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ON A

PROPOSED GRANT FROM THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

IN THE AMOUNT OF SDR 10.5 MILLION
(US$16 MILLION EQUIVALENT)

TO THE

EAST AFRICAN COMMUNITY

IN SUPPORT OF THE

EAST AFRICAN COMMUNITY FINANCIAL SECTOR DEVELOPMENT AND REGIONALIZATION PROJECT I

December 29, 2010

Finance and Private Sector Development
East and Southern Africa
Africa Region

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Table of Contents

I. Financial Inclusion and Strengthening Market Participants ... 1
II. The Banking Sector ... 19
III. Capital Markets ... 38
IV. Regulation and Supervision for an Integrated Insurance System ... 77
V. Regulation and Supervision for an Integrated Pension System ... 84
VI. The Regional Bond Market ... 89
VII. EAC Governance and Legislative Process ... 100
VIII. WBI Collaboration: Strengthening financial skills in the EAC ... 108

I. Financial Inclusion and Strengthening Market Participants

A. Background

1. Improving access to financial services by the underserved communities and businesses is critical for the development of an equitable financial sector. Access to sustainable and secure financial services contributes directly to increasing income and reducing vulnerability for the poor. Bringing more people, and therefore more money, into the formal financial system can lead to overall economic growth and development, and increased stability of the economies. Financial inclusion means building a financial system that serves as many people as possible in a country (Alliance for Financial Inclusion, 2010). To achieve this, the EAC FSDRP has acknowledged the role played by a variety of providers, products, and technologies that work within and are a reflection of the socio-economic, political, cultural, and geographic conditions of the region.

2. Although financial systems in the EAC are at different levels of development, they have two key characteristics in common: a) low financial inclusion rates and b) the banking sector dominates the formal financial sector. Hence, the main aim of Component 1 is to leverage the establishment of a single market in the EAC and the associated benefits of regionalization to enable the majority of citizens - particularly those currently not served - to have access to a broad range of formal financial services and products.

3. There has been a recent shift in donor policy emphasis from a focus on providing financial services to the poor - in particular via microfinance - to the need to provide 'finance for all' (World Bank 2008) and a wider focus on the unbanked and those on low incomes. This development builds on other developments in the financial sector and can be understood from the recent shift of approach within the sector towards building the financial sector as a whole and not just focusing on microfinance and focusing on 'building of inclusive financial systems'. This reflects a view that it is necessary to work with a wide range of actors in the financial sector and not microfinance organizations alone to deliver the outreach needed through organizational and technological innovation. Other emerging trends include the recognition of the changing role of policymakers and the importance of leadership to successful financial inclusion strategies and response; that microfinance can be used as an entry point for issues of access; that new technology is very important - but not the only - consideration; that savings are the cornerstone of responses; that banks have an important role to play; and that financial inclusion policy can and should not only focus on the supply side.

4. In addition to increasing access, there is a need for harmonization of the legal and regulatory frameworks that have an impact on provision of financial services to the unbanked/un-served. Of particular importance is the legal and regulatory frameworks for agent banking, mobile banking, AMF/CFT, microfinance, SACCOs, payment infrastructure for low-value/high volume transactions, and financial capability (financial literacy and consumer protection).

Table 1: Access strand[1] across the five EAC Partner States

Access Strand (weighted)	Kenya (FinAccess 2009)	Uganda (Draft Finscope 2010)	Tanzania (Finscope 2009)	Rwanda (Finscope 2008)	Burundi (data not available)
Formal	22.6 %	19 %	12.4 %	14 %	
Formal Other	17.9 %	10 %	4.3 %	7 %	
Informal	26.8 %	19 %	27.3 %	26 %	
Without Access	32.7 %	53 %	56 %	52 %	

5. Table 1 above shows the financial access landscape across the EAC. Data for Kenya, for example, shows an increase in access to Formal and Formal Others from 26.4 percent in 2006 to 40.5 percent in 2009 - largely attributed to M-Pesa and rapid expansion of Equity Bank into the lower end of the market. However, data from Tanzania indicates that those with access to Formal and Formal Others increased from 11.2 percent in 2006 to 16.7 percent in 2009 - reflecting a more modest expansion of formal access. The most surprising data is that of the proportion of the population without access to finance increased from 53.7 percent in 2006 to 56 percent in 2009 - indicating that the growth in access to formal financial services has not resulted in a reduced the proportion of those without access. Apart from Kenya, all data for the remaining member states show over 52 percent of adult population are still without formal and informal financial services.

B. Factors Affecting Access to Financial Services

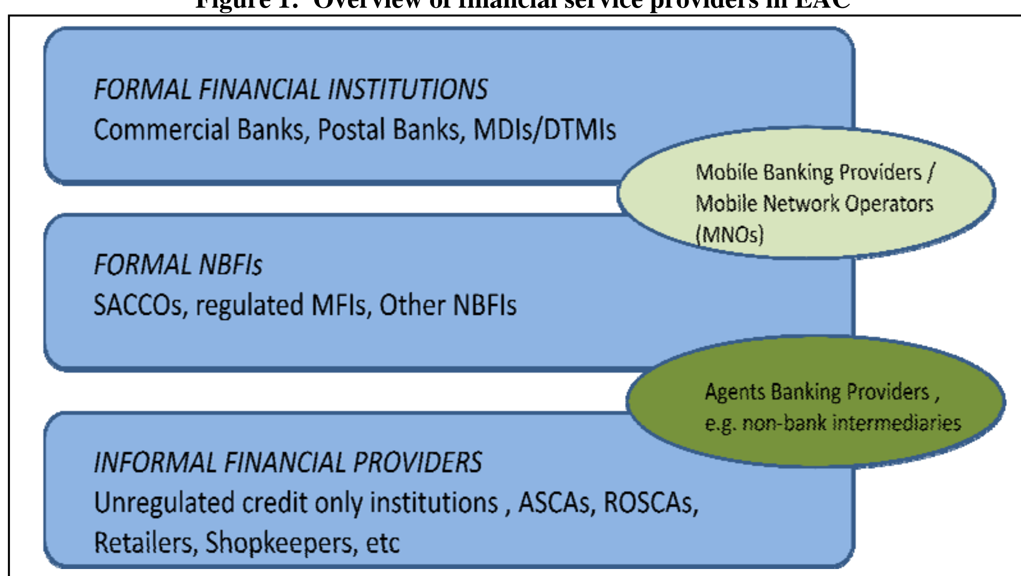
6. There are several factors that can affect access to financial services. These include supply side factors such as cost to banks of building and maintaining branch networks and the labor intensive MFI approaches. For example, the Bank of Rwanda informed that it is costly to expand services for the following reasons: (i) poor infrastructures; (ii) lack of qualified staff; (iii) poor product development skills; (iv) inadequate Market Information System (MIS). On the demand side are factors that include low and irregular income, low literacy level, lack of trust in formal financial services, lack of ability to save, overall negative perception of the formal sector, inconvenience in terms of geographic location/conditions. In Rwanda, for example, the factors that were identified by the Finscope 2008 study to affect access included lack of income and negative perception of bank accounts as having no value.

[1] The 'access strand', developed by DFID/FINMARK Trust/World Bank in 2005, presents usage of services by level of formalization: Formal- use of a bank, PostBank or insurance product; Formal other- do not use any formal product, but use services from non-bank financial institutions such as SACCOs and MFIs; Informal- do not use any formal/formal other products but use informal financial service providers such as ASCAs, ROSCAs and group/individuals other than family/friends; Those without access- use no formal/formal other or informal financial services.

7. The diagram below shows that there are a variety of financial service providers to be found within each Partner State of the EAC with varying degrees of scope and scale. Although banks constitute the minority of financial service providers among low income and poor consumers they provide an important backbone for the formal financial sector. However, the various financial access data also show that other formal and informal service providers, including shopkeepers/retailers, provide an important service among low income earners. In addition, mobile banking offered by Mobile Network Operators (MNOs) is proving to be the fastest and most convenient provider of financial services although currently largely limited to money transfer. Another emerging "Formal NBFI" is agent banking through non-bank intermediaries including retailers.

Overview of Financial Services Providers in EAC

Figure 1: Overview of financial service providers in EAC



C. Possible Policy Interventions

8. The level of exclusion in the majority of the EAC Partner States is high and need policy, legal and regulatory intervention that aims at addressing the factors that affect access, some of which have been highlighted above. Some of the policies that could be adopted to promote financial inclusion include:

- Overcome Information Barriers

9. Many commercial players are hesitant to enter the financial inclusion space because of lack of available information on customer acquisition and screening practices. McKinsey (2008) argues that the high-touch approach pioneered by the specialized microfinance institutions to compensate for this lack of information is too expensive compared to the low-ticket size of the loan or premium. Moreover, many potential financial services providers lack sufficient knowledge of potential customers needs to develop appropriate, affordable, and less risky

products. In addition, many financial services providers are uncertain about the market size for their products. However, there are strategies that can be developed (including those highlighted in the next section) to remove the barriers to financial inclusion through use of innovative products and alternative channels.

- Leveraging the Use of Non-bank Distribution Channels to Reach Low-income Markets

10. Some of the distribution channels currently in use, such as bank branches, ATMs, self-help groups (SHGs) and Microfinance Institutions have scale constraints. More recent financial inclusion efforts have focused on combining the skills of traditional commercial banks with complementary, non-traditional distribution channels to reach those without access. These include the use of local retail stores as agents or correspondents of commercial banks to distribute credit, savings and insurance products. An example is the recently gazetted agent banking guidelines in Kenya and the resulting partnership between Equity Bank and Safaricom to allow Safaricom M-Pesa customers to open saving accounts with Equity Bank. Expansion of mobile banking also has great potential to increase the number of those with formal access to financial services. This is primarily because telecom companies have huge advantages over traditional banks in terms of physical reach, customer base and lower transaction cost. Examples can be found in all the EAC Partner States of telecom companies forays into mobile banking with significant contribution to financial access.

- Pragmatic Regulation with a Focus on Consumer Protection

11. To achieve an increase in those with access to formal financial services, there is a need for a supportive regulatory environment. Hence, the regulators within the EAC will need to craft policies that promote the growth of an inclusive financial services system while at the same time protecting consumers. The pragmatic regulation should include those that allow or enable alternative distribution channels such as mobile banking and agent banking to emerge and thrive.

D. Proposed Key Drivers of Component 1 of EAC FSDRP I

12. The financial access data across the EAC show that over 52 percent of low-income earners do not have access to financial services. In order to reduce this figure, there is a need for more innovative approaches that transcend traditional access channels such as opening more bank branches, increasing the number of ATMs, and expanding microfinance institutions and SACCOs. Hence, the key drivers of financial inclusion that have been identified include mobile banking, agent banking, risk-based microfinance regulation, consumer protection and financial capability.

- Risk-Based Microfinance Regulation

13. The development of appropriate microfinance regulation is important for stimulating the emergence of innovative retail institutions that can increase financial inclusion. Microfinance institutions have played and will continue to play a pioneering role demonstrating that there is a market at the lower-end of the market. In a number of EAC countries, mainstream banks had previously seen the lower-end of the market as 'un-bankable' until emergence and growth of

microfinance institutions. The explosive growth of microfinance banks such as Equity Bank in Kenya and Centenary Bank in Uganda has not escaped the attention of mainstream banks that are now increasing their expansion at the lower end of the market and even re-opening branches in markets where they had previously closed citing them as unattractive.

14. In all the EAC Partner States, there are a variety of policy options already available to promote the transformation and commercialization of microfinance institutions (MFIs), institutional strengthening of MFIS, allowing non-profit or credit-only MFIs to operate easily, supervising the conduct of micro lenders and offering financing facilities for MFIs in some jurisdictions. In some of the EAC Partner States, regulators are encouraging commercial banks to downscale their operations to participate in microfinance activities in a variety of ways. These policy interventions have led to considerable additional financial access in some of the countries. As an example, the transformation of Equity from a building society to a commercial bank focusing on increasing financial access has led to an increase in its customer base from around 200,000 to over 4 million.

Stock-taking of Legal and Regulatory Environment of Microfinance in EAC

15. Various regulatory approaches prevail within the EAC. For example, Uganda and Rwanda have adopted a four tier approach to financial sector regulation while Kenya has modified its banking regulation to fit the microfinance institutions.

16. The MFIs specific legislation in the different Partner States are covered by the following Acts and Regulations:

- Tanzania:
  - The Banking and Financial Institutions Act enacted in 2006.
  - Microfinance Regulations enacted in 2005.
  - Financial Cooperative Regulations enacted in 2005.
- Kenya:
  - Microfinance Act enacted in 2006.
  - Microfinance Regulations (Deposit Taking Microfinance Institutions) enacted in 2008.
  - SACCO Societies Act enacted in 2008.
  - SACCO Societies (Deposit-Taking SACCO Business) Regulations enacted in 2010.
  - Cooperative Societies Act of 1997 amended through 2004.
  - Non-Governmental Organizations Coordination Act enacted in 1990.
  - Microfinance (Categorization of Deposit Taking Microfinance Institutions) Regulations enacted in 2008.
  - Microfinance (Deposit Taking Microfinance Institutions) Regulations enacted in 2008.

- Burundi:
  - Microfinance Deposit-Taking Institutions Act enacted in 22nd July, 2006.
  - Circulaire N° 01-M-10 relative a l'agrement des etablissements de microfinance.

    - Circulaire N° 02-M-10 relative au control interne des etablissements de microfinance.
    - Circulaire N° 03-M-10 relative au credit des etablissements de microfinance.
    - Circulaire N° 04-M-10 relative a l'agrement des commisaires aux comptes des etablissements de microfinance.
    - Circulaire N° 05-M-10 relative aux nomes prudentielles des etablissements de microfinance.
- Uganda:
    - Microfinance Deposit-Taking Institutions Act enacted in 2nd May, 2003.
    - Microfinance Deposit-Taking Institutions Regulations enacted in 15th Oct, 2004.
- Rwanda:
    - Microfinance Deposit-Taking Institutions Act enacted in 30th March, 2009.
    - Microfinance Deposit-Taking Institutions Regulation enacted in 26th August, 2008.

17. The organizations responsible for prudential supervision in each of the EAC Partner States vary:

- In Tanzania, the BOT is responsible for commercial banks, MFCs, FICOS, and Postal Banks. The Registrar of Cooperatives is responsible for SACCOS, yet its role limited to registration and ensuring compliance of cooperative principles. On the other hand, MFIs are registered as NGOs or limited companies and are not allowed to take deposits, thus unregulated.

- In Kenya, the Central Bank is the authority that is responsible for supervising the MFIs and SACCOs to ensure that they comply with the provisions of the Laws and Regulations applicable.

- In Burundi, the Banque de la République de Burundi is responsible for providing the licensing, regulation, monitoring and supervision of the MFIs which are organized in three categories – SACCOs (first), MFIs (second) and NGOs and ASBL (Associations Sans But Lucratif) (third).

- In Uganda the authority responsible for providing the licensing, regulation and supervision of MFIs is the Central Bank.

- In Rwanda, the Central Bank exercises the power to supervise the MFIs, and consider an MFI as any organization that exercises micro finance activities, regardless of its legal status, including savings and credit cooperatives.

18. Stock-taking the landscape of institutions providing microfinance across the EAC Partner States is complicated as each country has its own category of institutions and there is no single source of information. In this light, a regional level study is needed to fully capture the latest accurate information. However what is evident from the available figures is that in most of the EAC Partner States, the majority of institutions that are providing microfinance are unregulated,

which raise concerns over stability from the public confidence perspective by low income earners on the formal financial sector.

Table 2: Microfinance sector distribution across the five EAC Partner States [2]

	MDI/MFCs	MFIs	SACCOs
Tanzania	0		4,500+
Kenya	2		
Burundi	8	4	1052
Uganda	3		~ 3,000
Rwanda		11	107

Harmonizing Regulatory Framework in EAC

19. The core objectives for the regulatory framework are the same for microfinance activities and institutions as they are for other components and segments of the overall financial system. However, the key principles and standards for the design of a regulatory framework for institutions providing financial services and microfinance sector are likely to be different from those for formal banking and finance institutions, because the design must consider the operational, market, and client characteristics in the microfinance sector.

20. One dimension that should be harmonized across the EAC Partner States is the categorization and classification of institutions providing microfinance. Currently, in the Acts of the different Partner States, microfinance service providers are classified under different names and categories, yet moving toward regionalization, this need to be standardized.

21. It is also important to note that harmonization process in EAC needs to address the differences inherent in civil law (Rwanda, Burundi) compared to common law approaches (Kenya, Uganda and Tanzania)

22. The section below focuses on the regulatory framework issues that have an important influence on stability and safety.

Applying Basel Core Principles (BCP) for Microfinance Supervision[3]

23. While the Core Principles generally offer a suitable framework for supervisors of depository microfinance activities, four consistent themes with regard to their implementation emerged throughout in the analysis, indicating the need for microfinance supervisors to: (i) allocate supervisory resources efficiently, especially where depository microfinance does not represent a large portion of the financial system but comprises a large number of small institutions; (ii) develop specialized knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly microlending; (iii) recognize proven control and managerial practices that may differ from traditional banking but may suit the

[2] Data to be updated

[3] Source, Microfinance activities and the Core Principles for Effective Banking Supervision, Bank for International Settlements, February 2010.

microfinance business both in small and large institutions; and (iv) achieve clarity in the regulations with regard to permitted microfinance activities to different institutional types, while retaining flexibility to deal with individual cases.

24. Some BCP shall apply equally to banks and other MFIs engaged in microfinance regardless of the nature of microfinance activities, or complexity and size of supervised FMIs. These are Principle 1 (Objectives, independence, powers, transparency and cooperation), Principle 4 (Transfer of Significant Ownership), and Principle 5 (Major Acquisitions). Three other principles would also apply equally, but the present state of development of most microfinance markets render the applicability of such Principles very limited. These are Principle 12 (Country and Transfer Risk); Principle 24 (Consolidated Supervision); and Principle 25 (Home-Host Relationships).

25. However, other BCP require some degree of tailoring in its implementation compared to traditional banking, such as **Principle 2** (Permissible Activities) and **Principle 3** (Licensing Criteria), for instance, should be tailored to FMIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions, which may differ from banks. The types of permissible microfinance activities should be clearly defined in laws or regulations and tied to the size of the institution and its ability to manage risks inherent with such products and clients. Permission to engage in sophisticated activities should be substantiated by management's experience and ability to identify, control and mitigate more complex risks. The supervisory or licensing authority should maintain and publish a current list of licensed/supervised FMIs, and remain alert to and have the authority to deal with the illicit provision of financial services.

26. Lower initial capital requirements for FMIs may be appropriate given the limited complexity, scope and size of their operations, especially in rural areas. However, the threshold should be high enough to discourage unviable candidates and yield a manageable number of institutions to supervise. In exchange for lower initial capital, supervisors should limit the kinds of activities permitted to FMIs. Ongoing monitoring and surveillance may be used to identify when certain players or sectors become systemically significant or begin using new technologies (i.e. mobile phones and non-bank agents) therefore requiring different supervisory approaches.

27. A similar degree of tailoring is required for applying **Principle 6** (Capital Adequacy), as capital adequacy requirements should relate to (i) the nature of microfinance risks for all institutional types, and (ii) the size and constituents of capital of deposit taking institutions other than banks engaged in microfinance. Defining regulatory capital for SACCOs is particularly challenging, since capital invested by members may be generally withdrawn if the member decides to leave the cooperative. Also, where non-bank deposit takers have fewer options to raise capital compared to banks, or exhibit a more pronounced risk profile, a proportionately higher Capital Adequacy Ratio (CAR) may be warranted.

28. To implement **Principle 7** (Risk Management Process) effectively – that is, identify, measure and manage microfinance risks – supervisors shall need to develop specialized knowledge and tailor supervisory techniques to risks in microloan portfolios and other products for both banks and FMIs. They shall need also to take into consideration the relative significance of microfinance within an institution; that is, where microfinance is one of many lines of

business in a diversified financial institution, risks may be more easily mitigated. Supervisors also must be aware of potential differing governance weaknesses in FMIs compared to banks and implement regulation and supervisory practices to mitigate them. Further, as microfinance is a rapidly growing and dynamic sector, supervisors need systems to track and respond to changing risks in FMIs and in the microfinance sector as a whole.

29. Given the distinctive features of microfinance product design, client profile and loan underwriting methodology, managing credit risks is significantly different for microfinance providers. Implementation of **Principle 8** (Credit Risk) should be tailored and take into account the context in which microlending occurs, i.e. as a business line within a large diversified bank versus a small microfinance organization in which microloans comprise a significant proportion of total assets. Further, specialized knowledge of microlending and an appropriate degree of flexibility from supervisors are imperative for supervisory efficacy. For example, supervisors should set loan documentation standards that are efficient and feasible to maintain relative to the nature of the customers and their businesses, which may differ from those of traditional retail lending.

30. In applying **Principle 9** (Problem assets, Provisions and Reserves), supervisors should adjust provisioning and classification requirements to the unique risks of microlending compared to other loan types. The regulatory framework should compel financial institutions to recognize the risk posed by past due microfinance loans quickly and accurately, and provide the supervisor with flexibility to deal with unique situations, as necessary. Regulatory limitations on exposures dealt with in **Principle 10** (Large Exposure Limits) should also be tailored to the distinctive risks in geographic or sector concentrations often observed in microloan portfolios without unduly penalizing otherwise sound practices.

31. Not only credit risk requires specific knowledge and supervisory tools. In applying **Principle 13** (Market Risk) supervisors should pay particular attention to sources, risks and concentrations in FMI foreign currency borrowings. The application of **Principle 14** (Liquidity Risk) and **Principle 16** (Interest Rate Risk in the Banking Book) should take into account the unique features of microfinance assets and funding liabilities.

32. Implementation of **Principle 15** (Operational Risk) should be tailored to the differing risks, practices and trends in microfinance operations including outsourcing and the typical decentralized microcredit methodology, which has significant implications for operational risk management, as well as for the evaluation of internal controls put in place by the institution, as described by **Principle 17** (Internal Control and Audit). The implementation of these Principles must take into account that microlending methodologies may require different organizational arrangements and controls from those of conventional retail banking. Requirements should be strict while at the same time accommodating proven practices.

33. The application of **Principle 11** (Exposures to Related Parties) should be tailored to FMIs. Where governance of MFIs is weak, supervisors may enhance restrictions or prohibitions to avoid abuse. Conversely, member-owned institutions that are very widely held may warrant a more flexible treatment for loans to non-management members.

34. Supervisors should adopt a risk-based approach to the implementation of **Principle 18** (Abuse of Financial Services), which should be tailored to the risks posed by low-value microfinance operations undertaken by banks and FMIs. Such a risk-based approach better aligns crime prevention concerns and the rational use of supervisory resources.

35. Implementing Principle 19 (Supervisory Approach) and Principle 20 (Supervisory Techniques). Cost and feasibility considerations may allow for alternative supervisory arrangements to cover small, numerous institutions that pose low systemic risk in some jurisdictions. However, delegated/auxiliary supervision is not without its own risks and practical challenges.

36. The effectiveness, timeliness, quality and costs of off-site surveillance and on-site inspections will depend on the implementation of **Principle 21** (Supervisory Reporting), which should be tailored to FMIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions. The content of reports and their frequency must be aligned to the specialized analyses that are needed for effective microfinance supervision.

37. Participation in credit bureaus should be required of all supervised microfinance providers, if relevant data for microfinance borrowers is available.

38. **Principle 22** (Accounting and Disclosure) should also be tailored so that disclosure requirements for small FMIs engaged in microfinance are based on supervisory cost-benefit considerations. To fulfill their responsibilities, external auditors must have sufficient expertise in microfinance. Supervisors and accounting standard setting bodies should cooperate where possible to ensure accounting rules and principles are aligned with safety and soundness objectives.

39. Lastly, to implement **Principle 23** (Corrective and Remedial Powers), supervisors should tailor corrective measures typically used in commercial or conventional retail banking to be effective in microfinance institutions and even for microfinance activities in banks. The supervisor should have powers, policies and procedures to address supervisory concerns in a variety of situations, including the orderly resolution of problem FMIs, application of fines, and revocation of licenses when FMIs engage in unsafe or unsound practices, or do not otherwise observe prudential standards.

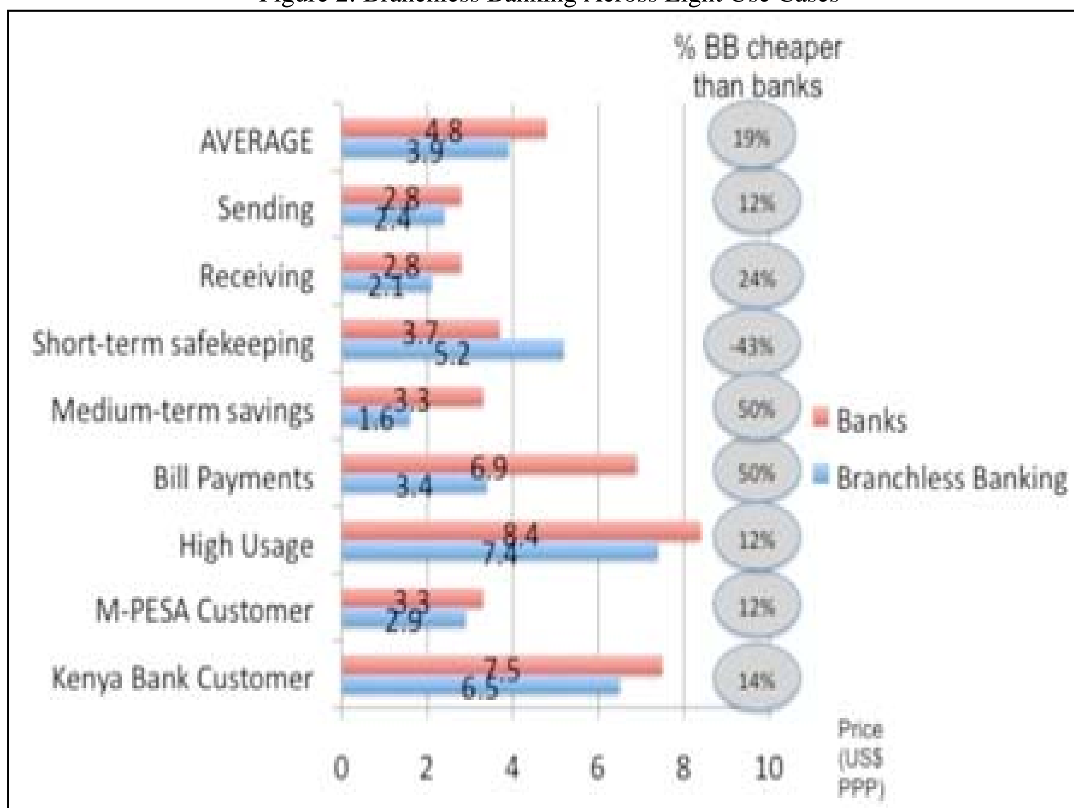
- Mobile Banking

40. The ‘explosion’ and rapid expansion in use of information and communication technologies within the EAC has great potential to reduce transaction costs and allow for the diversification of financial services. It has opened up new possibilities for non-bank players such as mobile network operators (MNOs) to provide financial services through mobile telephones and other devices. The technology-based financial service provision has several advantages that can help reduce the number of those without access to finance. These include the ability to overcome infrastructural challenges and reach more rural customers; lower transaction costs compared to normal bank channels in some of the uses that are most important for low-income earners (see figure 2 below); offering convenience to customers since most

agents are located close to customers; security of users and transactions as customers don't have to travel far to make their transactions. In addition, mobile banking now offers large corporates the opportunity to make low-value, high-volume transactions such as dividend and wages payments more cheaply and conveniently.

41. An example is the recent Safaricom payment of dividends through M-Pesa rather than bankers cheque. M-Pesa's money transfer service was launched in 2007. In June 2010, M-Pesa reported more than 10 million registered customers, who collectively transferred US$400 million that month alone.[4] The nationwide FinAccess survey in 2009 found that close to half of all Kenyan adults had already become users of the service.

Figure 2: Branchless Banking Across Eight Use Cases



Source: CGAP

42. Although the first stage of technology based financial services has focused on money transfer and bill payments, the next stage involving closer link between MNOs and banks is already beginning to take shape. An example is the Safaricom/Equity Bank (M-Kesho)-Safaricom/Family Bank (Pesa Pap) partnerships that allow customers of M-Pesa to link into Equity Bank and Family Bank accounts to enable them earn interest on their e-money and to send and receive money in either direction. The architects of these new approaches are working towards having the ability to provide loans and sell insurance products through these platforms.

[4] Safaricom, "M-PESA Key Performance Statistics", http://www.safaricom.co.ke/fileadmin/template/main/downloads/M-PESA_Statistics.pdf, 08 July 2010

The potential for increased financial inclusion is huge considering that M-Pesa alone has over 9 million users and 16,000 agents in Kenya alone.

43. African financial policy makers and regulators have in general barely come to grips with the issues raised by the mobile financial services. The arrival of the new mobile financial services accelerates and intensifies these issues, since their reach may be much wider and the risks to vulnerable consumers higher. EAC policy makers will have to make choices about the minimum entry requirements for payment providers and about what type of services they can provide.

44. The regulatory approaches to mobile banking vary across the EAC. Kenya for example has no formal regulation in place and relies on 'no-objection' and guidance from the Central Bank (although its forthcoming National Payment System Act will address this gap) and some aspects are regulated by the Communication Commission of Kenya in the Kenya Communications (Amendment) Bill, 2008.

45. While in Uganda and Rwanda, there are no regulations currently in place nor are any being developed, in Burundi, a regulatory framework for mobile banking is currently under elaboration. In Tanzania, specific regulations for mobile banking do not exist at the moment, but efforts are underway to address this.

- Agent Banking

46. Banking agents are retail and postal outlets –trusted local establishments that can double as a kind of bank branch– that work on behalf of a financial institution and let clients deposit, withdraw, and transfer funds, pay their bills, inquire about an account balance, or receive Government benefits (G2P) or a direct deposit from their employer. The clerk at the retail or postal outlet collects and disburses cash, and in some cases- depending on local regulation- can open bank accounts for new clients and fills in credit applications. The retail outlet earns a portion of the transaction fee. Technology can enable banks and their customers to interact remotely in a trusted way through existing local retail outlets. Customers can be issued bank cards with appropriate PIN-based or biometric security features, and the local store - the bank agent- can be equipped with a POS device controlled by and connected to the bank using a phone line or wireless or satellite technology. Banking agent's lower set-up costs - compared to set-up costs for bank branches- can help banks and microfinance institutions reach more low-income earners with more financial products a lower cost, particularly those living far from the nearest branch and in rural areas. Some estimate that for the price of one bank branch, 40 banking agents can be opened. The advantages of using agents, other than cost, are many and include agents can help banks attract customers who would otherwise shy away from using a bank branch.

47. The agent banking scenario in the EAC shows that only Kenya has enacted appropriate regulation allowing banks and Deposit-Taking MFIs (DTMI's) to appoint agents. Indeed the Equity Bank and Family Bank partnerships with Safaricom are primarily aimed at enabling the banks to appoint the over 16,000 M-Pesa agents as the bank agents with the potential of tapping into the over nine million M-Pesa users. This game-changer approach has the possibility to

significantly reduce financial exclusion in Kenya and bring it at par with Middle Income Countries in line with its Vision 2030 economic blue-print.

Box 1: Amendments in Finance Act 2010, Kenya

Recent legislation has been passed related to branchless banking, including the Finance Act of 2010, which amends a variety of laws relating to the financial sector in Kenya. In particular, the Act includes several amendments to the Banking Act (Section 67 of the Finance Act) and the Microfinance Act of 2006 (Sections 79-84) regarding the use of agents to provide banking and microfinance services. These amendments will become operational on January 1, 2011.

- The Amendment of section 54 of Cap. 488 says that Section 54 of the Banking Act is amended by renumbering the existing provision as subsection (1) and inserting the following new subsection:

  (i) Notwithstanding the provisions of subsection
  (ii) where any of the bodies referred to in that subsection is contracted by an institution as an agent to provide banking services on behalf of the institution; this Act shall apply to such body to the extent of the services contracted.

- Amendment of section 2 of No. 19 of 2006. 79. Section 2 of The Microfinance Act, 2006 is amended:

  (a) by inserting the following new definitions in their proper alphabetical sequence.
  "agency" means:

  (i) an institution's place of business operated within premises or structure owned or occupied by a third party by means of an agreement between the institution and the third party in the provision of deposit taking microfinance business; or
  (ii) a third party or entity contracted by an institution and approved by the Central Bank to provide deposit-taking business on behalf of the institution in such manner as may be prescribed by the Central Bank.

  "branch" means an institution's place of business, used for the provision of deposit-taking microfinance business in Kenya and directly responsible to the head office of the institution for the conduct of business, and which is situated at a permanent location and address;

  (b) by deleting the definition of "place of business" and substituting therefore the following new definition–

  "place of business" means any premises, other than the head office, including a branch, sub-branch, satellite branch, agency, outlet, mobile unit, marketing office or such other premises as may be approved by the Central Bank, at which an institution transacts deposit-taking microfinance business and which is open to the public.

48. The introduction of the proposed agent banking model will serve to strengthen the role played by existing financial sector players and thus bring services closer to the populace.

49. Last year, the CBK licensed one MFI and indicated its intention of giving the green light to more institutions that want to become Deposit-Taking Organizations as a way of increasing access to financial reach in the country.

50. For banks, the concept which doesn't require them to have a physical presence in the areas where they are providing their services, means reduced operational costs and the provision of cost-effective services.

51. The objective of promoting this kind of MFIs is double-edged. From the Governmental side the objective is developmental because its objective is financial reach and inclusion, and on the other hand, banks want to enlarge their reach at least cost.

52. The model will be rolled out as soon as stakeholders reach consensus on how the model could be implemented. Agents that will be picked by banks to deliver financial services on their behalf, will have to conform to the set regulatory framework.

53. The use of third party agents could be seen as a direct competition to the MFIs and SACCOs that mainly serve people in the middle and low income segment of the society. However the community-based institutions could come in handy particularly where banks want to establish a presence in the rural or remote areas of the country.

54. At the beginning of September 2010, the CBK reported over 5,800 agents licensed only four months after gazzeting the agent banking model.

55. In order to support technology-based options for financial inclusion such as mobile banking or agent banking, there is a need for risk-based regulatory frameworks. Hence the EAC-FSDRP will work with various regulators among the Partner States to establish a harmonized regulatory framework that enables rather than constrain financial inclusion.

- Capacity Building for Supervisors

56. Supervisory techniques in a microfinance context requires specialized knowledge and customized supervisory methodologies, particularly with regard to the evaluation of microcredit portfolios, ownership and funding structures. Thus, the supervisor should have the power to use a mix of off-site surveillance and on-site inspections for both banks and other FMIs. Supervisors must be trained and have comprehensive knowledge of the differences between microfinance and conventional banking, so as to set up and consistently apply specialized supervisory tools and measures to address weaknesses. Given the characteristics of microfinance, some techniques used to supervise traditional banking activities are not appropriate.

- Financial Capability and Consumer Protection

57. A robust financial sector should provide consumers with the following:

- Transparency by providing full, plain, adequate and comparable information about the prices, terms and conditions (and inherent risks) of financial products and services;
- Fair treatment by ensuring fair, non-coercive and reasonable practices in the selling of financial products and services, their contractual provisions, collection of payments, and data privacy and security;
- Effective Recourse by providing inexpensive and speedy mechanisms to address complaints and resolve disputes; and
- Financial Education that enables consumer to develop the financial capability required to understand the risks, rewards and obligations of the financial products and services that they buy, make good choices, avoid risky products and providers, and behave in responsible ways.

58. Consumers of financial services in East Africa make use of services from a broad range of providers. However, financial sector regulators provide some, but often incomplete and inconsistent, consumer protection to the customers of regulated institutions. In the absence of a market-wide consumer protection law or authority users of financial services within most of the EAC Partner states - and in particular those who use services from 'Formal Other' and informal providers - lack protection entirely.

59. Mass market financial services are growing at an impressive rate in the EAC, generating significant benefits for lower income consumers. But there is a growing body of evidence that the welfare of consumers is compromised by the lack of effective price disclosure, dispute resolution mechanisms, and abusive practices. For example, in a 2010 FSD-Kenya/CGAP survey, 25 percent of bank depositors said they were "surprised" by charges they did not know about. This is not surprising, given that a 2007 CBK survey found 53 different classes of charges that various banks levy on current accounts.

60. The financial regulators in the EAC currently have the strongest legal and indeed moral authority combined with the technical capacity to introduce basic directives for providers in their respective jurisdictions. Uganda is leading in this direction while Kenya has just concluded a consumer protection diagnostic study that aims at developing a comprehensive consumer protection framework for Kenya. Harmonization of these basic practices across the EAC will foster clear expectations from both consumers and providers, establish credibility for the mandate, and create precedents for policy and practice that can be eventually extended to the entire financial market. The scenario of consumer protection within the EAC shows that Uganda has consumer protection law in place while Tanzania has mandatory disclosure norms and is in the process of developing a consumer protection framework. However, in Kenya only banking laws provide protection to consumers of regulated financial service providers including DTMIs. Rwanda on the other hand has a competition and consumer protection policy which sets up a competition authority as a regulator.

61. Financial capability, on the other hand, aims at supporting and increasing the effectiveness of broader financial sector policy objectives through consumer education/financial literacy. These include policy objectives aimed at increasing savings; facilitating/optimizing

Government payments (e.g. G2P); strengthening credit culture, i.e. wise use of credit and timely repayment to avoid penalties; promoting competition between providers through comparison shopping; increasing confidence in - and use of - formal intermediaries; and supporting the adoption of new technologies such as mobile banking and agent banking. In order to expand financial services within the EAC, there is a need for consumer education and literacy on the various products on offer as well as increasing the confidence of low-income earners to use formal providers. Hence, the EAC-FSDRP will need to develop a strategy to support financial capability across the EAC.

Box 2: Road Map for Microfinance Regulatory Framework Harmonization in EAC[5]

Background

1. A workshop for harmonization of microfinance regulatory framework was held from 8th to 10th September 2010 at Kigali. The workshop was facilitated by and attended by central bank representatives and SACCO regulators from the five East African countries.

State of access to financial services in the region

2. The region is embarking on a harmonization process against a backdrop of very limited access within the member countries. Each country presented data from the supply and demand side of their countries, showing that not only was access limited but there are also stark inequalities and in accessing the available services between rural-urban populations, those with high versus those with low education levels as well as between male and female.

3. All the Partner States presentations revealed that each country has developed regulatory frameworks and supervisory arrangements for the various types of institutions that offer microfinance services. According to the Governor BNR, "Access for majority should be central goal of development of regional financial system". Participants also noted that the process of harmonizing regulatory framework should lead to full integration of the financial systems.

The challenge

4. The region needs effective and healthy institutions to address and improve access to financial services. Regulation of activities clear market signals on the rules so that private sector can invest in the sector.

5. From the experiences shared during the workshop, the benefits of regulation are well appreciated and prudential regulation for microfinance institutions has successfully been introduced in most of the countries but the challenge is the performance under such regulation.

6. Not only have few institutions been licensed but improvement in access is also still very limited. Furthermore, the services have not been able to keep up with the rapid increase in population. There is need to review the content of these regulations as well as to move away from the "brick and mortar" approaches to microfinance regulation and to embrace more innovative approaches that include use of non bank outlets (Agent Banking) if we are to improve the state of access in the region.

[5] Summary of Workshop "Harmonization of microfinance regulatory framework for the EAC" held in Kigali, September 2010

The issues

1. Where are we converging to? EAC model directive(s) on regulation and supervision of MFIs and SACCOs (by December 2011), aimed at increasing access, taking into consideration the different economic realities of each country and recognizing the overarching goal for a harmonized legal framework across the five EAC Partner States.

Policy

- For the different institutional types in the microfinance sector, should there be more than one regulation? More than one regulator?
- Should credit-only institutions and the very small microfinance institutions (including SACCOs) be regulated? If so, should they be subject to prudential regulation or only non-prudential regulation?
- Consumer protection and financial literacy should be developed as a complement to financial regulation.
- How to address and harmonize tax exemption, deposit protection, credit reference issues for the microfinance sector?
- Harmonization process needs to address the differences inherent in civil law (Rwanda, Burundi) compared to common law approaches (Kenya, Uganda and Tanzania)
- The different forms of regulation and possibly regulators to cater for the different institutional types in the microfinance sectors.

Supervision

- Definition of “deposit” and challenge of monitoring compulsory savings.
- Build supervisory capacity to meet the existing and emerging regulatory challenges

• Rich experiences across the region and in other developing countries.
• Can attract capital/investment.
• Improve policy making for the microfinance sector.

Other Considerations

- Expensive process for those who want to catch up; Costs of compliance can increased
- Lack of data
- Who will regulate/enforce consumer protection regulation: EAC consumer protection agency, national regulators?
- Could be delegated the SACCOs supervision to networks?

Drivers and strengths

2. The main drivers and strengths were:

- Recognized Convergence is an iterative process closer and closer to integration.
- Work on harmonization will look at best practices in harmonization and microfinance and SACCO regulation.
- Similar challenges which make it desire for all countries to find solutions.

- Urge to improve access and use of financial services (competitiveness and improvement in terms of service for the client).

II. The Banking Sector

A. Introduction

1. An efficient and stable banking sector is a pre-requisite for a country to achieve sustainable growth, especially when the majority of financial intermediation takes place through commercial banks taking deposits from the general public and lending to companies, individuals and the Government. This principle is equally valid in an integrated area in which several countries have opted for transferring part of their sovereignty to supra-national institutions in order to achieve higher levels of development and promote growth.

2. In this regard, the EAC Project entails that banking institutions are increasingly able to operate in each other's national market as they do in their own, which requires in turn that the regulation and supervision of the banking activity has to be in line with international standards (i.e. Basel Committee's Core Principles for Effective Banking Supervision, or BCP) not only at a national level, but at a community level as well.

3. The purpose of this technical note is, in the context of the FSDRP, to identify regulatory and supervisory areas that are key to achieve an efficient and stable integrated banking sector in the EAC so as to promote sustainable growth and financial inclusion within the Community, and to the extent possible to show the current state of progress of the various areas of development currently under way.

Importance of the Banking Sector

4. Banking services are essential to the smooth functioning of economic activity. In East Africa, the banking sector dominates the financial sector and, as in many other parts of Sub-Saharan Africa, banks have generally been quite proactive in taking advantage of the potential of the regional market. Several banks have, to some degree, adopted a regional business model **motivated by a range of factors i**ncluding client-demand, their own corporate structures, and/or opportunities perceived along regional trade corridors. These banks display a fair degree of operational integration not just within EAC markets but all the way along the trade corridors to southern Sudan and eastern DRC[6].

5. Kenya-based banks are leading regional integration in the EAC banking sector. About eleven multinational and Kenyan owned banks use Kenya as a hub for their operations in the EAC region. There are four indigenous Kenyan banks with branches within the region. These banks include KCB , Equity Bank, Fina Bank and Commercial Bank of Africa. These banks have a total of 63 branches outside Kenya (16 in Tanzania, 31 in Uganda and 16 in Rwanda), whereas banks domiciled in other EAC countries currently operate exclusively in their home markets.

- Since 2006 KCB has been expanding extensively in the EAC region. It has 164 branches in Kenya, and 36 branches in other countries in East Africa — Tanzania (10), Uganda

[6] Wagh et al, 2010

(11), Rwanda (9) and Southern Sudan (6). KCB's Tanzanian operation is the oldest of its regional subsidiaries having been established in 1997;

- In March 2009 Commercial Bank of Africa merged with First American Bank that has a Tanzanian subsidiary United Bank of Africa (the bank has since been renamed Commercial Bank of Africa – Tanzania);

- Fina Bank began its regional expansion into Rwanda in 2004 and has recently entered Uganda in 2009 with five branches already established. The bank now has a total of 11 branches regionally; and,

- In 2009 Equity bank completed the acquisition of Uganda Microfinance in a deal worth US26.9 million. The microfinance institution had over 45 field offices and branches. Equity Bank Uganda currently operates 15 branches.

Table 1 below summarizes the regionalized banking operations in the EAC in 2009:

Regionalized Banking Operations in the EAC

Bank	2009				
	Burundi	Kenya	Rwanda	Tanzania	Uganda
Barclays (UK)					
Bank of Africa (Mali)					
Citigroup (USA)					
Diamond Trust (Kenya)					
Ecobank (Togo)					
Equity (Kenya)					
Fina (Kenya)					
Kenya Commercial (Kenya)					
Standard/Stanbic (South Africa)					

Source: Various bank websites

While there are many benefits that accrue from banks scaling up their operation in this way, there are also several issues concerning cross-border operations that have to be addressed.

B. EAC Policies in the Banking Sector

6. In view of the increasing cross-border activity in the EAC banking sector and the significant growth in financial services based on new technologies (e.g. mobile banking), the EAC policy objectives in the banking sector are twofold. The first objective is to establish a

single market in financial institutions[7] and financial conglomerates on the basis, in particular, of mutual recognition and the "EAC passport". The second objective is to ensure that the market operates properly so that EAC citizens have all the security guarantees they need when using banking services.

Objectives of the EAC Policies for the Banking Sector

7. The main objective of the EAC policies regarding this area is to attain a single market in banking services as a means to promote sustainable growth in the Partner State countries and higher levels of financial inclusion in their populations, while at the same time ensuring that EAC citizens are secure in their banking operations and have due confidence in the solidity of the institutions they operate with.

8. The benefits of the above mentioned integration of the banking sector are many (i.e., economies of scale and of specialization, lower 'entry-barriers' and thus increased competition, better financing terms for SMEs, new business opportunities for entrepreneurs, etc.) but they could be summarized into two:

- Sounder allocation of resources, and hence sustainable growth;
- And more opportunities for financial inclusion.

Pre-conditions for the Successful Implementation of the EAC Policies for the Banking Sector

9. The benefits mentioned in the previous section are only to be achieved if certain pre-conditions are met beforehand regarding banking sector regulation and supervision in the participating countries.
The pre-conditions for a successful integration of national banking sectors regard the following main topics:

- Supervisory agency's mandate and status (BCP 1): All five Central Banks must have a clear mandate regarding the supervision of banking activity and enjoy sufficient operational independence and resources to properly comply with the task.

- Accounting and disclosure regime for banking institutions (BCP 22): Banking institutions should maintain adequate records, drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publish on a regular basis information that fairly reflects their financial condition and profitability.

- Authority of the supervisor to take corrective and remedial action (BCP 23): All five Central Banks must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions in case of need, including the ability, where appropriate, to revoke the banking license or at least to recommend its revocation.

[7] Credit institution is defined as a business whose purpose is to receive deposits or other repayable funds from the public and to grant credits for its own account.

- Licensing, regulation and minimum requirements (BCP 2 to 18): The regulation of the five Partner States should be sufficiently consistent at least with regards to the following areas:

    - List of permissible activities for banking institutions, and those reserved for them.
    - Licensing criteria, which should consist at least of the assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its Projected financial condition, including its capital base.
    - Transfer of significant ownership, which should be subject to supervisory authorization based on prescriptive criteria that should include at least business repute of the acquiring party and adequate transparency of its economic group.
    - Major acquisitions, which should be subject to supervisory review against a set of prescribed criteria, including cross-border operations, and the confirmation that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
    - Capital adequacy, since banks' capital base should be commensurate with their risk profile, as well as capital composition should take into consideration the loss absorbency capacity of the different instruments.
    - Risk management process of banks and banking groups should be comprehensive (including Board and senior management oversight) so as to appropriately identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile.
    - Credit risk management process must take into account the risk profile of the institution, with prudent policies and processes in place to identify, measure, monitor and control this risk, including counterparty risk.
    - Problem assets, provisions and reserves have to be dealt with adequately by banks and consequently they must establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
    - Large exposures to single counterparties and concentration risk must be appropriately managed by supervisors setting prudential limits to the former and banks having policies and processes that enable management to identify and manage concentrations within the portfolio.
    - Exposures to related parties requirements and limitations must be regulated so as to ensure that banks: extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control and eventually mitigate the risks; and write-offs are made according to standard policies and processes.

    - Country and transfer risks derived from international lending and investment activities must be adequately identified, measured, monitored and managed, and must be sufficiently covered by provisions and reserves.
    - Market risks have to be accurately identified, measured, monitored and controlled by banks having in place adequate policies and processes; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
    - Liquidity risk has to be controlled and to this end banks must have a strategy that takes into account the risk profile of the institution, prudent policies and processes to identify, measure, monitor and control this risk, and contingency plans for handling liquidity problems should they arise.
    - Operational risk has to be identified, assessed, monitored, controlled and eventually mitigated by banks having in place risk management policies and processes commensurate with their size and complexity.
    - Interest rate risk in the banking book has to be controlled by banking institutions having in place effective systems to identify, measure, monitor and control this risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management.
    - Internal control and audit functions in banks have to be adequate for the size and complexity of their business and must include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
    - Abuse of financial services should be adequately prevented by requiring banks to have policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

- Supervisory methodology, consolidated and cross-border supervision (BCP 19-21, 24, 25):

    - Supervisory approach should be such that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking systems.
    - Supervisory techniques should include on-site and off-site supervision and regular contacts with bank management.
    - Supervisory reporting should be such that permits supervisory authority to collect, review and analyze prudential reports and statistical returns from banks on both a

solo and a consolidated basis, and the independent verification of these reports, through either on-site examinations or use of external experts.

- Consolidated supervision should be in place so as to allow supervisors oversee the banking group on a consolidated basis, while adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
- Cross-border consolidated supervision must be possible by promoting cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors.

10. Meeting these requirements should result in national bank supervisors having the means and the authority to be able to act should the necessity arise. When different jurisdictions are involved, national supervisors must act coordinately by establishing appropriate Home-host arrangements:

- Ensuring effective cross-border consolidated supervision.
- Planning for cross-border supervisory activity.
- Timely exchange of relevant information.
- Enforcement of corrective measures.

C. Area of Work

11. To achieve a single market in banking services, it is necessary to eliminate the most obstructive differences between the laws of the Partner States as regards to the rules to which these institutions are subject. This will be done by enacting EAC Banking Acts and Regulations**.** These laws and regulations will supersede similar national laws and regulation in the Partner States. Thus, the Community will be bound by a common legal and regulatory framework in the banking sector, which will take effect in the Partner States as per the date of commencement of the Act, after they are passed by the East African Legislative Assembly (EALA).
In particular, comprehensive EAC legislation will need to be enacted in the following areas:

- Creation and pursuit of the businesses of credit institutions
- Prudential supervision
- Capital adequacy of credit institutions
- Annual accounts of banks and other financial institutions
- Reorganization and winding-up of credit institutions
- Deposit-guarantee schemes
- Financial conglomerates

12. The scope of these measures should be as broad as possible, covering all institutions whose business is to receive repayable funds from the public, whether in the form of deposits8 or

[8] Deposit is defined as any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any dept evidenced by a certificate issued by a credit institution.

in other forms (such as the continuing issue of bonds or the grant of credits for the institution's own account).

13. The principle of proportionality should apply to ensure that legislative measures taken do not go beyond what is necessary to achieve the objectives. It is appropriate to affect only the consistency necessary and sufficient to secure the mutual recognition of authorization and prudential supervision systems, making possible the granting of a single license recognized throughout the EAC and the application of the principle of home Partner State prudential supervision.

Creation and Pursuit of the businesses of Credit Institutions

Scope

14. The rules on the taking-up and pursuit of the business of credit institutions should be laid down by the EAC legislation. It constitutes an important instrument for achieving the point of view of the freedom of establishment in the field of credit institutions.

15. Exceptions should be provided for in the case of certain credit institutions to which this legislation might not apply such as: (i) the central banks of the Partner States; (ii) post office giro institutions; (iii) and other bodies specific to certain Partner States.

16. The provisions of this EAC legislation should not prejudice the application of national laws which provide for special supplementary authorizations permitting credit institutions to carry on specific activities or undertake specific kinds of operations.

Objective

The establishment of EAC single rules on the creation and pursuit of business of credit institutions constitutes an important instrument for achieving the single market from the point of view of both the freedom of establishment and the freedom to provide services in the field of credit institutions.

Key Issues

- **Requirement for Access to the Pursuit of Business**

17. The Partner States will have to agree on the requirements for authorization to take up and pursue the business of credit institutions. These requirements are normally: (i) existence of separate own funds; (ii) existence of minimum initial capital; (iii) presence of a certain number of persons who effectively direct the business of the credit institutions, who are of sufficiently good repute and have sufficient experience to perform such duties; (iv) notification to the competent authorities of the identities of the shareholders – whether direct or indirect, natural or legal persons - that have qualifying holdings[9] and the amount of those holdings; and (v) the list of activities that the credit institution can carry out.

[9] Qualifying holding is 10% or more of the institution capital.

- **Partner States can adopt additional conditions, of which the EAC should be informed of**.

18. All authorization should be notified to the EAC Secretariat and a list of authorized credit institutions should be published in the EAC Secretariat Gazette or in any other official journal. The normal practice is that applicants must be notified whenever an authorization is refused and the reasons for refusal must be given. By the same token, parties concerned and the EAC Secretariat must be notified when the authorization is withdrawn and the reasons for withdrawal must be given.

19. Credit institutions exercising their activities in a Partner State other than the one in which their head office is situated should use their original name on condition that it does not give rise to any doubt as to the national law to which the parent undertaking is subject. However, the host Partner State may, for the purposes of clarification, require that the name be accompanied by certain explanatory particulars.

20. The competent authorities of the home Partner State should require that all credit institutions have sound administrative and accounting procedures and adequate internal control mechanisms

- **Prudential Assessment of Shareholders**

21. Detailed criteria for the prudential assessment of shareholders and management team as well as a clear procedure for applying these criteria should be established. The assessment should apply in particular to: (i) credit institutions, insurance companies, reinsurance companies and investment firms; (ii) parent undertakings of credit institutions, insurance companies, reinsurance companies and investment firms; (iii) natural or legal persons in charge of credit institutions, insurance companies or reinsurance companies.

22. In particular, the authorities will have to make a judgment as to the character of the shareholder and, in the case of an acquisition, the financial soundness of the proposed operation on the bases of criteria such as: (i) reputation of the proposed shareholder; (ii) reputation and experience of any person who will direct the business of the institutions; (iii) financial soundness of the proposed acquirer; (iv) ability of the credit institution to comply with the prudential requirements; and (v) existence of reasonable grounds to suspect that attempted or actual money laundering or terrorism financing are taking place.

- **The essential rules for monitoring large exposures of credit institutions should be uniform.**

23. The monitoring and control of a credit institution's exposures should be an integral part of its supervision. Therefore, excessive concentration of exposures to a single client or group of connected clients may result in an unacceptable risk of loss. Such a situation can be considered prejudicial to the solvency of a credit institution.

24. When a credit institution incurs an exposure to its own parent undertaking or to other subsidiaries of its parent undertaking, particular prudence should be necessary. The management of exposures incurred by credit institutions should be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any other considerations. Where the influence exercised by persons directly or indirectly holding a qualifying participation in a credit institution is likely to operate to the detriment of the sound and prudent management of that institution, the competent authorities should take appropriate measures to put an end to that situation. In the field of large exposures, specific standards, including more stringent restrictions, should be laid down for exposures incurred by a credit institution to its own group. Such standards need not, however be applied where the parent undertaking is a financial holding company or a credit institution or where the other subsidiaries are either credit or financial institutions or undertakings offering ancillary services, provided that all such undertakings are covered by the supervision of the credit institution on a consolidated basis.

25. Credit institutions should ensure that they have internal capital that, having regard to the risks to which they are or may be exposed, is adequate in quantity, quality and distribution. Accordingly, credit institutions should have strategies and processes in place for assessing and maintaining the adequacy of their internal capital.

26. Competent authorities have responsibility to be satisfied that credit institutions have good organization and adequate own funds, having regard to the risks to which the credit institutions are or might be exposed.

27. In order for the internal banking market to operate effectively a Committee of EAC Banking Supervisors should contribute to the consistent application of the approved legislature and to the convergence of supervisory practices throughout the Community, and should report on a yearly basis to the EAC institutions on progress made.

- **Freedom of Establishment and Freedom to Provide Services**

28. A credit institution wishing to establish a branch[10] or provide services in another Partner State should be able to do so just upon notification to the authorities of its home Partner State, indicating the Partner State in which it plans to establish a branch, a program of operations, the address in the host Partner State from which documents may be obtained and the names of those responsible for the management of the branch.

29. The home Partner State should provide this information to the host Partner State within a fixed period, except if there is a reason to doubt the capacity of the administrative structure or the financial situation of the credit institution. If they refuse to provide the required information, the home Partner State should justify their decision. That refusal shall be subject to a right to apply to the courts.

[10] Branch is a place of business which forms a legally dependent part of a credit institution and which conducts directly all or some of the operations inherent in the business of credit institutions.

30. A credit institution wishing to exercise the freedom to provide services on the territory of another Partner State should notify the authorities of its home Partner State. Such notification must be forwarded to the host Partner State.

- **Relations with Third Countries**

31. Whenever it appears to the EAC that credit institutions in a third country do not receive national treatment and that the conditions of effective market access are not fulfilled, it may initiate negotiations to remedy the situation and suspend decisions for a definite period agreed, on requests for authorization from the third country in question.

32. Partner States may not apply to branches of credit institutions which have their head office outside the EAC for provisions resulting in more favorable treatment than that accorded to branches of credit institutions which have their head office in the EAC.

33. Third countries' undertakings and conditions of access to the markets of these countries should be: (i) Partner States shall not apply to branches of credit institutions having their head office outside the Community, when commencing or carrying on their business, provisions which result in more favorable treatment than that accorded to branches of credit institutions having their head office in the Community; (ii) the competent authorities shall notify the EAC Secretariat and the MAC of all authorizations for branches granted to credit institutions having their head office outside the Community; (iii) The Community may, through agreements concluded with one or more third countries, agree to apply provisions which accord to branches of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community.

- **Prudential Supervision**

Scope

34. Measures should be taken to ensure that the responsibility of supervising the financial soundness of a credit institution and, in particular, its solvency, should lay with its home Partner State. The home Partner State may be able to carry out on-the-spot verifications of the branch as soon as notification by the home to the host Partner State of the approval of the branch is sent. However, the host Partner State should be responsible for the supervision of the liquidity of the branches and monetary policies.

35. The scope of the legislation should therefore be as broad as possible, covering all institutions whose business is to receive repayable funds from the public, whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities and to grant credits for their own account. Exceptions should be provided for in the case of certain credit institutions to which this EAC Act might not apply as: (i) the central banks of the Member States; (ii) post office giro institutions; (iii) and other bodies specific to certain Partner States.

Objective

36. Supervision of credit institutions on a consolidated basis aimed at, in particular, protecting the interests of the depositors of credit institutions and at ensuring the stability of the financial system.

37. In order to be effective, supervision on a consolidated basis should therefore be applied to all banking groups, including those the parent undertakings of which are not credit institutions. The competent authorities should hold the necessary legal instruments to be able to exercise such supervision.

38. The competent authorities of both home and host Partner State should cooperate closely. The smooth operation of the internal banking market requires not only convergence of regulatory and supervisory practices between the competent authorities of the Partner Sates but also close and regular cooperation. To this end, measures should be taken to ensure mutual exchange of information which, in any case, should not replace the bilateral cooperation.

39. Such exchanges of information necessary for effective supervision and for strengthening the stability of the financial system are to be protected by the principle of professional secrecy. It is necessary to specify the conditions under which exchange of information in cases of fraud and insider offences liable to affect the host market stability is authorized.

Key Issues

- **Banking Subcommittee of the MAC**

40. In order for the single EAC banking market to operate effectively, the Banking supervision sub-committee of the MAC should contribute to the convergence of supervisory practices throughout the EAC. This Sub-Committee should assist the EAC Secretariat in ensuring the proper implementation of the future legislation and should carry out other tasks prescribed therein.

41. The EAC Act will lay down legislation and regulation for the prudential supervision of financial conglomerates, and will create equal conditions of competition and legal certainty for the financial institutions concerned. It will align the regulations applicable to financial conglomerates with those applicable to homogenous financial groups (who are active in one financial sector only), in order to ensure equal treatment and equal conditions of competition.

- **Technical Instruments of Prudential Supervision**

42. Supervisory practices and competent authorities have the responsibility of ensuring that credit institutions have good organization and adequate own funds –taking into account to the risks to which the credit institutions are or might be exposed.

43. Minimum capital requirements play a central role in the supervision of credit institutions and in the mutual recognition of supervisory techniques. Preserving a certain amount of capital (own funds) by the credit institutions against the different types of risk to which they are exposed is crucial to provide these institutions with resources in case of financial or economic stress.

44. Laying down minimum capital requirements is also crucial for preventing distortions of competition in the EAC common market and for strengthening the EAC banking system. On this point, in June 2004, the Basel Committee on Banking Supervision adopted a framework agreement on the international convergence of capital measurements and capital requirements. The EAC should agree on which Basel framework to adopt. 11.

45. Common rules on minimum capital requirements should be considered in conjunction with other specific instruments aimed at making the fundamental techniques for the supervision of credit institutions uniform. Examples of these techniques are: (i) definition of "own funds"; (ii) definition of exposures; (iii) definition of risks at which the credit institutions are exposed; and (iv) limits to and treatment of large exposures.

- **Own Funds**

46. A future legislation should put forward a definition of own funds comprising two elements: (i) original own funds and (ii) additional own funds. The amount of additional own funds included in own funds should not exceed the original own funds. In addition, the commitments of members of credit institutions (cooperative societies) and subordinated loans may not exceed one half of the original own funds. This legislation should also list the elements to be deducted from own funds and indicates the formula for calculating own funds on a consolidated basis.

47. The concept of "own funds" used by the Partner States should include other items provided that, whatever their legal or accounting designations might be, they should have the following characteristics: (i) they should be freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified; (ii) their existence should be disclosed in internal accounting records; and (iii) their amount should be determined by the management of the credit institution, verified by independent auditors, made known to the competent authorities and placed under the supervision of the latter.

48. Credit institutions shall not include in own funds either the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortized cost, or any gains or losses on their liabilities valued at fair value that are due to changes in the credit institutions' own credit standing.

- **Solvency Ratio**

49. The own funds of each credit institution are defined as a proportion of the weighted risks of its assets and off-balance-sheet activities. This mainly concerns credit risk incurred by possible non-payment by a borrower and establishes a distinction between the levels of risk

[11] There are three Basel frameworks: Basel I, Basel II (adopted in June 2004), and Basel III (under preparation).

associated with specific assets and off-balance-sheet elements, and with certain specific categories of borrowers.

- **Large Exposures**

50. Credit institutions should report every large exposure to the competent authorities in the manner provided for in the EAC legislation. Limits are set on the exposures that a credit institution may incur.

- **Supervision on a Consolidated Basis of Credit Institutions**

51. Every credit institution which has a credit institution or a financial institution as a subsidiary, or which holds a participation in such institutions, and all credit institutions the parent undertaking of which is a financial holding company, should be subject to supervision. The arrangements attempt to identify clearly elements whereby the competent authorities responsible for exercising supervision on a consolidated basis can be determined in the possible scenarios.

- **Consolidated Supervision**

52. Partner States shall adopt any measures necessary, where appropriate; to include financial holding companies in consolidated supervision. The consolidation of the financial situation of the financial holding company shall not in any way imply that the competent authorities are required to play a supervisory role in relation to the financial holding company on a stand ‑ alone basis.

53. To ensure that EAC credit institutions active in several Partner States are not disproportionately burdened as a result of the continued responsibilities of individual States' competent authorities, it is essential to significantly enhance the cooperation between the authorities. In this context, the role of the consolidating supervisor is crucial and should be strengthened.

54. Legal instruments to enable competent authorities to exercise supervision on a consolidated basis should be applied. For this purpose, any credit institution which has a credit institution or a financial institution as a subsidiary or which hold a participation in such institutions is subject to consolidated supervision. EAC rules to clearly identify elements whereby the competent authorities responsible for exercising supervision on a consolidated basis in the various possible scenarios should be determined.

Capital Adequacy of Credit Institutions

Scope

55. In order to ensure more effective financial risk management, this EAC legislation will ensure equal treatment between credit institutions and investment firms by making capital requirements consistent among the five Partner States. It also introduces a common framework for measuring the market risks faced by credit institutions and investment firms.

Objective

56. The EAC Act will aim to ensure the consistent application of the international guidelines for capital requirements adopted by the Basel Committee on Banking Supervision (BCBS). It determines the prudential framework for investment firms and credit institutions.

Key Issues

- **Types of Risk and Capital Adequacy Approaches**

57. The capital required to cover credit institutions' risks depends on the type of risk – whether this be credit risk, market risk, operational risk and reputational risk. A clear differentiation of the type of risk will also need to be established at the EAC level.

58. Specific requirements can be put in place for the funding of SMEs or other activities at which the EAC deems appropriate to provide preferential treatment. Retail loans to individuals or any other activity or product which involves lower risk can also be subject to special requirements.

- **Capital Adequacy**

59. Investment firms and credit institutions must have minimum capital requirements if they:

- Hold clients' money and/or securities;
- Receive, transmit and/or execute investors' orders;
- Manage portfolios of investments or financial instruments.

60. All other investment firms must have commensurate initial capital requirements. Provision is made for derogations from the capital requirements for certain specified cases in order to take account of the various kinds of investment firm and the type of operation they carry out.

61. The EAC legislation must also lay down a "base" requirement according to which each investment firm is required to hold own funds. This requirement will be intended to:

- Cover all risks faced by an investment firm, e.g. the risk of market collapse, reducing a firm's brokering income to a level insufficient to cover its expenses;
- Safeguard the ongoing financial soundness of such firms. Capital requirements are laid down to cover the market risks to which they are exposed.

62. Investment firms and credit institutions are required to assess their positions daily at market prices. Similarly, they are required to transmit to the competent authorities in their Partner State of origin any information necessary for those authorities to check that the rules laid down in the legislation are being observed.

- **Trading Book**

63. The concept of a “trading book” comprises positions in securities and other financial instruments which are held for trading purposes and are subject mainly to market risks and exposures relating to certain financial services provided to customers.

64. The first requirement concerns the position risk. According to the rules proposed, each firm must keep in the form of capital a given percentage of its long and short positions, after allowance has been made for its hedging operations.

65. Secondly, there is a foreign-exchange risk requirement in respect of losses which the firm may suffer in the event of adverse exchange-rate movements.

66. The third requirement relates to the treatment of risk arising from unsettled transactions and other transactions where counterparty risk arises.

67. The concept of a “trading book” also applies to positions in commodities or commodity derivatives which are held for trading purposes and are subject mainly to market risks.

Annual Accounts of Banks and Other Financial Institutions

Scope

68. This EAC legislation will apply to most credit institutions (e.g. banks) and other financial institutions.

Objective

69. The EAC Act will ensure uniformity in the format and contents of the annual accounts of all financial institutions within the Community.

Key Issues

70. The EAC should make the format and contents of the annual accounts of all financial institutions within the Partner States uniform. A standard balance sheet should be designed with a layout in which assets and liabilities are presented in decreasing order of liquidity –as the international best practice indicates. Standard profit-and-loss accounts should be designed according to the international practice –which applies two layouts.

71. A detailed list of the required contents of the notes on the accounts should be established as well as separate provisions relating to the drawing up of consolidated accounts.

- **Accounting Documents of Branches of Foreign Credit and Financial Institutions**

72. Best international practice removes the need for branches of foreign banks and other financial institutions having their head office in another Partner State or in a non-member country to publish separate annual accounts.

73. In the European Union, for example, a Directive -which applies to banks and other financial institutions which have their head offices outside the Partner State where the branch is established- abolished former requirements to publish separate branch accounts. These documents include annual accounts, consolidated accounts, annual reports, etc. and must be published and audited as required by the law of the Partner State in which the head office is located. Pending further coordination, Partner States may require branches to publish additional information –such as income, costs, total claims and liabilities attributable to the branch.

Reorganization and Winding-up of Credit Institutions

Scope

74. The EAC Act will ensure that, where a credit institution with branches in other Partner States fails, a single winding-up procedure is applied to all creditors and investors.

Objective

75. If a credit institution with branches in other Partner States has to be wound up, its assets divided among its creditors and the authorities in each Partner State where the institution is represented initiate separate insolvency proceedings, it can lead to conflicts of jurisdiction and unequal treatment of creditors. To prevent this from happening, the EAC Partner States will have to establish common winding-up rules to all EAC credit institutions.

76. A single winding-up procedure should be applied to all creditors and investors in those cases in which a credit institution with branches in other Partner States is liquidated. In line with the home country control principle that is the basis for the prudential supervision rules, the international best practice applied the principle of home country control under which, if a credit institution with branches in other Partner State fails, the winding-up will be subject to a single bankruptcy proceeding initiated in the Partner State where the credit institution has its registered office (i.e., its home State) and will thus be governed by a single bankruptcy law. If the head office is in a third country, the Partner State in which the branch is established will be regarded as the home Partner State.

Key Issues

- **Cooperation Between the Supervisory Authorities**

77. The principle of cooperation that operates in the prudential supervision process is also applied in the winding-up processes. International practice provides that the administrative or judicial authorities of the home Partner State will be required to inform, by any available means, the competent authorities of the Partner State in which the branch is established of their decision to open winding-up proceedings.

- **Protection of Creditors**

78. The EAC should come up with any additional measure that ensures protection of creditors. The standard practice is to set up publication and information requirements. Administrators are required to publish an extract from the decision in an Official Journal and in several national newspapers in each host Partner States. As for information requirements, known creditors established in other Partner States must be informed rapidly and individually in the official language of the home Partner State. In addition, the liquidators must keep creditors regularly informed on the progress of the winding-up.

- **Law Applicable**

79. Appropriate laws must be enacted pertaining to the winding up of credit institutions and appropriate text incorporated for the exceptions to the application of the principle of the home Partner State - as regards the effects of reorganization measures and winding-up proceedings on employment contracts and relationships (law applicable to employment contracts), contracts conferring the right to make use of or acquire immovable property and rights in respect of immovable property subject to registration. Transactions carried out in the context of a regulated market will be governed solely by the law of the contract which governs such transactions. Lastly, the effects of reorganization measures and winding-up proceedings on a lawsuit pending are must also be accounted for in the drafting of the legislation.

- **Withdrawal of Authorization**

80. Provision must be made for the withdrawal of authorization in the absence, or following the failure, of reorganization measures.

- **Professional Secrecy**

81. All administrative authorities involved in information or consultation procedures should be bound by professional secrecy, whilst judicial authorities continue to be bound by existing national provisions.

Deposit-Guarantee Schemes

Scope

82. The EAC Act will aim to protect the depositors of all credit institutions and to safeguard the stability of the banking system as a whole.

Objective

83. Deposit protection is a key aspect of completion of the internal market and forms an essential counterpart to the prudential supervision of credit institutions due to the solidarity it

creates between all the institutions operating in the same financial market in the event of a failure. In a single market, it is crucial that all depositors, regardless of their nationality, are equally protected.

84. To ensure equal treatment of credit institutions and equal protection of depositors throughout the EAC, it should be mandatory for every credit institution to join a deposit-guarantee scheme.

Key Issues

- **Amounts of Deposit Guarantees, Available Information, Time Limits/Delays**

85. The EAC Act will specify the minimum amount of the deposit guarantee, the beneficiary of the guarantee, the type and frequency of information to be made available to depositors, the time limits to verify and claim the pay.

- **Monitoring**

86. A monitoring system will periodically assess the following:

- The appropriateness and modalities of providing full coverage for certain account balances;
- Possible models for introducing risk-based contributions;
- The effects of the EAC legislation on the scope of products and depositors covered;
- The link between deposit –guarantee schemes and alternative means for reimbursing depositors.

Financial Conglomerates

Scope

87. The EAC Act will be imperative for the supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

Objective

88. The EAC Act on financial conglomerates should ensure alignment of the prudential legislation applicable to homogeneous financial groups active in a single sector (banking, insurance, investment) both in order to protect consumers, depositors and investors and to boost the dynamism of the EAC financial market.

89. For financial services firms active in more than one sector of the financial market (e.g. insurance, asset management, retail banking, wholesale banking, investment banking, etc.), the EAC will need to introduce specific prudential legislation so as to amplify the sectoral prudential legislation. The birth of such conglomerates can exacerbate both the risks inherent in the

business undertaken by each of the regulated entities belonging to the financial conglomerate and the systemic risk on financial markets.

Key Issues

- **Solvency**

90. Financial conglomerates must have adequate capital independently. In particular, multiple gearing of own funds must be abolished. The parent company will no longer be able to issue loans to finance its regulated subsidiaries ("excessive leveraging"). Specific rules on methods for calculating solvency ratios and capital adequacy at group level should be determined.

- **"Intra-group" Transactions and Risk Concentration**

91. EAC rules should introduce: (i) quality standards for 'intra-group" transactions and "risk concentration" at group level; (ii) requirements on reputation and experience of directors and managers; etc.

- **Professionalism**

92. The EAC must impose requirements as to reputation and experience of directors and managers

- **Supervision**

93. The EAC will follow the international recommendations on the supervision of conglomerates adopted by the Group of 10 under the *aegis* of the Bank of International Settlements (BIS) which provides for supervision of the conglomerates and promotes closer coordination between the supervisory authorities and the exchange of information between them.

94. The EAC Act on financial conglomerates should organize the way in which the supervisory authority is exercised.

III. Capital Markets

A. Investment Services

Scope

1. The EAC Act should establish the legal framework governing investment services and financial markets in the Community. It should cover all tradable financial products with the exception of certain foreign exchange trades. This includes commodity and other derivatives.

Objective

2. The EAC Act should aim at creating a true Single Market in which services can be provided freely and instruments traded across borders. It should promote the emergence of an efficient, transparent and integrated financial trading infrastructure and establish a high level of investor protection and confidence. Additionally, it should strengthen enforcement and supervisory cooperation between the Partner States. It should give investment firms an effective "single passport", allowing them to operate throughout the Community on the basis of authorization in their Home State. The EAC Act should have the objective of establishing a comprehensive regulatory regime governing the execution of transactions in financial instruments (irrespective of the trading methods used to conclude those transactions) and thus ensuring a high quality of execution of investor transactions and uphold the integrity and overall efficiency of the financial system.

Key Issues

Markets

Maximum Harmonization

3. A level playing field can only be achieved by a harmonized approach within the Community.

Single Passport

4. The “Single Passport” rule should be the main concept for investment services. Investment firms should be given an effective “Single Passport”, allowing them to operate throughout the Community on the basis of authorization in their Home State (“country of origin principle”). Firms should be authorized and regulated (in their Home State) and should be able to use their “Single Passport” to provide services to customers in other Partner States. The objective of the EAC Act should be to make it easier and less expansive to carry out cross border investment services.

New Requirements for Trading Platforms

5. The EAC Act should make a distinction between different levels of markets in terms regulatory requirements. The EU model makes the distinction between "regulated markets", "multilateral trading facilities" (MTF) and "systematic internalizers".

6. "Systematic internalizer" means an investment firm which, on an organized, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF. The EAC Act should treat systematic internalizers as mini-exchanges, hence, they will be subject to pre-trade and post-trade transparency requirements.

7. "Multilateral trading facility (MTF)" means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract in accordance with the provisions of the EAC Act.

Intermediaries

Scope of Regulated Activities

8. Regulated activities for intermediaries would cover reception and transmission of orders in relation to financial instruments; execution of orders on behalf of clients; dealing on its own account; portfolio management; investment advice; underwriting/placing of financial instruments on firm commitment basis; placing of financial instruments without a firm commitment basis; operation of multilateral trading facilities and ancillary services.

Financial Instruments Covered by the EAC Act

9. Financial instruments covered by the EAC Act are:

- Transferable securities
  - Shares in companies
  - Securitized debt, bonds
  - Securities giving right to buy/sell
- Money-market instruments
- Units in collective investment undertakings
- Derivatives
  - Options, futures, swaps

10. Relating to securities, currencies, interest rates, derivative instruments indices, commodities, climatic variables, inflation rates etc. to be settled in cash or physically.

Authorization Conditions

11. Performance of investment services on regular/professional basis should require prior authorization and public register. Those who fulfill the authorization conditions can be licensed. With respect to firms, they must provide information on program of operations, business, organizational structure, etc. With respect to persons, they must have good reputation and

experience. Decision with regard to authorization should be given in some certain period of time by the competent authority (within 6 months in the EU) and the applicant should be provided information of such decision. The competent authority can withdraw the authorization in the case that the authorization is not used, conditions are not met any longer or in the case of a serious infringement of the law.

Initial Capital

12. Members should ensure that the competent authorities do not grant an authorization unless the investment firm has sufficient initial capital in accordance with the requirements of the EAC Act, and having regard to the nature of the investment service or activity in question.

Investor Compensation Scheme

13. While dealing with the process of authorization, the competent authority has to verify that any entity seeking an authorization as an investment firm meets its obligations with regard to being a member of an investor compensation scheme at the time of the authorization.

Organizational Requirements

14. The EAC Act should bring new organizational obligations to firms providing investment service to clients.

15. Investment firms are required to introduce organizational requirements such as establishing adequate policies and sufficient procedures to ensure compliance of the firm (including its managers, employees and tied agents) with its obligations under the provisions of the EAC Act; taking all reasonable steps designed to prevent conflicts of interest affecting the interests of its clients; ensuring continuity and regularity in the performance of investment services and activities; to avoid undue additional operational risk; having sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems; to arrange for records to be kept of all services and transactions undertaken by it; safeguarding clients' ownership rights (especially in the event of the investment firm's insolvency), and to preventing the use of a client's instruments on own account; making adequate arrangements to safeguard the clients' rights when holding funds belonging to clients. Additionally, there should be pre - and post trade transparency obligations in place for all trading venues.

Conduct of Business Obligations

16. Investment firms must act honestly, fairly and professionally in accordance with the best interests of their clients. Any information addressed to clients should be fair, clear and not misleading. Comprehensible information should be supplied to client on the investment firm and its services; financial instruments and investment strategies; execution venues and costs and associated charges so that they are able to understand the nature and risks of the investments and to take investment decisions on an informed basis.

17. Investment firms should keep record of documents agreed between the firm and the client that set out the rights and obligations of the parties. It should provide adequate reports on the service provided, including the costs associated with the transactions and services undertaken. Investment firms should carry out prompt, fair and expeditious execution of client orders. There should be the prohibition to pay or receive inducements to/from the third parties unless these are aimed to enhance the service quality and they do not impair acting in the client's interests. The inducement should be clearly disclosed to the client prior to the provision of the service.

Client Categorization

18. The EAC Act should follow a system of client categorization:

- Retail clients are any natural or legal persons who (potentially) receive investment services. They should have the highest level of investor protection.

- Professional clients are those who possess experience, knowledge and expertise to make investment decisions and properly assess the risks that they incur. They should have less regulatory protection. They should fulfill certain criteria.

- Eligible counterparties are investment firms, credit institutions, insurance companies, UCITS, national Governments, central banks, supranational organizations, etc. These typically require hardly any investor protection.

19. This classification is based on the level of investor protection. Clients can move between categories to obtain more or less regulatory protection. Clear procedures must be in place to categorize clients and assess their suitability for each type of investment product. The appropriateness of any investment advice or suggested financial transaction must still be verified before being given.

Best Execution Rule

20. The EAC Act should require that investment firms take all reasonable steps to obtain the best possible result in the execution of an order from a client. Client's interests are protected by requiring firms to seek out the best price for their client. The process should promote competition in the securities market and thereby support price formation and facilitate the efficient allocation of capital. The best possible result should not only be limited to the execution price but should also include cost, speed, likelihood of execution and likelihood of settlement and any other factors deemed relevant (size, nature of the order..etc).

21. The investment firm should establish order execution policy. For each class of instruments, information on the different venues and the factors affecting the choice of execution venue should be available. The clients should have appropriate information with regard to the execution policy and give consent to the execution policy. Client's specific instructions should prevail. Investment firms must review their execution arrangements regularly to be sure that they continue to provide the best possible result. The review process means firms should check

whether their existing execution venues enable them to continue to deliver best execution or whether they need to access other execution venues. This involves a review of the execution quality across all execution venues accessible by the firm. Investment firms should monitor effectiveness of arrangements and demonstrate at request that orders are executed according to the execution policy.

Conflict of Interest Rules

22. Conflicts of interests arise when an investment firm or its employee have competing personal interests. This can arise between the investment firm and the client or between the clients. The EAC Act should require firms to establish a "written conflicts of interest policy". The policy should detail the circumstances that give rise to conflicts of interest and the procedures that will be adopted to manage such conflicts.

23. The EAC Act should introduce a "conflicts policy" composed of three pillars: identification, management and disclosure.

24. Identification of Conflicts: When identifying conflicts of interest, actions which are likely to make a financial gain, or avoid a financial loss at the expense of the client should be taken into consideration. Conflicts of interest occur when there is an interest in the outcome of a service provided to the client (or of a transaction carried out on behalf of the client) which is distinct from the clients interest. This might occur when the investment firm carries the same business with the client; or when there is an inducement in relation to a service provided to a client (in the form of monies, goods or services, other than the standard commission fee which is received).

25. Managing Conflicts: Effective procedures to prevent or control the exchange of information should be in place (which could include a physical barrier such as a "Chinese Wall", document classification, security and computer protections, confidentiality agreements…etc). There should be separate supervision of relevant persons and removal of direct remuneration links. Measures to prevent or limit any person from exercising inappropriate influence should be in place. Additionally, there should be measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate services or activities.

- Disclosure: The purpose of this disclosure is to give the client the information needed to make an informed decision on whether to proceed with the service given by the investment firm. The level of detail provided will depend on the business and the client involved.

Client Assets Regime

26. The objective of this regime is to maintain confidence in the financial system and enable consumer protection by securing the appropriate degree of protection for consumers. Client assets and money cannot be used by an investment firm for its own account. In case of insolvency, clients should get back their assets and money (as far as possible) which are rightfully theirs.

27. Investment firms must arrange adequate protection for clients' assets. While holding financial instruments belonging to clients, investment firms should make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of client's instruments on own account, except with the client's express consent. Additionally, investment firms should make adequate arrangements to safeguard the clients' rights when holding funds belonging to them and should prevent the use of client funds for their own account.

28. Under the EAC Act, Clients' assets should be a Home State responsibility.

Record Keeping and Transaction Reporting

29. EAC Act should impose an obligation to keep record of the services provided to clients and the transactions executed.

30. Additionally, the EAC Act should introduce an obligation to report transactions to the competent authorities. Investment firms must report to the competent authority the details of all transactions in any financial instrument admitted to trading on a regulated market.

Investment Advice

31. Investment advice is the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments.

32. Know your customer rule: It is necessary to understand the essential facts about the client (investment objectives, financial situation, knowledge and experience). Where an investment firm does not obtain the information required, the investment service should not be allowed to be provided. Specific transactions cannot be recommended if they do not meet client's investment objectives, financial situation and experience.

- Investment firms must obtain the necessary information about the client's knowledge and experience in the relevant investment field, his/her financial situation and his/her investment objectives so as to enable the firm to recommend to the client or potential client, the investment services and financial instruments that are suitable for him/her. In case the client refuses to provide the necessary information, the firm should not be allowed to provide advice, but could still execute the orders.

B. Capital Adequacy

Scope

33. The EAC Act shall apply at a minimum to intermediaries providing financial investment services within the Community.

Objective

34. The objective of the Directive should be to lay down the capital adequacy requirements applying to intermediaries providing financial investment services within the Community, the rules for their calculation and the rules for their prudential supervision.

Key Issues

35. The initial capital of intermediaries should be determined according to their type of activities:

- Investment advice
- Reception and transmission of investors' orders for financial instruments
- Management of individual portfolios of investments in financial instruments
- Operating Multilateral Trading Facilities
- Placing of financial instruments without a firm commitment basis.

36. When an intermediary is not allowed to hold client's money or financial instruments to deal on its own account or to underwrite on a firm commitment basis it could have a lower initial capital, whereas when an investment firm is allowed to hold client's money and financial instruments it should be required to have a higher initial capital.

37. The EAC Act should describe in detail some of the important concepts of capital adequacy such as the trading book, own funds, scope of application of capital requirements, risk management and capital assessment, reporting, supervision, disclosure, consolidated supervision, capital requirements for foreign exchange risk, commodity risk, equity and interest rate risk of the trading book, use of internal risk models and large exposures.

38. The competent authorities may impose additional or more stringent requirements than those of the EAC Act. Furthermore, provisions of the EAC Act may provide for options on the above mentioned topics which will be implemented at the discretion of the national competent authorities.

39. As the capital adequacy regulations in the EAC Act shall include references to regulations on accounting (such as the annual accounts of certain types of companies, consolidated accounts and annual accounts of banks and other financial institutions...etc), the accounting regulations of the Partner States should be harmonized.

C. Prospectus Requirements

Scope

40. The scope of the EAC Act should cover the drawing up, approval and distribution of the prospectus when securities are offered to the public or admitted to trading on a regulated market, situated or operating in a Partner State. The EAC Act should establish framework principles on issues such as circumstances where a prospectus is required, approval of prospectus, single passport, language regime, high level specification of form and contents and status of Annexes, etc.

41. The scope of the EAC Act should be broad and apply to all transferable securities. The EAC Act should cover all offers to the public (not just IPOs) and have a wide definition of the term "offer".

42. Exclusions from the scope could be CISs; non-equity securities issued by Partner States' regional authorities and central banks; securities included in an offer where the total value of the offer is less than a certain threshold. Partner States may apply domestic disclosure requirements for such a type of exclusion (unless it is subject to another regime).

Objective

43. The main objective should be to introduce an effective single passport for primary market activities and to facilitate the widest possible access to investment capital on a community-wide basis, including for small and medium sized enterprises and start-ups. Other important objectives should be investor protection and market efficiency in accordance with high regulatory standards adopted in the relevant international arena. For this purpose, best practices should be adopted at the international level in order to allow cross-border offers of equities, such as the single set of disclosure standards established by IOSCO.

Main Principles of the EAC Act

44. The EAC Act should require a prospectus where securities are offered to the public anywhere in the Community and securities are admitted to trading on a regulated market in the Community. All prospectuses must be approved by the relevant competent authority. The approved prospectus should be valid for a certain period of time (for example 12 months in the EU), subject to updating. The approved prospectus should be able to be used anywhere in the Community.

Maximum Harmonization

45. A level playing field can only be achieved by a harmonized approach within the Community. The prospectus requirements should be binding and directly applicable in all Partner States without being subject to any further national discretion.

Single Passport

46. This principle is the center piece of the prospective requirements regime. The EAC Act should implement the "Principle of Home State Control" (country of origin principle). There should be a single competent authority responsible for the approval of the prospectus and the updates. The EAC Act should also confer the possibility to transfer the approval right to another competent authority.

47. Issuers should be able to use the prospectus in Host State/s without a second approval procedure. There should be an automatic mutual recognition based on a certificate of approval from the home competent authority. There should be no additional approval or administrative procedures in the Host State/s. Upon request, notification of the prospectus (and the certificate of approval) should be made to the competent authority of the Host State.

Home State Principle

48. Home State is:

- Where the issuer has its registered office.
- In the case of certain non-equity securities, in particular with a denomination of at least a certain amount (1000 € in the EU), the state where the public offer and/or admission to trading takes place (at the choice of the issuer).
- Special case: "third country issuers" (outside the Community).

- Host State is:

- The country in which the public offer of securities and/or their admission to trading takes place.

Broad Scope of Application

49. The EAC Act should have a broad scope of application covering the drawing up, approval and distribution of the prospectus when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Partner State. Only prospectus requirements should be governed by the EAC Act, not the admission procedure. Certain securities indicated by the EAC Act could be exempted from the scope of application of the prospectus regime.

Exemptions

50. The EAC Act should provide for exemptions (which apply to offers of transferable securities to the public and to admission of securities to trading on a regulated market) from the obligation to publish a prospectus. There should be harmonization among the Partner States of exemptions from the obligation to produce a prospectus such as:

- an offer addressed only to qualified investors
- an offer addressed to fewer than 100 persons, other than qualified investors, per member jurisdiction
- an offer of securities with a unit value of at least a certain amount (€50,000 in the EU)
- an offer where the total consideration payable for the securities cannot exceed a certain amount (€100,000 in the EU)

51. Other exemptions when a prospectus is not required for an offer or the admission of securities to trading could be where the securities are offered or allotted:

- in the context of a merger or a takeover
- free of charge to existing shareholders
- to employees

52. These exemptions could apply if the issuer makes available sufficient information about the securities and the offer.

Definition of Public Offer

- In this context, an "offer" should be defined as a communication to persons in any form and by any means which presents sufficient information enabling the investor to make an investment decision.

Format of the Prospectus

53. The EAC Act should confer issuers two separate options as to the format of prospectus. Issuers can either chose a single document as a prospectus or a set of three separate components. In case of the choice of three separate documents, these documents should be:

- Registration document containing information relating to the issuer
- Securities note containing details of the securities
- Summary note conveying essential characteristics and risks associated with the issuer and the securities in non-technical language.

Use of Languages

54. Language regime should be regulated by the EAC Act. In case of a cross border offer, a prospectus could be drawn up in "a language customary in the sphere of international finance". The Host State may only require that the summary be translated into its official languages.

55. The issuer, offeror, or a person asking for admission to trading frequently, should have the choice of using a language customary in the sphere of international finance. Where an offer to the public is made or admission to trading on a regulated market is sought only in the Home State, the prospectus should be drawn up in a language accepted by the competent authority of the Home State. In other Partner States excluding the Home State, the prospectus should be

drawn up either in a language accepted by the competent authority of those Partner States or in a language customary in the sphere of international finance, “at the choice of the issuer, offeror or person asking for admission”. The competent authority of each Host State may only require that the summary be translated into its official language(s).

56. Where an offer to the public is made or admission to trading on a regulated market is sought, in more than one Partner State including the Home State, the prospectus should be drawn up in a language accepted by the competent authority of the Home State and should also be made available either in a language accepted by the competent authorities of each Host State or in a language customary in the sphere of international finance, at the choice of the issuer, offeror, or person asking for admission to trading. The competent authority of each Host State may only require that the summary referred to be translated into its official language(s).

Publication Methods

57. Once approved, the prospectus should be filed with the competent authority of the Home State and be made available to the public as soon as possible, at a reasonable time in advance of the offer at the latest by the beginning of the offer to the public or the admission to trading of the securities involved. This should be at least a certain number of working days (6 working days in the EU) before the end of the offer if the class of shares is admitted to trading for the first time. The prospectus should be deemed to be made available to the public in case it is published in the following manners:

- Insertion in one or more newspapers circulated throughout, or widely circulated within the Partner States in which the offer to the public is made or the admission to trading is sought.
- Made available to the public in a printed form and free of charge.
- In an electronic form on the issuer's Website and, if applicable, on the website of the financial intermediary/intermediaries placing or selling the securities (including paying agents).
- In an electronic form on the Website of the regulated market where the admission to trading is sought.
- In electronic form on the Website of the competent authority of the Home State.

58. A Home State may require issuers to publish their prospectus in an electronic form or require publication of a notice stating how the prospectus has been made available and where it can be obtained by the public. The competent authority of the Home State shall publish on its website over a certain period (12 months in the EU) all the prospectuses approved, or at least the list of prospectuses approved, including hyperlinks to the prospectus published on the website of the issuer or on the website of the regulated market.

59. If the prospectus comprises several documents and/or incorporating information by reference, the documents and information making up the prospectus may be published and circulated separately, provided that the said documents are made available to the public free of charge. The text and the format of the prospectus and/or the supplements to the prospectus published or made available to the public should at all times be identical to the original version approved by the competent authority of the Home State.

60. Although a prospectus is made available in electronic form, a paper copy must be delivered to the investor upon his/her request free of charge.

Advertisements

61. Advertisements should state that a prospectus has been or will be published and should indicate where investors are or will be able to obtain the prospectus. If the prospectus is already published, advertisements should be clearly recognizable, should not be inaccurate or misleading and should be consistent with the information contained in the prospectus. Advertisements should be consistent with the information required to be in the prospectus if the prospectus is published after the advertisements. All information concerning the offer to the public or the admission to trading on a regulated market should be consistent with that contained in the prospectus.

62. When no prospectus is required, material information provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, including information disclosed in the context of meetings relating to offers of securities, should be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed. Where a prospectus is required to be published, such information should be included in the prospectus or in a supplement to the prospectus.

- The means of communication should include addressed or unaddressed printed matters; electronic messages or advertisements received via a mobile telephone or pager; standard letters; press advertisings with or without order form; catalogues; telephones with or without human intervention; seminars and presentations; radios; videophones; videotexts; electronic mails; facsimile machines (fax); televisions; notices; bills; posters; brochure and web postings including internet banners.

63. The competent authority of the Home State should have the power to exercise control over the compliance of advertising activity.

D. Investment Compensation Schemes

Scope

64. The ICS should come into effect when the covered institution is unable to meet its obligations arising out of investors' claims and the competent authorities have determined so or when a judicial authority has made a ruling, for reasons directly related to an investment firm's

financial circumstances, which has the effect of suspending the investors' ability to make claims against it.
The cover should be provided for claims arising from an investment firm's inability to repay money owed to or belonging to investors and held on their behalf in connection with investment business. Additionally the ICS should return investors any instruments belonging to them and held and administered for them.

Objective

65. The main objective of an ICS is the provision of protection for investors and maintenance of confidence in the financial system. Minimum harmonization of investor compensation regulation is necessary for the completion and proper functioning of the market for firms providing investment business.

Key Issues

Introduction of at Least One Investor Compensation Scheme

66. Each Partner State should ensure that within its territory at least one investor compensation scheme is introduced and officially recognized.

Mandatory Participation

67. No investment firm or credit institution authorized in a Partner State may carry on investment business unless it belongs to an ICS.

Occurrence of the Compensation Case

68. The scheme should provide cover for investors where the competent authorities have determined that an investment firm appears to be unable to meet its obligations arising out of investors' claims and has no early prospect of being able to do so.

69. A scheme should also provide cover for investors where a judicial authority has made a ruling which has the effect of suspending the investors` ability to make claims against it.

Scope of Cover

70. There should be a minimum cover for each investor (e.g. 20.000 Euros in the EU). Partner States may limit the cover to at least some certain percentage (e.g. 90 percent in the EU) of the claim as long as the amount to be paid under the scheme is less than a certain threshold (e.g. 20,000 Euros in the EU).

71. Partner States may offer a higher amount or more comprehensive cover.

72. The cover should apply to the investor`s aggregate claim irrespective of the number of accounts, the currency and location of the investment within the Community.

Calculation of Claims

73. The amount of an investor's claim should be calculated by reference to the market value at the time of the assessment of damage after having regard to set off and counterclaims.

74. Each investor`s share in a joint investment business should be taken into account in calculating the cover provided for (e.g. 20.000 Euros in the EU).

75. Certain investors should be excluded from cover or should be granted a lower level of cover. For example investment firms, credit institutions, financial institutions, insurance undertakings, Government, regional, local and municipal authorities, directors and managers of investment firms and their close relatives could be under this exclusion.

76. Claims arising out of transactions in connection with which a criminal conviction has been obtained for money laundering should be excluded from any compensation.

Compensation Procedure

77. The compensation scheme should take appropriate measures to inform investors in the case of compensation and should compensate them as soon as possible.

78. The period during which investors shall be required to submit their claims should not be less than a certain period of time (e.g. five months in the EU) counting from the date of the declaration of the damage.

- An investor`s claim has to be paid as soon as possible and at the latest within a certain number of months (e.g. three months in the EU) of the establishment of both the eligibility and the amount of the claim. In special cases the time limit may exceed that established period (which may exceed three months in the EU).

Reporting Requirements

79. Investment firms should take appropriate measures to make available to actual and intending investors the information necessary for the identification of the investor compensation scheme of which the investment firms are members and of the provisions applicable, including the amount and scope of cover etc.

80. Partner States should establish rules limiting the use of the investor compensation scheme by the investment firms, for advertising purposes.

Other Areas Which Can Be Left to the Partner States to be Regulated

81. Partner States should also decide on the details of regulations about the issues mentioned below. In the EAC Act, these areas may be left un-regulated and left to the discretion of the Partner States:

- Organization of the ICS (operator, legal form)

- Funding
- Extended rights and duties of the ICS (auditing rights, sanctions)
- Supervision of the ICS

E. Market Abuse

Scope

- **Insider Dealing**

82. The illegal use of inside information should be prohibited since the insider gains an unfair advantage over other market participants by using the nonpublic information. Insider trading occurs as a result of a person's willful breach of a fiduciary duty. An insider has an unfair advantage because he/she knows facts about the corporation that are not known to those with whom he deals. Moreover, he/she knows these facts because of his/her fiduciary relationship, and not through any special skill or diligence.

- **Market Manipulation**

83. Market manipulation is a complex category of market abuse. Its complexity makes it difficult to prove, and therefore difficult to punish. Partner States should ensure that market operators adopt structural provisions aimed at preventing and detecting market manipulation practices. Unusual changes to market prices can have many causes. It is not easy to demonstrate that any particular change in the price or volatility of the security was a result of any particular factor or behavior. For this reason, the EAC Act should try to stipulate some benchmark behaviors or patterns of transactions as examples to determine such unlawful practices. It should be noted that these unlawful practices may change by time in terms of patterns.

Objective

84. A financial market requires market integrity. Market abuse, which involves insider trading and/or market manipulation, harms the integrity of financial markets and public confidence in securities and derivatives. Therefore it has to be avoided. The main goal of the EAC Act should be to increase investor confidence and to supply the integrity of the financial markets in the Community. The regulatory and supervisory structure of market abuse should be strong.

Key Issues

Insider Dealing

Definition

85. Inside information: is information of a precise nature which has not been made public relating directly or indirectly to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

86. Insider dealing: means to use inside information by:

- Acquiring or disposing of financial instruments for the insider's own account or on the account of a third party.
- Disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.
- Recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.

Public Disclosure of Inside Information

87. Issuers should inform the public as soon as possible of inside information which directly concerns the said issuers.

88. The issuer may under his own responsibility delay the public disclosure of inside information such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information.

Insider Lists

89. Issuers or persons acting on their behalf or for their account, are required to draw up a list of those persons working for them, under a contract of employment or otherwise, who have access to inside information.

90. Issuers and persons acting on their behalf or for their account behalf shall regularly update this list and transmit it to the competent authority whenever the latter requests it.

Directors' Dealings

91. Persons discharging managerial responsibilities within an issuer of financial instruments and, where applicable, persons closely associated with them, should notify to the competent authority the existence of transactions conducted on their own account relating to shares of the said issuer, or to derivatives or other financial instruments linked to them.

92. Public access to information concerning such transactions should be made available as soon as possible.

Market Manipulation

Definition

93. The following behaviors constitute market manipulation:

- 1Transaction based market manipulation which involves transactions or orders to trade which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments, or which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level.

- Transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance.

- Information based manipulation which involves dissemination of information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumors and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading.

94. Regarding the definition of market manipulation, in order to provide guidance both for market participants and competent authorities, signals should be considered when investigating possible manipulative behaviors. There should be a distinction among the two types of behaviors; “manipulative behaviors related to false or misleading signals and to price securing” and “manipulative behaviors related to the employment of fictitious devices or any other form of deception or contrivance”.

95. Transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance share some characteristics of the transaction based manipulation and the information based manipulation. Fictitious devices are to be seen as all ways of deceitfully manipulating the market by methods other than buying and selling shares, in order to create a false impression of activity o the market. Partner States need to be on guard against “any other form or deception or contrivance” as a tool for market manipulation. According to this, market participants and the regulatory authorities should take into consideration some non-exhaustive signals which should not necessarily be deemed to constitute market manipulation.

96. These two types of behaviors are as follows:

- Whether orders to trade given or transactions undertaken by persons are preceded or followed by dissemination of false or misleading information by the same persons or persons linked to them.

- Whether orders to trade are given or transactions are undertaken by persons before or after the same persons or persons linked to them produce or disseminate research or investment recommendations which are erroneous or biased or demonstrably influenced by material interest.

97. Market participants and competent authorities should take into consideration some signals while detecting manipulation. Some non-exhaustive examples which should not necessarily be deemed to constitute market manipulation are mentioned as presumptions for market manipulation. As it is mentioned above, these types of behaviors are non-exhaustive examples.

98. The definitions of market manipulation should be adapted so as to ensure that new patterns of activity that in practice may constitute market manipulation could be included.

99. Information based on manipulation is defined as "dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumors and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading"

100. A special exemption should be conferred for journalists. Deriving, directly or indirectly, an advantage or profits from the dissemination of the information in question could be required for applying sanction on journalists when they act in their professional capacity regarding their above mentioned manipulative behaviors. Otherwise, while assessing the dissemination of such information the rules governing their profession should be taken into account.

Exemptions from Market Manipulation

101. Some activities, although manipulative in nature, should be exempted from market manipulation as they serve for some legal purposes. Therefore the regulations should be in place to cover these areas and confer them the necessary exemption:

- Safe Harbors for Buy-Back Programs and Price Stabilization.

102. Although manipulative in nature, buy-back programs and price stabilization activities of a financial instrument should be exempted from market abuse regime. In other words, these two types of behaviors shall not constitute market manipulation under certain conditions. General conditions for buy-back programs and price stabilization of financial instruments, the object of these activities, the details of public disclosure regarding these activities and methods for an

easier determination for the market participants to assess under which circumstances these activities do not constitute market manipulation should be regulated.

- **Accepted Market Practices**

103. In cases where a person who entered into the manipulative transactions or issued manipulative orders to trade establishes that his reasons for doing so are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned, he should not be subject to any sanction as accepted market practices are regulated as an exemption from market manipulation.

- **Conduct of Monetary Policy**

104. The market abuse regime should not apply to transactions carried out in pursuit of monetary, exchange-rate or public debt-management policy by a Partner State, by a System of Central Banks, by a national central bank or by any other officially designated body, or by any person acting on their behalf.

- **Public Institutions Disseminating Statistics**

- Public institutions disseminating statistics should also be exempted from market abuse sanctions. However, they should be liable to disseminate these statistics in a fair and transparent way.

Investment Recommendations

105. Investment recommendations must be produced and disseminated in accordance with high standards of care in order to avoid misleading market participants. The EAC Act should aim at avoiding manipulative behaviors by means of investment recommendations which the market participants can take as a basis for their investment decisions. Journalists should be subject to their own professional regulations.

Obligation to Notify

106. Any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation should notify the competent authority without delay.

F. Transparency Obligation

Scope

107. The EAC Act should apply to all issuers of securities (debt and equity) admitted to trading on a regulated market within the Community and establish requirements for the disclosure of periodic and ongoing information for such issuers. Additionally, it should adopt a common approach to the dissemination and storage of the so called “regulated information”.

Objective

108. The EAC Act should aim to raise the quality of information available to investors on companies' performance, financial position, major shareholdings and thus, to improve the investor protection and investor confidence within the Community which is of vital importance to complete a milestone in moving towards an integrated regional financial market.

Key Issues

Three Important Areas to be covered by the EAC ACT: Dissemination, Filing and Storage

109. The EAC Act may introduce a three-step approach regarding the disclosure of regulated information. These steps are dissemination, filing and storage.

110. In the case of major holdings of voting rights, a fourth step, namely a notification duty could be imposed by the EAC Act upon the major shareholder. In this procedure, the shareholder should be under the duty of notifying the regulated information to the issuer and the competent authority. Subsequently, the issuer has to disseminate the regulated information to the public throughout the Community and file the situation to the competent authority. In order to disseminate the information, the issuer has to send it to different kinds of media. This obligation can also be performed by using a third party (e.g. information provider) which distributes the information to the media. If that third party performs other services such as serving as a storage mechanism, those different functions have to be kept clearly separated from the services related to the dissemination. In the filing procedure, the information and the fact that the information has been disseminated and the ways of dissemination should be filed to the competent authority.

111. Furthermore, the issuer has to send the information to the "officially appointed mechanism" whose qualifications are set by the EAC Act for the purpose of storage. In that respect, the officially appointed mechanism could be intended to serve as a data base for regulated information under the EAC Act. The officially appointed mechanism can be run by a private entity or the competent authority as the Partner State chooses. It has to securely store the information and provide easy access to the users of the mechanism.

Two Main Types of Information Covered by the Directive: Periodic Information and Ongoing Information

Periodic Information (Financial Reports):

112. The Directive should prescribe contents of reports and statements, publication periods and availability to the public.

Annual Report: Issuers should be required to publish their annual report within some certain period at the end of their financial year (four months in the EU). The annual report must include:

- An audited financial statement;
- A management report; and
- Statements from the persons responsible within an issuer that the financial statements prepared give a true and fair view of assets, liabilities and the position of the issuer.

Half Yearly Financial Reports: Issuers should also be required to publish half-yearly financial reports within some certain period after the end of the relevant period (two months in the EU) entailing a condensed set of financial statements, an interim management report and statements by the persons responsible.

Interim Management Statements: Issuers should also be required to publish interim management statements entailing an explanation of material events and a general description of the issuers' position in the relevant period.

Ongoing Information – (Major Holdings of Voting Rights)

113. The EAC Act should establish a two-tier system for disclosing major shareholdings where initially the shareholder notifies the issuer, and then the issuer makes the information public.

114. Shareholders must notify an issuer each time if they acquire or dispose of shares and their holdings reach, exceed or fall below some thresholds (e.g. 5, 10, 15, 20, 25, 30, 50 or 75 percent in the EU) at the latest some certain trading days (e.g. four trading days in the EU) following the day they learn of the acquisition or disposal.

115. No later than some certain trading days (three trading days in the EU) following receipt of the notification the issuer should make the information public.

116. While determining the thresholds, the voting rights should be calculated on the basis of all the shares to which voting rights are attached even if the exercise thereof is suspended. Moreover this information should also be given in respect of all the shares which are in the same class and to which voting rights are attached.

117. Specific exemptions could be conferred in different situations such as: (i) controlled undertakings (notification by parent); (ii) parents of management companies and of investment firms (no aggregation of holdings if management company/investment firm is independent from parent); (iii) custodians holding shares in their custodian capacity (exemption if no discretion to vote on shares held in custody); (iv) market makers acting in its capacity of a market maker; (v) voting rights held in the trading book of a credit institution or an investment firm (not counted by being subject to conditions); and (vi) shares acquired for the sole purpose of clearing and settlement.

118. The idea is to avoid unnecessary burdens for certain market participants and to clarify who actually exercises influence over an issuer. There should be no need to require notification of major holdings within limits and guarantees to be applied throughout the Community. Another concern for the parent undertaking that should be clarified could also be who the actual major holder is. The parent undertaking should not be required to aggregate their own holdings with other holdings (provided that voting rights are exercised separately and certain further conditions are fulfilled).

119. The issuer should disclose to the public any changes in the voting rights by disclosing the total number of voting rights and capital at the end of each calendar month during which an increase or decrease of such a total number has occurred. The issuer should make public, without delay, at least any change in the rights attached to the various classes of shares; any changes in the rights of holders of securities other than shares and new loan issues, in particular any guarantee or security in respect thereof.

Dissemination of the Information

Definition and Context of Regulated Information

120. The EAC Act should define "Regulated Information". The dissemination obligations under the EAC Act should apply to "Regulated Information" which should cover:

- Periodic information (financial reports)
- On-going information (major holdings of voting rights) and
- Information to be disclosed under the Market Abuse Regime/Directive (such as inside information)

The Manner to Disseminate Information

121. Issuers must disseminate the information as follows: (i) in a manner ensuring fast access; (ii) on a non-discriminatory basis; (iii) using such media as may reasonably be relied upon for effective dissemination to the public throughout the Community; and (iv) without charging investor any specific cost for the information.

122. Partner States should not impose use of national media only. The EAC Act should be neutral as to the media used for dissemination. Partner States may still impose newspaper publications.

123. The issuer should make available to its shareholders on its internet site for at least some certain days (21 days in the EU) at least the information specified in the EAC Act.

Storage of the Information

124. Each Partner State should ensure that there is at least one officially appointed mechanism for the storage of regulated information. Issuers are required to submit the information in a

timely fashion to a storage mechanism, established in each Partner State. The idea is to create a database where investors can access capital market information in one central place at a low cost or free of charge. The storage mechanisms should adhere to certain standards. The officially appointed mechanism should comply with minimum standards of (i) security; (ii) time recording; (iii) certainty as to the information source; and (iv) easy access to end users. Issuer can also make use of a third party for submission.

Filing with the Competent Authority

125. When issuer disseminates information, it should, at the same time, make it available to the storage mechanism and file it with the competent authority.

Supervisory Regime

126. Same competent authority should be responsible for both the Model Transparency Directive and the Model Prospectus Directive as these two are closely interrelated. The competent authority may delegate tasks to another entity.

127. Competent authorities should be given minimum powers including requiring information disclosure, suspending trading, making the infringements public and carrying out onsite inspections.

128. There should be co-operation between the competent authorities. Partner States should conclude agreements for the exchange of information.

129. Partner States should be given powers to impose administrative and/or civil penalties. These sanctions should be effective, proportionate and dissuasive. Additionally, Partner States could impose criminal penalties

G. Auditing

Scope

130. The EAC Act should establish rules concerning the statutory audit of annual and consolidated accounts. The Directive should clarify the duties of statutory auditors and provide for their independence and ethical standards; introduce a requirement for external quality assurance; provide for public oversight of the audit profession, including third country auditors, and improve cooperation between oversight bodies in the Community. It should also provide a basis for international cooperation between competent authorities in the Community and with competent authorities in third countries.

Objective

131. Recent financial crisis highlighted the importance of high-quality accounting and auditing practices. The objective of the EAC Act should be to optimize the quality of audits of annual accounts throughout the Community, thus increasing confidence in such reporting and improving the situation in the financial markets, and to establish a level playing-field for the accountancy

sector within the Community. The EAC Act should aim at a harmonized approach to statutory auditing at the Community level.

Key Issues

Approval of Statutory Auditors and Audit Firms

132. Statutory audit should be carried out only by statutory auditors or audit firms that are approved by the Partner States. The competent authorities of Partner States may only grant approval to natural persons or firms of good repute.

Public Register

133. Each Partner State should ensure that statutory auditors and audit firms are entered in a public register.

Educational Qualifications and Continuous Education

134. A natural person may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, then completed a course of theoretical instruction, undergone practical training and passed an examination of professional competence of university final or equivalent examination level, organized or recognized by the Partner State concerned.

135. Partner States should ensure that statutory auditors are required to take part in appropriate programs of continuing education in order to maintain their theoretical knowledge, professional skills and values at a sufficiently high level.

Professional Ethics

136. Partner States should ensure that all statutory auditors and audit firms are subject to principles of professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care.

Independence

137. Partner States should ensure that while carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in the decision making process of the audited entity. Therefore, a statutory auditor or an audit firm should not carry out a statutory audit if there is any direct or indirect financial, business, employment or other relationship (including the provision of additional non-audit services) between the statutory auditor, audit firm or network and the audited entity.

Audit Rotation

138. Key audit partners who are responsible for carrying out a statutory audit should rotate from the audit engagement within a maximum period of [certain number] of years (e.g. seven years, in the EU) from the date of appointment and should be allowed to participate in the audit of the audited entity again only after a period of at least [certain number] of years (e.g. two years, in the EU).

Annual Transparency Reports of audit Firms

139. Audit firms that carry out statutory audits of publicly-held entities and capital market institutions should publish on their websites annual transparency reports. These reports, which have to be published within certain period (3 months in the EU) of the end of each financial year must include at least descriptions of the legal structure and ownership, of the governance structure of the audit firm, of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning. Furthermore, they should contain an indication of when the last quality assurance review took place, a list of publicly held companies and capital market institutions for which the audit firm has carried out statutory audits during the preceding financial year, a statement concerning the audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted, a statement on the policy followed by the audit firm concerning the continuing education of statutory auditors, financial information showing the importance of the audit firm such as the total turnover divided into fees from the statutory audit of annual and consolidated accounts, and fees charged for other assurance services, tax advisory services and other non-audit services and information concerning the basis for the partners' remuneration.
The transparency report should be signed by the statutory auditor or audit firm.

Auditing Standards and Audit Reporting

140. Partner States should require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards. Where an audit firm carries out the statutory audit, the audit report should be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm.

Quality Assurance Systems

141. Each Partner State should ensure that all statutory auditors and audit firms are subject to a system of quality assurance which meets at least some pre - determined criteria.

Audit Committee

142. Each public-interest entity should have an audit committee. The Partner State should determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one

member of the audit committee should be independent and have competence in accounting and/or auditing.

Public Oversight and Regulatory Arrangements between Partner States

143. Partner States should organize an effective system of public oversight for statutory auditors and audit firms. They must ensure that regulatory arrangements for public oversight systems permit effective cooperation at Community level in respect of Partner States' oversight activities. To that end, each Partner State should make one entity specifically responsible for ensuring that cooperation.

H. Takeovers

Scope

144. Companies that are listed on a regulated market should be under the scope of the EAC Act. The Directive should establish minimum guidelines for the conduct of takeover bids involving the securities of companies governed by the laws of Partner States, where all or some of the securities of the target company are admitted to trading on a regulated market. The Directive should create a community-wide framework for takeover bids which lays down certain basic principles. In other words, the EAC Act should draw a minimum standard of rules. The Partner States should regulate more detailed issues by themselves taking into account the general standards and principles set by the EAC Act.

Objective

145. The EAC Act should aim at keeping the balance between the legal accuracy with respect to takeover regulation and the protection of shareholders of the target company (particularly the minority shareholders) as well as the employees and other stakeholders. Takeover regulations mainly aim at protection of minority shareholders when there is a change of control in the company. Therefore, the Directive should coordinate the safeguards for the protection of shareholders and others exposed to the takeover of a company, the securities of which are admitted to trading on an organized market. A broader objective should be to create community wide clarity and transparency in respect of the legal issues to be settled in the event of takeover bids/offers and to prevent patterns of corporate restructuring from being distorted by arbitrary differences in governance and management cultures.

Key Issues

Definition

146. A takeover bid in general can be described as an offer to all or some shareholders to purchase shares of a corporation, where the offeror, if successful, will obtain enough shares to control the target corporation. Takeover concept is Anglo-American rooted. There could be mainly two types of tender offers: voluntary and mandatory offers. Distinct from the European system, there are no mandatory tender offers in the US system due to the dispersed shareholder structure and the different cultural approach to the takeover concept.

Voluntary Offers – Mandatory Officers

147. A takeover bid can either be mandatory or voluntary. EAC Act should mainly regulate voluntary offers/bids. However, for the purpose of minority shareholder protection, specific requirements for mandatory offers should also be regulated. Particularly, this could be an important concern for East African Community as the markets are yet developed and mainly family owned companies with block shareholdings (having the control of the company) commonly exist. The definition of voluntary and mandatory tender offers could be as follows:

Voluntary Tender Offer: An offer made to the shareholders for acquiring control in a company. A voluntary bid is made by the offeror's own decision to acquire the control of the company.

148. Mandatory Tender Offer: Following the acquisition of shares that provide control of the company, an offer mandatorily required by law to be made to the remaining shareholders of that company. Unlike the voluntary bid, a mandatory bid is a legal obligation. Where a natural or a legal person, as a result of his own acquisition or the acquisition by persons acting in concert with him, holds securities of a company which give him a specified percentage of voting rights in that company that give him the control over that company, Partner States must ensure that such person is required to make a mandatory bid as a means of protecting the minority shareholders.

Directive Should set the Basic Principles for Takeovers

149. There should be main principles in the EAC Act which form a base for takeover rules. An article should be drafted solely for this purpose in the EAC Act. The EAC Act should set the following basic principles:

- Equal treatment for shareholders.
- Providing adequate time and information for shareholders.
- Duty of the board of the offeree company to act in the interest of the company.
- Prohibition on creating false markets.
- Offeree company must not be hindered due to a bid in the conduct of its affairs longer than a reasonable time period.
- Offeror must announce the bid only after ensuring that he can fulfil in full any cash consideration.

150. These principles foresee that all shareholders of an offeree company of the same class must be afforded equivalent treatment. Accordingly, shareholders of an offeree company must be protected in case of a change of control in the company. With the view of protecting the interest of the shareholders this principle should also be supported by the principles which set the condition of ensuring the necessary consideration in full before making a bid as well as requiring that the shareholders should be given have sufficient time and information to enable them to reach a properly informed decision on the bid. Additionally, the board of an offeree company should be given the duty to act in the interests of the company as a whole while it is prohibited from hindering the offeree company in the conduct of its affairs for longer than is reasonable by

a bid for its securities. The creation of false markets in the securities of the offeree company, of the offeror company or of any other company concerned by the bid is forbidden. The offeror should announce the bid only after ensuring that he can fulfil in full any cash consideration.

The Breakthrough Rule and the Board Neutrality

151. The EAC Act should regulate the board neutrality rule and the break-through rule (BTR). These rules should not be designed as mandatory, and Partner States should be given the opportunity to opt out.

152. According to the board neutrality rule, the board of the offeree company should be forbidden to take any defensive measures during the period of acceptance period of the bid once the board received formal notice of the bid, unless there is a prior authorization from the general meeting of shareholders convened for this specific purpose. In other words, the EAC Act should state that once a takeover bid is announced, the target board may not take frustrating action without the approval of the general meeting of shareholders, to be given after the announcement of the bid that is known as the neutrality rule. Accordingly, the Directive should give the shareholders the power to decide whether or not to implement defensive measures against takeover bids. As a compromise however, the Directive should provide Partner States with an opt-out possibility with respect to this rule.

153. The BTR addresses a different kind of defensive mechanism. The BTR is aimed to eliminate wide variety of pre-bid takeover defenses to takeover which are viewed as an impediment to well-functioning cross-border takeover market. Mainly, BTR may provide that a bidder should be permitted upon an acquisition of some certain threshold of share capital (e.g. 75 percent in the EU) to convene a general meeting of shareholders at a short notice to impose on one-share one vote principle.

Payment of Fair Price to Shareholders

154. The price offered to shareholders for the purchase of their shares should be fair. The EAC Act should regulate the fair price concept in details and give particular importance to this issue. Directive should require that the bid price should be the highest price paid to the same securities over a period determined by the Partner States which could not be less & more than some certain period (e.g. not less than six and not more than 12 months in the EU or as otherwise decided by the Partner States).

155. The type of consideration can be cash, securities or combination of both. Partner States may even require the offeror to offer cash under any circumstances. In other words, choosing only a cash consideration should be possible under the Directive.

156. During the period between the making public of the bid and the closure of the offer for acceptance if a higher price is paid to the target shares than the offer price the offer price must be raised at least to the level of that higher price paid during that period. Accordingly, in cases where a higher price is paid for the shares before the end of the bid period, the bid price must become that higher price paid and it is disclosed to the offeree company shareholders.

157. The EAC Act should set the general rules with respect to achieving the equitable price. In practice, some common problems are being observed with respect to pricing. After setting the general rules by the Directive, additional provisions referring to specific problems that commonly arise in takeover applications while determining the equitable price in different situations can be addressed. Moreover, problems which are not addressed by the Directive can be decided on a case by case basis by the competent authority.

Exemptions

158. For an effective application of the takeover rules, derogations from the general rules to some extend and granting of some exceptions should be allowed by the EAC Act in principle. In order to be effective, takeover regulation should be flexible and capable of dealing with new circumstances as they arise and should accordingly provide for the possibility of exceptions and derogations. In addition to the protection provided in the Directive, Partner States may provide further instruments with the aim of protecting the interests of shareholders.

159. However, the Directive should also state that these exceptions and derogations could only be applicable as long as supervisory authorities respect certain general principles. Partner States could derogate from the rules of the Directive by granting their supervisory authorities to take account of the circumstances at a national level or other specific circumstances supported by a reasoned decision.

Sanctions in case of a Violation of the directive

160. The EAC Act should set the requirement that Partner States must determine the sanctions to be imposed. However, it should not determine itself the specific sanctions to be imposed for breach of takeover bid rules. It should set forth the general principles regarding the sanctions. These sanctions must be effective, proportionate and dissuasive. In many developed market applications, a breach of mandatory bid requirements will result in the suspension of the voting rights attaching all shares of the offeree company owned by the offeror. That is to say, voting rights attached to shares held by a party which is obliged to make a mandatory bid are suspended until the required mandatory bid is made. As this kind of sanction is found effective and necessary, a clause for suspension of voting rights could be inserted to the national regulation. However, since suspension of voting rights interfere with the very fundamental right attached to a share there may be some concerns whether this could be done through a EAC Act. Therefore some changes might be necessary in the relevant securities regulations of the Partner States.

161. Other sanctions could be administrative pecuniary fines or criminal pecuniary fines for the breach of disclosure requirements including those in takeover situations. The difference between the administrative and criminal fine is that the former can be applied directly by the competent authority, while the latter can only be applied through a court decision. Moreover, the prohibition of the bid could be triggered when the offeror does not comply with the procedural rules for getting approval for the disclosure of the offer document.

Defense Mechanisms

162. General meeting of shareholders is required before the application of defense mechanisms. This issue should be voluntary of Partner States.

Strict Public Disclosure Requirements

163. There should be strict public disclosure requirements with regard to:

- Disclosure of the bid
- Informing the regulatory authority
- Informing the employee representatives
- Detailed regulation on the scope of takeover document (Terms of the bid, information about the offeror, the offeror's intentions with regard to the future business of the target company)

Squeeze-Out and Sell-Out Rights

164. The squeeze-out right can be defined as "the right of a majority shareholder in a company to compel the minority shareholders to sell their shares to him", and the sell-out right can be defined as "the right of the minority shareholder to compel the majority shareholder to purchase his shares from him". These definitions can be explicated as while the squeeze-out right is in favor of the majority shareholder, the sell-out right is in favor of the minority shareholder. Certain thresholds must be reached by the bidder (majority shareholder) in order to trigger the squeeze-out and the sell-out rights.

165. The grounds that justify the both rights can be summarized as the squeeze-out right allows the bidder to overcome the free rider problem, while the sell-out right has the potential to eliminate the pressure to tender problem.

- Right to Squeeze-Out:
  - If the offeror can obtain shares above a specific threshold (e.g. usually %90 - %95)
- Offeror can force the remaining % 5 - %10 shareholders to sell their shares
- At a fair price, within some specific period (e.g. three months in the EU)

- Right to Sell-Out:
  - The opposite of Squeeze-out right
  - The remaining shareholders below a specific threshold can force the offeror to buy their shares
  - At a fair price, within some specific period (e.g. three months in the EU)

Clearing and Settlement

166. The EAC Act/s in this area should regulate two main matters: “Settlement Finality” and “Financial Collateral”.

I. Settlement Finality

Scope

167. The following categories will fall under the scope of this EAC Act: any clearing and settlement system governed by the law of a Partner State; any participant in such a system; any collateral security provided in connection with participation in a system, or operations of the central banks of the Partner States in their functions as central banks shall fall under the scope of Model Settlement Finality Directive.

Objective

168. Transfer orders and netting should be legally enforceable and should be binding on third parties even in the event of insolvency proceedings against a participant, provided that transfer orders were entered into a system before the moment of opening of such insolvency proceedings.

Key Issues

169. The EAC Act should provide legal definitions of System, Participant (in a system), Transfer Order, Insolvency Proceedings, […] etc.

170. When a transfer order has been entered into a system, it should be protected from third parties in the event of bankruptcy of one or more participants in the system. A transfer order should not be revoked by a participant in a system or a third party from the moment defined by the rules of the system. There should be no retroactive effect of insolvency proceedings.

171. In case of a decision to open insolvency proceedings, this decision should immediately be communicated to central authority authorized in each Partner State.

172. Applicable law for “Systems” should be the national law of any Partner State. Applicable law for “Securities Provided as Collateral” should be the law of the Partner State where these securities are registered.

173. Partner States could notify their appointed systems and authorities to the EAC Secretariat. General Secretariat could keep an official register on their web site.

J. Financial Collateral

Scope

174. All financial collateral arrangements which satisfy the requirements set out in the Model Financial Collateral Directive will fall under its scope. Financial collaterals are legal obligations to provide cash and financial instruments, as well as any rights or claims connected with such instruments, which are used as collateral either under security financial collateral arrangements or title transfer financial collateral arrangements whether or not these are covered by a master agreement or general terms and conditions between creditor and debtor. The EAC Act should define financial collateral agreements.

Objectives

175. The aim of the EAC Act should be to create a clear, uniform and efficient Community legal framework for financial collateral arrangements and to reduce the formal administrative burdens, formal acts and cumbersome procedures to create and enforce collateral. The collateral process should be harmonized and clarified at the minimum level. The EAC Act should contribute to the integration and cost efficiency of the financial markets, stability of the financial system which will enable lower credit losses and cross-border business and competitiveness.

Key Issues

176. The financial collateral provided must consist of cash (refers only to money which is represented by a credit to an account, or similar claims on repayment of money (such as money market deposits) or financial instruments (refers only to shares and bonds and other forms of debt instruments that are negotiable on the capital market).

177. The “collateral taker” should be entitled to exercise a right of use in relation to financial collateral. This should not, however, give the “collateral taker” the right to reduce the value of the collateral. The collateral must be in the possession of or under the control of the collateral taker.

178. The applicable law should be the law of the Partner State where the financial collateral is located (Lex Rei Sitae rule). Consequently, it is necessary to have the settlement where the financial collateral is located.

179. The Directive should only protect financial collateral arrangements which can be evidenced. Clear evidence in writing, or in any other legally enforceable manner, must exist, ensuring thereby the traceability of the collateral.

180. The parties to the financial collateral arrangements can be public authorities; central banks; financial institutions subject to prudential supervision including credit institutions, investment firms, insurance undertakings, undertakings for collective investment in transferable securities, management companies and central counterparties, settlement agents or clearing houses.

K. Collective Investment Schemes (CIS)

Scope

181. Collective Investment Schemes (CIS) under this section cover only some specific matters relevant to Undertakings for Collective Investment in Transferable Securities (UCITS). Apart from the securities market section, there is a specific section in the Project – "Section 2.5. Investment funds" that covers, in detail, the UCITS and private equity funds.

182. Undertakings for Collective Investment in Transferable Securities situated within the territories of the Community should fall under the scope of the EAC Act.

183. The EAC Act should lay down common requirements for the organization, management and oversight of the UCITS. It should impose rules relating to fund diversification, liquidity and use of leverage. The EAC Act should define a list of eligible assets in which the fund can invest. Once authorized, a UCITS fund can be marketed to the public across the Community subject to notification in each Partner State where it is sold.

Objective

184. To create a harmonized legal framework to facilitate cross-border offering of investment funds to the retail investor and to develop an integrated and competitive Community Single Market for investment funds and to establish a defined level of investor protection through strict investment limits, capital, organizational and disclosure requirements, as well as asset safekeeping and fund oversight (by an independent depositary)

Key Issues

Characteristics of UCITS

185. UCITS are undertakings the sole object of which is:

- investment in transferable securities and/or in other liquid financial assets referred to in the EAC Act
- of capital raised from the public, and
- which operates on the principle of risk-spreading.

UCITS have to be open ended structures.

UCITS can be set up in different legal forms:

- as common funds (contractual form) managed by management companies;
- as unit trusts (common law concept of trust law);
- as investment companies (corporate form).

UCITS Authorization Requirements

General requirements

- For unit trusts: approval of management company, fund rules & choice of depositary.
- For investment companies: approval of instrument of incorporation & choice of depositary.
- Sufficient good repute and sufficient experience of the directors of the depositary and the management company.

Specific investment requirements/limitations

- Investment in «eligible assets»: securities, money market instruments, deposits, investment funds and derivatives [should be further to determine whether other categories will be included under eligible assets definition].
- Compliance with fixed quantitative investment limits.
- Explicit exclusions or permission of certain investment techniques.

Disclosure requirements

186. An investment company and, for each of the unit trust/common funds it manages, a management company, must publish:

- full prospectus
- simplified prospectus
- to be offered to the investor prior to the conclusion of the contract
- can be used as a marketing tool
- periodic reports

Product Passport

- Product passport is to facilitate the cross-border circulation of (certain types of) investment funds and consists of the following two pillars:

Authorization of UCITS: Home State Principle

- Authorization granted by the competent authority of the Partner State where the UCITS is situated ("Home Member").
- Should be valid for all Partner States.

Marketing of units in other Partner States - Notification Procedure

- Notification to Host State (with attestation by the Home State that the UCITS fulfils the conditions of the UCITS EAC Act) .
- UCITS can start marketing its units in a certain period (two months in the EU) after such communication unless a reasoned decision by Host State of non-compliance of marketing arrangements is made. Other notification arrangements may be envisaged.

Responsibilities between the competent authorities

187. The main principle for the host Partner States should not be to challenge the exclusive responsibility of the Home State over the fields governed by the EAC Act. In order to facilitate direct and immediate access to the market of another Partner State, the control of compliance of the marketing arrangements with the rules applicable in a Host State will take place on an on-going basis, but only after the UCITS has placed its units on the market of a host Partner State. The purpose could be to enhance transparency regarding local marketing rules (obligation on Partner States to publish on their websites all applicable marketing rules).

Good communication and co-operation between competent authorities

188. The notification procedure should require and ensure good communication between Community competent authorities in order to be successful. Therefore, electronic transmission of information about UCITS and their marketing arrangements should be foreseen. This should allow host Community competent authorities to better prepare for on-going monitoring of compliance with marketing rules. UCITS will however be obliged to directly inform the host competent authorities of any amendments to their marketing arrangements.

Methods of distribution of obligatory disclosures in the host Partner States

189. The language regime should not limit or delay the distribution of funds units. UCITS must translate only the key investor information in the local language. However, it should be up to the UCITS to decide whether other obligatory disclosures are to be translated into the language of the host Partner State or in a language customary in the sphere of international finance. Investors will be aware in which language the prospectus and the annual or half-yearly reports are available because this will be specified in the key investor information. The translation (under the sole responsibility of the UCITS) of documents other than the key investor information into the language of a host Partner State will therefore be a market driven decision (in line with the language regime of the Model Prospectus Directive).

Management Company

Initial Authorization

190. Access to the business of management companies is subject to prior official authorization to be granted by the Home State’s competent authority. Authorization granted under the EAC Act to a management company shall be valid for all Partner States. Still, no management company may engage in activities other than the management of UCITS authorized according to this EAC Act except the additional management of collective investment undertakings other than UCITS and for which the management company is subject to prudential supervision but which cannot be marketed in other Partner State under the EAC Act.

191. The competent authorities should not grant authorization to a management company unless at least following conditions are fulfilled:

- The management company has an initial capital of at least some certain amount (e.g. 125.000 E in the EU) that should be established in accordance with the type of the activities provided.
- The persons who effectively conduct the business of a management company are of sufficiently good repute and are sufficiently experienced also in relation to the type of UCITS managed by the management company. The conduct of a management company's business must be decided by at least a number of persons (e.g. two persons in the EU) meeting such conditions.
- The application for authorization is accompanied by a program of activity including the organizational structure of the management company.
- Both its head office and its registered office are located in the same Partner State.

Prudential Supervision

192. The prudential supervision of a management company shall be the responsibility of the competent authority of the Home State, whether the management company establishes a branch or provides services in another Partner State or not, without prejudice to those provisions of the EAC Act which gives responsibility to the competent authorities of the host Partner State.

193. Each Home Partner State shall draw up prudential rules which management companies, with regard to the activity of management of UCITS authorized according to the EAC Act, shall observe at all times. In particular, the competent authority of the Home State having regard also to the nature of the UCITS managed by a management company, shall require, at minimum, that each such company:

- Has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees or for the holding or management of investments in financial instruments in order to invest own funds and ensuring, inter alia, that each transaction involving the fund may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was effected and that the assets of the unit trusts/common funds or of the investment companies managed by the management company are invested according to the fund rules or the instruments of incorporation and the legal provisions in force.

- Is structured and organized in such a way as to minimize the risk of UCITS' or clients' interests being prejudiced by conflicts of interest between the company and its clients, between one of its clients and another, between one of its clients and a UCITS or between two UCITS.

194. Each Partner State should draw up rules of conduct which management companies authorized in that Partner State shall observe at all times. Such rules must implement at least the principles set out in the following indents. These principles should ensure that a management company:

- Acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market.
- Acts with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market.
- Has and employs effectively the resources and procedures that are necessary for the proper performance of its business activities.
- Tries to avoid conflicts of interests and, when they cannot be avoided, ensures that the UCITS it manages are fairly treated.
- Complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its investors and the integrity of the market.

Depositary

195. The depositary should have a double mission of (1) safekeeping of the fund's assets and (2) carrying out a number of oversight functions to ensure that the assets are managed legally by the management company.

196. A depositary should be an institution which is subject to public control. It must also furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function. The Partner States should determine which institutions could be eligible to be depositaries. A depositary should either have its registered office in the same Partner State as that of the management company or be established in that Partner State if its registered office is in another Partner State.

197. A depositary should, moreover:

- ensure that the sale, issue, re-purchase, redemption and cancellation of units effected on behalf of a unit trust or by a management company are carried out in accordance with the law and the fund rule;.
- ensure that the value of units is calculated in accordance with the law and the fund rules;
- carry out the instructions of the management company, unless they conflict with the law or the fund rules;
- ensure that in transactions involving a unit trust's assets any consideration is remitted to it within the usual time limits;
- ensure that a unit trust's income is applied in accordance with the law and the fund rules.

198. A depositary should be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. Liability to unit-holders could be invoked either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.

199. No single company should act as both management company and depositary. In the context of their respective roles the management company and the depositary must act independently and solely in the interest of the unit-holders.

Investment Policies of UCITS

200. The investments of a unit trust or of an investment company should consist of [the list should be subject to further discussions with the Partner States]:

- transferable securities and money market instruments admitted to or dealt in on a regulated market;
- recently issued transferable securities, subject to certain conditions;
- units of UCITS authorized according to the UCITS EAC Act;
- deposits with credit institutions which are repayable on demand or have the right to be withdrawn, and maturing in no more than some certain period (12 months in the EU);
- financial derivative instruments, including equivalent cash-settled instruments, dealt in on a regulated market.

201. The management or investment company should employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio; it should employ a process for accurate and independent assessment of the value of OTC derivative instruments. It should communicate to the competent authorities regularly and in accordance with the detailed rules they shall define, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS.

202. The UCITS EAC Act should impose certain restrictions in terms of the investment policy, i.e. investments in transferable securities or money market instruments issued by the same body ; investment in deposits made with the same body etc.

L. Others Areas for Consideration

Taxation

203. Taxation is a political issue. Partner States should avoid discriminative taxation in order not to favor one state against the other/s. This is one fundamental must for the market infrastructure which has to be in place for regional harmonization.

Accounting

204. Accounting principles require some harmonization throughout the Community. International accounting standards should be in place.

Company Law

205. There might be need for a harmonized approach to some important company law concepts such as the mergers and divisions of public limited liability companies, formation of such companies and the maintenance and alteration of their capital, sell-out and squeeze-out rights…etc. These regulations might require (depending on the current structure in each Partner State) Ministry of Justices or other Governmental bodies' involvement to align the Commercial/Corporate Law Regulations. The competent authority responsible for the securities area should work together with these Governmental bodies.

Money Laundering

206. Financial systems are commonly being used for money laundering and terrorist financing purposes. There should be community- wide regulation in place on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

IV. Regulation and Supervision for an Integrated Insurance System

A. Introduction

1. An efficient and stable insurance sector is a pre-requisite for a country to achieve sustainable growth, especially as insurance entities are significant participants in capital markets and holders of large quantities of Government securities, particularly to support their technical provisions. Under an integrated approach where several countries have agreed to transfer part of their sovereignty, the stability and efficiency of the sector remains an important pre-requisite for regional growth and development.

2. The East African Community initiative contemplates insurers being able to operate freely in the markets of each of the participating countries and policy holders being able to purchase insurance coverage in any one of the participating countries. Under these circumstances, the proper regulation and supervision of the operatives in the insurance sector is vital and in this regard, the core principles and methodology (ICP) of the International Association of Insurance Supervisors (IAIS) should serve as the basic benchmark for insurance supervisors, both for all countries and for the Community as a whole.

3. The purpose of this technical note is to note those key regulatory and supervisory matters that are essential to achieving the integration of the insurance sector within the Community

B. Objectives of the EAC Policies for the Insurance Sector

4. The attainment of a single market in the insurance sector has as its major objectives allowing greater access to insurance markets across the participating countries and deepening the investment opportunities for the assets of insurance entities. These objectives have to be met within a framework in which policy holders are confident in the integrity of the entities in which they have sought insurance cover and certain that their claims will be met efficiently, effectively and equitably.

5. The **benefits** of the integration of the insurance sector include increased access by policy holders, greater competition and more efficient and effective investment markets for insurance entities.

C. Preconditions for the Successful Implementation of the EAC Policies for the Insurance Sector

6. The success of the integration and the ability of the region to enjoy the benefits of integration rely on the ability of the participating countries to meet pre-conditions for regulation and supervision. It is essential that key matters of supervision and regulation are sufficiently harmonized and coordinated among the participating countries.

Within the framework of the ICPs, the pre-conditions for successful integration are discussed under the following broad headings:

7. The Insurance Supervisor (ICP 2, 3, 4 and 5): The EAC Act must contain a clear statement of the mandate and the responsibilities of the supervisor. The requirement to include the statement in the Act is necessary to ensure transparency and to prevent ad hoc changes to the mandate and responsibilities. The mandate needs to include the maintenance of efficient, fair, safe and stable insurance market for the benefit and protection of policy holders. Where the Act mandates multiple objectives, the supervisor needs to disclose and explain how these objectives will be met.

8. The supervisor must have adequate powers and sufficient resources to discharge its responsibilities. It must be operationally independent both from Government and the industry but accountable. It requires a suitable number of qualified and trained staff with high professional standards. The supervisor and its staff have a duty to treat information confidentially.

9. The supervisory processes adopted by the supervisor must be clear, transparent and consistent. Its role, rules and procedures need to be publicly available. Its supervisory approach is applied equitably, consistently and proportionately. Its supervisory decisions must be subject to judicial review, but this requirement should not impede its ability to act quickly and decisively where this is warranted.

10. As part of its accountability framework, the supervisor must publish reports at least annually detailing its objectives and its performance in meeting those objectives.

11. The insurance supervisor needs to enter into arrangements with other supervisors (preferably but not necessarily by way of a formal agreement) for the timely and efficient exchange of information. This is particularly important in the context of insurers that are operating in more than one country or insurers that are part of a financial conglomerate.

12. The activities of the insurance supervisor (ICP 11 to 17): The EAC Act must permit the supervisor to require the lodgment of market wide systematic reporting to analyze market events that may impact on market stability. It must be required to publish industry data for the industry and other interested parties.

13. The EAC Act must give the supervisor the power to set the requirements for the submission of regular and systematic financial and other information from all insurance entities licensed in its jurisdiction. The supervisory authority must require information on a solo and group basis where the insurance entity is part of a financial group. It must set out the principles for accounting and consolidation and the valuation of assets and liabilities. Insurance entities must report off-balance sheet exposures and their outsourced functions.

14. The EAC Act needs to give the supervisor wide ranging powers to conduct on-site reviews and gather information necessary to perform its functions. The power needs to extend to both targeted and full reviews. The supervisor needs to have the power to review and obtain information from intermediaries and parties to which the entity has outsourced business functions.

15. The EAC Act has to give the supervisor the power to take both preventative and corrective actions including accepting a plan of remediation from an entity which is in breach of the Act and directing an entity concerning practices which may lead to non-compliance with the Act or which are otherwise deemed prudentially unsound.

- The Act must give the supervisor the power to enforce corrective action and impose sanctions where necessary, based on clear and objective criteria that are publicly disclosed. These include:

  - Restrictions on business;
  - Cessation of new business;
  - Withholding approval for new business lines or acquisitions;
  - Direction to cease or correct unsound practices;
  - Putting assets in trust or prohibiting the disposal of assets;
  - Revoking the license;
  - Removing directors and managers;
  - Barring individuals from involvement in the insurance sector;
  - Fines.

16. The EAC Act must define the point at which it is no longer permissible for an insurance entity to remain in the market and specify procedures for the insolvency and wind up of the entity giving high priority to the protection of policyholders and other policy beneficiaries.

17. The EAC Act needs to cater for those situations in which the insurance entity is part of a larger insurance group or a financial conglomerate. The Act must defined "insurance group" and "financial conglomerate" to enable the supervisor to determine the scope of supervision. The supervisor must be required to perform effective and efficient group-wide supervision.

18. The licensing and control of insurance entities (ICP 6, 7 and 8); The EAC Act must define the term "insurer" and determine what legal forms are acceptable for an insurer to operate in the EAC. The EAC Act needs to require that insurers operating in the EAC are licensed and prohibit unlicensed entities from acting as insurers. Normally, entities should be permitted to operate either in the life segment or the non-life segment but not both unless they have received prior approval from the supervisor.

19. The Act must contain clear and objective licensing criteria which are made public. These include:

- Significant owners, Board members, senior management, auditor and actuary must be fit and proper both individually and collectively. Fit and proper within this context is that these persons possess the appropriate integrity, competency, experience and qualifications for their respective roles. Where significant owners are no longer fit and proper, the supervisor must have the power to take action including requiring

owners to dispose of their interests and to disqualify the appointment of persons who do not comply with the fit and proper requirements;

- (To facilitate the assessment by the supervisor, the applicant must provide details of qualifications and experience sufficient to meet the standard set by the Act. The supervisor, where appropriate exchanges information with other supervisors as part of the assessment. The supervisor must be able to prevent parties from holding more than one role in an entity where doing so could result in a material conflict of interests. The Act must create an obligation on the entity to notify the supervisor of any information relevant to the on-going assessment of the fitness and propriety of the parties);

- The applicant must hold the minimum capital;

- The applicant must have risk management systems (including reinsurance arrangements), internal control systems, IT systems, policies and procedures that are adequate for the nature and scale of the business activities;

- A detailed business plan for at least three years reflecting the proposed business lines, risks, set up costs, capital requirements, solvency margins, reinsurance arrangements and how the business will develop. This includes both insurance and inward reinsurance;

- Information about products to be offered;

- Information about contracts with affiliates and third parties to which the applicant will outsource material business activities;

- Details of the reporting arrangements to be in place both to internal management and Board and to the supervisor;

- Input from the home supervisor where the applicant is not domestic and where a home supervisor exists.

20. The Act must determine how a foreign company can operate in the domestic market – by local branch, subsidiary or on a services only basis. The EAC Act must establish that no domestic or foreign insurer operating in the domestic market is free from supervision and where the entity has a host supervisor in another country, the Act must compel the supervisor to obtain the following:

- Confirmation that the licensee is authorized in the home state to carry on the lines of business contemplated in the application;
- Assurance that the applicant is solvent and meets all the regulatory requirements in the home state;
- The name and address of the branch office (in the case of a branch) or alternatively the name of the local authorized agent in the case of a services only arrangement ;

- The information outlined in the previous paragraph.

21. The supervisor must be able to exercise jurisdiction over changes in control of the entity and for this purpose the concept of "control" needs to be adequately defined in the EAC Act. The Act must require parties that are seeking control to approval for the acquisition or change of control including where these parties are located outside the home supervisor's country. Persons seeking control must be required to meet the fit and proper criteria laid down in the Act.

22. The Act must contain provisions that safeguard the interests of policy holders where an insurance entity transfers all or part of its insurance business. The supervisor must have the power to assess and deny or approve any transfers.

23. The governance and internal controls of insurance entities (ICP 9 and 10): The EAC Act must require that the insurance entities set out corporate governance principles to which the supervisor will hold them accountable. The Board of the entity must establish policies and strategies for meeting its business objectives and monitor its performance against them. The Board must organize the structure of the entity so as to promote effective and prudent management and Board oversight of the management. It must have a clear distinction between its role and responsibilities and those of the management. It must establish standards of business conduct and ethical behavior for itself, senior management and other personnel including in the areas of conflicts of interest, private transactions, self dealing and preferential treatment of internal and external entities. It must have a process for appointing, remunerating senior management which must be made available to the supervisor. The Board must communicate with the supervisor as required and meet when requested by the supervisor.

24. The EAC Act must require that insurance entities have in place internal controls that are adequate having regard to the nature and the scale of the business undertaken. It must have in place systems to allow senior management and the Board to oversee compliance with the internal controls. The internal controls include the external and internal audit, actuarial and compliance functions.

- Prudential requirements (ICP 18 to 23): Insurance entities must be required under the Act to establish comprehensive risk management policies and systems to identify, to measure, to monitor and mitigate the risks they face commensurate with the nature and scale of the entity. The system must monitor and control all material risks and establish an appropriate risk tolerance for each risk. Insurance entities are required to review the market in the context of their own risk management framework and take appropriate action to modify their framework where warranted.

25. As a material risk facing insurance entities is underwriting risk, they are required to have in place policies governing underwriting and the setting of premiums in order that premiums are set having regard to the risks and that there is adequate risk transfer through reinsurance and other risk transfer mechanisms to ensure that risk retained is consistent with the level of capital held.

26. Legal provisions must be in place for insurance entities to establish adequate technical provisions and other liabilities based on sound accounting and actuarial principles. The supervisor needs to have the power to prescribe the standards for establishing the provisions and liabilities and to require the entities to increase them where it deems them to be inadequate.

27. The Act must either set the requirements for investments or alternatively empower the supervisor to do so. The requirements must have regard to the type, mixture and diversification of the assets, asset- liability matching, liquidity, safekeeping and valuation. An investment policy is required as part of the overall policy requirements, and the management of investment risk must form part of the risk management framework.

28. The Act must either set the requirements for the use of derivatives or alternatively empower the supervisor to do so. The requirements consider the risks, the level of understanding and expertise in the entity to manage derivatives and pricing. A derivatives policy is required as part of the overall policy requirements, and the management of risk must form part of the risk management framework and internal controls.

29. The EAC Act must establish a solvency regime to protect policy holders from undue loss. The regime needs to address the valuation of liabilities including technical provisions and their margins, the quality, liquidity and valuation of assets, the matching of assets and liabilities, the forms of capital that are deemed to be suitable and the overall capital adequacy requirements.

30. Market conduct and consumer protection (ICP 24 to 26): The Act must require that insurance intermediaries are licensed and that the supervisor has the power to take action against persons acting as intermediaries without a license and to take corrective action against licensees including sanctions and the cancellation of licenses if necessary. A prerequisite for granting a license is that applicants are fit and proper.

31. The supervisor must have the power to require insurance entities and intermediaries to deal with consumers fairly and with skill and diligence. These parties must have policies in place for the purpose and provide training to their staff- entities and intermediaries are required to make sufficient enquiries of customers in order to assess their needs and recommend products appropriate to those needs. A simple, easily accessible and equitable process must be in place to deal with claims and consumer complaints.

32. Insurance entities are to be required to disclose information about their financial position and the risks to which they are subject to market participants. Audited financial statements are to be produced and made available to stakeholders at least annually. The Act must give the supervisor the power to monitor information given by the insurance entities and take corrective action to ensure compliance with the disclosure requirements.

- Fraud, anti- money laundering and the financing of terrorism (ICP 27 and 28): The Act needs to address the issue of insurance fraud by giving the supervisor the power to establish and enforce regulations to deter, detect, record, report and remedy.

33. Fraud in insurance. The supervisor is to ensure that insurance entities take effective measure to detect and deter insurance fraud. The Act needs to ensure that claims fraud is a punishable offence.

34. The Act must permit the supervisor to require insurers and intermediaries which market life and investment products to take effective measures to deter, detect and report money laundering and the financing of terrorism and to supervise the implementation and operation of those measures. The supervisor must have the power and authority to cooperate effectively with enforcement agencies both domestic and foreign for the purpose of AML/CFT.

V. Regulation and Supervision for an Integrated Pension System

A. Introduction

1. An efficient and stable pension sector is a pre-requisite for a country to achieve sustainable growth, especially as pension funds are significant participants in capital markets and holders of large quantities of Government securities. Under an integrated approach where several countries have agreed to transfer part of their sovereignty, the stability and efficiency of the sector remains an important pre-requisite for regional growth and development.

2. The East African Community initiative contemplates pension funds being able to operate freely in the markets of each of the participating countries and contributors being able to transfer balances and future benefits between funds in participating countries. Under these circumstances, the proper regulation and supervision of the operatives in the sector is vital and in this regard, the recommendations of the International Organization of Pension Supervisors (IOPS) for the structure and activities of the supervisor and the European Directive on Pensions should be persuasive, both for all countries and for the Community as a whole.

3. The purpose of this technical note is to present those key regulatory and supervisory matters that are essential to achieving the integration of the pension sector within the Community.

B. Objectives of the EAC Policies for the Pension Sector

4. The attainment of a single market in the pension sector has as its major objectives allowing greater mobility of the work force across the region, deepening the investment opportunities for fund assets and allowing contributors a greater choice in providing for their retirement. These objectives have to be met within a framework in which contributors to the pension sector are confident in the integrity of the entities in which they have entrusted their retirement savings and certain that their retirement benefits are being safeguarded.

5. The benefits of the integration of the pension sector include a sounder allocation of labor resources across the region, higher returns to contributors through more efficient allocation of fund investments and lower costs through increased competition.

C. Pre-conditions for the Successful Implementation of the EAC Policies for the Pension Sector

6. The success of the integration and the ability of the region to enjoy the benefits of integration rely on the ability of the participating countries to meet pre-conditions for regulation and supervision. It is essential that key matters of supervision and regulation are sufficiently harmonized and coordinated among the participating countries.

Structure and Activities of Supervisory Agencies

7. Within the framework of the recommendation of IOPS, the pre-conditions for successful integration are discussed under the following broad headings:

8. The objectives of the supervisory agencies (IOPS principle 1): The supervisory agencies for pensions in all five countries must have a clear statement of their objectives. These objectives need to be included in the law and be made public. The objectives need to be, at a minimum, to protect the interests of members and beneficiaries, to ensure the security and stability of pension funds and the sustainability of the sector as a whole, to promote good governance and to foster the development of the sector.

9. The structure and status of the agencies (IOPS principles 2, 3, 10): The supervisory agencies need to be operationally independent and free to exercise their functions without political or commercial interference. The agencies are to be under the direction of a board of manageable size which is subject to its own code of conduct. The Board needs to review its own performance. The Board must establish a well documented process for decision making and its compliance with the process is to be subject to internal audit. The directors of each agency must be appointed under clear and transparent mechanisms covering nomination, appointment and removal. They must be qualified and technically competent and be subject to standards of corporate governance at least as rigorous as their expectations of the pension sector management. Each agency must have sufficient financial, human and technical resources to perform its functions effectively. The funding of each agency needs to be achieved in a manner that minimizes the likelihood of its independence being compromised.

10. The powers of the agencies (IOPS principle 4): The supervisory agencies need to have adequate legal powers to be able to meet their objectives as outlined in IOPS Principle 1. While the IOPS principles do not recommend specific powers, a full suite of powers gives supervisors access to all the operatives in the pension sector including those parties to whom the trustees have outsourced particular functions. The suite includes the power to make enquiries, to issue directions, to disqualify persons from holding office, to order independent audits and actuarial valuations, to appoint administrators, to wind up or transfer the business of operatives. The powers of the agencies must enable them to act prospectively to prevent problems as well as to remedy existing problems.

11. The supervisory activities of the agencies (IOPS Principles 5 to 9): Supervision must be risk based and focus activities in the areas of greatest risk either to individual funds or the sector as a whole. The staff of each agency needs to be trained in risk measurement. The agencies must communicate their risk based approach to the entities being supervised. Supervisory activities are directed at preventing issues from arising. The powers which each agency has must be exercised proportionality and consistently – proportionate in that the power exercised reflects the seriousness of the issue being addressed and consistent over time and between regulated entities. Agencies must respect the confidentiality of the information received in the course of their activities. Supervisory processes must be clear and transparent; entities must be made aware of the reasons for any supervisory interventions and have a right of appeal which does not compromise the independence of the agency.

Requirements of the Model Law

12. Within the framework of the model law, the pre-conditions for successful integration are discussed under the following broad headings:

13. Activities of pension providers (Articles 7 & 8): The Model Law needs to ensure that the activities of institutions within their country are limited to the provision of retirement benefits and activities that the directly related to the provision of retirement benefits. The Model Law must ensure that there is legal separation between the provider and any organization that is sponsoring it to ensure that the interests of members and beneficiaries are safeguarded in the event of t he bankruptcy of the sponsor.

14. Conditions of operation (Article 9): The Model Law must provide that the institutions are operated by persons of good repute with appropriate professional qualifications and experience or alternatively employ persons with those qualifications and experience. The Model Law must provide that pension institutions are registered in a National Register and where involved in cross border activities, those countries where they are operating. It must require that each fund has properly constituted rules detailing how the pension fund is operating and members must have access to these rules. The members are also informed of the conditions of the fund, particularly their rights and obligations and the nature and distribution of the risks associated with the fund.

15. The Model Law must provide that all technical provisions are to be computed and certified by an actuary or another specialist in the field on the basis of actuarial methods recognized by the supervisory agency. If a sponsoring institution guarantees the payment of retirement benefits, it must commit to regular financing.

16. The provision of information to interested parties (Articles 10 to 13): The Law must provide that each institution located within a participating country prepares annual accounts and supplementary information that give a true and fair view of the activities and financial position. These are to be consistent, comprehensive, fairly presented and duly approved by authorized persons.

17. Members and beneficiaries are to be provided with details of any changes to the rules of the pension fund. Members and beneficiaries must also be entitled to receive (on request) the annual reports referred to in the previous paragraph, a statement of the investment policy principles, the target level of retirement benefits and the benefits if employment is ceased. Also on request, members are entitled to receive details of the investment alternatives available to the arrangement for transfer of rights to another fund in the case of ceasing membership. Members also shall receive annually particulars of the situation of the institutions and the current level of financing of their entitlements. When a member’s entitlements become due, he or she shall be advised of the benefits and the payment options.

18. The Law is to provide that each relevant institution located in its country prepares and revises a written statement of investment policy objectives containing prescribed information including as a minimum, investment risk measurement methods and the risk management

processes employed and the strategic asset allocation with respect to the nature and duration of the pension liabilities.

19. Sufficient information is to be provided to the supervisory agency to enable it to discharge its functions effectively. This includes the ability to supervise third parties to which some of the pension fund activities have been outsourced. Specific information to be provided includes:

- Statement of investment policy principles;
- Annual accounts and annual reports;
- Actuarial valuations and detailed assumptions;
- Asset –liability studies;
- Evidence of consistency with investment principles;
- Evidence that contributions have been paid;
- Auditors' reports.

20. Powers **and duties of the supervisory agency** (Articles 13 and 14): The Model Law must give the supervisory agency in each country sufficient powers including the power to intervene. The agency must have the power to conduct on-site inspections including inspecting those parties to which business activities have been outsourced. The basis of the relationship between the agency and the supervised entities is the expectation that every relevant institution in the country will have sound administrative and accounting procedures and adequate internal control mechanisms.

21. The agency must have the power to take any measure against an institution or the management of an institution to prevent or remedy any irregularities that may prejudice the interests of members. The agency may restrict the disposal of assets, transfer the management to a special representative or restrict the activities of the institution. The institution must be provided with precise reasons for the intervention and be given the right of appeal to the courts.

22. The calculation and funding of technical provisions (Articles 15 & 16): The Model Law must require that institutions operating schemes in which cover is provided against biometric risks or guarantees of investment performance or the level of retirement benefits hold adequate technical provisions against the risks. The calculation of the level of technical provisions shall be performed annually unless otherwise agreed with the supervisory agency. The calculations are to be performed and certified by an actuary or other approved persons on a prudent basis and using prudent assumptions. The maximum rates of interest used are to be determined in accordance with the rules of the supervisory agency and take into account the yields on corresponding assets held in the pension funds and future investment returns. Biometric tables are to be prudent and based on the main characteristics of members in the fund. The basis and method of calculation of technical provisions is to remain constant over time unless there are changes in economic, legal or demographic factors.

23. Each institution is required to have sufficient and appropriate assets to cover the technical provisions. Where there is a shortfall in the assets held, the supervisory agency may agree a concrete and realizable recovery plan to bring the level of assets to the required sufficiency. Where an institution operates in one or more of the participating countries, it must have sufficient assets to cover technical provisions at all times.

24. The supervisory agency in each country is to have the discretion to require a level of assets to be held by the institution that exceeds the technical provisions.

25. Investment principles (Article 18): The Model Law needs to require that investments of fund assets are made in the best interests of members and beneficiaries and follow the prudent person approach. The primary considerations need to be security, quality, liquidity and the overall profitability of the investment portfolio. The Law needs to require that investments are made predominantly on regulated markets and that investment in derivative instruments is not speculative but is made to reduce investment risk or facilitate efficient portfolio management. Adequate diversification is required to avoid excessive risk concentrations and reliance on one asset, issuer or group of issuers. Investments in sponsoring entities are to be restricted to no more than 5 percent of the portfolio unless the sponsor is a group in which case the limit can be extended to 10 percent in the securities of the group. Pension funds are to be prohibited from issuing guarantees in favor of third parties or from borrowing unless for liquidity purposes which require the consent of the supervisory agency. Participating countries shall not require investments in any particular class of assets.

26. Management and custody (Article 19): The Model Law has to facilitate a pension fund employing the services of an investment manager or a custodian established and duly authorized in another participating country. Each participating country must ensure that its legal framework can prevent a custodian or depositary from disposing of assets located within its territory at the request of the home supervisory agency. Each participating country has discretion to require that the assets of pension funds are held by custodians or depositaries.

27. Cross border activities (Article 20): The Model Law must permit employers in one participating country to enroll their employees in a pension fund in another participating country. This is subject to the approval of the supervisory agency in the country in which the fund is located. The fund must provide specific information to its supervisory agency, which in turn has a period of three months to issue an objection if it has grounds to do so.

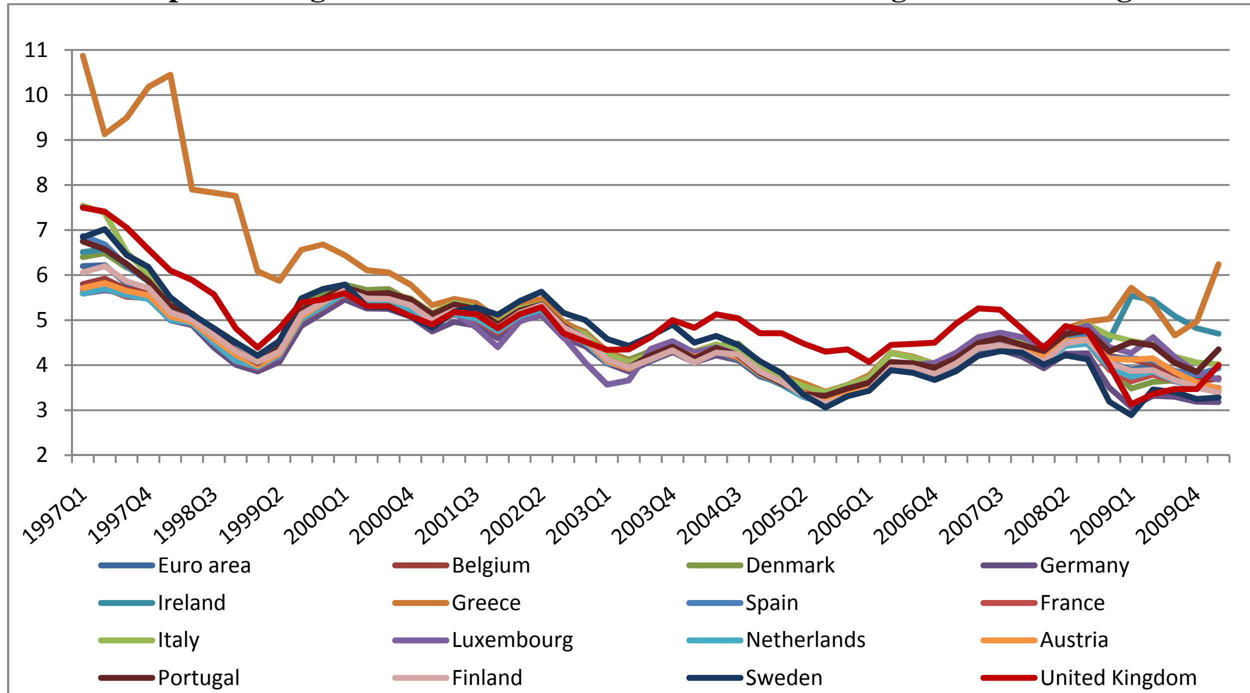
VI. The Regional Bond Market

28. A regional bond market is a market where East African bonds are issued and traded. A regional bond is a bond issued by Governments, corporations and financial institutions of East African countries and offered for sale in a number of countries in the region and denominated in a currency of one of the Partner States. While on the supply side issuers will be mostly regional, on the demand side investors will be both regional and global.

1. Benefits of a regional bond market: Most of the countries in the region have a relatively small investors' base. Markets are illiquid and borrowers are paying high yields as a result of the small size of the market, number of inefficiencies (e.g. higher issuing costs, transaction costs) and restrictions on investing and trading in local currency. The regional bond market is likely to result in number of benefits both for borrowers and investors. The experience has shown that financial centers with simple regulatory and tax framework have attracted more capital. Hence in an open and bigger regional market competitive pressures will encourage countries to simplify their regulatory regime for issuing and trading, and hence generate efficiencies across the region. Also, efficiency of East-African bond markets will depend on well developed regional systems of payment, clearing, settlement and depositary services that ensure real time gross settlement with delivery versus payment for cross-border transactions of bonds. These regional systems will be less costly and more efficient, compared to those developed on country level. Depth and liquidity of the regional bond market will also improve if regionally specialized rating agencies which are global rating firms are established. These developments are likely to result in more transparent, deeper, more diversified and efficient market, which as such will be more attractive to investors both regional and global. Ultimately borrowers and broader economy (including priority sectors such as infrastructure, SMEs, housing finance) will benefit from access to bigger investors' base, lower cost of capital and extended terms of financing.

2. Graph 1 illustrates some benefits of the regional bond market in the single market in Europe, by showing the convergence of long-term yields. Obviously, countries with originally higher cost of capital benefited the most from the convergence in yields**.** The latest de-convergence suggests that macro fundamentals in individual countries matter. Poorer sovereign credits have seen jump in their long-term yields in the aftermath of financial crisis.

Graph 1: Long term interest rates in Euro-zone: Convergence/De-convergence



Source: Eurostat

A. Macro fundamentals in Partner States

3. Lower inflation, more sustainable fiscal and current account balance and consequently better exchange rate will help extend maturities and flatter yield curve. Simply – investors will be more willing to borrow money on better terms and at longer maturities to Governments with better sovereign credits. Yield curve extension and flattering will make it also easier for non-Government sector to finance itself in the bond market.

4. At the moment, macro-fundamentals vary across the Partner States. Countries that are more dependent on grants from international agencies have worse fundamentals. Those that are already financing themselves in the bond market and depend less on international aid have healthier macro picture. Convergence of macro indicators is desirable to avoid crowding out of the worst performers in the regional bond market. Additionally, efficient debt management and transparent communication with investors is an important prerequisite for the bond market development.

Table 1: Macro-fundamentals in Partner States

As of 2009	Burundi	Kenya	Rwanda	Tanzania	Uganda
GDP (USD bil)	1.3	32.7	5.2	22.3	15.7
GDP Growth	3.5	2.1	4.1	5.5	7.1
Inflation	11.3	11.8	10.4	12.1	14.2
Current Account balance	-0.2	-6.2	-7.2	-2.1	-4.8
Fiscal Balance (exc. grants)	-28.1	-4.8	-12.2	-11.1	-5.3
Fiscal Balance (inc. grants)	-4.3	-3.9	-1.6	-5.7	-1.9

Source: IMF

B. Scaling-up the benefits of a regional bond market: Regional Facilities

5. Development of a regional bond market would help mobilize the long-term financing for priority sectors in East Africa, such as infrastructure, housing, small and medium enterprises. At the moment housing financing facilities started emerging in countries in the region (Tanzania) with support from IDA Projects, with objective to become self-sustainable through financing in bond markets. With development of regional bond markets, housing finance, SME finance and Public-Private-Partnership in infrastructure could be created on regional level to mobilize resources on larger levels resulting in numbers of benefits for different players, such as:

- Economies of scale
- Better risk management for borrowers (long term financing for long-term Projects)
- Lower interest rates
- Reduced refinancing risks through longer tenors
- Investment opportunities for institutional investors
- Financial Sector Diversification

6. Majority of infrastructure financing in Sub-Saharan Africa from local sources is through bank loans, which is usually short-term and expensive, while infrastructure investments are long-term and paid off in long time intervals. That compares with 20 percent of outstanding corporate bonds in South Africa (2006) that were issued by infrastructure providers. In Chile, on average US$1 billion of infrastructure bonds a year were issued between 1996 and 2003, which is equivalent to 50 percent of all issues (Table 2).

The World Bank Support (US$115 million) to PPP Initiative in Nigeria: The World Bank's is supporting private investments in the Nigerian PPP infrastructure market and specifically the core infrastructure sectors. The initiative will help address a number of failures that have to date prevented PPPI from successfully coming to market and providing sustained services to the population. This includes the "coordination" and "demonstration effect" failures. PPPI Projects are complex and require a predictable and transparent framework of collaboration across a range of public sector ministries, departments and agencies, private sector investors/developers and financial institutions and banks. The operation will use an Adaptable Program Loan (APL) instrument with two phases that also incorporates a Financial Intermediary Loan (FIL) sub-component in the second phase. An APL is best placed to support PPPI because they can finance capacity building in the early stage of developing client's ability to develop and manage PPPs and provide funding at a later stage once the Projects are ready for concessioning.

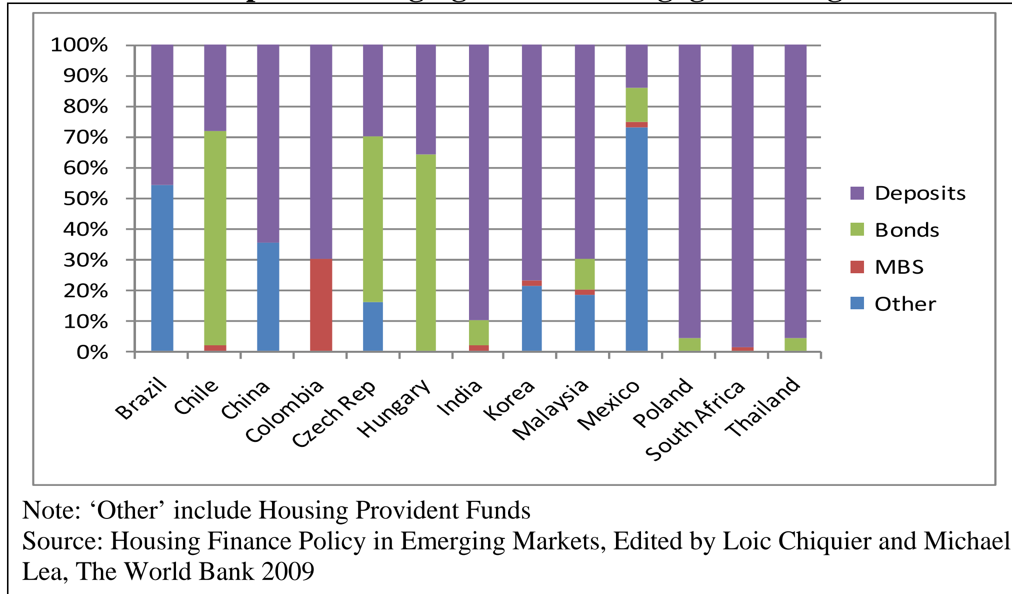
Table2: Locally sourced infrastructure financing by financial instrument
Amount outstanding at end-2006 or most recent available

Country (US$ million)	Bank loans[1]		Government Bonds[2]		Corporate Bonds		Equity Issues	
Benin	124	70%	0	0%	52	30%	0	0%
Burkina Faso	85	68%	0	0%	39	32%	0	0%
Cape Verde	108	100%	—	—	0	0%	0	0%
Congo, Dem. Rep.	6	100%	0	0%	0	0%	0	0%
Côte d'Ivoire	335	72%	0	0%	0	0%	133	28%
Ethiopia	248	100%	0	0%	0	0%	0	0%
Ghana	178	100%	0	0%	0	0%	0	0%
Kenya	575	14%	0	0%	65	2%	3,408	84%
Lesotho	21	100%	0	0%	0	0%	0	0%
Madagascar	68	100%	0	0%	0	0%	0	0%
Malawi	17	100%	0	0%	0	0%	0	0%
Mozambique	61	82%	0	0%	13	18%	0	0%
Namibia	117	28%	0	0%	298	72%	0	0%
Niger	67	100%	0	0%	0	0%	0	0%
Nigeria	2,444	98%	47	2%	0	0%	0	0%
Rwanda	26	100%	0	0%	0	0%	0	0%
Senegal	286	13%	93	4%	67	3%	1,827	80%

Source: Local sources of financing for infrastructure in Africa, The World Bank March 2009

7. In Sub-Saharan Africa the use of bonds markets to support the housing finance needs has been negligible. At the same time, countries such as Chile, the Czech Republic and Hungary meet over half of their mortgage funding needs through simple debt instruments such as covered bonds. In 2007, 17 percent of mortgages in Europe were funded by covered mortgage bonds (CMBs)

Graph 2: Emerging Market Mortgage Funding



Note: 'Other' include Housing Provident Funds
Source: Housing Finance Policy in Emerging Markets, Edited by Loic Chiquier and Michael Lea, The World Bank 2009

C. Status of the Government Bond Market in Partner States

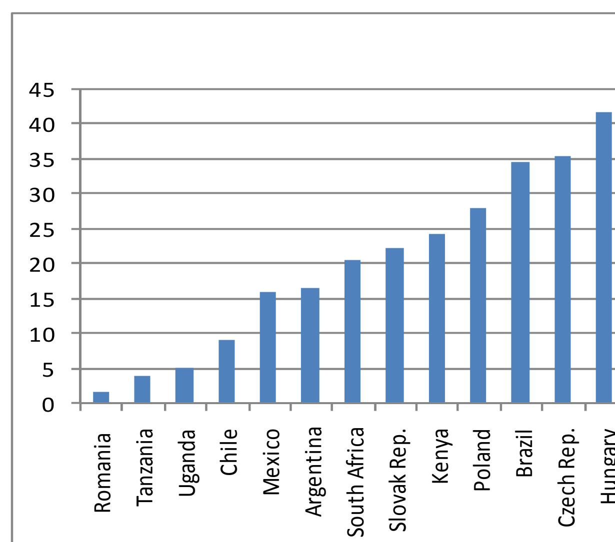
8. There is a notable difference in terms of size and liquidity in bond markets across Partner States. In terms of GDP the Size of the market is the biggest in Kenya at 24.3 percent, followed by Uganda at 5.1 percent, Tanzania at 4 percent, Burundi at 3.5 percent at Rwanda at 0.3 percent. Market appears to be very liquid in Kenya and Uganda with turnover ratios (annual turnover/market cap) at 54 and 59 percent respectively. This might be reflection of investors' appetite and potential to absorb larger amounts of debt. Secondary trading in Tanzania has been taking place at a bigger scale only in the last six months and according to local investors this is a result of scarce investment opportunities in the economy and abundance liquidity in the banking system. When compared to some major emerging markets (Graph 3) the size of the Government bond market in most of the countries in the region appears small, except in Kenya.

Table 3: Size and liquidity of Government (%)
Bond market in PSs

	Size of the Gov. Bond Market (% of GDP)	Turnover Ratio
Burundi	3.5%	-
Kenya	24.3%	54%
Rwanda	0.3%	-
Tanzania	4.0%	15.0%
Uganda	5.1%	59%

Source: National Exchanges

Graph 3: Government Debt/GDP



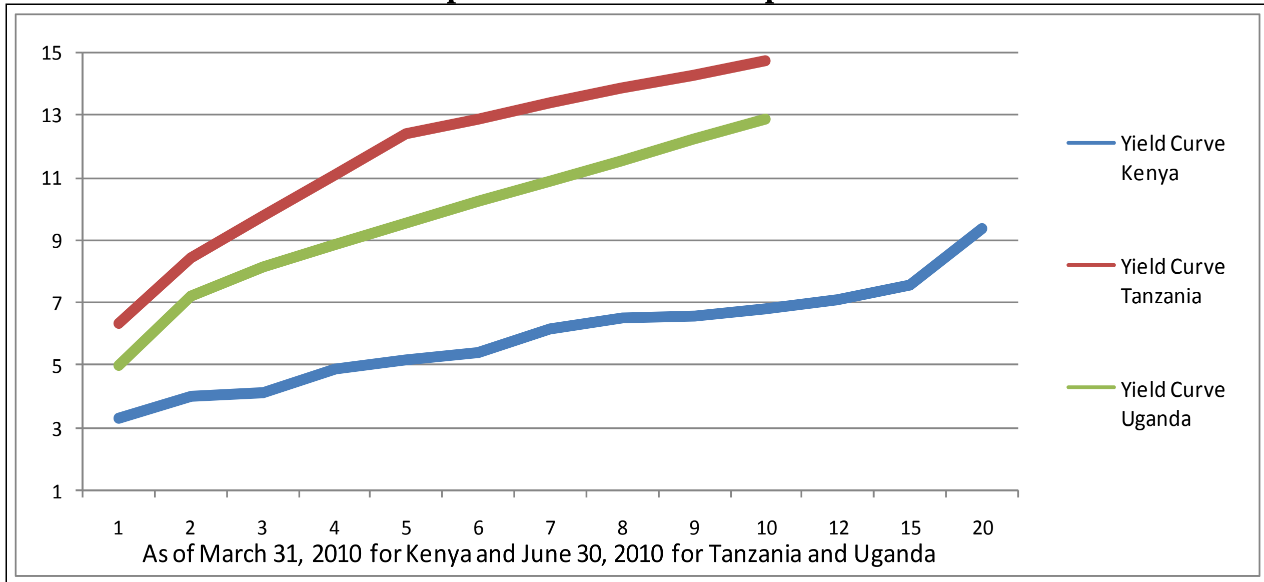
Source: World Bank and national exchanges
Note: 2010 for PSs, 2010 for other countries

9. Harmonization of maturities, coupon and other features across countries is desirable to built critical mass of issuance volumes for Government bonds and create benchmark for non-Government issuers. At the moment main features of Government bonds are quite different across the countries. Countries like Tanzania and Uganda seem to be focusing on building few major benchmarks bonds, while Kenya has been moving in that direction recently, after have been issuing regularly across the curve. Thanks to better fundamentals and more developed investors' base, Kenya has been able to issue debt at much longer terms and at lower rates, compared to Tanzania and Uganda (Graph 4), which have seen some curve flattening only recently.

Table 4: Comparison of the Maturity Structure of the Government Bond Market (% of Total Outstanding Government Debt

	2yr	3yr	4yr	5yr	6yr	7yr	8yr	9yr	10yr	11yr	12yr	15yr	20yr
Burundi	27.9%			15.1%	34.3%	11.4%	11.4%						
Kenya	8.0%		0.6%	20.1%	4.8%	3.7%	5.9%	2.2%	16.9%	0.7%	7.9%	25.9%	3.5%
Rwanda	25.0%	75.0%											
Tanzania	20.6%			28.0%		29.4%			22.0%				
Uganda	13.8%	62.2%		15.8%					8.2%				

Graph 4: Yield Curve Comparison



Source for Table 4 and Graph 4: National securities exchanges and central banks

E. Status of Non-Government Bond Markets in East Africa

10. Non Government bond markets in East Africa are relatively small (Table 9) and only in Kenya the size of the corporate debt market has slightly surpassed 2 percent. While in Kenya broad range of sectors have tapped the bond markets, the banks have been major issuers in other countries. Also, in Kenya the market has been growing significantly despite the global financial crisis. Only in 2009 there was a record issuance of US$500 million, over 90 percent of that being infrastructure related, KenGen (US$330 million) and Safaricom (US$100 million). As it is the case in many emerging markets, liquidity in the market is very low.

Table 5: Corporate Bond Issues in Kenya

Kenya	Industry	Ksh (M)	Gurantee	Year of Issue	Tenor	Coupon
East African Development Bank	DFI	800	None	2004	7	7.5% Fixed
Faulu Kenya	Microfinance	500	AFD	2005	5	91 day T-bill + 0.5%
PTA Bank	DFI	800	None	2005	7	7.80% Fixed
Athi River Mining	Cement	800	None	2005	5	91 day T-bill + 1.75%
Shelter Afrique	Housing DFI	200	None	2005	7	91 day T-bill + 1.0%
CFC Stanbic Bank (Private Place	Banking	600	None	2005	7	182 day T-bill + 1.5%
PTA Bank	DFI	1,000	None	2007	7	182 day T-bill + 1.0%
Barclays Bank of Kenya	Banking	1,206	None	2007	7	91 day T-bill + 0.6%
Barclays Bank of Kenya	Banking	740	None	2007	7	182 day T-bill + 1.0%
Sasini Tea & Coffee	Agriculture	600	None	2007	5	11.75% Fixed
Mabati Rolling Mills	Manufacturing	1,200	None	2008	8	182 day T-bill + 1.75%
Mabati Rolling Mills	Manufacturing	800	None	2008	8	13.00% Fixed
I & M Bank (Private Placement)	Banking	600	None	2008	7	91 day T-bill + 2.5%
Zain Kenya (Private Placement)	Telcom	5,700	Parent Co	2008	3	182 day T-bill + 1.75%
CFC Stanbic Bank	Banking	98	None	2009	7	182 day T-bill + 1.75%
CFC Stanbic Bank	Banking	2,402	None	2009	7	12.50% Fixed
Shelter Afrique	Housing DFI	1,000	None	2009	3	11.00% Fixed, Floating (182 day T-bill +1.50%
KenGen	Infrastructure	25,000	None	2009	10	Fixed 12.5%
Safaricom	Infrastructure	7,500	None	2009	5	Fixed 12.25%, Floating day T-bill +1.85%
TPS Serena (Private Placement)	Tourism	400	None	2010	5	12% and 10% fixed
Athi River Mining (Private Place	Cement	1,600	None	2010	5	12.5% fixed and equity upside
		53,546				

Source: Nairobi Stock Exchange

Table 6: Corporate Bond Issues in Uganda

Uganda	UGX M	USD M
Uganda Telecom	24,000	10.5
East African Development Bank (EADB)	20,000	8.8
Standard Chartered Bank Uganda	23,000	10.1
Housing Finance Bank	35,000	15.4
Stanbic Bank	30,000	13.2
PTA Bank	10,000	4.4
	142,000	**62.4**

Table 7: Corporate Bond Issues in Tanzania

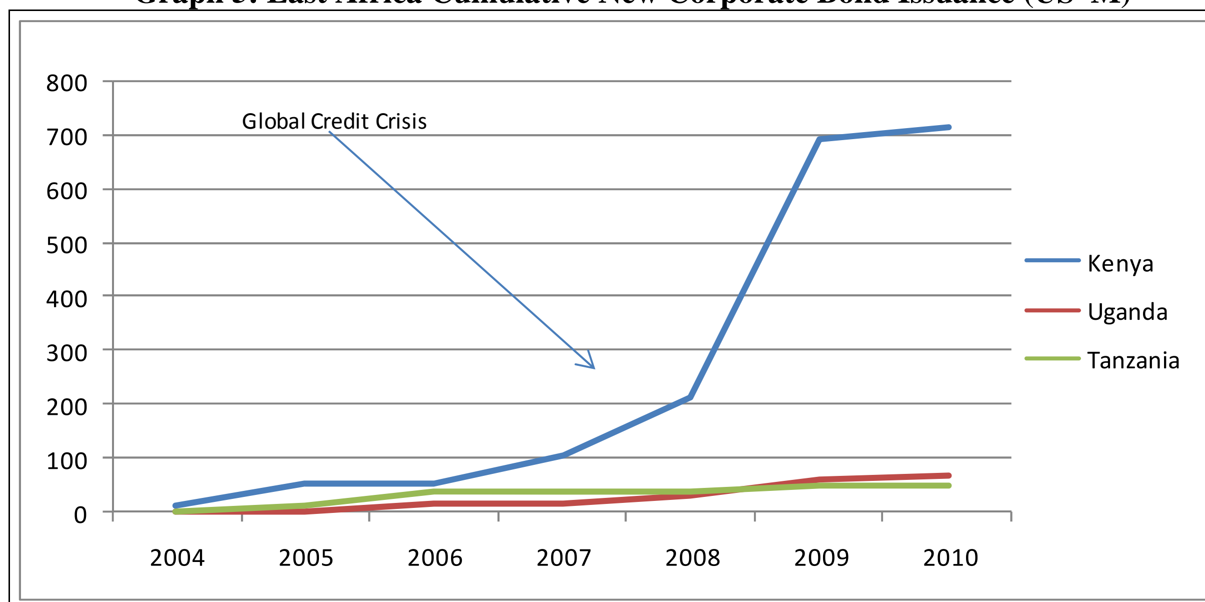
Tanzania	TSh M
East African Development Bank (EADB)	9,000
PTA Bank	6,000
Barclays Bank Tanzania	24,600
Standard Chartered Bank Tanzania	8,000
ALAF	15,070
	62,670

Rwanda	Rfw M	USD
Banque Commercial Rwanda (BCR)	1,000	
	1,000	

Country	USD	% of GDP
Kenya	654	2.1
Uganda	58	0.5
Tanzania	45	0.3
Rwanda	2	0.1
East Africa	**759**	**1.2**

Source: National exchanges

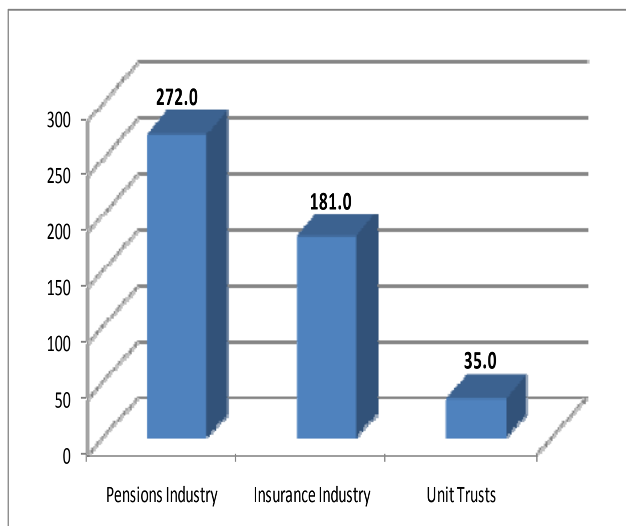
Graph 5: East Africa Cumulative New Corporate Bond Issuance (US M)



Source: National exchanges

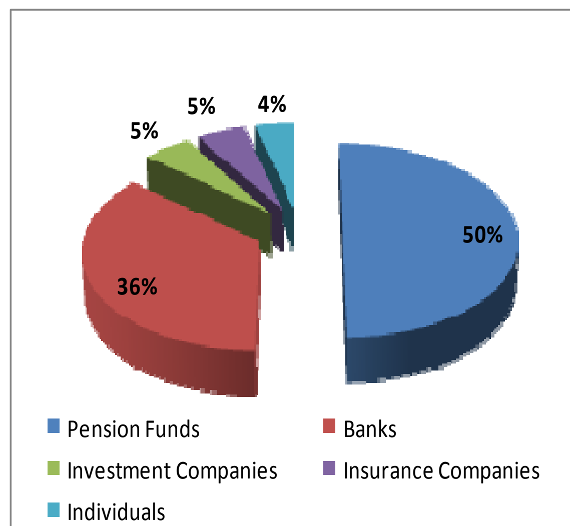
Role of Pension and Insurance Sectors in Kenya

Graph 6: Estimated Investors Assets in Kenya (Ksh. Billion)



Source: Capital Markets Authority (?)

Graph 7: Investors' assets by type



Source: Capital Markets Authority (?)

11. Besides issuance costs or other regulatory or tax inefficiencies, the low and non-diversified investors' base is also contributing strongly to the small size of the corporate debt market. In Kenya, pension reforms that took place in 2001 contributed to significant growth in assets under management to date. Pension and insurance funds accounted for 55 percent of investments in corporate bonds and 42 percent in Treasury bond holdings in 2009. Data on other countries are limited, but major investors seem to be commercial banks. Undergoing pensions reform (Tanzania) supported by IDA Project will help built more diversified and educated investors' base. Also, ESMID Project has been working with issuers and intermediaries across the region to increase their capacity to tap the market.

F. Conclusion

12. Potential benefits of a regional bond market in east-Africa are huge and some of them include for example access to bigger investors' base and lower cost of capital for borrowers and access to bigger and more diversified span of investment opportunities for investors. However, due to poor economic fundamentals and number of regulatory inefficiencies markets remain relatively small and under developed in most of the Partner States. Table 10 and 11 elaborate on the major prerequisites for the market development and suggest the list of activities to be undertaken in order to boost development of the regional bond market.

Table 10: Prerequisites for a Regional Bond Market

Legal and Regulatory	Market Infrastructure	Market Participants
Developed Government bond markets in PS (main features harmonized)	Regional CSD Framework	Issuers aware of the benefits of the bond market financing
Harmonized prospectus rules and issuance process	Regional Pre and Post Trade Transparency Requirements	Well educated investors and intermediaries able to operate across PS
Favorable Tax Regime	OTC trading in place	Credible credit rating agencies

Table 11: Activities proposed under the EAC FSDRP

1. Elaboration of the Government bond market development strategy
2. Implementation of Government bond market development strategy
3. Development of primary and secondary market for gov. bonds
4. Development of primary and secondary market for corporate bonds
5. Corporate bond market activities including transactions support
6. Capacity building for setting up regional facilities

VII. EAC Governance and Legislative Process[12]

A. Introduction

1. The purpose of this technical note is, in the context of the EAC FSDRP, to shed some light on how the EAC is structured, to articulate the EAC legislative process and to discuss a few implications for the FSDRP.

B. Structure of the EAC

2. The EAC has seven principal organs for effective management:
- The Summit of the Heads of State
- The Council of Ministers
- The Co-ordination Committee
- Sectoral Committees
- The East African Court of Justice
- The East African Legislative Assembly
- The Secretariat

The Summit

3. The Summit consists of the Heads of State or Government of the Partner States. The Summit meets at least once every year and may hold extraordinary meetings at the request of any member of the Summit. The tenure of office of the Chairperson of the Summit is one year and the office of the Chairperson is held in rotation among the Partner States. The decisions of the Summit are made by consensus. The Summit discusses business submitted to it by the Council and any other matter that may have a bearing on the Community.

Functions of the Summit

- Gives general directions and impetus as to the development and achievement of the objectives of the Community.
- Considers the annual progress reports and such other reports submitted to it by the Council as provided for by the Treaty.
- Reviews the state of peace, security and good governance within the Community and the progress achieved towards the establishment of a Political Federation of the Partner States.
- The Summit causes all rules and orders made by it under the Treaty to be published in the Gazette; and any such rules or orders come into force on the date of publication unless otherwise provided in the rule or order.

Council of Ministers

[12] Data for this Annex is sourced from the EAC website (www.eac.int), the EAC Treaty and the EAC Acts and Regulations clarification e-mail from Dr. Kafumbe on 8/23/2010

4. The Council consists of the Ministers responsible for East African Community affairs of each Partner State and such other Ministers of the Partner States as each Partner State may determine and the Attorney General of each Partner State. The Council meets twice a year, one meeting of which is held immediately preceding a meeting of the Summit. Extraordinary meetings of the Council may be held at the request of a Partner State or the Chairperson of the Council. Subject to a protocol on decision-making, the decisions of the Council are made by consensus.

Effects of Regulations, Directives, Decisions and Recommendations of the Council

5. Subject to the provisions of the Treaty, the regulations, directives and decisions of the Council taken or given in pursuance of the provisions of the Treaty are binding on the Partner States, on all organs and institutions of the Community other than the Summit, the Court and the Assembly within their jurisdictions, and on those to whom they may under the Treaty be addressed.

Functions of the Council

- Make policy decisions for the efficient and harmonious functioning and development of the Community.
- Initiate and submit Bills to the Assembly.
- Subject to the Treaty, give directions to the Partner States and to all other organs and institutions of the Community other than the Summit, Court and the Assembly.
- Make regulations, issue directives, take decisions, make recommendations and give opinions in accordance with the provisions of the Treaty.
- Consider the budget of the Community.
- Consider measures that should be taken by Partner States in order to promote the attainment of the objectives of the Community.
- Make staff rules and regulations and financial rules and regulations of the Community.
- Submit annual progress reports to the Summit and prepare the agenda for the meetings of the Summit.
- Establish from among its members, Sectoral Councils to deal with such matters that arise under the Treaty as the Council may delegate or assign to them and the decisions of such Sectoral Councils shall be deemed to be decisions of the Council.
- Establish the Sectoral Committees provided for under the Treaty.
- Implement the decisions and directives of the Summit as may be addressed to it.

Co-ordination Committee

6. The Co-ordination Committee consists of the Permanent Secretaries responsible for East African Community affairs in each Partner State and such other Permanent Secretaries of the Partner States as each Partner State may determine. Subject to any directions that may be given by the Council, the Co-ordination Committee shall meet at least twice in each year preceding the meetings of the Council and may hold extraordinary meetings at the request of the Chairperson of the Co-ordination Committee.

Functions of the Co-ordination Committee

- Submit from time to time, reports and recommendations to the Council either on its own initiative or upon the request of the Council, on the implementation of the Treaty.
- Implement the decisions of the Council as the Council may direct.
- Receive and consider reports of the Sectoral Committees and co-ordinate their activities.
- Request a Sectoral Committee to investigate any particular matter.
- Have such other functions as are conferred upon it by the Treaty.

Sectoral Committees

7. The Co-ordination Committee recommends to the Council the establishment, composition and functions of such Sectoral Committees, as may be necessary for the achievement of the objectives of the Treaty. Subject to any directions that may be given by the Council, the Sectoral Committees meets as often as necessary for the proper discharge of their functions and determines their own procedure.

Functions of the Sectoral Committees

- Responsible for the preparation of a comprehensive implementation programme and the setting out of priorities with respect to its sector.
- Monitor and keep under constant review the implementation of the programmes of the Community with respect to its sector.
- Submit from time to time, reports and recommendations to the Co-ordination Committee either on its own initiative or upon the request of the Co-ordination Committee concerning the implementation of the provisions of the Treaty that affect its sector.

The East African Court of Justice

8. The East African Court of Justice (the Court), is one of the organs of the EAC established under Article 9 of the Treaty. The Court's major responsibility is to ensure the adherence to law in the interpretation and application of and compliance with the Treaty. The Judges of the Court are appointed by the Summit from among sitting judges of any National court of judicature or from jurists of recognized competence. The Registrar is appointed by the Council of Ministers.

The President and the Vice President are also appointed by the Summit from the Judges of the Court.

The court has jurisdiction to hear and determine:

- Disputes on the interpretation and application of the Treaty.
- Disputes between the Community and its employees arising from the terms and conditions of employment or the interpretation and application of the staff rules and regulations.
- Disputes between the Partner States regarding the Treaty if the dispute is submitted to it under a special agreement.
- Disputes arising out of an arbitration clause contained in a contract or agreement which confers such jurisdiction on the Court to which the Community or any of its institutions is a party.
- Disputes arising out of an arbitration clause contained in a commercial contract or agreement in which the parties have conferred jurisdiction on the Court.
- The jurisdiction of the Court may be extended to appellate and human rights at a suitable date to be determined by the Council.
- Advisory Opinions of the Court - The Summit, the Council or a Partner State may request the Court to give an advisory opinion regarding a question of law arising from the Treaty and which affects the Community.

Execution of Judgments

9. The execution of judgments of the Court, which imposes a pecuniary obligation on a person, are governed by the rules of civil procedure in force in the Partner State in which execution is to take place. Where there is no pecuniary obligation involved, the Partner States and the Council are under obligation to implement a judgment of the Court without delay.

The East African legislative Assembly

10. The EALA (or the Assembly) is the legislative organ of the EAC; established under Article 9 of the EAC Treaty. The functioning of this organ of the EAC will be discussed in further detail in the Legislative Process section below.

The Secretariat

11. The Secretariat is the executive organ of the Community. The following are the key offices in the service of the Community:

- Secretary General;
- Deputy Secretaries General;
- Counsel to the Community;

Secretariat - Functions of the Secretariat

The Secretariat is responsible for:

- Initiating, receiving and submitting recommendations to the Council, and forwarding of Bills to the Assembly through the Co-ordination Committee.

- The initiation of studies and research related to, and the implementation of, programmes for the most appropriate, expeditious and efficient ways of achieving the objectives of the Community.

- The strategic planning, management and monitoring of programmes for the development of the Community.

- The undertaking either on its own initiative or otherwise, of such investigations, collection of information, or verification of matters relating to any matter affecting the Community that appears to it to merit examination.

- The co-ordination and harmonization of the policies and strategies relating to the development of the Community through the Co-ordination Committee.

- The general promotion and dissemination of information on the Community to the stakeholders, the general public and the international community.

- The submission of reports on the activities of the Community to the Council through the Co-ordination Committee.

- The general administration and financial management of the Community.

- The mobilization of funds from development partners and other sources for the implementation of Projects of the Community.

- Subject to the provisions of the Treaty, the submission of the budget of the Community to the Council for its consideration.

- Proposing draft agenda for the meetings of the organs of the Community other than the Court and the Assembly.

- The implementation of the decisions of the Summit and the Council.

- The organization and the keeping of records of meetings of the institutions of the Community other than those of the Court and the Assembly.

- The custody of the property of the Community.

- The establishment of practical working relations with the Court and the Assembly.

- Such other matters that may be provided for under the Treaty.

C. Legislative Process

12. The East African Legislative Assembly (EALA) is the legislative organ of the EAC. This section describes the application of EAC Acts and Regulations in Partner States and the process for initiation, preparation and adoption of EAC Acts.

Process for Initiation, Preparation and Adoption of EAC Acts:

- Introduction of the Bill into the Assembly: The EAC Council is the policy organ of the Community which initiates and submits Bills to the Assembly. The EAC Secretariat initiates, receives, and submits recommendations to the Council, and forwards Bills to the EALA through the Co-ordination Committee. Further, any Member may propose any motion or introduce any Bill in the Assembly. Thus, a Bill could be introduced into the Assembly via the Council or any Member.

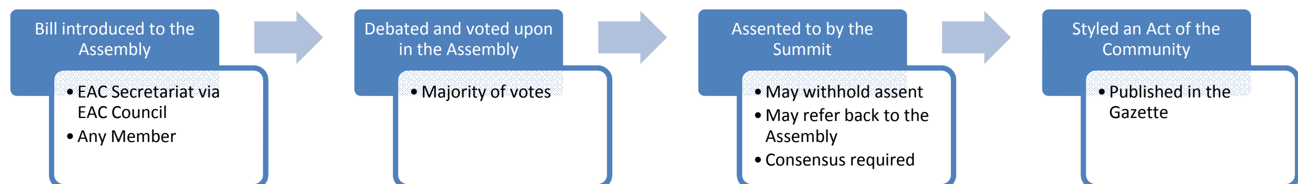
- Debate and voting in the Assembly: All questions proposed for decision in the Assembly are determined by a majority of the votes of the members present and voting after a quorum has been established. The enactment of legislation of the Community is effected by means of Bills passed by the Assembly and assented to by the Summit.

- Assent by the Summit: After a Bill has been passed by the Assembly, the clerk within fourteen days causes the text of the Bill to be sent to the Community printer for printing. Subsequently the Speaker of the Assembly forwards the Bills to the Summit by signing a statement prescribed to that effect. The decisions of the Summit are made by unanimous consensus. The Heads of State may assent to or withhold assent to a Bill of the Assembly. A Bill that has not been received within three months from the date on which it was passed by the Assembly is referred back to the Assembly, giving reasons, and with a request that the Bill or a particular provision thereof be reconsidered by the Assembly. If the Assembly discusses and approves the Bill, it is resubmitted to the Heads of State for assent. If a Head of State withholds assent to a re-submitted Bill, the Bill shall lapse. The Summit of the EAC may not delegate its powers and functions with respect to assents to Bills.

- Styled an Act of the Community: The Secretary General, within 14 days causes every Act of the Community to be published in the Gazette after the Summit's assent has been signified. The commencement of the Act begins on the dates provided in or under the Act or where no date is provided, the date of its publication as notified in the Gazette and every Act is deemed to come into force

at the first moment of the day of commencement. Provision may also be made in a particular Act to the effect that the Council of Ministers shall determine the date (usually through notice in the Gazette) when the Act shall come into force. Many Acts also have provisions that enable the Council of Ministers to make regulations for the better implementation of the Act in question.

The following schematic gives a summary of the legislative process:



Note: To clarify, Regulations generally give effect to the various provisions of an Act and many Acts provide for them. Acts and their regulations are therefore considered as one package.

13. With respect to the application of EAC Acts and Regulations in Partner States, there are three key issues that need to be taken into consideration – a) domestication of EAC Acts in Partner States, b) supremacy of EAC Acts over local ones and c) procedures on how EAC Acts shall come into force in Partner State jurisdictions.

- Domestication of EAC Acts in Partner States: All Partner States have enacted national legislations domesticating the EAC Treaty.

- Supremacy of EAC laws over local ones: Per Article 8(4) and 8(5) of the EAC Treaty, the Partner States undertake to make the necessary legal instruments to confer precedence of Community organs, institutions and laws over similar national ones for the implementation of the Treaty. In practice, all EAC Acts have been successfully enforced in all the Partner States without any problem to date. Accordingly, there has been no immediate need to amend Partner States' laws domesticating the EAC Treaty to expressly provide that EAC Organs, Institutions and Laws take precedence over similar national ones. However, in the future if problems ever arise then it will be necessary for Laws of the Partner States that domesticate the EAC Treaty to expressly clarify the supremacy of EAC Organs, Institutions and Laws and specify that they take precedence over similar national ones. Currently there are no interpretations and enforcement problems of EAC laws. Further, it may be of interest to note that Article 8(1) (C) of the Treaty requires Partner States to abstain from any measures likely to jeopardize the achievement of the objectives or the implementation of the provisions of the Treaty.

- Procedures on how EAC laws shall come into force in Partner State jurisdictions: Even though all Partner States have enacted national legislations domesticating the EAC Treaty. By Article 8(4) of the Treaty, Partner States have undertaken to

accord precedence to Community laws. In this regard, and taking into account the constitutional positions in the Partner States on this matter, once a Community law has been enacted and gazetted in the EAC Gazette, it should have binding effect in the Partner States.

D. Implications for the FSDRP

14. Enacting EAC legislation and close collaboration between the EAC organs and Partner States in a timely manner are critical to achieve the higher level objectives of the EAC FSDRP. Given the structure of the EAC and its legislative process, it is evident that:

- All Partner States have enacted national legislations domesticating the EAC Treaty. However, it must be noted that although the Treaty mentions that Partner States undertake to 'make the necessary legal instruments to confer precedence of Community organs, institutions and laws over similar national ones', the Partner State national legislations that domesticate the Treaty do not expressly state that EAC Organs, Institutions and Laws take precedence over similar national ones. This might hinder the effective enforcement of EAC legislation, and additional time may be required to change Partner State domestication laws to confer precedence of EAC laws over national ones.

- Regarding the procedures on how EAC laws shall come into force in Partner State jurisdictions, the Council has directed all Partner States to implement EAC legislation once enacted and published in the EAC Gazette *(EAC/CM 21/Decision 10)*.

- Although a majority of votes is sufficient to pass a Bill in the Assembly, a unanimous consensus is required at the Summit level. Thus, objections from even a single Partner State can hold up the process for a sign*ificant period of time.*

Source of information in this Annex 8G: Treaty for the Establishment of the East African Community

VIII. WBI Collaboration: Strengthening financial skills in the EAC

A. Objective

1. The purpose of this technical note is, in the context of the EAC FSDRP, to first review the capacities of various educational institutions, in Rwanda and Burundi, in providing capacity development to financial sector personnel in banking, pension, capital markets and insurance. Rwanda and Burundi joined the EAC later (in 2007) than the original three Partner States and have the highest skills gap that needs to be addressed. The review is followed by an overview of the financial skills capacity building initiatives envisaged by the FSDRP – World Bank Institute (WBI) collaborative effort. This section consists of an overview of the action plan for the coordination, design and delivery of the capacity building initiatives by the WBI via the School of Finance and Banking in Kigali and the Light University of Bujumbura – Department of Management and Administration.

B. Background

2. Building financial skills in the EAC is an important aspect of the capacity building component (Component 6) of the FSDRP and is important at both the regional and the national levels to ensure that the market functions effectively and that all economic agents in the regional area are aware of and are able to realize the benefits from the process of integration.

3. Under the FSDRP, capacity building will initially begin with Rwanda and Burundi in 2011 and 2012 and will be extended to the other Partner States from 2013 to 2019. This is done in order to address the highest skills gap in Rwanda and Burundi.

4. The regional financial skills capacity building initiatives will be co-anchored by the School of Finance and Banking in Kigali and the Light University of Bujumbura – Department of Management and Administration.

5. The School of Finance and Banking has about 3,000 students and on average, 300 students graduate each year. The school is a public institution and is currently reviewing its strategic plan. It offers Bachelor of Business Administration degrees in finance, accounting, human resource and marketing. It also provides joint MBA programs like the Maastricht MBA. The school is an accredited center for ACCA (Association of Chartered Certified Accountants), CPA/ICPAR (Certified Public Accountant/Institute of Certified Public Accountants of Rwanda), CFA (Chartered Financial Analyst, to be completed soon) and CII (Chartered Institute of Insurers). The school intends to develop into a regional center for finance and business.

6. The Light University is a private entity, established in 2000 and presently has 3004 students with 30 staff members and produces around 400 graduates per year. In addition to Bachelors of Business Administration degrees in finance, accounting, management and marketing, the University also awards MBA degrees. The Light University is a member of the Inter University council of East Africa.
The following summaries of the review of institutions to provide capacity building in Rwanda and Burundi highlight the need for capacity building programs in these countries.

C. Summary of Capacity Assessment - Rwanda

7. The summary of the capacity assessment in the financial sector is as follows:

- Institutions – There are two institutions providing relevant courses and training support to the financial sector. These are the School of Finance and Banking (SFB) and the National University of Rwanda (NUR). These institutions require support and need to be strengthened.

- Skilled *human capital in the financial sector* – There is a shortage of skilled resources in the financial sector with attrition caused by the movement of this small pool of employees from one institution to another. Thus, there is a need to create retention for staff and to rationalize their remuneration.

- *Skills gap* – A skills gap assessment in the financial sector, was completed in July, 2010.
- *Quality of institutions* – The quality of institutions that train financial sector personnel requires improvement.
- *Government skills development strategy* – Reforms are needed in the education system and the Government is currently preparing a national skills development strategy.
- *Skills in secondary schools* – There is a need for skilled teachers in secondary schools to provide financial education.
- *Teaching staff at universities* – The teaching staff require incentives and motivation.
- *Curriculum* - Training should be demand driven and university curriculums need to be developed so that they are linked with the labor markets.
- *Equipment and teaching aids* – The universities require support to acquire equipment like computers.

8. Gaps in skills have been identified in risk management, computer operations, data analysis, human resource personnel, finance, auditing and IT. A census of the Existing Skills in the Financial Sector in Rwanda was completed as of July 2010. The volume and quality of training that the educational institutions provide in the financial sector are low compared to the demand for such trainings.

9. The table below summarizes the key issues and shows the degree of significance of constraints to each group of financial institutions.

Categories	Broader constraints		Skills gaps and shortages		Problems manifested		
	Limited labour pool	Limited supply of training (locally available)	Technical skills	Management skills	Sector salary volatility	High rate of staff turn-over	Required to recruit foreign staff
BNR - National Bank of Rwanda	+ +	+	+ +	+	+ +	+ +	-
Commercial banks	+ +	+ +	+ +	+ +	+ +	+ +	+ +
NBFIs	+ +	+ +	+ +	+	+	+	+
Microfinance institutions – small	+	-	+	+	-	-	-
Microfinance institutions – large	+	+ +	+	+	-	-	-

Note: **-** *Not significant* + *Significant* ++ *Highly significant*

Source: Census of Existing Skills in the Financial Sector of Rwanda, July 2010, Oxford Policy Management

D. Summary of Capacity Assessment – Burundi

10. The summary of the capacity assessment in the financial sector is as follows:

- *Skilled human capital in the financial sector* – There exists a shortage of skilled resources in the financial sector with attrition caused by the movement of these few employees from one institution to another. Thus, there is a need to create retention schemes for staff.
- *Skills gap* – There is a need to perform a skills gap assessment in the financial sector.
- *English as a business language* – Personnel in the financial sector require training in English as a business language.
- *Quality of institutions* – The quality of institutions that train financial sector personnel is low.
- *Government skills development strategy* – The Government does not have a national skills development strategy.
- *Skills in secondary schools* – There is a shortage of skilled teachers who provide financial education in secondary schools.
- *Universities* –Technical assistance is required to develop various financial courses and for staff development in order to address the low quality of education. There are no specialized colleges or universities that teach business finance.
- *Teaching staff at universities* – The teaching staff require incentives and motivation.
- *Curriculum* - University curriculums need to be linked with the labor markets.
- *Equipment and teaching aids* – The universities require support to acquire equipment like computers.

E. Overview of the FSDRP - WBI Collaboration to Strengthen Financial Skills in the EAC

11. Given the importance of capacity building for the long-term success of an integrated financial sector in the EAC, the Project will draw on the specialized capacity development skills available from the WBI. Relevant WBI staff will therefore collaborate with other Project team members in designing the capacity building aspects of FSDRP I and II, covering capacity building for the EAC Secretariat, strengthening of financial sector regulators in member countries as well as upgrading the skills of private sector financial market participants. Under FSDRP I, capacity building activities will be targeted at Rwanda and Burundi, the most recent entrants into the EAC and the most disadvantaged in terms of current financial sector capacity.

12. As the executive organ of the EAC, the Secretariat will have a central role to play in the implementation of FSDRP I and II. Hence, the Project will provide support to strengthen the institutional capacity of the Secretariat. Potential areas of support include:

- Assessment of institutional development needs of the Secretariat and of the new Financial Sector Regionalization Department.
- Identification and hiring of professional staff for the Regionalization Department.
- Identification and hiring of professional staff for other departments of the Secretariat.
- Identification and hiring of Resident Advisors to support financial sector policy formulation and implementation.
- Development of IT infrastructure to support the work of the Secretariat.
- Development of an Operational Manual for the Secretariat.
- Training for key staff in the Secretariat involved in financial sector policy formulation and implementation.

13. The Project team has identified the School of Finance and Banking in Kigali and the Light University of Bujumbura – Department of Management and Administration as focal points for the delivery of training and other capacity building activities for financial sector regulators as well as financial sector professionals. Therefore, it is envisaged that the Project will provide support to these two educational institutions in the following areas:

- Developing and introducing a curriculum for financial sector regulators (banking, insurance, pension and capital markets).
- Developing curricula for market participants in banking, insurance, pension and capital markets.
- Developing relevant training manuals for these institutions.
- Enhancing skills in curriculum development and training evaluation.
- Training-of-trainers in various topics relating to banking, insurance, pension and capital markets.
- Upgrading IT capabilities at these institutions.
- Establishing partnership programs between these universities and more advanced financial sector training institutes in Africa and beyond.
- Engagement of non-resident advisors in relevant areas (e.g. curriculum development, training-of-trainers).
- Engagement of Visiting Lecturers.

- Establishment of a library at these institutes, with materials relevant to financial sector topics.

14. In addition to the foregoing forms of direct support to the these institutions, the Project also envisages developing a partnership between these institutions and existing professional associations in Rwanda (Rwanda Bankers Association) and Burundi (Burundi Bankers Association and Burundi Insurance Association) to pursue the following objectives:

- Designing and implementing certification syllabi for banking, insurance, pension and capital market professionals.
- Establishing the relevant institutional and regulatory framework for certification.
- Designing and implementing a continuing education program for financial sector professionals.
- Twinning programs for professional associations.
- Outreach and awareness-raising for financial sector professionals.