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Financial Sustainability and Regulatory Proportionality of African Capital Market Regulators
-
White Paper

Dalberg

Contents

1. Introduction

Financial markets are platforms to buy and sell securities and can include both capital and commodity markets. Capital *markets* enable investment in the equity or debt of other entities, allowing investors to channel their funds to both businesses and governments. This can function by means of publicly listed financial securities such as stocks and bonds in which investors purchase new securities issued through the primary market or trade existing securities via the secondary market.[1] Capital markets can also function through private markets, as commonly seen in the venture capital or private equity industries. In all these cases, the investment in equity or debt represents an ownership stake in, or a loan to, a company or an institution. Conversely, ***commodity markets*** are platforms for rules-based trading of raw materials or primary products through contracts which have standardised terms for quantity, quality and location.[2] Behind each contract being bought and sold is not a company, but rather a physical good – oil, wheat, gold and much more. The value of a commodity market lies in facilitating the matching of buyers and sellers – but without requiring physical delivery of the goods. Financial markets provide important benefits for economic development. They direct scarce resources to their most productive use, foster liquidity and price discovery, and allow risks to either be hedged or taken and rewarded.

Historically, the formalisation of financial market regulation has typically been an *ex* post action and, indeed, usually in reaction to dysfunction or scandal. Such crises have led to the establishment of a regulator, legal reforms, or the development of new rules to govern the market. For instance, in India, stock trading started as early as the eighteenth century but regulation did not commence until 1925, in response to numerous scandals. The regulator, SEBI, was initially established as an administrative body but, due to consistent market misconduct, it received additional statutory and judicial powers.[3] Similarly, in the US, the SEC was established in 1934 due in part to concerns about misinformation and financial practices believed to have contributed to the stock market crash in 1929. The pattern of expanding regulatory reach in reaction to problems has also been evident in recent years. The China Securities Regulatory Commission (CSRC) began regulating regional commodities exchanges several years after the exchanges' establishment as the CSRC noted the risks from an absence of minimum capital requirements and investor protections.[4] Likewise, the Financial Services and Markets Act 2000 (FSMA) in the UK established the Financial Services Authority following a series of scandals which had adversely impacted investor confidence. [5]

Financial markets regulators operating in frontier and emerging economies have particularly difficult roles to play. With the advantage of learning from the history of other markets, they can establish the right rules of the game in order to preempt fraud or financial crisis. Yet they usually operate in economies with a narrower scope of economic activity, and correspondingly, a more limited level of investment activity. Unfortunately, financial markets do not simply materialise; merely establishing their structure and mechanisms is not enough for a vibrant market to appear. Regulators in African countries may seldom have to conduct a post-mortem on a scandal, but they may not have much to analyse or oversee in the first place.

[1] The Economic Times, Definition of Capital Market, accessed: December 2021

[2] USAID – Feed the Future, Assessing the Preconditions for Commodity Exchange Success: A Guidance Document, 2017

[3] Ipsita Das et al, Growth of SEBI as a Regulator of the Capital Markets, PalArch's Journal of Archaeology of Egyptology, 2020

[4] United Nations Conference on Trade and Development, Development Impacts of Commodity Exchanges in Emerging Markets, 2009

[5] Baldwin C et al, The Oxford Handbook of Regulation, 2011

Thus in Africa, regulators are tasked with a dual mandate: both developing a financial market, as well as *regulating* it. This raises the difficult question of how a regulator might play a dual role, including determining the right strategic focus, activities and capacity to do so effectively. This is particularly important in resource-constrained economies where the regulator must usually manage with a limited team and budget. Its functions must be delivered with limited financial resources and managed in a way that is proportional to market context. This paper proposes an analytical framework to assess the state and stage of a country's financial market, which provides guidance as to how the market regulator should approach its mandate, focus areas and funding model.

2. Stages of Financial Markets Development

The regulator's approach should be proportional to its market context. Assessing the state of a given market can help identify the stage of its financial market development. This in turn provides guidance on what the market needs. The sequential questions below, tailored to our assessment of the challenges, opportunities and themes common to many financial markets across Africa, are a first step in this analysis:

1. **Building Blocks**: Is the underlying foundation – i.e. the economy, government, investment environment and banking system – in place and ready to support financial markets?
2. **Financial Market Type**: Is the capital or commodity market the right driver for economic growth, given the degree of economic diversification beyond the agricultural sector?
3. **Capital Supply-Demand**: Are supply and demand for capital sufficient? Should this be served by capital markets, rather than banks, and do the means exist to channel savings accordingly?
4. **Capital Market Depth**: Are capital markets deep, providing a source of capital and liquidity? Are there attractive growing opportunities outside of government debt?
5. **Capital Market Sophistication**: Will increased product diversification and sophistication deepen markets and enhance their value proposition?

In this section, we consider each of these questions as they apply to African economies, assessing the state and stage of financial markets. This analytical grounding then serves as the basis for exploring market needs and opportunities, and thus the implications for regulators.

Building Blocks

Four basic building blocks are foundational for financial markets. These are preconditions to fulfil, without which financial markets are unlikely to grow. The first of these is the ***health of the economy*** itself. Financial resources do not create economic activity *ex nihilo*; rather, they are attracted by, and directed to, businesses, institutions or commodities where potential value already exists and thus a financial return – commensurate to the risk taken – becomes possible. In simple terms, an economy must be large enough and offer enough growth potential. Furthermore, participants in the economy must have sufficient income or wealth to provide the savings needed for investment. The second building block is the ***government's demonstration of credibility and competence*** for would-be participants to invest confidently in financial markets. Political stability, the rule of law and control of corruption must meet a minimum threshold for investors, both domestic and foreign. Third, the ***environment for business*** must be adequate, with clarity on corporate governance, investor rights and contract enforcement. Finally, the ***health of the financial system*** is critical. A stable, robust banking system and a functional, trusted payments system are prerequisites to the financial markets that will rely on this infrastructure.

The development of financial markets is closely intertwined with the health and growth of the underlying economy. Macroeconomic factors such as GDP and market stability shape the environment in which financial markets can grow or stagnate. Financial markets, in turn, mobilise resources and channel them to help grow the highest-potential, most productive sectors.[6] While the relationship is symbiotic, the direction of influence depends in part on the country's stage of

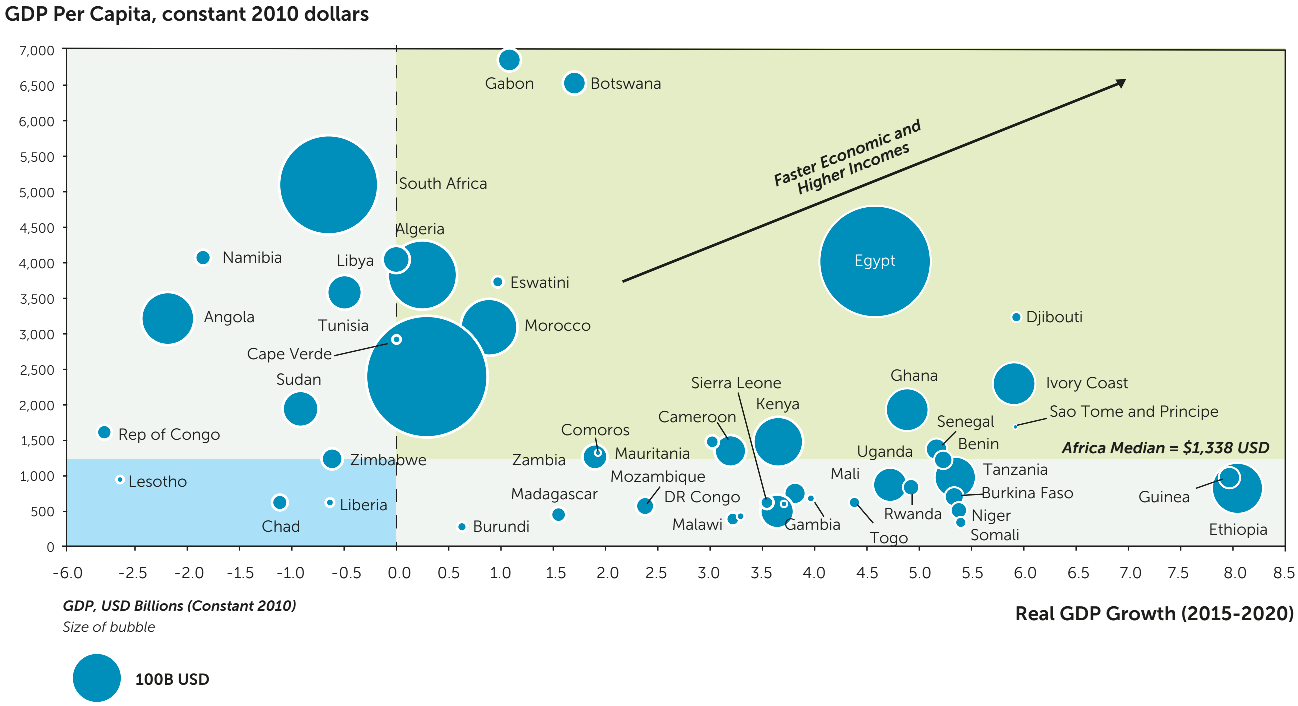
[6] Ibid

development.[7] In earlier stages of economic development, the evidence suggests a 'demand-following' model in which economic growth stimulates demand for financial services, eventually leading to the growth development of financial markets.[8] In other words, financial markets – which help allocate capital to where it will generate the highest risk-adjusted return – can only function where there is underlying economic activity to generate such returns in the first place. Moreover, financial markets are only one means of achieving this; banks, savings groups, microfinance institutions and others are alternate means to channel savings to productive opportunities. Thus in frontier and emerging economies, financial markets are most likely to emerge because of economic growth. Indeed, the evidence suggests a largely unidirectional relationship for emerging economies such as Brazil and India, where economic development leads to capital market development; evidence for the reverse relationship is weaker.[9] In more advanced economies such as the United Kingdom, the relationship evolves into a bidirectional one; capital market development stimulates economic growth and vice versa, albeit with a lower correlation as compared to frontier and emerging economies.

Most African countries fit the demand-following model, in which adequate size and growth of underlying economic activity is a prerequisite to the emergence of a robust financial market. The figure below provides a quick snapshot of the differences across economies. All else equal, the countries in the upper-right quadrant – with relatively faster growth and higher per-capita incomes – are in better economic health. Per-capita income varies widely across the continent. It matters because financial markets require savings to channel into investments, and such savings are possible only when the population can already meet basic needs.[10] Growth of real income and an accompanying increase in the savings rate are positive predictors of the stock market.[11] [12] Thus, while Ethiopia's annualised growth rate of 8% easily outpaced Nigeria's, which remained stagnant over the same period, the average Nigerian is in far better position to save and invest. When it comes to the foundations for financial markets, size also matters. Many countries have seen annual GDP growth in the mid- to high-single digits, yet the size of their economy is modest. Egypt and Uganda have experienced similar growth from 2015 to 2020, but the economy of the former is nearly ten times bigger than that of the latter. Therefore for would-be investors, Egypt is much more promising for financial market development.

[7] Walter Jansson, Stock Markets, Banks and Economic Growth in the UK, 1850-1913, Social Science Research Network, 2018
[8] Naresh Kumar, Estimation of Market Capitalization and Economic Growth in India, Social Science Research Network, 2014
[9] Meta Ayu Kurniawati, Financial development and economic growth: Evidence from panel cointegration, IJaber, 2016
[10] The World Bank, Capital Markets Development – Causes, Effects and Sequencing, 2019
[11] Valeriano F. Garcia et al, Macroeconomic Determinants of Stock Market Development, Journal of Applied Economics, 1999
[12] Nsofor Sabina Ebele, Appraisal of the Effect of Savings on Stock Market Development in Nigeria, Journal of Economics and Sustainable Development, 2016

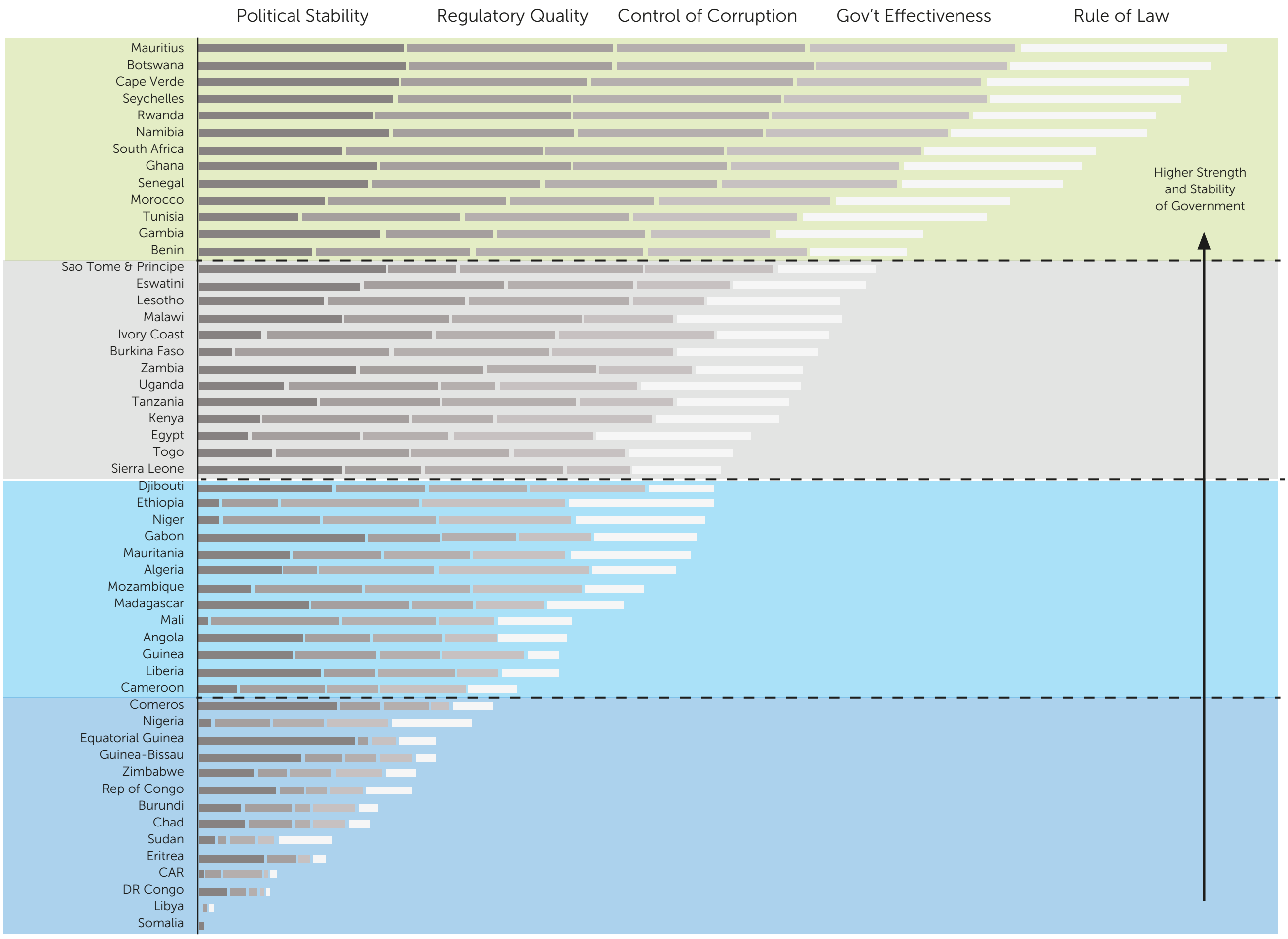
Figure 1: GDP, Real Growth and Per-Capita Income [13]



The second and third preconditions are closely related, capturing different aspects of an enabling environment. To build the critical mass of participants necessary for functioning financial markets, the ground rules must be understood, accepted and trusted. Thus the government must be stable and credible – or at least, stable and credible enough to prevent capital flight. High levels of uncertainty lead investors to pull their savings from frontier and emerging markets – putting them 'under the mattress', so to speak, or else removing them from the country entirely. A fast-growing economy that is *not* anchored on a reasonably trustworthy, competent government is unlikely to inspire much confidence. As the figure below illustrates, the gap can be huge. Consider the relative degree of trust that the governments of Mauritius or Rwanda command, which stands in stark contrast to that of Nigeria, which performs worse on every dimension: political stability, corruption, effectiveness and the rule of law.

[13] World Bank, 2015-2020; Dalberg analysis

Figure 2: Government Capability and Credibility [14]

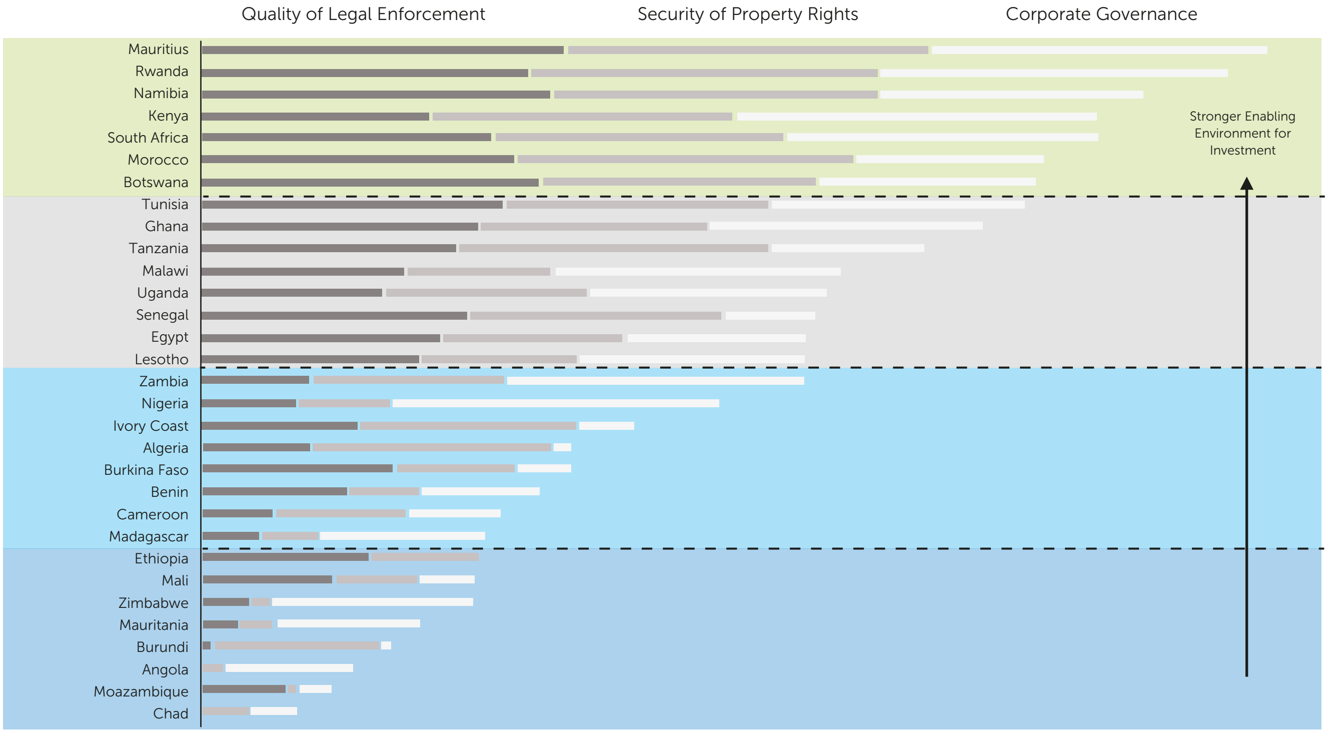


One manifestation of an effective government is, of course, an attractive business and investment environment. This includes strong corporate governance and investor protections, and requires not just the right statutory laws, but quality in the enforcement of said laws. Not surprisingly, there is a strong correlation between countries' performance in government capability and the enabling environment they create – or fail to create – for business. However, this does not apply uniformly. Kenya, for example, is a middling performer on government, but has managed to develop one of the strongest environments for investors on the continent. Conversely, Ethiopia, which rates only slightly worse than Kenya on the government building block, slides to the bottom quartile here. In fact, it is the worst performer in the entire dataset on the dimension of corporate governance.

[14] World Bank, 2020; indices for stability, regulatory quality, control of corruption, government effectiveness and rule of law; Dalberg analysis

[15] Liliana Suarez, Towards Strong and Stable Capital Markets in Emerging Market Economies, Bank of International Settlements Papers No 75, 2014

Figure 3: Business and Investment Environment [16]



The final building block is the financial infrastructure required for financial markets to function and thrive. The elements of this infrastructure include the banking system, payment systems, clearing mechanisms and standardised accounting procedures, among others. As a frontier or emerging economy grows, the banking system is usually the first and primary channel for basic financial services. Thus, financial market deepening is more likely in countries with sound and competitive banking systems. [17] This relationship is complementary and not substitutive. [18] Consider that banks need to align with internationally recognised regulations and supervisory practices, such as the Basel framework, to build capacity and improve confidence. Strong, stable banking systems can then provide the liquidity needed by financial markets. Their allocation of capital through lending serves an essential role in the economy – and can also help foster demand for diverse means of raising capital, such as through financial markets. [19] As shown in the figure below, the stability and lending activity of banking systems across countries provides a useful proxy indicator of this building block. Countries in the top-right quadrant, such as Morocco, Egypt, Mauritius and South Africa, have stronger systems – and therefore stronger foundations for their financial markets.

[16] IESE, Venture Capital and Private Equity Country Attractiveness, 2020; sub-indicators for corporate governance, security of property rights and quality of legal enforcement; Dalberg analysis

[17] World Bank, Capital Markets Development: A Primer for Policymakers, 2020

[18] Liliana Suarez, Towards Strong and Stable Capital Markets in Emerging Market Economies, Bank of International Settlements Papers No 75, 2014

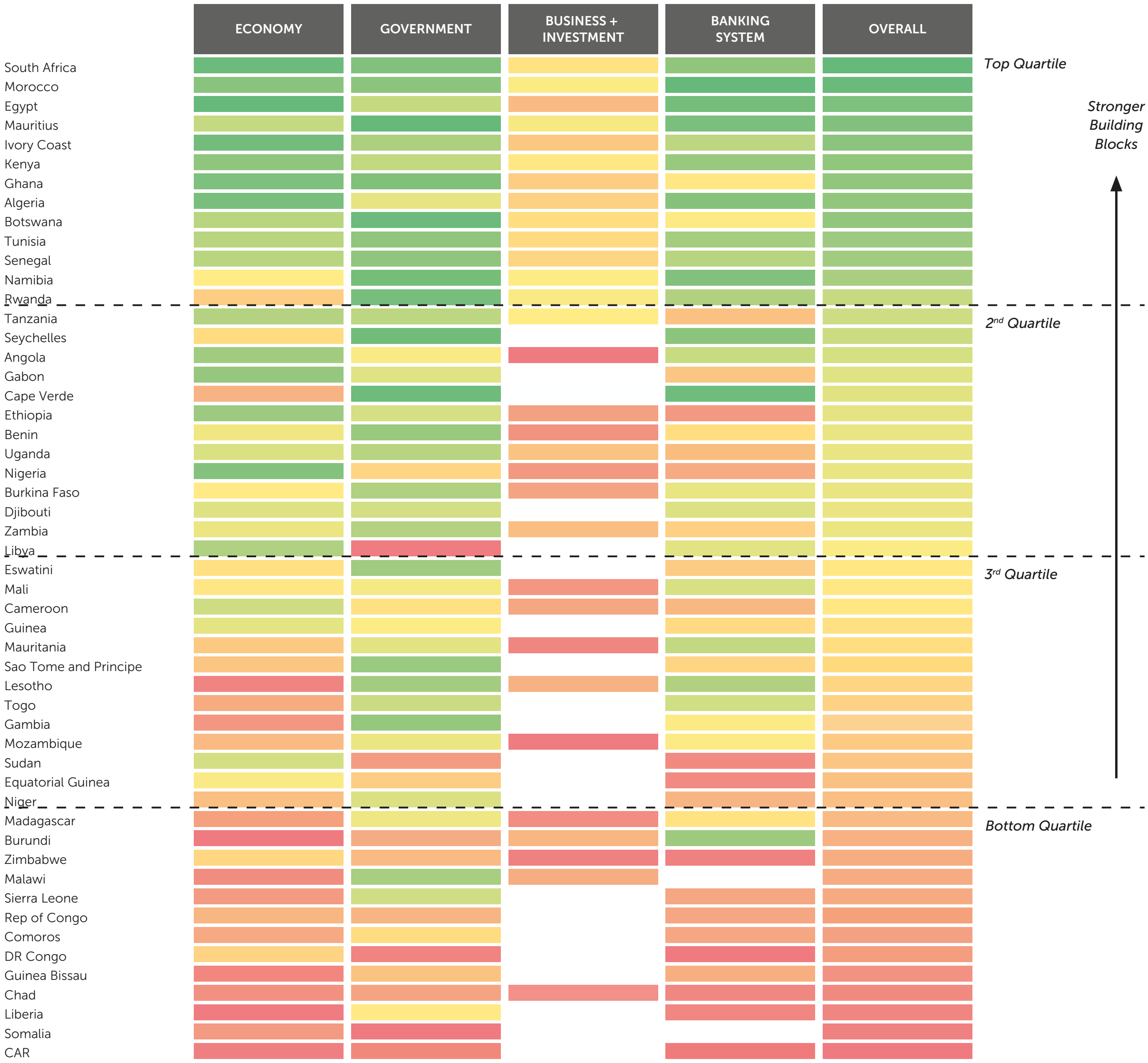
[19] Ibid

Figure 4: Bank System Stability and Activity [20]

With a synthesised view of all four building blocks, some countries are clearly readier than others to support financial markets. While this provides only an indicative analysis, most of the top-quartile countries are precisely those that already have vibrant financial markets, or are on the path to developing them. As will be shown later, South Africa, Morocco, Egypt and Mauritius have the deepest, most active capital markets in Africa. Ivory Coast, Kenya, Ghana, Botswana and Namibia also have more mature financial markets, at least relative to their continental peers. At the other end of the spectrum, most of the bottom-quartile countries face significant economic and political challenges. The right building blocks for financial markets simply are not in place. While these countries could certainly attempt to set up regulated financial markets, most may have more pressing and fundamental issues to address first. One notable exception is Zimbabwe, which has had a functioning stock market since the late nineteenth century. Yet its capital market is also relatively shallow in comparison to its peers, suggesting that its shaky building blocks do indeed present a problem.

[20] World Bank, 2020, bank lending as share of GDP; IMF, 2020, bank assets as share of GDP; Bankscope, 2020, z-score; Dalberg analysis

Figure 5: Building Blocks Strength [21] [22]



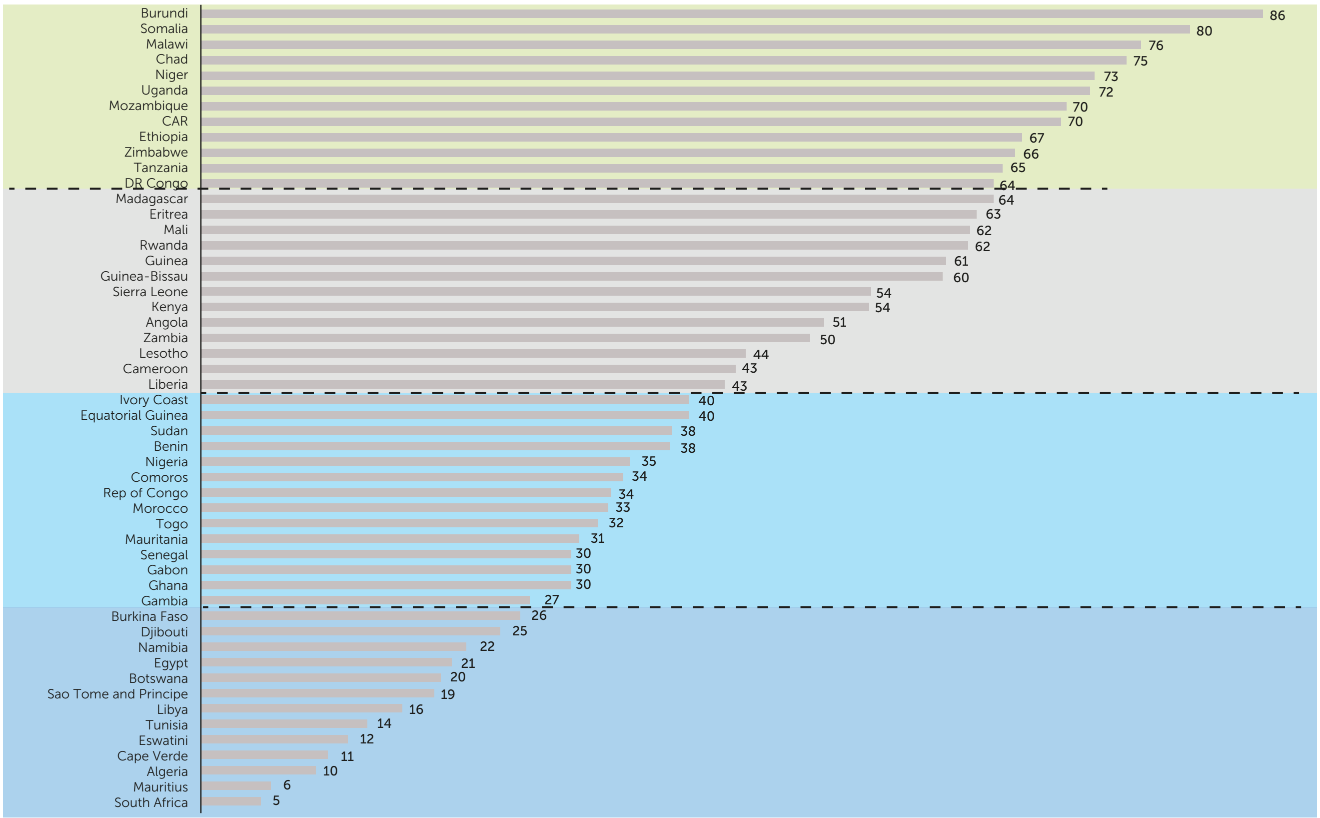
Countries with adequate building blocks in place have the potential to see the emergence and growth of financial markets. These financial markets typically appear in the form of capital and/or commodity markets. Here the country's economic structure matters. Many countries focus primarily on setting up stock and bond markets, and many express a strong interest in attracting foreign capital. These are rational and worthwhile objectives. Yet countries may pursue these capital market objectives while ignoring the opportunity of commodity markets. The majority of countries in Africa have large

21 Synthesis of data from World Bank, IMF, Bankscope and IESE; Dalberg analysis

22 Note: Data for a number of countries was not available, particularly for the enabling environment for business and investment and the banking system. Rather than remove these countries from the analysis entirely, the authors have kept them in the dataset to provide a more complete view of the continent. While the lack of data effectively 'penalised' these countries and led to lower scores, for most of these, the lack of data is in itself a telling indicator of the state of these building blocks.

agricultural sectors that account for nearly 20% of GDP on average and can range as high as 35 to 40%. The share of employment from agriculture is even higher, averaging 44% for the continent. At the high end, some countries rely on the agricultural sector for 75% or even more of total employment, as shown in the figure below.

Figure 6: Employment in Agriculture, % Share of Total Employment [23]



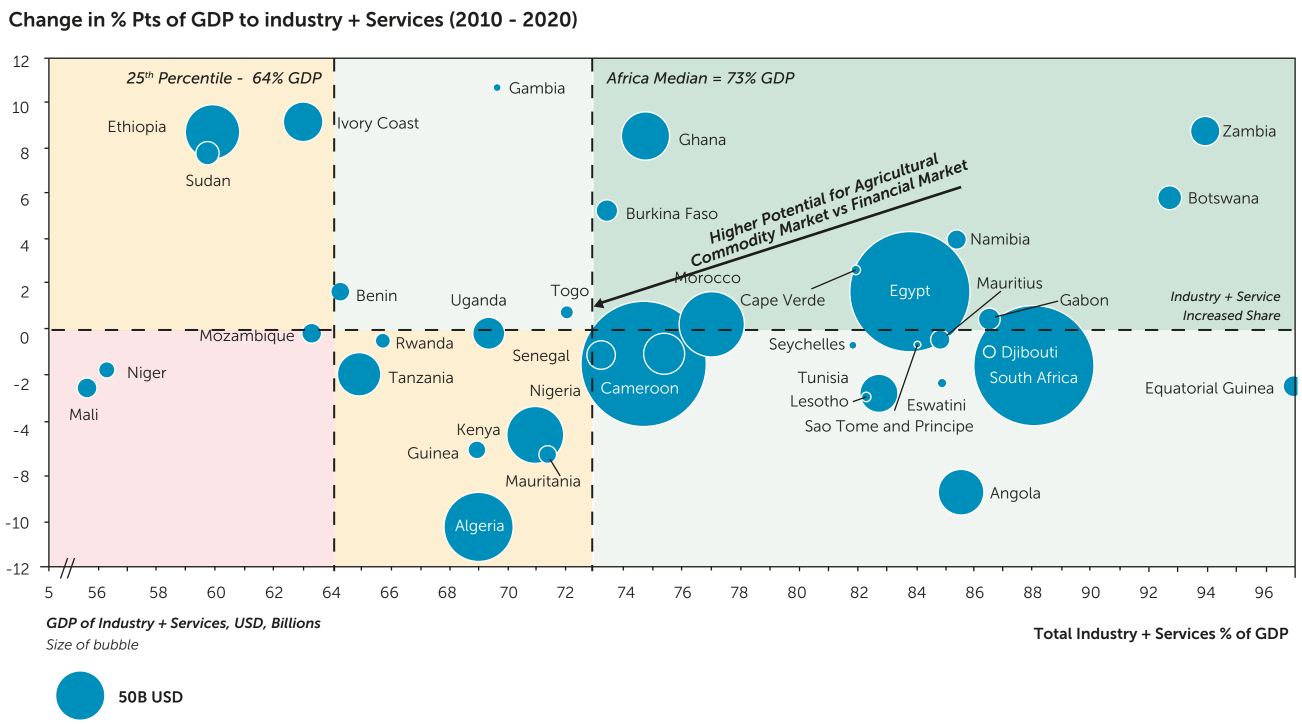
For the development of financial markets, the centrality of agriculture in many economies is important to consider. As noted at the outset, financial markets emerge based on underlying economic activities that already exist. This is a critical lens to apply in African economies in which a significant share of value addition and employment comes from a large agricultural sector that is – and will remain – an important part of the country's development. Informal, inefficient trading systems and illiquid markets carry a significant cost for farmers, aggregators, processors and exporters. Simply having the assurance of being able to buy or sell at an acceptable quantity, quality and price would be highly impactful. As such, an agricultural commodity exchange that enables a reliable, structured spot trade market, thereby reducing transaction costs and facilitating price discovery, would be tremendously valuable to market participants. It would be an important lever with potential to stimulate further investment in farm productivity, crop quality, post-harvest management and value-added processing.

The gradual diversification of African economies away from agriculture – and towards industry and services – would support the development of a capital market. However, there is significant variance across Africa, as shown in the figure below. A handful of economies have little agriculture; in the top-right quadrant, Zambia and Botswana, for instance, are heavily dependent on the extractives industry. Yet many more countries are highly dependent on agriculture and have even seen their share of GDP from industry and services slightly decline from 2010 to 2020; notable among these are Rwanda,

[23] World Bank, 2019; Dalberg analysis

Tanzania, Kenya and Nigeria. Other countries, such as Ivory Coast and Ethiopia in the top-left quadrant, have experienced share gains for non-agricultural sectors, yet they still have very high dependence on agriculture for growth and employment. Thus in many markets, the case remains strong for considering an agricultural commodity exchange that serves on-the-ground economic activities.

Figure 7: Size, Share and Growth of Industry and Services in GDP [24]



It is critical to note that capital and commodity markets are not mutually exclusive, but rather complementary. Indeed, many countries will be well served by pursuing both. For regulators in countries towards the bottom-left of the figure above, the key question is that of focus and sequencing, i.e. weighing whether scarce attention and resources should be directed towards the agricultural sector. The next sections will focus on capital markets, with particular emphasis on public capital markets. As will be discussed below, however, countries that have equity and bond markets may find they struggle with few issuances and thin trading; these capital markets may not fully align with the actual activities and needs of the economies they serve.

Capital Supply-Demand and Investment Channels

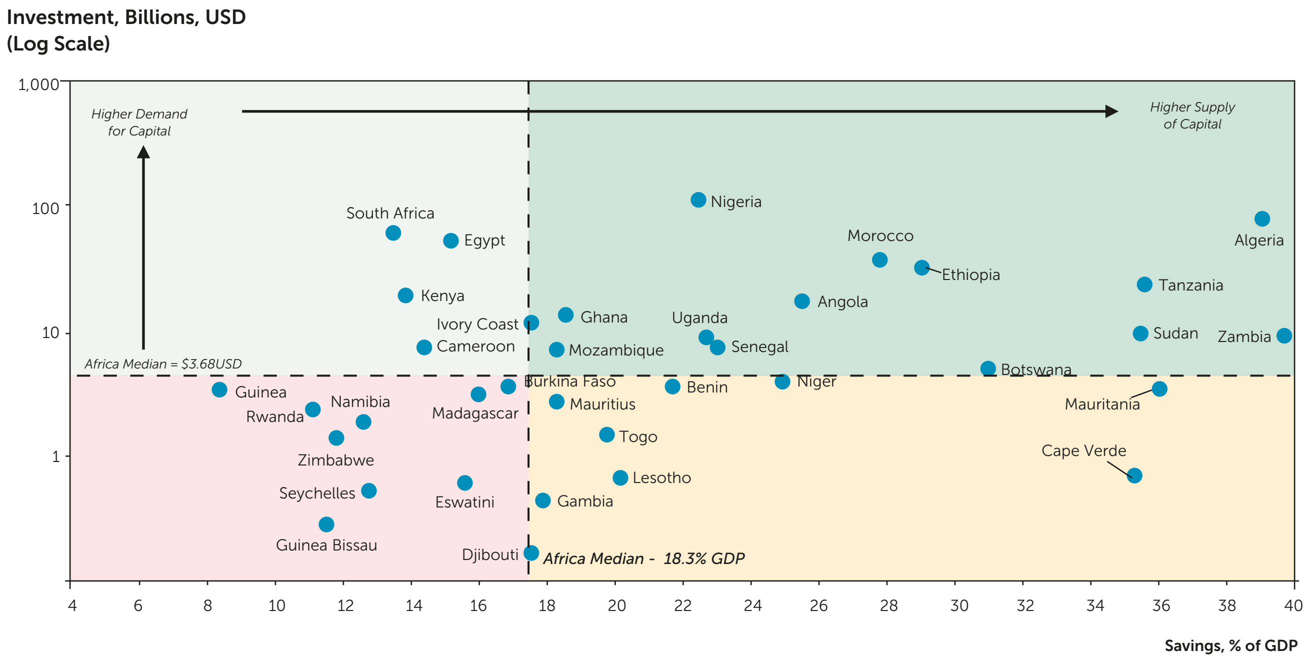
Capital markets require sufficient supply of, and demand for, capital – as well as channels to direct them accordingly. For African countries that have the right building blocks and for which a capital market is the relevant need, the next area of focus is the capital itself. This comes from the savings of households and businesses, which form the capital needed for any type of investment – whether to purchase real assets like land, lend through savings groups, or deposit in banks (which can then use the funds for onward lending). The figure below shows how African countries perform in national savings rates relative to the total investment capital demanded. [25] In general, higher savings rates and higher demand for capital indicate stronger potential for the emergence of a capital market. The median level of national investment capital on the continent is just $3.6 billion USD per annum.

[24] World Bank, 2010-2020; Dalberg analysis

[25] Total savings and total investment demanded, i.e. gross capital formation, are highly correlated and nearly equal in most markets. For simplicity, the figure shows only total investment demand.

While this is not insignificant, it is far from the quantum typically required for a thriving capital market. Countries near or below this median may struggle to build the critical mass of supply and demand needed, noting that most capital in these economies are invested through channels other than capital markets.

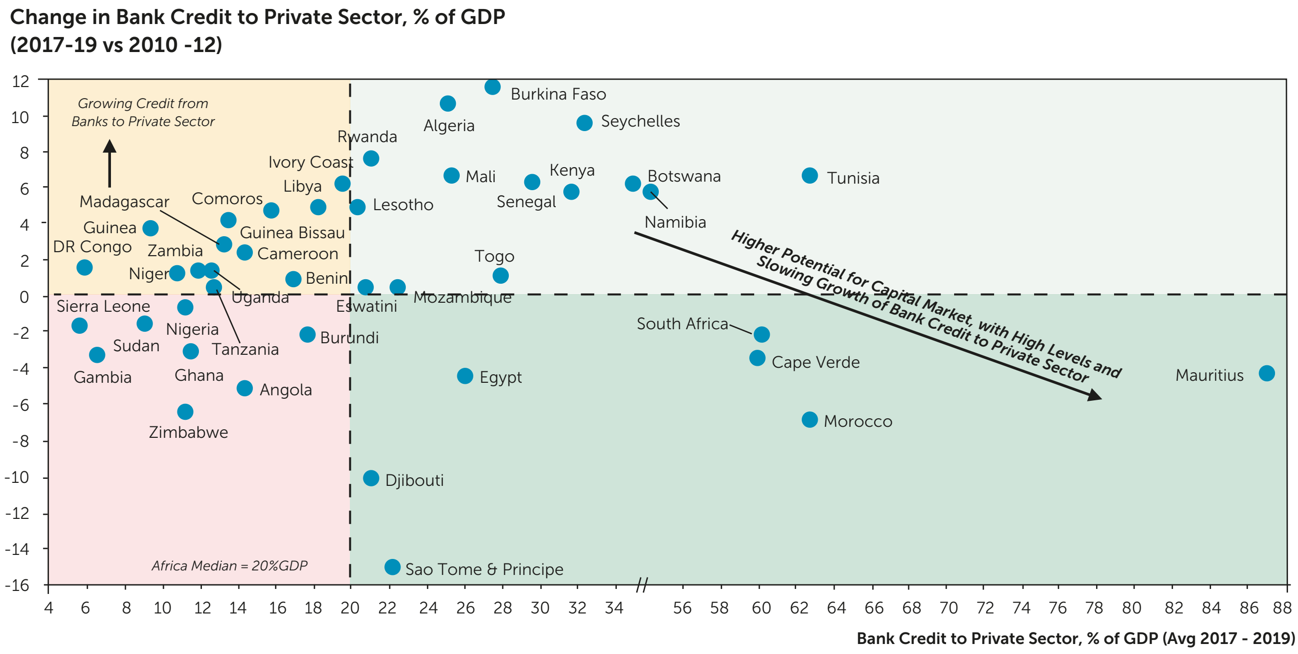
Figure 8: Savings Rate and Investment Demanded [26]



An additional lens to apply is the degree to which banks effectively deploy capital to meet private sector demand. In general, higher and growing credit from banks should bode well for capital market development. There is some nuance to this, however, and the figure below suggests two dynamics to consider: the importance of bank lending to the private sector, and whether the importance is increasing or declining over time. First, countries in the left quadrants see only modest levels of bank lending – measured as a share of GDP – to the private sector. Those economies in the top left have increased credit over time, which reflects a strengthened private sector or banking industry, or both. Countries such as Cameroon and Guinea are on the right path, but in all likelihood, the banking industries in these markets are still maturing, and thus are unlikely to be strong candidates for a capital market. The second dynamic is that countries with growing economies and more mature bank industries see higher bank credit as a share of GDP. Countries in the top right, such as Rwanda, Kenya and Botswana, still see growth in bank credit to the private sector, but the high overall levels of capital deployment would suggest potential room for a growing capital market. Those with more mature financial markets, including Mauritius, Morocco and South Africa, fall into the bottom-right quadrant. Bank credit has declined, but this is likely due to other non-bank sources of financing emerging, including deeper capital markets that can serve these economies.

[26] World Bank, 2019; Dalberg analysis

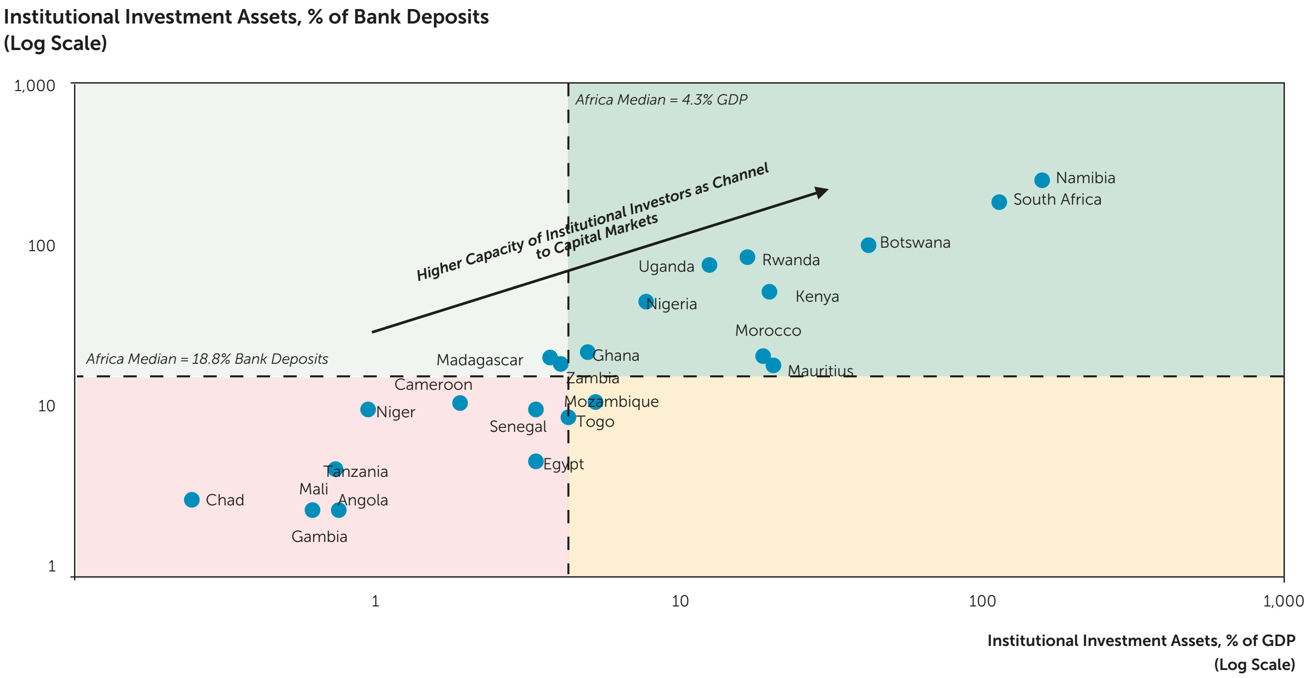
Figure 9: Bank Credit to the Private Sector and Change Over Time [27]



A final consideration is the capacity of institutional investors that can channel savings to capital markets. Savings can be stashed under the proverbial mattress, deposited in banks or invested through pensions, mutual funds, insurance companies or other investment schemes. The first of these serves little purpose in an economy, and the second is typically used by banks for onward lending, as illustrated in the figure above. The third of these is the means by which most households access capital markets. As shown below, some markets have a much stronger presence of institutional investors – indicated as assets under management (AUM) relative to both overall GDP and total bank deposits. This is not to posit a linear causal link between institutional AUM and capital markets, but rather to suggest the mutually reinforcing relationship between the two. South Africa has a stronger presence of institutional investors and correspondingly deep capital markets. The state of Mali and Tanzania, on the other hand, suggests that the capacity of, and choice among, institutional investors will need to grow to provide proper support to their capital markets.

[27] World Bank, 2019; Dalberg analysis

Figure 10: Institutional Investments, Assets Under Management [28]



Private and Public Capital Markets

Capital markets can function as either public or private markets. Public markets enable equity or debt securities to be traded by anyone in the general public and are typically accessed through an exchange. Companies with publicly listed securities must usually abide by strict disclosure and regulatory requirements, and investors usually enjoy a high degree of liquidity, i.e. the ability to trade easily. In contrast, private markets enable the raising of capital that is not publicly traded on an exchange, and is typically provided by institutional investors such as venture capital or private equity funds. Privately held businesses are not subject to the same types of disclosure requirements, and private market investors usually cannot liquidate their holdings easily. A typical private equity investment is made with a time horizon of several years before an anticipated 'exit' – or sale – of the stakes. In return for such illiquidity, investors often expect higher financial returns and/or greater levels of strategic and operational influence than they would have with public markets.

Both private and public markets can support the development of African economies, providing different types of capital for different types of opportunities. Just as agricultural commodity markets and capital markets can be complementary, within the category of capital markets, both private and public markets have important roles to play. Private markets enable businesses to raise more patient capital than is usually available for publicly traded securities. Angel, venture capital and private equity investors can also invest in businesses whose size and stage of growth may not be suitable for the expectations of public markets. The same principle applies to certain sectors, where riskier, newer or less understood industries may struggle to raise capital outside of private markets. For example, a social impact enterprise that aims to provide low-cost solar home systems to rural households is unlikely to raise capital through public markets. In all likelihood, such a business lacks the capacity and resources to handle the disclosure requirements for a publicly listed company. For most public market investors, such a business may be too early stage, the quantum of capital it seeks may be too small, its product and business model may be unfamiliar, and its dual focus on profit and positive social impact may not

[26] World Bank, 2019; Dalberg analysis

be attractive. Yet this business could be attractive to an impact investor or an energy-focused venture capital fund. A large-scale commercial real estate project, such as a shopping mall to serve the growing African middle class, might also turn to private market investors for financing. The reasoning could differ from a social enterprise, yet it too could find that the most suitable source of capital lies in private equity rather than public markets. While the remainder of this paper focuses primarily on public markets, capital market regulators in Africa must also consider the benefits of private markets – and the importance of providing the right type and degree of regulatory support.

Capital Market Depth

Once established, the effectiveness of a capital market lies in the depth that it provides. A deep market is comprised of many active participants and offers them efficiency, liquidity and an appropriate risk-reward calculus. It functions as a primary market for new equity and debt issuances, as well as a secondary market for continued trading of securities. Similar to the other metrics considered earlier, the variance across African economies is significant, as shown in the figure below. Not surprisingly, countries with greater depth in their capital markets are also those with strong building blocks, significant levels of savings and investment deployed to the private sector, and relatively robust institutional investors.

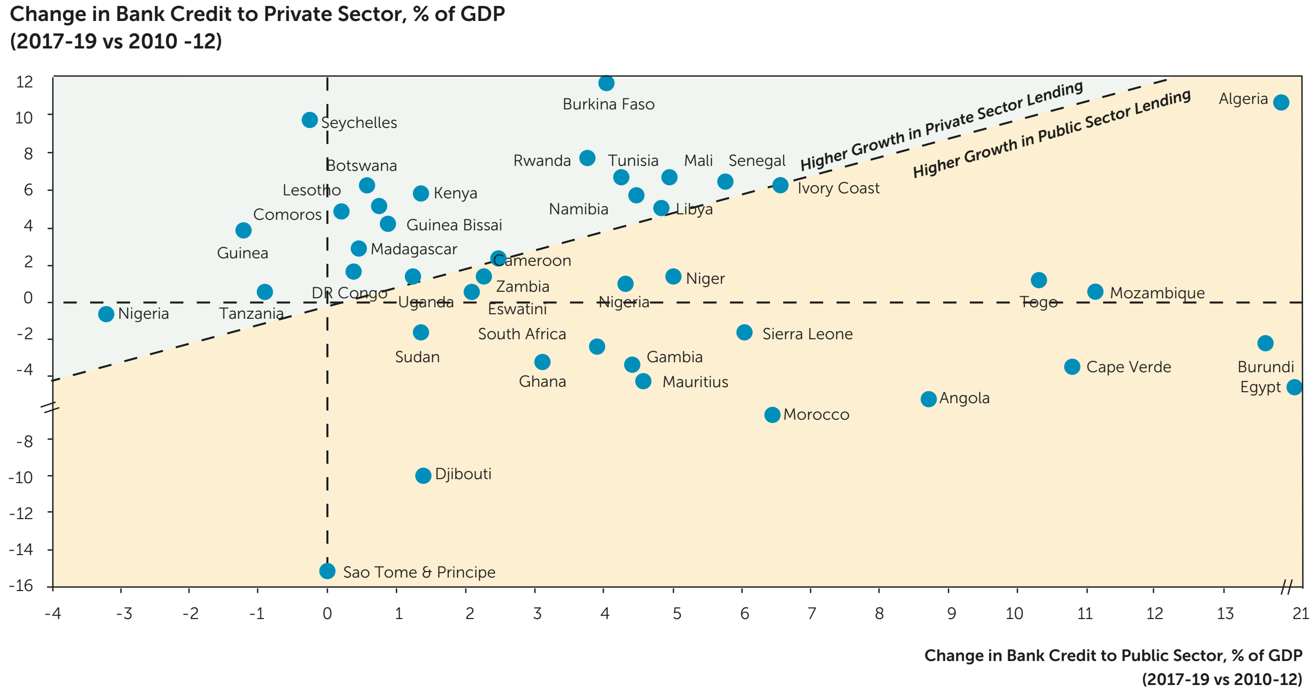
Figure 11: Depth of Capital Markets [29]

This indicator of capital market depth is relative to other African markets, however, and reflects the reality that most of these are emerging economies. For example, against the same metrics, the United States offers ~1.7 times more capital market depth than Egypt and South Africa. Similarly, while Rwanda pursues its ambition to serve as the 'Singapore of East Africa', its capital markets currently provide half the depth of Singapore. While many African economies are diversifying and growing rapidly, there are still relatively few companies with the size and capacity to raise equity or debt through the

[29] IESE, Venture Capital and Private Equity Country Attractiveness, 2020; sub-indicators for size and liquidity of stock market, trading volume, public securities issuances, M&A activity and debt market; Dalberg analysis

capital market, rather than from banks. Trading of securities from those companies that have raised capital this way is often thin, with relatively few investors engaged in active buying and selling. Another important issue across much of the continent is the impact of government debt, which may be a more attractive investment, thus crowding out the private sector. The figure below uses bank credit to the private and public sectors as a proxy indicator for this effect and shows that for half the continent – shown in the yellow area of the chart – credit flows to government grew faster than those to business.

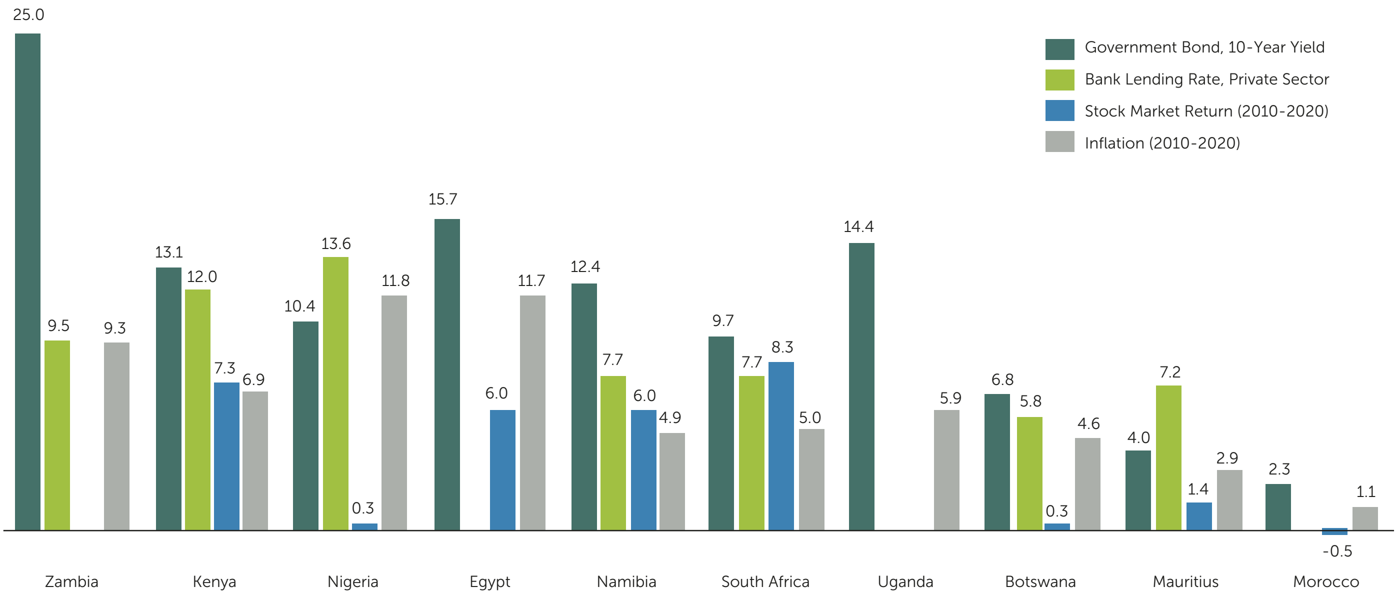
Figure 12: Change in Credit Flows to Private and Public Sector [30]



Crowding out by the public sector is not surprising given the risk-return profile of government debt. In most markets, government-issued debt is considered risk-free, or nearly so, by investors, and should thus offer the lowest yields across different types of securities. Yet in Africa, the ten-year yields of many government bonds exceeds the average lending rate of banks to the private sector, as shown in the figure below. The ten-year nominal return of most domestic stock markets from 2010 to 2020 is not particularly compelling in most countries given the risk that this entails and the effects of inflation. In short, all else equal, rational investors would likely park their capital in public debt, rather than corporate equity or bonds.

[30] World Bank, 2010-2012, 2017-2019; Dalberg analysis

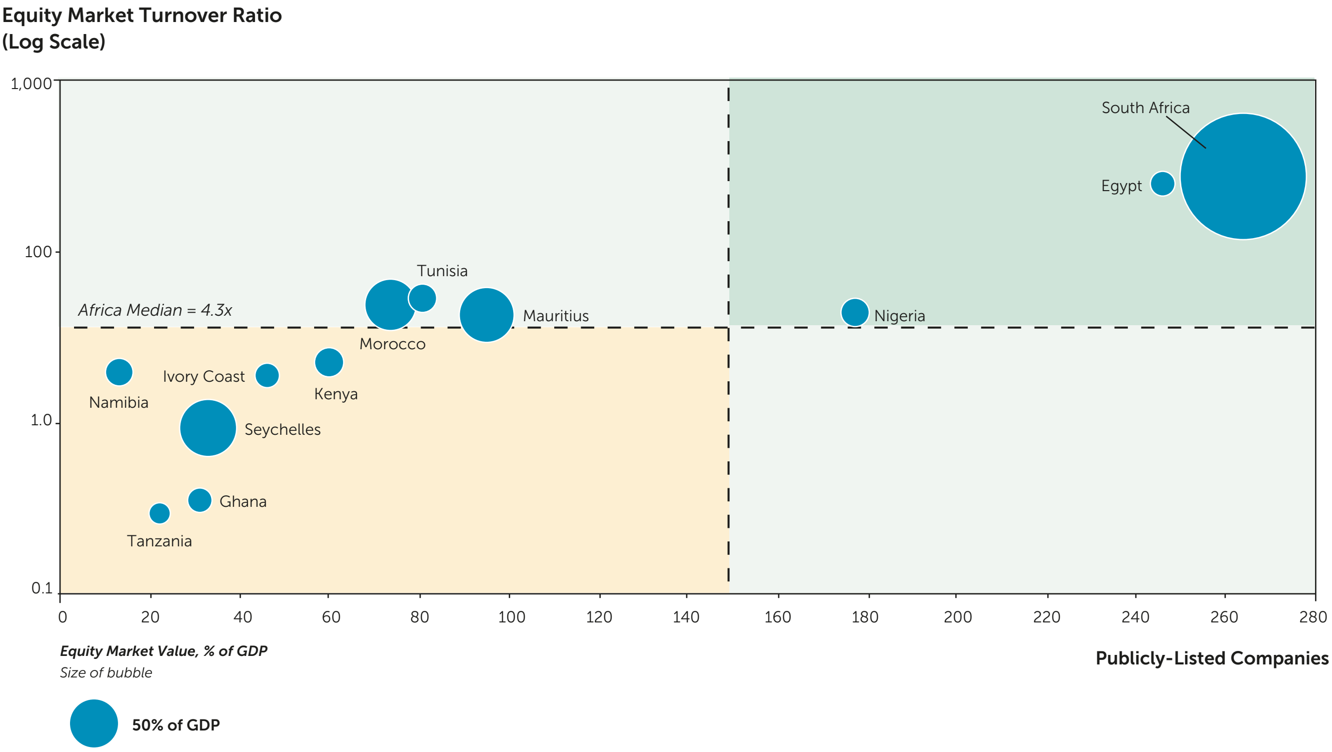
Figure 13: Change in Credit Flows to Private and Public Sector [31]



Therefore even equity markets that are relatively well developed by continental standards are still not particularly deep. Outside of South Africa and Egypt, the number of listed companies is low, as shown below. Market capitalisation relative to GDP and total turnover are also modest, including for Nigeria, Mauritius, Morocco and Kenya. Thus for most capital markets on the continent, the key need is not diversifying into more sophisticated products. Rather, the focus must be on further deepening the market with existing products by increasing the investor base, attracting and preparing more companies to list and fostering more active trading.

[31] World Government Bonds, 10-year yield; International Monetary Fund, bank lending rate; Global Financial Development Database, stock market returns; Dalberg analysis

Figure 14: Publicly-Listed Companies and Equity Market Turnover [32]

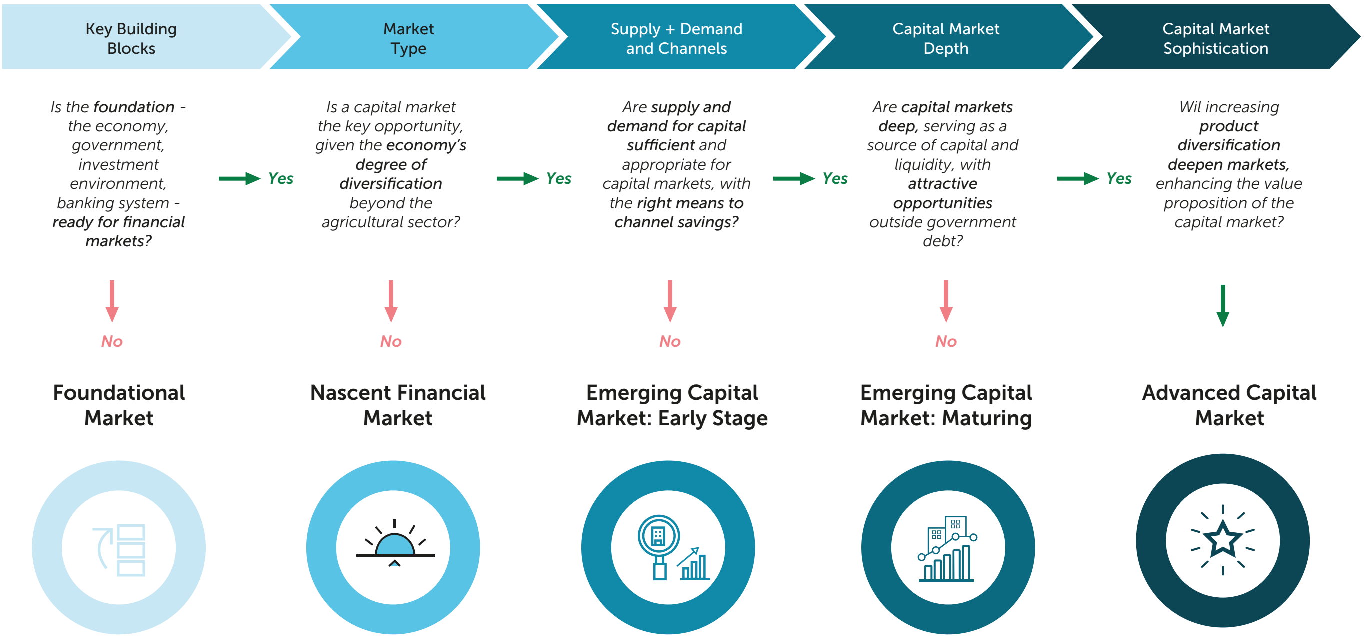


Market Development Stage

The areas of inquiry – building blocks, market type, capital supply-demand and channels, and capital market depth – provide a simple analytical framework that suggests each country's stage of financial markets development. In effect, each question functions as a screen with which to assess which markets have achieved the criteria for the subsequent stage, as illustrated in the figure below.

[32] World Bank, 2019; Dalberg analysis

Figure 15: Analytical Framework for State and Stages of Capital Markets



While the questions are intentionally structured to force a binary 'yes or no' answer, the reality of any given market is more nuanced, of course. This is not intended to be a deterministic exercise with simplistic categorisations; a degree of judgement is still necessary. Zimbabwe may not yet have all the right building blocks in place, yet it already has a capital market and is also wrestling with the challenges that come with a later stage. Relative to peer countries on the continent, Kenya has a relatively mature capital market – yet it can still consider the needs of earlier stages, such as mobilising capital from domestic institutional investors and supporting the structured trade of agricultural goods. The categorisations in the figure below are therefore indicative only, and deliberately suggest both a 'primary' category (dark grey), as well as other potential categories (light grey).

Figure 16: Analytical Framework for State and Stages of Capital Markets [33]

Crucially, these indicative categorisations of stage should be considered neither a destiny nor a blueprint. They provide a starting point for considering the needs and opportunities of each market and the potential role for its regulator to play. In the following section, we consider the implications for how regulators supervise and develop their markets.

[33] Synthesis of data from World Bank, IMF, IESE, Global Financial Development Database, World Government Bonds; Dalberg analysis

3. An Approach for the Regulator

A regulator applying the concept of proportionality matches its actions to the growth stage of the financial market. In advanced economies such as the United Kingdom, the regulator's mandate is primarily market surveillance, including securing investor protection, overseeing innovations, enhancing the market's integrity and promoting competition.[34] Regulators in emerging economies, on the other hand, must fulfil this same supervisory role but must also focus on basic market functionality and ensuring the foundational elements for financial markets are in place.

Insufficient regulations are, of course, a clear risk. The examples of SEBI in India and FSMA in the UK cited earlier were both reactions to scandals and illustrate the risk of insufficient supervision. In the US, insufficient regulations on the securitisation and marketing of mortgage-backed securities allowed a housing crisis, leading to a financial crisis and the 'Great Recession'. In the same vein, the China Securities Regulatory Commission (CSRC) entered commodities exchange regulations five years after the market had been established, by which point serious problems had already emerged to threaten market integrity. These included no minimum capital requirements, the mixing by brokerages of internal funds and customers' investments, and limited investor protection protocols. In fact, 90% of brokers had lost money in overseas markets. The CSRC was obligated to step in to establish a stricter legal and regulatory framework. [35]

However, regulators on the African continent must walk a fine line, as premature regulations may waste resources or even deter market development. Launching new offerings – with the right regulations and supervision to support them – to fit market needs and context is easier said than done. For example, SEBI has had several instances of attempting and failing to anticipate market needs in India. Investors only began trading stock index futures five years after the launch date, and exchange-traded funds for gold took four years from formal launch to being actively traded. Similarly, the market introduced interest rate derivatives in 2003, but had to relaunch them in 2009. [36] The Superintendencia Financiera de Colombia (SFC) provides a successful counter-example. It engaged market actors and other regulators to ensure that regulatory actions balanced investor protection with market evolution. For instance, in response to market demand in the mid-2000s, the SFC allowed private pension funds to invest in more diverse assets, such as private equity. [37]

What is clear is that regulators in Africa must adopt proactive, consultative approaches to shaping the market. This is a conscious shift from a reactive approach, as seen historically in other markets, to a forward-looking one in which the regulator follows a systematic approach to review the 'perimeter' of regulation and to identify and mitigate systemic risk, in line with the IOSCO Principles. As markets move from one stage to the next, the demands on regulators naturally evolve. The regulator's relative emphasis on market development or market supervision shifts, and its role and mandate grows proportional to the size and sophistication of the market. The figure below illustrates a high-level perspective on the likely evolution of a regulator – with the obvious caveat that these are only indicative areas of focus.

[34] Financial Conduct Authority, About the FCA, 2021

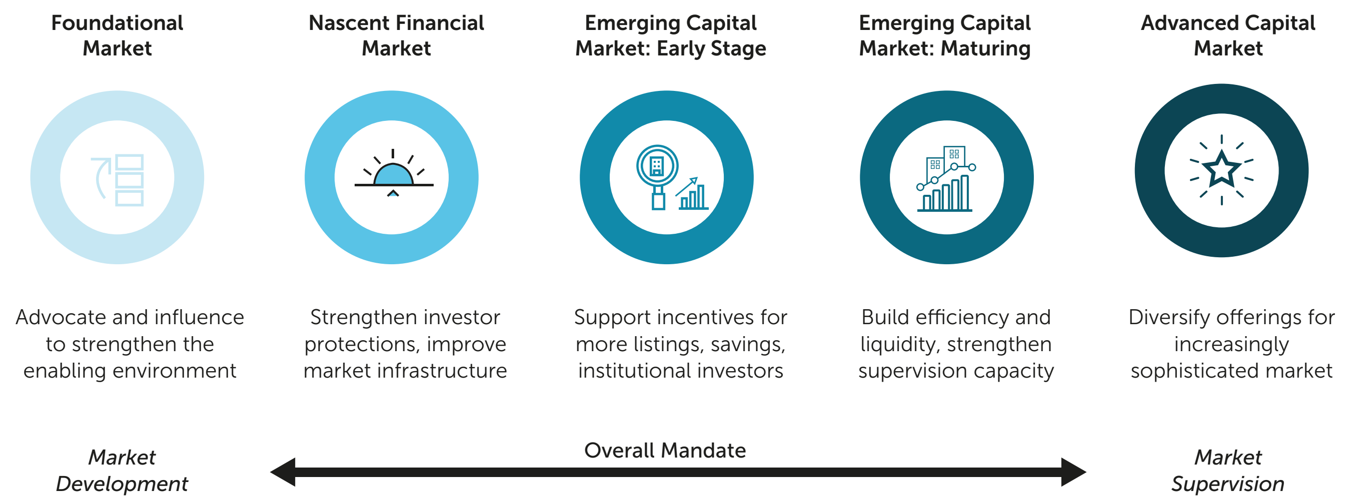
[35] United Nations Conference on Trade and Development, Development Impacts of Commodity Exchanges in Emerging Markets, 2009

[36] ADBI Working Paper Series, Financial Development in Emerging Markets: The Indian Experience, 2011

[37] CFA, Latin America Local Capital Markets – Challenges and Solutions, 2018

[38] International Organization of Securities Commissions, Objectives and Principles of Securities Regulation, 2017

Figure 17: Indicative Role for Regulators



In the early stages, the regulator should focus on basic foundational and infrastructural investments. An economy in the Foundational Market stage that is missing key building blocks does not need much – if any – active regulation of financial markets. However, a regulator for markets at this early stage can play a valuable role in influencing other stakeholders, particularly public sector actors that can shape the enabling environment to improve the business environment and banking system. For economies with the right building blocks, in the Nascent Financial Market stage, regulators must make smart strategic choices on where to focus investments – growing a commodity market, supporting private markets or launching public capital markets – and then lay the groundwork for investor protections and market infrastructure, such as the central depository, brokerage requirements, payment systems and more.

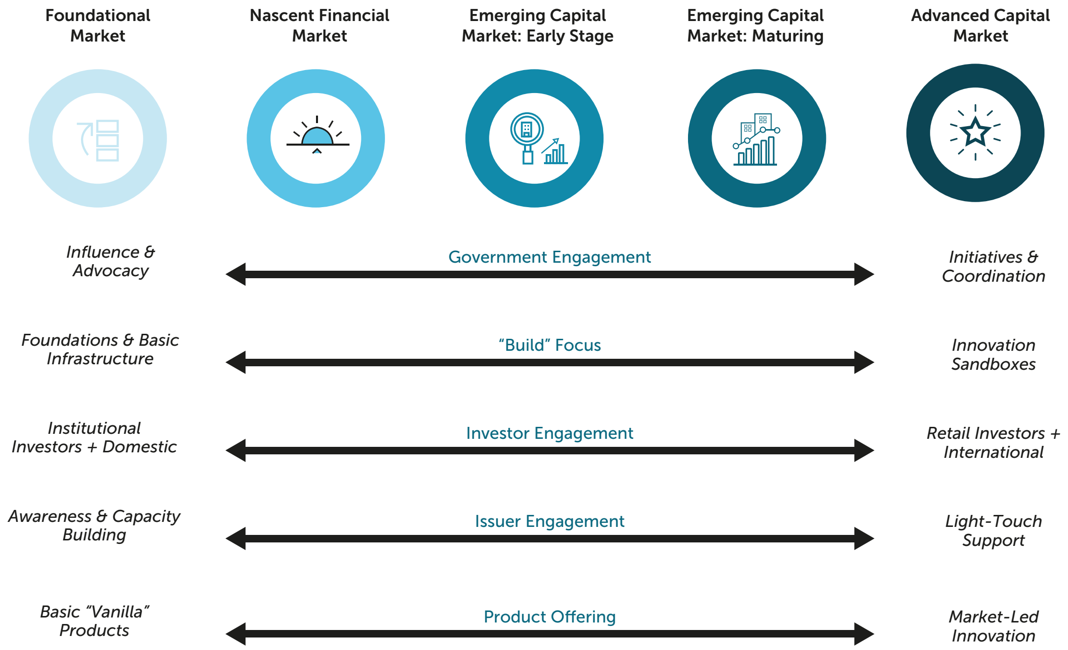
In the later stages, the regulator's role shifts from influencing the foundations of a market to building and supervising the market itself. An Emerging Capital Market: Early Stage economy needs to build a critical mass in which capital supply and demand are brought together through capital markets. Here the regulator's focus should be on attracting businesses to issue equity and debt, supporting them in understanding the process, and calibrating the listing requirements to build trust and transparency in the emerging market – but without making said requirements needlessly onerous. The regulator may also see an opportunity to boost savings that can be directed to capital markets, perhaps by setting the right rules and oversight for institutional investors or influencing taxation on capital gains relative to other forms of income. For a Maturing capital market, the regulator is focused on deepening so the market delivers on its promise of efficiency and liquidity. It may also need to improve its capacity for more robust, rigorous supervision, particularly as the activity and sophistication of market actors increases. Finally, as economies enter the Advanced Capital Market stage, the regulator may recognise the opportunity for more diversified products – along with the possibility of higher levels of systemic risk. Here, the regulator must foster market innovation and encourage new products for risk and reward to be divided and allocated, while staying ahead of new and greater systemic risks.

Evolution of the Regulator's Focus

As the regulator's role evolves, its focus across a number of dimensions changes as well. The figure below provides a conceptual framing that illustrates the transition. For instance, the regulator must work closely with other parts of the government, such as the finance ministry, central bank, tax authority and oversight bodies for pensions, insurers or other institutional investors. Needs and opportunities will vary by country, but the effectiveness of any regulator will be closely linked to its ability to coordinate and work on shared objectives with other government bodies. In the early stages of development, its clout is limited and there may not yet be a meaningful financial market in place. The regulator may thus use influence and advocacy to shape policies that will be conducive to stronger financial markets in the future. As the financial market matures and the regulator's role, capacity and credibility grow, it may have an opportunity to play a more proactive role in spurring innovation and coordinating across the government. For example, the lack of credible data is a challenge for many markets, and the regulator could help push for rules to support ratings agencies. Tax policy could also be either a deterrent or incentive for investing through financial markets, and the regulator could advocate for more favourable treatment for capital gains or dividends as a means to develop a more active market.

Similarly, the regulator's work in 'building' financial markets will at first be focused on foundational elements. With a maturing market, the regulator can use 'sandboxes' to test out new concepts in a controlled environment, thus matching innovation with protections against potential fraudulent or systemic risk. In the UK, the FCA has been very proactive in developing rules aligned with its changing environment. In 2021, the regulator developed guiding principles for designing, delivering and disclosing sustainable fund instruments to ensure that issuers provide clear information about the products and their inherent risks. [39] Within Africa, the Moroccan Capital Market Authority (AMMC) has proactively developed guidelines and directives for sustainable bonds that are increasingly popular in its market. [40]

Figure 18: Shift in Focus for Regulators



[39] Financial Conduct Authority, Regulatory Initiatives Grid, 2021
[40] AMMC, Gender Bonds Guidelines, 2020

Similar shifts are necessary as the regulator engages with market participants. Early establishment of a strong investor protection framework is especially important. Over the past decade, for example, the Nigeria SEC has strengthened its complaint management framework, developed a National Investor Protection Fund, supported the quasi-judicial Administrative Proceedings Committee and refined its Anti-Money Laundering and Combatting the Financing of Terrorism (AML/CFT) framework. [41] As the market matures, the regulator may collaborate with other government entities to mobilise more domestic investment. In many countries, pension funds and insurance companies are the key local vehicles to channel funds into capital markets. Thus the regulator may work with the relevant entities to encourage greater investment into local capital markets. For instance, in Kenya, FSD Africa and the Capital Markets Authority collaborated with the Retirement Benefits Authority (RBA) to encourage pension funds to increase investments in real estate investment trusts (REITs) and to allow more capital into private equity.

As a practical measure, the regulator of an earlier-stage market may also focus on investor education. [42] Investor education is vital for generating interest in the financial markets since it allows would-be investors to learn about the financial intermediaries and instruments. Moreover, it serves as a complement to consumer protection, helping investors understand potential risk factors. [43] Many regulators across the world have developed investor education programmes or tools to encourage local investors to channel their investments into the capital markets. For instance, Kenya's Capital Market Authority has developed an extensive toolkit for investors on its website. The toolkit has a diverse set of detailed educational links on financial products, investor protection guidelines, complaint procedures, listing guidelines and the comprehensive regulatory framework. [44] Outside the continent, the SEC in the US has a dedicated office, website and tools to provide investors with comprehensive services and information on capital markets, products and actors. [45] [46]

With greater maturity, the regulator may also pivot towards attracting more foreign capital. Offshore investors hold the potential to deepen and accelerate the development of emerging capital markets and to incentivise improvements in transparency and governance of domestic companies. [47] For example, the regulator's strategy could be a sequential approach that starts with understanding the types of foreign investors that they can engage and their key concerns, such as settlement risk. From this initial step, the regulator could then move to broader marketing aspects such as setting up an investment promotion agency and disseminating information on the regulatory framework, viable sectors and credit ratings. [48] The regulator can then scale the approach to include structural aspects such as limiting financial controls and allowing investment in previously restricted industries and products. With all these efforts, the regulator needs to frame their actions appropriately, considering effects on market signals, macroeconomic stability and other country-specific factors. [49] The regulator also needs to develop a clear plan to prepare the market and to attract foreign capital, while considering the risk that larger, faster capital inflows and outflows may create more volatility.

Just as the regulator's engagement with market actors evolves, it should evolve its product and service strategy. A lack of suitable products limits investor demand. [50] As the Indian experience with

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[41] World Bank, Lessons on Building Robust Capital Markets through Smart Regulation and Innovation, 2016
[42] World Economic Forum, Accelerating Capital Market Development in Emerging Economies: Case Studies, 2016
[43] OECD, Policy Framework for Investor Education, 2017
[44] Capital Markets Authority, Capital Markets Information Toolkit, accessed: January 2022
[45] US Securities and Exchange Commission, Office of Investor Education and Advocacy, accessed: January 2022
[46] US Securities and Exchange Commission, Investor.gov, accessed: January 2022
[47] IFC, Creating Domestic Capital Markets in Developing Countries: Perspectives from Market Participants, 2020
[48] International Growth Centre, Attracting quality foreign direct investment in developing countries, accessed: January 2022
[49] IFC, Creating Domestic Capital Markets in Developing Countries: Perspectives from Market Participants, 2020
[50] ODI, Research series for financial development in Africa, Policy Brief 2, 2021

interest rate derivatives and gold ETFs demonstrates, however, promoting products prematurely is also a risk. Government bonds often dominate nascent markets, with few corporate bond and equity issuances. [51] To build greater depth, earlier-stage financial markets typically require basic offerings that are understood and accepted by the market. Derivatives tend to develop in the later stages only after the markets have reached a certain level of liquidity. The sophistication of instruments should increase gradually, responding to the market's and participants' capacity. [52] Growing interest in sustainable finance, such as climate financing, and impact investing are also important opportunities for regulators to consider. Given investor appetite and capital for such opportunities, regulators in Africa may also consider ways to use reporting standards or other means to help companies provide credible and relevant information for investors seeking to meet environmental or social impact objectives.

Given the competing demands of market surveillance and development, regulators must be particularly attuned to market needs. They can take a consultative approach to gauge the level of interest in the market for specific products. This may include hosting investor events and inviting requests for input on papers examining emerging issues, allowing them to collect input while building the knowledge level of the regulator's staff. For more mature capital markets, the regulator can allow market actors to experiment with novel products in a controlled testing environment or through regulatory relief, using a regulatory sandbox. For example, in Australia, firms must disclose their participation in the sandbox as an unlicensed entity, provide a channel to compensate clients for losses or damages, and set up a dispute resolution system for consumers to settle complaints outside the formal legal system. [53] This relaxed regulatory environment allows regulators and participants to test a product and understand the benefits and risks it could have for participants and the general market.

Evolution of Capacity and Funding Model

As the regulator adopts the outlined roles, it needs to ensure that it develops its capacity internally to grow proportionally with the advancing market. The regulator can start by ensuring that it has the right resources and capabilities to operate effectively and flexibly in the changing capital market environment. [54] The actions could include recruiting staff with the right mix of skills and qualifications to identify and understand potential risks arising from the design and distribution of financial services. Further, the regulator could provide staff training and development that is up to date with the latest technological developments and applications. In addition to upskilling staff, the regulator needs to adapt its regulatory and supervisory tools to the environment. [55] Possible actions include establishing or upgrading systems to collect and analyse relevant data to inform regulatory decisions and supervisory efforts and understand the behaviour of market participants. The regulator could also explore the use of technology such as RegTech and SupTech to assist them in supervising financial services providers and identifying and monitoring risks arising in the financial system.

Such capabilities must be delivered at the right size and structure and within resource constraints. In line with their earlier stages, regulators in most African countries need to be relatively smaller in size, with divisions and departments that are more aligned towards market development and working as generalists. As markets grow and become more complex, staff with diverse skills and more specialised departments are needed to monitor the activities of more sophisticated markets.

[51] Ibid
[52] Ibid
[53] Australian Securities and Investments Commission, Regulatory guidance, 2018
[54] Pew Trusts, How Can Regulators Promote Financial Innovation While Also Protecting Consumers? 2018
[55] Ibid

The right funding model is therefore critical. Capital market regulators have varied funding sources for their core regulatory and operational activities. These sources of funding differ across jurisdictions and stages of market development. In general, there are five sources of funding:

- **Government contribution**: Transfer of funds from the government, usually the Treasury, to finance the activities of capital market regulators
- **Donor contribution**: Comprises grants and other forms of finance from donors, multilateral organisations and bilateral partners
- **Industry fees**: Constitutes operational licences, annual renewal fees, transaction levies and special project fees from industry players who participate in the regulator's capital market
- **Penalties**: Includes charges to industry players who do not comply with specific regulations such as non-reporting or to actors who have participated unfairly in the markets
- **Other income**: Encompasses a wide range of sources such as publications, training services or external investments

In the early stages of capital market development, regulators primarily depend on the government to fund their operations. At this point, there are few financial instruments and limited demand, and as a result, little market activity to generate the fees needed to support the regulator. Hence, the regulator will rely on government funds rather than industry fees. CMA Rwanda is a good example of a regulator that relies on government funding in anticipation of the market gaining momentum.

In addition to government funding, donor contributions play a critical role in financing the regulator. As the regulator invests in developing the market in the early stages, budget deficits usually limit their efforts. In such cases, donor contributions are crucial in supporting regulators to deliver on their mandate. Furthermore, the funding and technical assistance can enable the regulator to build its capacity, including technological and human resources, or conduct special market programmes such as investor education.

As the capital market evolves into the emerging mature and advanced stages, the regulator will increasingly rely on industry fees and other income. These latter development stages typically have high product diversity and liquidity levels due to the increased number of participants. The increased activity means that the regulator has diverse funding channels, including licence fees, transaction levies and other income from training activities. Thus, the regulator can evolve from depending on government and donor contribution to solely funding itself from the market activities. This results in a more independent regulator.

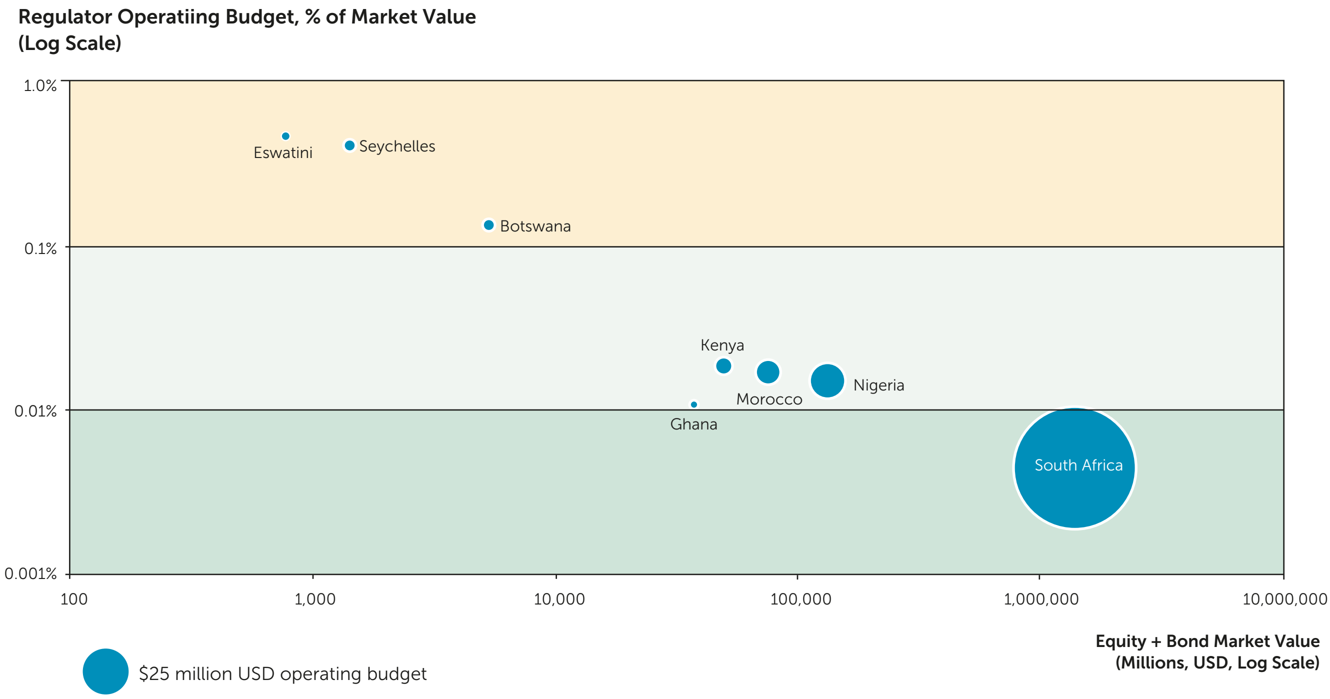
This observed evolution ties closely to the concept of budgetary independence. IOSCO states that a regulator should have a degree of independence, but this is shaped by its funding sources. When a government funds a regulator, the budget size and requirements should ideally arise from the agency, and political pressure should not influence the process. However, this is not usually the case; hence, a regulator might derive more independence from relying on non-government sources.

Even though reliance on industry fees reduces political pressure and potentially leads to increased independence, it carries its own set of risks. Relying on fees risks increasing dependence and potential interference from the industry. Moreover, depending solely on the sector might leave the regulator vulnerable during financial crises, should market actors struggle to pay their fees.

[56] International Monetary Fund, Should Financial Sector Regulators Be Independent? 2004
[57] Ibid

Typically, African regulators have budgets proportional to the size of their capital markets. Across Africa, regulators either rely solely on industry funding or have a mixture of industry funding with government contribution. Not surprisingly, regulators operating in smaller markets – with lower equity and bond market values – have smaller budgets. The NBFIRA of Botswana operates on $6.9 million USD per year, while the South African regulator runs with over $60 million. Notably, there are significant returns to scale, with regulator budgets declining as a share of equity market capitalisation and total bond market value in larger capital markets.

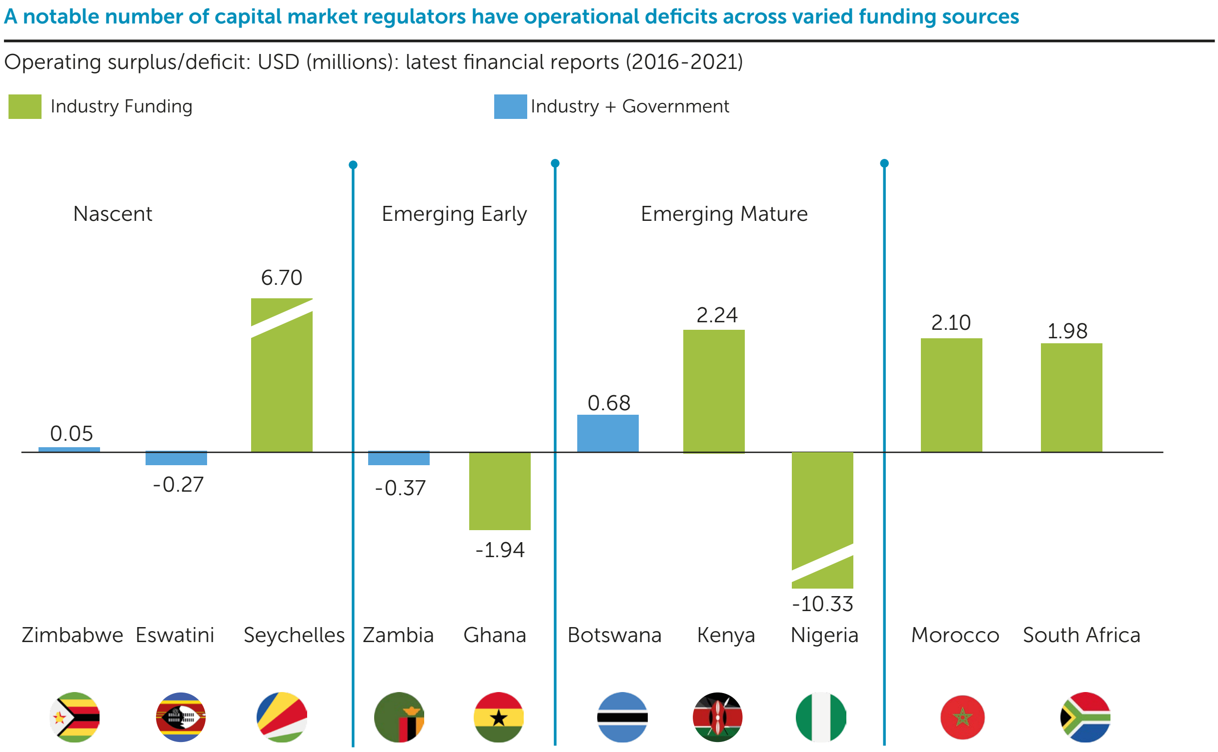
Figure 19: Regulator's Operating Budget Relative to Market Size [58] [59] [60]



A detailed review of regulator budgets shows that operational deficits can exist across different funding models and development stages. Regulators such as AMMC (Morocco) and FSCA (South Africa) had a sizeable operating surplus from their funding sources over the recent financial years. Nonetheless, well-established regulators such as the SEC Nigeria and SEC Ghana have experienced considerable operational deficits. These operating deficits suggest that regulators might not have evolved proportionally with their capital markets

[58] World Federation of Exchanges, Statistics Portal – African Exchanges, accessed: January 2022
[59] Absa, Absa Financial Market Index, 2021
[60] Annual reports of the capital market regulators of Eswatini, Zambia, Cameroon, Zimbabwe, Ghana, Seychelles, Botswana, Morocco, Nigeria and South Africa

Figure 20: Funding Model and Operating Surplus/Deficits of Capital Market Regulators [61] [62]



Given the risks of both funding models and the financial unsustainability of regulators, a more fluid mix between industry funding and government contribution may be a sensible alternative. This approach would allow regulators to generate industry fees, while maintaining access to more certain funding flows. Partial government funding offsets potential pressure or interference from the industry itself, and it allows the regulator to build adequate reserves to counter any shocks from unprecedented financial crises. Several regulators such as the Australian Securities and Investment Commission (ASIC) have adopted this funding model. [63]

[61] Ibid
[62] The local currencies were converted to US dollars with the respective exchange rates as of 31st January 2021
[63] Australian Securities and Investment Commission, Industry Funding, accessed: January 2022

Case Study: ASIC's Funding Model

ASIC is Australia's integrated corporate, market, financial services and consumer credit regulator. The regulator is an independent government body that maintains financial systems, promotes investor protection and administers the law.

Recent regulatory changes have altered the funding structure of ASIC. The government launched the Financial System Inquiry in 2013 to examine how the financial system could best meet Australia's evolving needs and support economic growth. One of the inquiry's recommendations was that the regulator alters its funding model from government contributions to industry funding. The shift to industry funding was projected to provide greater funding certainty and ensure that the regulator is sufficiently funded to deliver on its mandate. Furthermore, the transition would create price signals to the industry on the actual use of ASIC's resources and discourage poor conduct among regulated firms. In line with this recommendation, the government passed a law in 2017 to allow ASIC to shift to this new form of funding.

Despite its shift to industry funding, the ASIC still relies on government contributions to cover certain costs. Within the industry funding model, ASIC still receives revenue from the government through appropriations. The government also pays ASIC the discounts it levies to financial actors. The purpose of these discounts is to ensure that retail investors are not priced out of the market due to the relatively high levies.

Ultimately, ASIC's new funding model has enabled it to resolve the budgetary deficits it experienced in the early 2010s while building the market's confidence through its transparent levy structure.

4. Appendix

Snapshots of Regulators and Proportionality to Markets

On the question of the proportional size and structure of regulators, there is no prescribed way of clearly setting up a balanced regulator relative to its market size. However, certain regulators have done a commendable job in aligning their funding and structure to the size of the capital markets. These are the capital market regulators in Ethiopia (foundational stages), Morocco and the United Kingdom. Moreover, certain regulators such as SEC Ghana have great potential to achieve proportionality after adjusting their structure and funding model.

Ethiopia

Ethiopia has a rapidly growing economy, with analysts predicting more than 8% growth in 2021/22. The service and industry sectors will primarily drive short- to medium-term economic growth. Nonetheless, a close analysis into the financial services sub-sector highlights that although the country has a deep commodities exchange, a fully fledged capital market is yet to develop.

Vision of success

The Ethiopian government intends to develop a futuristic, accessible capital market that leverages technological advancements and critical learnings from the development of other capital markets. The Ethiopian government enacted the Capital Markets Proclamation to launch a competitive capital market in Ethiopia. The government also established the Ethiopia Capital Markets Project Implementation Team (CMPIT) to operationalise the proclamation. This team acknowledges that Ethiopia is late to the capital market stage; however, they plan on using this as an advantage by learning from other leading markets and regulators. In doing so, the team will use the key learnings to develop a digital platform that is accessible to a broader pool of investors and launch a variety of digital assets within the medium term. The team has already conducted multiple visits to CMA Kenya and the Capital Markets Board of Turkey to gain this experience. Furthermore, the team has engaged organisations such as FSD Africa and the World Bank to tap into their knowledge and develop a practical capital market for Ethiopia.

Regulatory structure

The CMPIT is adopting a phased approach to developing a regulator. Currently, the CMPIT team is incubated at the National Bank of Ethiopia until the Prime Minister appoints a Director-General. Within its incubation, the CMPIT is in charge of drafting the initial regulations and building the regulator's capacity. The CMPIT team constitutes 14 senior experts with extensive knowledge of capital markets and regulations, working in six workstreams. These workstreams include:

- **Institutional design and resource requiremen**ts: In charge of drafting the organisational structure, organogram, staff job descriptions and recruitment strategy

[64] Reuters, Ethiopia's economy seen expanding 8.7% in 2021/22, 2021
[65] African Development Bank, Ethiopia Economic Outlook, 2021
[66] FSD Africa, Development of the Policy and Regulatory Framework for the Licensing and Regulation of Capital Market Service Providers in Ethiopia, 2021

- **Regulatory framework workstream**: In charge of drafting the directives and licence procedures for the different financial products, including equities, bonds and derivatives
- **Capacity development and investor education**: In charge of developing an investor education strategy and tools that will create interest and build an investment culture for the capital markets
- **Long term development roadmap**: Outlines the strategic vision for the regulator and the capital market
- **Enabling environment**: Reviewing policies and developing recommendations that will support the market, such as tax incentives and foreign controls
- **Establishment of the exchange**: Developing the overall design of the platform, including the different facets and product features

The CMPIT team expects that these workstreams will evolve into the key departments of the regulator within the short term. Furthermore, the team plans on adopting a phased staff recruitment strategy that will align itself closely to the growth and needs of the capital market.

Funding model

The initial funding model approach will rely on government transfers before shifting to industry funding. The new regulator will depend on the government funding as the exchange gains momentum and more market participants engage in the capital market. However, they plan to change to industry funding to become a fully independent regulator in the medium term.

Critical lessons for nascent stage countries

In addition to the regulator's structure, other key lessons include leveraging key experts and investing in stakeholder involvement. Throughout the whole process, from drafting the proclamation to the current implementation, the process has been expert and principle-driven. This approach allows key learning and extensive knowledge to drive such a technical process. Moreover, the technical team engaged different stakeholders and collated their views to develop a proclamation, a regulator and a capital market that are attractive and conducive to all participants. These factors ultimately set the stage for building investor confidence in a new capital market with revolutionary potential.

Morocco

Morocco has one of the leading capital markets in Africa. The capital market has a value of $66 billion USD, the second highest on the continent. [67] Industry experts and peers consider its regulator, the Moroccan Capital Market Authority (AMMC), as appropriately structured and well aligned to the country's capital market development stage.

[67] World Bank, Market capitalization of listed domestic companies, accessed: January 2022

Regulator's mandate

The AMMC is the regulatory body in charge of the supervision and control of the Moroccan capital market. [68] The regulator's primary missions include ensuring the protection of savings in financial instruments, maintaining the transparency and integrity of the capital markets and fostering the financial literacy of investors.

Structure

Number of employees (2020): 151.

The AMMC has a set of divisions and departments that enable it to proactively support the development of the market while maintaining strict surveillance of activities. The regulator's six divisions are Asset Management and Savings Protection, Corporate Finance and Markets, Investigation and Controls, Standardization and Legal Affairs, Resources, and Organization and Information Systems. In addition to these divisions, three auxiliary entities report directly to the leadership. These entities include Internal Audit, Risk Management, and Communication and International Relations. [69] (*See the graphic below*.)

Cognisant of its stage in the capital market spectrum, AMMC has invested diligently in training to build its internal capacity. In the 2020 financial year, the regulator leveraged digital education channels to engage 90% of its staff on 39 training courses. These courses include financial market regulation, fintech, corporate finance and foreign languages. [70]

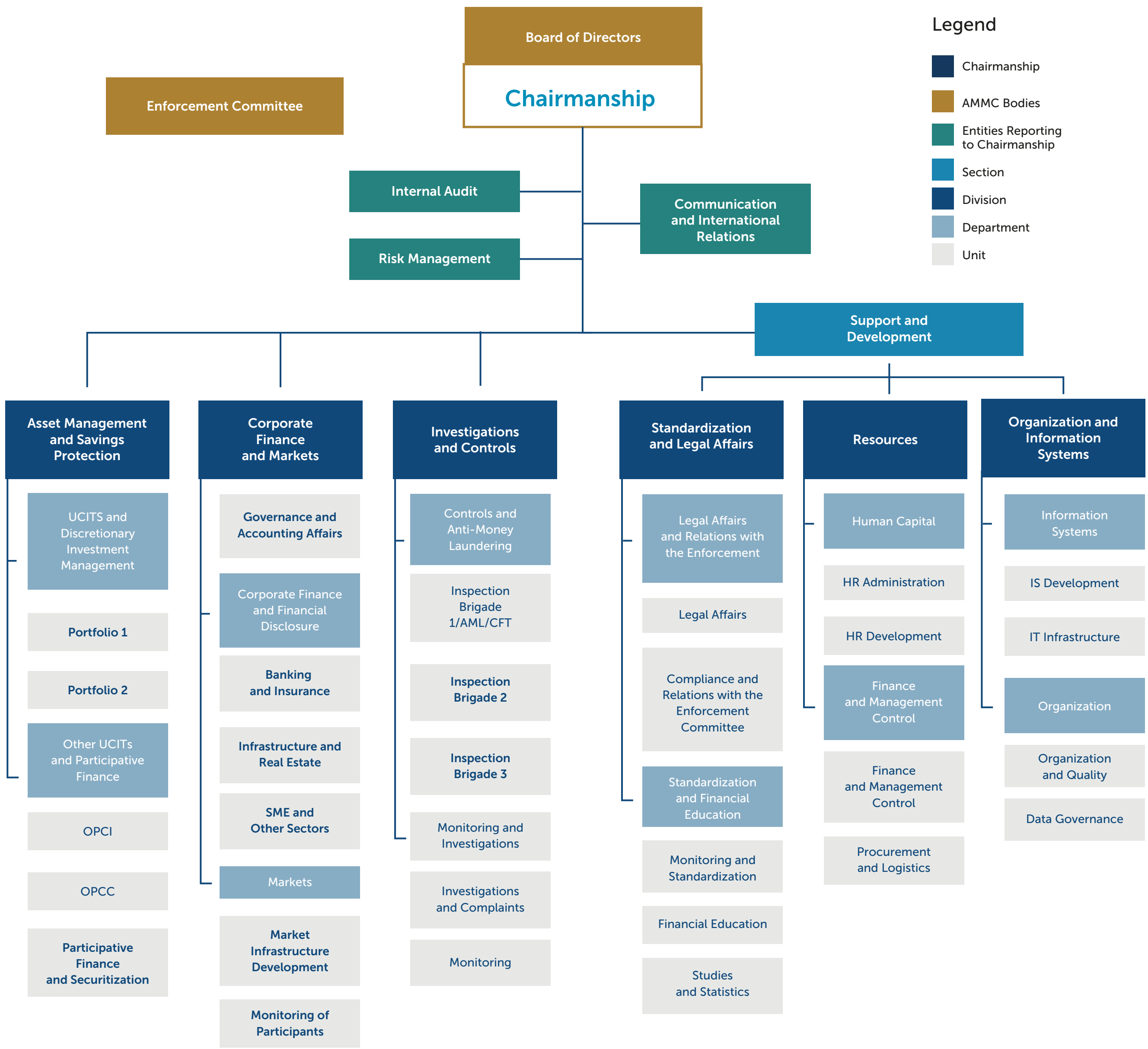
Funding model

The AMMC primarily relies on industry fees and has reported operational surpluses in the recent financial years. In 2019/20, the regulator reported an operating surplus of $2 million USD. 86% of the revenue was from Undertakings for Collective Investment in Transferable Securities (UCITS) fees. The rest of the income came from transaction fees, parafiscal tax and Maroclear fees.

Figure 21: AMMC's 2020 Operational Surplus/Deficit

[68] AMMC, Annual Report, 2020
[69] Ibid
[70] Ibid

Figure 22: Figure 4: Organisational Chart of AMMC (Morocco) [71]



Operational efficiency

In assessing the operational efficiency and, in effect, the proportionality of regulators, the white paper relied on two metrics. The first metric is the market capitalisation for each staff member, which assesses the dollar value of the equity market attributed to or held by each employer. The second metric is the regulator's operational expense as a percentage of the market capitalisation. This metric analyses how big a regulator is relative to its market size.

Based on these two metrics, the AMMC is proportional to its market stage compared to its peers. In the first metric, AMMC staff hold $494 million USD in market value, which is considerably higher than peer regulators in Nigeria, Kenya and Mauritius. Furthermore, the regulator is of proportional size, given that its operational expense is only 0.02% of the market capitalisation. This value is lower when compared to the Mauritius FSC, whose operating expense is 0.14% of the market capitalisation.

Table 1: Operational Efficiency of Emerging Mature Capital Market Regulators [72] [73]

Indicators	Morocco: AMMC	Nigeria: SEC	Mauritius: FSC	Kenya: CMA	Ghana: SEC
Market cap per staff member (USD)	494M	144M	37M	218M	169M
Operational expense as % of market cap	0.02%	0.02%	0.14%	0.03%	0.04%

Proportional market development and regulation roles

True to its position on the growth spectrum, the AMMC has taken steps to incentivise trading activity while imposing stricter surveillance as its market becomes sophisticated. The regulator has recently launched tools and vehicles to increase the level of activity in the market. In detail, these steps include:

- **Financial literacy tool**: The AMMC launched the 'QUIZZ FINANCE' mobile app to familiarise public investors with basic capital market concepts and increase their interest in financial instruments
- **Real estate investment vehicle**: The AMMC and the central government refined the regulatory framework to launch property investment mutual funds (OPCIs). The OPCIs enable a fund to collate several real estate assets and later distribute the income to shareholders [74]

The regulator has developed guidelines and frameworks on the market surveillance side to promote the market's integrity with the increasing number of new products and more sophisticated investors. These steps include:

- **Gender bonds guidelines**: In collaboration with FSD Africa, AMMC launched the gender bonds guidelines, which lists sustainability-linked principles that can structure sustainable bonds. [75] These guidelines can be linked to the development of the first gender bond by Banque Populaire in 2021 [76]
- **Anti-money laundering guidelines**: The AMMC developed a guide to help capital market participants understand the regulatory requirements for Anti-Money Laundering and Combatting the Financing of Terrorism. The guide also includes risk-based control approaches to identify and monitor high-risk transactions [77]

[72] Latest annual reports of regulators in Morocco, Kenya, Nigeria and Mauritius
[73] World Federation of Exchanges, Statistics Portal – African Exchanges, accessed: January 2022
[74] Oxford Business Group, Regulatory reform and new products to bring dynamism to Morocco's capital markets, accessed: January 2022
[75] AMMC, Gender Bonds Guidelines, 2020
[76] Africa Business Communities, Banque Populaire launches microfinance program for women, 2021
[77] AMMC, Annual Report, 2020

United Kingdom

The United Kingdom has one of the world's most attractive and competitive capital markets. The equity market has a market capitalisation of $3.3364 billion USD, among the highest in the world.

FINANCIAL CONDUCT AUTHORITY

Regulator's mandate

The Financial Conduct Authority is the regulator charged with protecting consumers, enhancing the integrity of the UK's financial system and promoting competition. As of 2021, the regulator supervised 51,000 financial service firms and markets in the UK.

Structure

Number of employees: 4,194

The FCA is a multi-faceted organisation with multiple interlinking committees. At the board level, there are seven committees: External Risk and Strategy, Audit, Remuneration, Nominations, Oversight, Regulatory Decisions and Competition Decisions. These committees combine their roles to make strategic decisions on the regulator's operations and set appropriate policies to manage risks. Additionally, there are other committees at the senior management level that are in charge of the day-to-day operations of the regulator within their workstreams. These include the Strategy and Competition, Retail and Authorisations, Investment and Wholesale, Enforcement and Market Oversight and Operations committees.

Funding model

The FCA's primary funding source is industry fees. The Financial Services and Marketing Act (FSMA) empowers the FCA to raise levies to meet its budgeted ongoing regulatory activity (ORA). This mandate also means that the FCA does not receive any form of funding from the government. The FCA typically receives annual periodic fees, special project fees and application fees. Of these sources, the recurring regulatory fees (Ongoing Regulatory Activity Fees) constitute 87% of the regulator's income.

An analysis of the annual reports indicates that the regulator is financially sustainable. Over the past five years, the regulator has reported operational surplus from its core regulatory activities. For instance, in 2020/21, the regulator recorded an excess of $50 million USD. **The observed financial sustainability implies that the regulator has a balanced operating budget to conduct its tailored market development and surveillance roles.**

[78] Financial Conduct Authority, Highlights of the FCA's new approach, 2021

[79] Financial Conduct Authority, Annual Report, 2021

Figure 23: : FCA 2020/21 Operating Surplus/Deficit

Operational efficiency

However, despite consistent financial sustainability, the FCA is performing less efficiently than its peers. The analysis shows that the FCA has the lowest market cap per staff member, at $802 million USD, and the highest operational expense relative to the market size. **These metrics show that a regulator can be financially sustainable but has potential operational deficiencies within its structure.**

Table 2: Operational Efficiency of South Africa and Advanced Market Regulators

Indicators	United Kingdom: FCA	South Africa: FSCA	India: SEBI	United States: SEC
Market cap per staff member (USD)	802M	1.8B	3.0B	9.0B
Operational expense as % of market cap	0.02%	0.01%	0.003%	0.01%

Proportional roles

In addition to the roles highlighted throughout the document, the FCA has elevated its market surveillance role by launching initiatives that protect investors and ensure that market participants operate efficiently in its sophisticated market. Some examples of the 2021 regulatory initiatives include:

- **Trust in the market for ESG investments**: The FCA developed guiding principles for the design, delivery and disclosure of sustainable fund instruments to ensure that issuers provide clear information about the products and their inherent risks
- **Artificial intelligence research**: The FCA collaborated with the Alan Turing Institute on a research project to explore AI transparency in financial services. The project's output will strengthen the regulator's investor protection approach

[80] Financial Conduct Authority, Regulatory Initiatives Grid, 2021
[81] Ibid

Ghana

Ghana has one of the fastest developing capital markets in Africa. The West African country is ranked sixth in market capitalisation and has one of the continent's most active private equity environments.

Regulator's mandate

The Securities Industry Act mandates the Securities and Exchange Commission (SEC) of Ghana to regulate and promote the growth of an efficient and transparent capital market. To fulfil this mandate, the SEC advises the Minister of Finance on the securities industry and maintains surveillance on securities and licences products and actors. [82]

Structure

Number of employees (2020): 62

The Ghana Securities and Exchange Commission has nine complementary departments that enable the regulator to focus on its market development and surveillance roles. These are Audit and Risk Management, Brokers and Advisors, Exchange and Markets, Funds Management, Issuers, Legal and Enforcement, Policy and Information Technology, and Finance and Human Resource.

Funding model and operational efficiency

The SEC's most significant funding source is industry fees, particularly depository and transaction levies. In the recently published annual reports, the depository levies and transaction fees constituted 42% and 35% of regulator's total funding. Licence fees, approval fees and the World Bank's contribution constituted the remaining portion.

Despite the reliance on a more certain funding source, the annual reports indicate that the SEC does not have appropriate funding to deliver its mandate. The commission had operating deficits of $1.5 million USD and $700K USD in 2019 and 2018 respectively. [83] These deficits conflict with the efficiency metrics (table one), which indicate that the regulator has an appropriate operating budget for its market size. This implies that the regulator might have an appropriate operational budget but limited funds to support it. Therefore, the commission needs to effectively access more funding to cover the operating deficits.

Figure 24: SEC Ghana 2020 Operational Surplus/Deficit [84]

[82] Ghana Securities and Exchange Commission, Functions of the Commission, accessed: January 2022
[83] Ghana Securities and Exchange Commission, Annual Report 2019 and 2020
[84] Ibid

Proportional roles

Given Ghana's position as an emerging early market, the SEC has progressively taken up roles to develop its capital market and strengthen the existing institutional guidelines. Under market development, the key highlight has been:

- **Capital Market Master Plan (CMMP)**. In 2019, the SEC launched the master plan to serve as the blueprint for developing the capital market in Ghana over the next ten years. The key pillars in the document include improving the diversity of investment products, increasing the investment base and strengthening market infrastructure and enforcement

Over the past three years, the SEC has proactively drafted directives and guidelines to help investors to launch new products while protecting investors. One of the 2021 guidelines is:

- **Investment Guidelines for Fund Managers**. This includes a set of guidelines for licensed fund managers of collective investment schemes and pension funds operating in the Ghanaian capital markets

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