investors, corporations, individuals and other investment trusts. Individuals, however, usually do not have the means or the propensity to invest if shares are sold in large blocks. The main sources of investment would, therefore, be institutional investors and select corporations.

Such a pattern of investment is found today in the U.K.'s Investment Trust industry. Investment from individuals now accounts for less than 25 percent of total investment trust shareholdings. This is a dramatic decline from the amount of investment in the 1960s when investment from individuals accounted for the majority of investment. There are a number of external factors which account for this shift in investment, but analysts believe that competition from unit trusts is the major factor.

The pre-operational expenses for an investment trust include all costs associated with the formation of a limited liability company including duty on share capital and the costs associated with preparing a prospectus. Moreover, the company could be subject to stamp duties on transactions in shares.

On-going management expenses will also be incurred, including the appointment of a professional manager, professional advisors, and professional, support, and administrative staff. Professional advisors are normally appointed by the shareholders on the basis of the size of their shareholding and compensation is generally based upon a percentage of profits plus a small fixed fee.
Unit Trusts and Investment Trusts

An investment trust fulfills certain objectives which are not possible through a private placement or investment company. Such a trust could mobilize savings for productive investment through structuring the fund to meet the preferences and requirements of the institutional investors. Unlike the first two options, a trust company would permit investors to acquire an ownership position in a broad range of investments and thereby reduce their exposure to the financial performance of any one company.

An investment trust, however, does not usually cater to the retail market, or smaller investor. Because the number of shareholders is usually small, the opportunity for selling shares in the fund is more limited than with a unit trust. Rather than being sold in large blocks, the shares in a unit trust are sold in units which could be priced in such a manner as to attract the retail market. Although this segment of the market is not currently viewed as a major source of funds in most countries of Sub-Saharan Africa, this option would at least permit the individual an opportunity to invest savings in equities and begin the process of capital accumulation.

A unit trust is also usually open ended which permits an increase in investments through the issuance of additional units to the public. This does not mean that it can do without an operating stock exchange. The latter is needed for valuation purpose of the underlying stock. Conversely, an investment trust could only be increased in size by an increase in shareholding authorized by the majority of existing shareholders. New acquisitions would be difficult and an investment trust would not, therefore, emerge as a new financial intermediary in the long term.

The management function in an investment trust is usually strongly influenced by the majority shareholder. Conversely, the management function in a unit trust would not be controlled by any individual unit holder; the trust deed would define the powers and authority of the trustees and the managers. Fees, however, may be slightly higher with a unit trust than, say, an investment trust due to the larger number of shareholders and heavier administrative requirements.

Stock Exchange

A stock exchange is one of the institutions in the secondary market where securities that meet prescribed listing requirements are traded. Brokers, or securities professionals, act as agents for both buyers and sellers, usually without trading on their own account. In active markets trading is conducted on a continuous basis. In less active stock exchanges, securities are bought and sold in rotation or at a specific time.
Trading in securities may also occur outside the organized stock exchanges. In these so-called over-the-counter markets, transactions take place by means of negotiation between the buyer and seller. An example of such a market is NASDAQ in the United States. In an over-the-counter market, the brokers buy and sell securities to and from their own inventories. Customers, or other brokers representing customers, buy or sell securities from other brokers who act, in fact, not as "agents," but as a "principals"—that is, a "dealers." Thus, the over-the-counter market is off the exchanges; it is a "dealers" market.

Traditionally, the instruments traded on stock exchanges are shares. Equity-related instruments such as convertibles, bonds, and issues with warrants are also often traded. Shares and bonds are likely to constitute the only instruments traded on exchanges in the early stages of development. Over time, however, other instruments are likely to arise to meet the country's changing conditions. Other instruments, such as floating-rate bonds, indexed bonds, options, and futures are likely to develop with time. Security markets in futures, for example, have been developed only recently to minimize risk against foreign exchange fluctuations. These are simply mentioned to illustrate the flexibility of exchanges and their responsiveness to changing conditions.

Stock exchanges are regulated in one form or another to provide fair, orderly, and open markets. In most developed countries, markets are controlled through "self-regulatory organizations" which place responsibility with the exchange itself in conjunction with associations of securities professionals. In all instances, listing requirements on the exchanges are specified as well as trading rules, including priority, parity, and precedence. Listing requirements will include regulations on disclosure, or the need to make available to potential investors in a public offer, relevant information about the issuer and its business, operations, and financial status. The purpose of disclosure is to give investors the information which would enable them to make informed decisions on whether to invest in a company—that is, material information.

In other stock exchanges, particularly in Africa, further listing requirements are usually established in an effort to protect investors. These requirements may include minimum limits on paid-up capital and limitations on the amount of the shares which can be offered.

The price at which securities are bought and sold in a stock exchange is generally determined by market principles. In developed countries, prices are determined by investor perceptions of future earnings and capital appreciation. In other instances, such as the Nairobi Stock Exchange, the initial offer price is determined by public organization, rather than on the basis of supply and demand.
The final investment mechanism, the stock exchange, is ideal in terms of providing the necessary liquidity in the marketplace and providing opportunities for smaller investors to participate in a wide range of debt and equity instruments. Development of a stock exchange, however, is not considered feasible in the short to medium term. An interrelated set of institutional, fiscal, tax, and legal issues, as mentioned in the main paper, has to be resolved before the development of a successful stock exchange is possible. From an institutional perspective, most countries of Sub-Saharan Africa currently lack any market intermediaries (for example, brokers, dealers, or investment banks) which bring buyers and sellers together. The financial instruments associated with trading in this type of market are also not commonly used within the corporate sector of Sub-Saharan Africa. Finally, there are a number of legal and regulatory issues which require alteration to attract public offerings and investors.

In the long term, the development of a stock exchange is both desirable and necessary to channel savings into long-term investments and encourage development of productive enterprises. In the short to medium term, however, it is not feasible to expect that the creation of a stock exchange in and of itself will create an equities market or meet any of the objectives of the current program.

*Source:* Various IFC memoranda and reports.
ANNEX II
INSTRUMENTS AND INSTITUTIONS
OF THE FINANCIAL MARKETS

Table 1
THE MONEY MARKET

- COMMERCIAL PAPER
- BANKERS ACCEPTANCES
- TREASURY BILLS
- CERTIFICATES OF DEPOSIT
- REPURCHASE AGREEMENTS

- CENTRAL BANK
- COMMERCIAL BANKS
- DEALERS
- MUTUAL FUNDS
### Table 2
THE CAPITAL MARKET: NON-SECURITIES SEGMENT

<table>
<thead>
<tr>
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Table 3
THE CAPITAL MARKET: SECURITIES SEGMENT

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<td>EQUITY-RELATED BONDS</td>
<td>BROKERS AND DEALERS</td>
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<td>VENTURE CAPITALISTS</td>
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### Table 4
THE CAPITAL MARKET:
SECURITIES MARKET INSTRUMENTS

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### Table 5
THE CAPITAL MARKET: SECURITIES MARKET INSTITUTIONS

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<td>Self-regulatory associations of securities dealers</td>
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<table>
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<td>Brokers</td>
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<td>Marketplace</td>
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Source: International Finance Corporation, Capital Markets Department.
ANNEX III

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BOOKS


PAPERS


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