

**IMPACT OF INVESTMENT BANKING ON ECONOMIC GROWTH IN  
KENYA**

**BY**

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## **DEDICATION**

I dedicate this study to my dear family members for the support they gave me as I prepared and worked on this project.

## **ACKNOWLEDGEMENT**

It has been an exciting and instructive study period at the University of Nairobi and I feel privileged to have had the opportunity to carry out this study as a contribution to the body of knowledge on the subject of investment banking and economic growth in manifestation of knowledge gained during the period studying for my master's degree.

Firstly, I am grateful to the Almighty God for all the blessings he showered on me and for being with me throughout the study. Secondly, I am deeply indebted to my supervisor for his exemplary guidance and support without whose help this project would not have been a success. My gratitude also goes to my loving family and friends who are a constant source of motivation and for their never ending support and encouragement during this period.

It is impossible to remember all who in one way or another contributed to the completion of this project, I take this opportunity to thank them all equally.

## ABSTRACT

Investment banks are an essential part of the financial sectors of modern economies. Providing alternative savings tools to savers and non-bank sources of financing for enterprises, the markets promote economic growth through improved efficiency in savings mobilization (Hunter, 2003). Nevertheless, in an economy of many private enterprises, many firms list in the market while many that qualify to do so do not.

Capital market authorities may be unaware of plausible factors that induce firms to list in the market. Worse, they may be unaware of persisting negative factors that may inhibit qualified firms from listing in the stock exchange. The capital markets consist of the primary market and the secondary market. The primary markets are where new stock and bonds issues are sold (underwritten) to investors. The secondary markets are where existing securities are sold and bought from one investor or speculator to another, usually on an exchange.

This study was a descriptive study. According to Schinler and Coopers (2004) descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions. It serves a variety of research objectives such as descriptions of phenomenon or characteristics associated with a subject population, estimates of proportions of a population that have these characteristics and discovery of associations among different variables.

This study was carried on investment banks in Kenya and the population of the study was all the 23 investment banks in Kenya (CBK, 2008). Census was used in carrying out the study. The whole population was covered hence no sampling done. Secondary data was used in this study. This was obtained from NSE database and included Gross Domestic Product measured as the real Gross Domestic Product generated within the year, average commission fee charged by the investment banks in Kenya, the total number of investment banks in Kenya within the year; The total value of stocks traded or transacted within the year; the trading cycle within the investment market to measure the microstructure of investment markets.

The study revealed that efficient investment banking in the general economy strives to; improve their capital bases, reduce operational costs, improve assets quality by reducing the rate of non-performing loans, employ revenue diversification strategies as opposed to focused strategies and keep the right amount of liquid assets. Indeed the descriptive analysis of these factors by number of investment banking showed that large investment banks perform better than the small and medium investment banks hence superior in their contribution to economic growth.

This study therefore, sought to establish the impact of investment banking on economic growth of Kenya.

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## **LIST OF ABBREVIATIONS**

CBK	Central Bank of Kenya
CMA:	Capital Markets Authority
EMH:	Efficient-Market Hypothesis
FPI:	Foreign Portfolio Investment
GDP:	Gross Domestic Product
GNP:	Gross National Product
LCH:	Life Cycle Hypothesis
MFI:	Micro Finance Institution
MPT:	Modern Portfolio Theory

## **CHAPTER ONE: INTRODUCTION**

### **1.1 Background of the Study**

According to Lindsey (2004), the term 'investment banking' was coined in the United States in the early part of the twentieth century and is now widely used in other countries. It is a term that is generally descriptive of the specialized intermediary functions or activities they perform, rather than a specific designation given by the state or by a professional association. Although referred to as 'banks', historically they have not held banking licenses or been permitted to provide commercial banking services such as taking deposits from or lending money to retail customers (Kaplan, 2004).

Investment banks are an essential part of the financial sectors of modern economies. Providing alternative savings tools to savers and non-bank sources of financing for enterprises, the markets promote economic growth through improved efficiency in savings mobilization (Hunter, 2003). Nevertheless, in an economy of many private enterprises, many firms list in the market while many that qualify to do so do not.

Capital market authorities may be unaware of plausible factors that induce firms to list in the market. Worse, they may be unaware of persisting negative factors that may inhibit qualified firms from listing in the stock exchange. The capital markets consist of the primary market and the secondary market. The primary markets are where new stock and bonds issues are sold (underwritten) to investors. The secondary markets are where existing securities are sold and bought from one investor or speculator to another, usually on an exchange (Hellmann, 2000)

### **1.1.1 Investment Banking**

The Capital Markets Authority (CMA) is responsible for the regulation of Investment Banks in Kenya. In addition to its regulatory role, the CMA also develops a framework to facilitate the use of electronic commerce for the development of capital markets. There are factors that have to be addressed in terms of the stage of development of the investment banking. Countries with big equity markets have less volatile, more price efficient markets with substantial degrees of liquidity. Most Investment Banks, as in Kenya, are highly concentrated (Baker, 2003). As a result they tend to be undeveloped, and are small and illiquid, exhibiting pricing volatility and error. The more integrated the market to international markets, the less volatile the returns. A factor that drives markets strongly is the level of institutional arrangement and the regulatory framework. In developed versus developing country evidence, certain factors seem to differ on development of capital markets. The equity for debt substitution as a motive for listing in developed markets seems to be altered in developing economies (Geisst 1995).

Investment banking development seems to offer greater room not just for the substitution but also for diversification of risk. Firms have seemed to increase borrowing after listing. For large listed firms in developing economies, debt/equity ratios seem to rise while they fall in developed country markets. Small firms do not seem to expand their borrowing or debt/equity ratios. Market development would thus seem to favor large listed firms (Hellmann, 2002). A key-differentiating factor that has driven developing country markets in recent years is the process of structural adjustment. Governments induced by pressing fiscal deficits and divestiture programs have off-loaded restructured firms into the stock market (Kaplan, 2004). In Kenya, the largest additions in the market have come from parastatals - Kenya Airways and Kenya Commercial

Bank They coincided with the era of structural adjustment and privatization They drove the Nairobi Stock Exchange to historic levels of activity in the 1990s.

According to (Maskara, 2005) a hidden factor in stock market development is the macroeconomic outlook Firms think short-term in conditions of uncertainty, so that unstable macroeconomic conditions are likely to affect the issue of equity. The summary of the problem is that if the stock exchange is to be enhanced as a vehicle for mobilizing capital for development, then all players in the scene must change their approaches. The stock exchange must play an increasingly educational role; the Capital Markets Authority as the regulatory agency must alter its approach from the sometimes heavy-handed type of control to a more proactive, creative and supportive role in order to assist in the creation of a more vibrant and forward looking capital market environment (Steinberg, 1996). It can do this by seeing itself as a catalyst in development rather than as a traditional regulator of what is a very small market

### **1.1.2 Economic Growth**

The relationship between economic growth and developments in the financial sector has been one of the most discussed areas in economics for a long time; and the direction of causality - whether financial development causes economic growth or vice versa - is by no means a settled issue Schumpeter (1912), in his effort to analyse the importance of technological innovation in long-run economic growth, emphasised the crucial role that the banking system would play in facilitating investment in innovation and productive investment by the entrepreneur

Robinson (1952), however, maintained that it was economic growth which would create the demand for various types of financial services to which the financial system would respond In other words, Schumpeter and Robinson point to the mutually opposite directions of causality.

The literature on the nature of relationship between economic growth and financial development has since grown enormously and arguments supporting either view on the direction of causality are as strong as their counterparts

Whether financial development influences economic growth is not just a matter of intellectual curiosity - it is a crucial policy issue as well. Financial development may be either of the bank-based type or stock market-based type. It is a crucial policy question which type of development should the government actively promote. The relative importance of these two types of financial structures in economic growth has been debated for over a century (Allen and Gale, 1999; Stiglitz, 1985). The proponents of the bank-based type argue that banking development plays a crucial role in economic growth and can avoid the shortcomings of the market-based financial systems.

Main variables are economic growth; population, Consumer price index (1990—91), real GDP (1900-81), population, and total investment used in research. Growth rate of these variables are calculated using log alteration method that wipes out strong irregularity in distribution. The log alteration smoothed time trend in the data set. There is volatility in the data to make it more clear. Hodrick Prescott filter is used for dataset. The author applied Granger causality test to measure the linear causation between investment market and economic growth. T—statistic demonstrates that the null hypothesis is rejected.

### **1.1.3 Investment Banking and Economic Growth**

Kaplan, (2001), states that emerging markets are heavily reliant on investment banks for their capital requirement because stock markets and bond markets are not as developed as they are in developed countries. On the importance of accounting data, Lerner, (1995) asserts that,

"Accounting data convey useful and timely information to investors. While this conclusion definitely holds for earnings data, the marginal contribution of the voluminous non-earnings data published in financial reports is still largely unknown " In any case the preparation and use of accounting data could vary from country to country due to differences in economic activity. For example, while other countries use IAS, others use local standards (IBSA, 2002).

Information or news in the Efficient Market Hypothesis is defined as anything that may affect prices that is unknowable in the present and thus appears randomly in the future (Dewatripont, 1995). Investment banking is actively engaged in search of superior information in offering advice on Mergers and Acquisitions.

The realization that possession of information not in the public domain may result in above normal returns has led to investment banking scouring for this information both published and unpublished as input to lending decisions. Empirical evidence seem to suggest that EMH in its strong form is not supported. Investment banking offers advice on diversification of risks through such initiatives as mergers and acquisitions that tend to reduce risk through diversification of markets, products and suppliers, Markowitz, 1952 advanced the theory of diversification of risk through investing in a portfolio of securities. Investment banking tends to offer advice and lending decisions based on the perceived quality of information contained in financial statements and other unpublished sources (Klein, 1981).

According to Kroszner, (2001), the thrust of studies by economists in the latter half of the 20<sup>th</sup> Century was an attempt to gain insight into the life cycle of household economic behaviour, namely income, savings, consumption and investment habits. These studies examined personal investment habits accumulation and its determinants on the foundation of saving and consumption theory. In this line of inquiry, the Life Cycle Hypothesis (LCH ) of Modigliani and Blumberg (1954) appears to have gained wider acceptance in its proposition that age is the most important determinant of a person's investment habits and that it (investment habits) follows a hump-shape to a person's age; rising during the youthful age, peaking just before retirement and

declining thereafter McLaughlin, (1990) expands these works and develops the life cycle hypothesis of saving where they test empirical data to show that savings, a necessary precursor to investment habits also follows a hump shape to age

The examination of investment options is based on the assumption that the main concern of asset holders is the earnings stream from these capital outlays. Investors face choice dilemmas in that assets are dissimilar in attributes such as the size, timing and riskiness of returns and capital. Assets also differ in terms of the transaction costs, lumpiness and liquidity (Otieno, 2003). At the macro level, assets also exhibit significant differences in the relationships between their prices and key economic variables such as interest rates and inflation. The foregoing highlights the importance of the range of available assets and the investment choice.

The vast majority of the pioneering works on personal investments that are informed by risk management tended to focus on financial assets as the only options that were available for personal investments. Such studies concentrated on investments in cash, treasury bills and treasury bonds, corporate bonds and shares which are also called liquid assets on account of the ease of convertibility to cash without risk of loss of capital or earnings (Research Analyst Independence, 2003).

Owing to advances in the body of knowledge, improvement in technology and the emergence of alternative stores of investment habits, researchers have recently widened their scope to include non-financial assets such as housing, private business and human capital. In this respect the importance of housing in personal investments is reinforced by scholars. Shapiro, (1983) showed that the returns to real estate are only weakly correlated with those of financial assets. They use this discovery to argue, and justifiably so, that an efficient diversified portfolio ought to have real estate in the range 5% to 20%. Nevertheless, investment habits holdings in business and human capital tend to be omitted in studies under the risk management framework because of problems relating to transferability and measurement (Simons, 1993).



#### **1.1.4 Investment Banks in Kenya**

Investment Banks, in Kenya, are both private and government agency established by the Capital Markets Authority Act of 1989 that facilitates, regulates and oversees investment activities CBK, (2008) The objectives of CMA therefore are the development of all aspects of the Investment Banks with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investments in productive activities, to facilitate the existence of a nationwide system of stock market and brokerage services so as to enable wider participation of the general public in stock market, to create, maintain and regulate a market in which securities can be issued and traded in an orderly, fair, and efficient manner, through the implementation of a system in which the market participants regulate themselves to the maximum practicable extent and to protect investor interests (Allen, 1993).

In Kenya, investment banks are part of the financial system that provides funds for long term development. It is market for securities, where companies and governments can raise long-term funds. Capital markets brings together lenders (investors) and borrowers (companies that sell securities to public) of capital.

A typical capital market comprises of several institutions, namely: banks, insurance companies, mutual funds, mortgage firms, finance companies and stock markets. Capital market includes the stock market and the bond market. Financial regulators, such as Kenya's Capital Markets Authority, U.S. Securities and Exchange Commission, oversee the capital markets in their designated countries to ensure that investors are protected against fraud In sub-Saharan Africa, banks have historically dominated long-term financial intermediation Central Bank of Kenya, (2008) In recent years, however, a more holistic approach has gradually shifted emphasis away

from development of banks per se, to development of stock markets and other financial institutions alongside banks. The Capital Markets Regulations were amended in 2009 to increase the share capital for stockbrokers and investment Banks from Kshs 5 million and Kshs.30 million to Kshs.50 million and Kshs. 250 million. The proposal is likely to increase investor confidence and general market stability. It is noteworthy that high level capitalization is associated with high technical capacity and efficiency, leading to improved quality of services.

## **1.2 Problem Statement**

A progression is usually a move in a forward or upward direction. In most spheres of life, this connotes a regression. The development of an economy is not an exception to this reasoning. Economic development is not achievable without an improved rate of capital formation. One important way of capital formation for developing economies is through improving their investment banking industries. Since the turn of the 20th century, investment banks have been providing financial intermediary services, which have been integral to the efficient operation of the financial system (Chu, 1990). They play an important role in the market for corporate control; they advise the bidder and the target, evaluating the assets of the target firm and providing technical and tactical assistance throughout the takeover process.

While the strength of securities markets that make investment banks focal points of modern finance is their ability to mobilize long term savings for financing long term ventures, to improve efficiency of resource allocation through competitive pricing mechanisms, to provide risk capital (equity to entrepreneurs), and to encourage broader ownership of firms (Goar, 1991), Kenya is plagued with less efficient financial market characterized with various problems in accessing long-term funds. Any company intending to raise capital, therefore, finds itself in a precarious

position and investors also have to contend with bearing huge losses when a player in the capital market enters into liquidity problems. It is due to this importance of the development of investment banks and the direct effect that the investment banks and banking has on growth of emerging markets that intensive studies should be done on this gap.

Locally, very few studies have been done in Kenya related to the impact of investment banking development on economic growth of emerging markets (Otieno and Schmidt 1996). Moreover, Muhamed (2006) studies considered the relationship between stock market development and economic growth without considering the role of the banking sector. The study uses pooled cross-country time series regressions considering the data on 21 firms over a period of 5 years. The paper used an aggregate index of overall stock market development constructed by Demirguc-Kunt and Levine (1996) which combines information on stock market size, liquidity and integration with world capital markets. While assessing the relationship between stock market development and economic growth, the paper includes a large number of control variables viz., the logarithm of initial per capita GDP, the logarithm of initial secondary school enrolment rate, the number of revolutions and coups, the ratio of government consumption expenditures. Using the instrumental variable method of estimation, the study observes that the stock market development is positively correlated with economic growth even after controlling for other factors associated with long-run growth.

Miyote (1996) examined the causal relationship between financial development and economic growth from a time-series perspective considering data from 45 NSE firms over 7 years and demonstrate that the relationship is country-specific. Financial development has been measured by two ratios viz., ratio of bank deposit liabilities to nominal GDP and ratio of bank claims on

the private sector to nominal GDP. They find from the Engle-Granger results that at least one of the financial indicators is co-integrated with real GDP per capita in these firms. In Kenya, no study, known to the researcher, has been conducted on the effect of investment banking on the economic growth with the closest study being on the granger causality effect of stock prices on interest rate Anene,(2011). This leaves a wide knowledge gap that this study seeks to establish. The study, thus, seek to answer the research question: what is the impact of investment banking development on economic growth of Kenya?

### **1.3 Objectives of the Study**

The study sought to establish the impact of investment banking on economic growth in Kenya

### **1.4 Value of the Study**

The study will be invaluable to the management of the investment banks as it will form a blueprint on how they can enhance investment in security.

The study will be of importance to capital market regulators, for example the CMA since by identifying the importance of investment banks they will implement regulation that would not be a scuttle neck to the investment banks (Perry, 1991).

The study will also be of importance to academicians or Kenyan scholars for it will form an invaluable source of material upon which further research and studies will be based

## CHAPTER TWO: LITERATURE REVIEW

### 2.1 Introduction

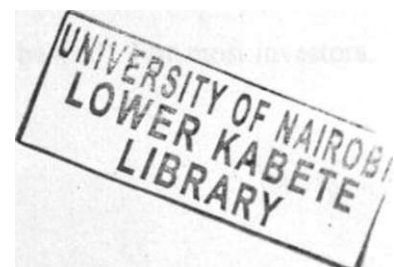
This chapter presents the literature review, specifically the literature review focuses on the variables of the study, and the discussion includes personal investment habit influencing factors, theories, market reviews, and determinant factors. The review of literature focuses on the the impact of investment banking development on economic growth of emerging markets (Allen and Gale, 1995).

### 2.2 Theoretical Review

Investment markets tend to service the liquidity needs of investors and provide the underwriter with up-to-date information to aid in pricing a new issue. In addition to this, the advisory dimension has emerged throughout the 1980s as one of the most critical investment banking functions and has created a polarization in the industry between full service shops and specialist corporate finance houses. Consequently, advice can no longer be categorized as a related service, but as a main activity (Boot, 2000).

#### 2.2.1 Efficient-Market Hypothesis Theory

Asserts that financial markets are "information ally efficient" The weak version of EMH supposes that prices on traded assets (stocks, bonds, or property) already reflect all past publicly available information. The semi strong version supposes that prices reflect all publicly available information and instantly change to reflect new information. Strong version supposes that market reflects even hidden/inside information.



There is evidence to suggest that the first two versions are valid while there is strong evidence against the last one. Therefore, according to theory, it is improbable to consistently outperform the market by using any information that the market already has, except through inside trading. Information or news in the EMH is defined as anything that may affect prices that is unknowable in the present and thus appears randomly in the future (Dewatripont, 1995).

The theory of capital appreciation and dividend income asserts the main reason for investors investing decision is to receive capital appreciation when the price increase, the share value will equally increase and overall the stocks capital go up. On the other hand, as share price increase and capital appreciation goes up, the dividend also goes up and this being a source of income for many investors, it has double advantage as the wealth will increase and so is disposable income for the investors. Once the investors realize shares value is going up for certain Company, they normally make the move and invest as they see this as opportunity for making more capital appreciation and at the same time they are guaranteed to receive interim and final dividend as regular income in future years (UK Law Commission, 1992).

### **2.2.2 Modern Portfolio Theory**

According to Barth et al (2000) one of the most important and influential economic theories dealing with finance and investment is the Modern Portfolio Theory (MPT), developed by Harry Markowitz and published under the title "Portfolio Selection" in the 1952 *Journal of Finance*. MPT states that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification - chief among them, a reduction in the riskiness of the portfolio. MPT quantifies the benefits of diversification, also known as "not putting all of your eggs in one basket". For most investors,

the risk they take when they buy a stock is that the return will be lower than expected (Mwamba, 2003) In other words, it is the deviation from the average return Each stock has its own standard deviation from the mean, which MPT calls "risk".

The risk in a portfolio of diverse individual stocks will be less than the risk inherent in holding any one of the individual stocks (provided the risks of the various stocks are not directly related). Consider a portfolio that holds two risky stocks: one that pays off when it rains and another that pays off when it does not rain A portfolio that contains both assets will always pay off, regardless of whether it rains or shines (Carosso, 1970). Adding one risky asset to another can reduce the overall risk of an all-weather portfolio. In other words, Markowitz showed that investment is not just about picking stocks, but about choosing the right combination of stocks among which to distribute one's nest eggs (Chemmanur and Fulghieri, 1994).

Modern Portfolio Theory has had a marked impact on how investors perceive risk, return and portfolio management The theory demonstrates that portfolio diversification can reduce investment risk. In fact, modern money managers routinely follow its precepts. Likewise, it is logical to borrow to hold a risk-free asset and increase your portfolio returns, but finding a truly risk-free asset is another matter Government-backed bonds are presumed to be risk free, but, in reality, they are not Securities such as gilts and Government treasury bonds are free of default risk, but expectations of higher inflation and interest rate changes can both affect their value (Geisst, 1995).

Then there is the question of the number of stocks required for diversification How many is enough? Mutual funds can contain dozens and dozens of stocks Investment guru William J Bernstein says that even 100 stocks is not enough to diversify away unsystematic risk. By

contrast, Elton and Gruber, in their book "Modern Portfolio Theory and Investment Analysis" (1981), conclude that you would come very close to achieving optimal diversity after adding the twentieth stock

### **2.2.3 Financial Investment Theory**

Informed by finance theory, the seminal paper on MPT by Dow and Gorton, (1997) provided researchers with a set of quantitative tools for prescribing how investors should combine their financial assets to maximize return for a given risk thus emphasizing on the nature and mix of investment habits held. Research in this field received a significant boost in the 1990s following the compilation and availability of monthly and annual return data for typical assets such as shares in listed companies, bonds and housing as well as estimates of annual inflation rates. A central aspect of MPT is that the enthusiasts proposed that every investor should hold an optimal portfolio that is fully diversified (Harjoto, 2005).

Almost working in parallel, the thrust of studies by economists in the latter half of the 20<sup>th</sup> Century was an attempt to gain insight into the life cycle of household economic behaviour, namely income, savings, consumption and investment habits. These studies examined personal investment habits accumulation and its determinants on the foundation of saving and consumption theory.

In this line of inquiry, the Life Cycle Hypothesis (LCH) of Kaplan and Stromberg, (2001) appears to have gained wider acceptance in its proposition that age is the most important determinant of a person's investment habits and that it (investment habits) follows a hump-shape to a person's age; rising during the youthful age, peaking just before retirement and declining thereafter. Kaplan and Stromberg, (2001) expands these works and develops the Life Cycle



Hypothesis of saving where they test empirical data to show that savings, a necessary precursor to investment habits also follows a hump shape to age

### **2.3 Role of Investment Banks: Intermediaries, Advisers and Counterparties**

According to Allen (1993), a prerequisite for an integrated analysis of the structure of investment banking industry is the definition of the main investment banking functions. There is a rapidly increasing range of products and services, and the task to distinguish the main investment banking services becomes rather difficult. Depending on their participation or not in various market segments, their width and breadth of services and their corporate structure, investment banks offer investment banking services in different ways and forms (Baker and Gompers, 2003).

However, Carosso, (1970), states that investment banking can be reduced to two basic functions: raising capital for corporations and providing financial advice on mergers and acquisitions. All other activities are either supportive or elaborative of these two functions. Investment bankers originate structure and market corporate securities to raise funds for companies. Besides capital raising, providing advice in initiating and implementing mergers and acquisitions is the other basis of investment banking services. Often, when two companies merge, both will retain an investment bank to help in the transactions. This assistance comes in the form of identifying companies to acquire or to be acquired, by valuing the transaction, and negotiating, consummating and financing the deal (Chemmanur and Fulghieri, 1994)

There are two antithetic trends regarding these functions: the first is the convergence of the financing and advisory function that elevates the importance of capital-raising ability as a

competitive factor. Because of the merging of these two functions, success has become even more dependent on an institution's willingness to commit risk capital on the one hand and the quality of advice and expertise on the other. The second is the autonomy of the advisory function from the financing activity that permits specialist corporate finance houses like Hombre Magan to capitalize successfully on it (Geisst, 1995).

Hellmann and Puri (2002) define investment banking services somewhat differently and identify three distinct services that full service investment banks perform: Management of new financing issues involves determining the security's issue price, timing the issue, and recruiting the firms that will distribute the securities. Closely related to issue management is the provision of corporate financial services, ranging from consulting on corporate capital structure to advice on mergers and acquisitions; absorption of the risk assumed when the underwriter contracts to purchase an issuer's securities at a fixed price in spite of the uncertain price at which the securities can be re-offered to investors; selling the securities to the ultimate holders (Hochberg, 2004). Distribution divides naturally into two parts: distribution to institutional investors and distribution to individuals. The latter often includes several investment banks in a "syndicate" to achieve broad distribution of the security. Distribution is usually performed by firms that are also active brokers or principals in the secondary corporate securities markets.

According to Hunter, (2003), these secondary markets service the liquidity needs of investors and provide the underwriter with up-to-date information to aid in pricing a new issue. The secondary-market function could alternatively be categorized as a separate, fourth service performed for corporate clients as a component of the maintenance of access to the public capital markets. All three steps are often referred to as "primary securities underwriting", "securities

underwriting", or "financing" In addition to this, the advisory dimension has emerged throughout the 1980s as one of the most critical investment banking functions and has created a polarization in the industry between full service shops and specialist corporate finance houses. Consequently, advice can no longer be categorized as a related service, but as a main activity (Kaplan, 2004).

Investment banks' strengths and reputations vary considerably according to the function For example, Goar, (1991) states: "The big question for Salomon's future is whether the firm will be able to develop an investment banking capability to match its trading prowess". Perry, (1991) says about Nomura: "It has never really succeeded in becoming a 'home-player' anywhere outside of Japan Rather, it acts as conduit for Japanese securities in foreign markets ..it has confined itself to the role of a follower and a copier in the development of high-value-added products and techniques". Within the industry the volume of managing underwritings is seen as an important indicator of a securities firm's success. Thus a leading position in the underwriting volume statistics is perceived as a valuable new-business tool in trying to sell current and potential corporate clients a variety of services, including merger and acquisition expertise. Serving as a company's underwriter provides the excuse to maintain contact and suggest other client services. Moreover, underwriting managements help ensure a steady flow of securities merchandise that keeps the firm's sales personnel in touch with investor customers and particular institutions (Hayes, 1979).

As Kochan, (1991) states, this interrelationship of investment banking services creates cross-selling opportunities and synergy effects that can improve the competitive position of an investment bank. In summary then, and taking into account the developments of the last decade,

the function of investment banking is to create and mediate the flow of assets between "issuers" and "investors". Issuers include companies and other entities that sell assets, such as stocks, bonds and even parts or all of the company itself. Investment banks have a very active role in "creating issuers", for example, spotting companies that could be a takeover target. Investors include investment banks (merchant banking), companies, institutions and people who buy these assets. The nature of "assets", e.g. value-added products (M&A advice) or commodity-like products commercial paper influences the investment banking function. The potential for customer-investment bank interface is higher when we have a value-added product and limited in a commodity-like product. In the first case, the investment banks have more opportunities to manage their positioning and other intangible aspects that determine the effectiveness of the investment bank's differentiation (Boot and Thakor, 2000).

The investment bank serves its clients on multiple levels as an intermediary, an adviser and counterparty. These three are nowadays the main investment banking functions. As the central lending link may decline in importance, the relationship can be maintained within a much broader context - one that embraces the capital and money markets, and is based on financial engineering, risk, liquidity, and asset management" (Kochan, 1991).

## **2.4 Role of Investment Banking**

Investment Banking involves providing general financial advice on a range of issues, such as funding structure (perhaps the company is too indebted, and should issue shares to raise more money, or does it have too much cash on its balance sheet, just sitting there not earning interest, so that it should consider paying a large dividend to its shareholders or buying back some of its own shares?).

### **2.4.1 Mergers and Acquisitions**

The majority of financial advice relates to Mergers and Acquisitions (M&A). The client company seeks to expand by acquiring another business. There are many possible commercial reasons for this, such as: increasing the range of products, increasing the business' geographical footprint, complementing existing products, integrating vertically (i.e. acquire suppliers, further up the chain, or customers, further down the chain) and protecting a position (for example by preventing a competitor from acquiring the business in question).

In practice therefore, Investment Banking divisions tend to be divided into industry sector teams, who can then familiarize themselves with the principal players, economics and dynamics of the sector. According to Booth and Smith (1986), there are also many possible financial reasons for making an acquisition, such as raising profitability, and therefore the share price, increasing in size, followed and more widely invested in; again, likely to have a positive effect on the share price, financing growth, improving quality of profits - the market likes predictable profit streams, and will value these more highly and shifting the business towards sectors more favorably viewed by the market (Mwamba, 2003).

The Investment Bankers' roles in these transactions involve using their knowledge of the industry sector, to help with the identification of potential targets which meet commercial criteria such as those referred to above. Investment bankers also use their knowledge of the investment market, to advise on valuation, form of consideration (should the sellers be paid in cash - which is likely to involve the buyer borrowing the money - or in the buyer's shares - so that the seller ends up with a stake in the buyer, or a blend of the two<sup>7</sup>), timing, tactics and structure. Investment banker coordinate the work of the other advisers involved in the transaction - lawyers, who prepare the

documentation for the acquisition and help with the "due diligence" to be performed on the business being acquired, accountants, who advise on the financial reporting aspects of the transaction, and tax consequences; brokers, who advise on shareholder aspects (how are the buyer's shareholders likely to view the acquisition?) and how the market as a whole is likely to receive the transaction; and public relations consultants, who ensure that the transaction has a favorable press (Wambui, 2003).

#### **2.4.2 Raising Capital**

If a company is to grow, it has to invest and, often, that capital comes from external sources. This can be in the form of either "equity", when the company issues more shares to investors, who buy them for cash; or debt, either from banks or - more usually nowadays - directly from investors. Investors may be either institutional (pension funds and the like) or "retail" (individuals).

Investment Banks advise on the raising of capital - in what form, how much, from whom, timing and may also charge a fee for arranging the financing or for "underwriting" (guaranteeing to take up any securities that are unsold in the market, so that the issuer knows for sure how much cash it is going to raise and can plan accordingly). In practice therefore, Investment Banking divisions tend to be divided into industry sector teams, who can then familiarize themselves with the principal players, economics and dynamics of the sector (Wambui, 2003).

#### **2.5 Relationship Between Investment Banking and Economic Growth**

Investment banking is a key activity in the provision of corporate financial services in all countries which have a developed private sector economy. The principal activities of investment banking are the raising of capital for corporations and the provision of advice on mergers and

acquisitions To raise capital, investment bankers originate structure and sell corporate securities in order to raise funds for client companies. Additionally, providing advice on initiating and implementing mergers and acquisitions involves investment bankers in identifying suitable partners or target companies for acquisition, valuing the transaction and negotiating appropriate terms (The Australian Financial Review, 2004).

Investment banks profit from companies and governments by: raising money through issuing and selling securities in the capital markets (both equity and bond), as well as providing advice on transactions such as mergers and acquisitions. A majority of investment banks offer strategic advisory services for mergers, acquisitions, divestiture or other financial services for clients, such as the trading of derivatives, fixed income, foreign exchange, commodity, and equity securities.

Trading securities for cash or securities (facilitating transactions, market-making and others), or the promotion of securities (underwriting, research, among others) is referred to as the "sell side". Dealing with the pension funds, mutual funds, hedge funds, and the investing public who consume the products and services of the sell-side in order to maximize their return on investment constitutes the "buy side". Many firms have buy and sell side components.

The influence of investment banks in the financial system and broader community is vast and their importance is increasing (Research Analyst Independence, 2003). The transactions on which they advise can have significant consequences for business competition and employment, often on an industry-wide or national basis. These transactions can transform the financial and corporate landscape of entire economies and affect many thousands of people as customers or workers. The financial advisory fees they generate from advising are large. Kenya has witnessed

a steady growth of investment banks Kenya now boasts of 12 investment banks, 19 investment advisors and 7 stockbrokers Rau, (2000). In Kenya investment bankers and brokerage firms play a critical role in contributing to the efficient functioning of securities and equities markets in the economy. With the deluge of information available to market participants, the value of investment analysts' opinions both to investors and issuers is greater than ever before (Central Bank of Kenya, 2008).

Investment banking is part of the financial services industry and offers an increasingly important range of services to corporations throughout the world. The range of products and services is increasing rapidly and it is difficult to distinguish the most important services because investment banks offer their services in different ways and forms. However, Chu (1980) identifies two basic functions: raising capital and giving advice on mergers and acquisitions. All other services are largely supportive of or developed from these two functions; examples include corporate securities for fund-raising and handling mergers and acquisitions. Hayes *et al* (1983), however, define three investment banking services; origination and management of new financial issues; underwriting of issued securities and distribution, involving selling securities to ultimate holders.

The function of investment banking is to create and mediate the flow of assets between "issuers" and "investors". Issuers include companies and other entities that sell assets, such as stocks, bonds and even parts or all of the company itself. Investment banks have a very active role in "creating issuers", for example, spotting companies that could be a takeover target. Investors include investment banks, companies, institutions and people who buy these assets. Throughout the past ten years or so there has been continuing and rapid growth in investment banking



transactions and although it is somewhat difficult to estimate the total value of business of the industry, in 1991 underwriting business totaled about \$32 billion Euro Money, ( 1994) and M&A totaled about \$267 billion (Mergers and Acquisitions International, 1994).

The management of these huge flows of money transactions has led to the development of very special expertise largely concentrated among a relatively small number of companies. The most important results of the rapid growth and magnitude of financial transactions and volumes have been the emergence of "super-powerful" market participants, shifts in competitors' strength and market share, renewed attempts by regulators to understand and ultimately influence financial market stability and failures and large losses among financial market participants.

## **2.6 Measures of Economic Growth**

Labels used to measure economic growth vary quite a bit. The measures used to describe the economic development process itself, however, are much more rigorously defined. For example, while the terms "economic growth" and "economic development" are often used interchangeably, there is an important distinction between these two terms. The growth is measured by observing an increase (or growth) in real national income or product expressed usually as per capita income. National income or product itself is commonly expressed in terms of a measure of the aggregate output of the economy called Gross National Product (GNP) (Lipsey, 1999). Per capita income then, is simply GNP divided by the population of the country. When the GNP of a nation rises, whatever the means of achieving the outcome, economists refer to it as a rise in economic growth. The term "economic development," on the other hand, implies much more

The main variables of measuring economic growth are economic growth; population, Consumer Price Index (1990—91), real GDP (1900-81), population, and total investment used in research. Growth rate of these variables are calculated using log alteration method that wipes out strong irregularity in distribution. The log alteration smoothed time trend in the data set.

## **2.6 Empirical Evidence**

The literature sharply distinguishes between bank and market-based financial systems. On the one hand, in bank-based systems intermediaries establish long-term relationships with firms and keep loans in their balance sheets. On the other hand, in market-based systems firms sell their security directly to investors (in 'direct' markets business firms are supposed to meet face to face with investors), who form portfolios to diversify risks (Steinberg, 1996). Nevertheless, while this distinction is useful to help thinking about striking cross-country differences among financial systems (Allen and Gale, (1995), it obscures the fact that in developed security markets firms sell their security through investment banks with which they establish long-term relationships.

A large literature argues that relationships facilitate monitoring and screening and can overcome the problems created by asymmetric information. As Boot (2000) argues, in a relationship the bank invests in obtaining firm-specific information, which is often proprietary in nature, and evaluates the profitability of these investments through multiple interactions with the same customer over time or across products. Thus, the benefits of relationships stem from the investment bank making decisions based on better information than what is publicly available.

Booth and Smith (1986) argue that underwriters certify that the valuation of the security made by the firm is appropriate. In so doing, they increase the net flow of capital to issuing firms and,

moreover, ensure that on average higher quality firms get funding. If so, then security markets with an established investment banking industry should perform better. It has been argued that relationships with commercial banks have the drawback of introducing a soft budget constraint, because banks cannot credibly commit to withdraw credit when the borrower is in financial trouble, and this worsens ex-ante incentives (Bolton and Scharfstein 1996; Dewatripont and Maskin, 1995). An investment bank avoids this problem, because typically it does not maintain the firm's security in its balance sheet, but sells it to investors. It has also been argued that relationships may subject the firm to a hold up from the commercial bank with whom it has a relationship

Goldsmith (1969) along with Shaw (1973) and McKinnon (1973) who pioneered work on financial sector liberalization and its effect on overall macroeconomic growth and development, asserted that financial deregulation, more particularly, liberalization of the commercial banking system would lead to higher savings, improved resource allocation and economic growth (Dewatripont and Maskin, 1995). While this is clearly understandable, there was no clear indication of the impact of capital markets on this process, or a meaningful response to whether the development of a stock market is inevitably detrimental to the health and welfare of the banking system.

The financial sector in Kenya, has to some degree, followed the example of Japanese and German financial sectors that are bank-dominated. By and large the big foreign-owned branches have traditionally provided financing to select enterprises through lines of credit and overdrafts, often participating in management as well as monitored the client activities, acting as lenders, as well as supervisors in close co-operation with the government regulators. However, such an arrangement is not likely to be sustainable in the rapid developing economy of Kenya. It is no

surprise that the similar bank-dominated systems, both in our region as well as the rest of the World, have experienced serious strain in recent years with new emphasis on reforming and global integrating their capital markets that is a move away from bank finance. But does this development sound the death knell for domestic banking that has nurtured and supported the developing economy for so long?

To answer this question we need to revisit the Shaw-McKinnon (1973) model, which, was extended to include general capital market liberalization, by several authors, notably Krrunza (1974, 1979). Errunza explicitly considered the role of securities markets in economic development. He argued that through the market price mechanism, more efficient risk sharing and the accumulation and dissemination of vital information would improve resource allocation. As markets develop we should expect to see the emergence of specialized institutions and instruments, increased liquidity, and diversification opportunities which would raise savings rates, capital accumulation and enhanced production possibilities directly as well as through increased access to technology (Barth et al, 2000). All these factors are in fact positive developments for the banking system as it makes their "job" easier. It would seem therefore that an efficient capital market encompassing investment banking would in fact complement rather than constrain a liberated banking sector.

According to Lemer, (1995), it's important to understand the relationship between capital structure and the level of development of the stock market and whether stock markets help or hinder the financing function of the banking sector. That is whether equity and debt finance complement each other or serve as substitutes. Results of Kroszner and Strahan, (2001) suggest a positive and significant relationship between firm leverage and stock market development. Equity finance will increase the borrowing capacity of firms through risk sharing and may raise

the quality and quantity of bank lending through timely and systematic information flows. More recently, Kroszner and Strahan, (2001) found that the level of stock market development is highly correlated with the development of the banks, non-banks, insurance companies and private pension funds. Thus, debt and equity finance should be viewed as complements—a natural progression as development proceeds providing finance with characteristics.

In a comprehensive study, Puri (1996) document that the financial sector development (size of the banking sector) is robustly correlated with current and future economic growth. In a recent study, Schmidt et al, (1996) found that stock market and banking development indicators predict long-run growth and that the two sectors provide different bundles of financial services. To summarize, capital markets can play an important role in economic development. A well-functioning stock market would help privatizations by facilitating efficient valuation and allocation of state-owned assets among local and foreign investors. UK Law Commission, (1992). Other benefits that could be expected from developing equity markets include, facilitating foreign direct investments and other forms of foreign equity participation (Simons, 1993). Indeed, a well-functioning local market is a precondition for attracting foreign portfolio investments (FPIs).

In the wake of the financial crises in Mexico and South-East Asia, FPIs or highly liquid short-term capital has become practically a curse word in many developing countries. However, what has been clear in hind-sight is that the nature of the money itself was not the problem, rather the use of short-term or "hot" money for long-term or development projects ( a mismatch of maturities) provided the preconditions for crises (Perry, 1991). When combined with the penchant for borrowing in external currencies, generating income in local currencies within fixed rate regimes, and backed by implicit or explicit government guarantees, it now seems painfully

obvious that these economies were inherently unstable and destined to fall once the market became aware of their vulnerabilities. The tragic set of circumstances and how to avoid them in the future are now common knowledge among central, investment and commercial bankers (Bolton, 1996)

Miyote (1996) conducted a study on the causal relationship between financial development and economic growth from a time-series perspective considering data from 45 NSE firms over 7 years and demonstrate that the relationship is country-specific. Miyote measured financial development using two ratios; ratio of bank deposit liabilities to nominal GDP and ratio of bank claims on the private sector to nominal GDP. He found from the Engle-Granger results that at least one of the financial indicators is co-integrated with real GDP per capita in these firms. Anene (2011) did a study on the causal relationship between stock prices and foreign exchange performance. He used Granger causality test to establish a five year period, from 2006-2010 data. Anene established that the two variables (stock prices and foreign exchange) are cointegrated.

## **2.7 Summary**

The summary of the problem is that if the economic growth is to be enhanced as a vehicle for mobilizing capital for development, then all players in the scene must change their approaches. The stock exchange must play an increasingly educational role; the Capital Markets Authority as the regulatory agency must alter its approach from the sometimes heavy-handed type of control to a more proactive, creative and supportive role in order to assist in the creation of a more vibrant and forward looking capital market environment (Steinberg, 1996). This is underpinned by Efficient-Market Hypothesis Theory, Modern Portfolio Theory and Financial Investment

Theory The first hypothesis suggests that markets are information ally efficient when the economy is able to react to information by reflecting the same in the stock prices affected by the information (Dewatripont, 1995).

Modern Portfolio Theory suggests that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification - chief among them, a reduction in the riskiness of the portfolio (Barth *el al.*, 2000). Financial Investment Theory offers guideline on how investors should combine their financial assets to maximize return for a given risk thus emphasizing on the nature and mix of investment habits held (Harjoto, 2005). The literature suggests that capital market regulatory authorities can do stimulate economic growth by seeing itself as a catalyst in development rather than as a traditional conservative regulator.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This section discusses the research design, target population, research instruments, data collection and data analysis procedures that were used in this study. It discusses the methodology used to analyze the impact of investment banking development on economic growth of Kenya

#### **3.2 Research Design**

This was a descriptive study, according to Schinler and Coopers (2004) descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions. It serves a variety of research objectives such as description of phenomenon or characteristics associated with a subject population, estimates of proportions of a population that have these characteristics and discovery of associations among different variables

#### **3.3 Target Population**

This study was carried on investment banks in Nairobi and the population of the study will be all the 23 investment banks in Kenya (CBK, 2008).

#### **3.4 Data Collection**

Secondary data was used in this study, this was obtained from the NSE database and included Gross Domestic Product measured as the real GDP value generated within a given year; average commission fee charged by the investment banks in Kenya; the total number of investment banks in Kenya within the year; the total value of stocks traded or transacted within the year; the trading cycle within the investment market to measure the microstructure of investment markets.



The data was supplemented with data from various government publications such as the Central Bank of Kenya publications (Annual Bank Supervision Reports) and Central Bureau of Statistics data (Economic Surveys).

### 3.5 Data Analysis

The research is both quantitative and qualitative in nature. This implies that both descriptive statistics and inferential statistics were employed. Once the data is collected it was checked for completeness ready for analysis. The data from the field was first coded according to the themes researched on the study. Analysis was done with aid of the statistical package for social sciences (SPSS) package. Descriptive statistics generated such as percentages, mean scores and proportions were presented in tables and figures. Qualitative data from open questions was presented in prose.

### 3.6 Model specification

Granger causality test model (1973) was utilised to measure the linear causation between the impact of investment banking on economic growth of Kenya. Simple OLS (Ordinary Least Square) method was used to see the relationships. The detail of formulation of regression equations has been explained as below. Multiple linear regression model was used to test the impact of investment banking on economic growth of emerging markets. The model was of the form:

$$GDP = p_0 + p_1 IOM + \beta_2 JNV + p_3 MRT + \beta_4 CYC + s$$

Where

$I$   
GDP = Gross Domestic Product measured as the real GDP value generated within the year.

COM = Average commission fee charged by the investment banks in Kenya;

INV = The total number of investment banks in Kenya within the year,

MRT = The total value of stocks traded or transacted within the year;

CYC = The trading cycle within the investment market to measure the microstructure of investment markets;

$P_0$  = The regression model coefficient;

$P_1 - P_4$  = the regression model coefficients; and

$e$  = the regression model error term or significance.

## CHAPTER FOUR: DATA PRESENTATION AND ANALYSIS

### 4.0 Introduction

In this chapter, the study provided two types of data analysis, namely descriptive analysis and inferential analysis. The descriptive analysis helps the study to describe the relevant aspects of the phenomena under consideration and provide detailed information about each relevant variable. For the inferential analysis, the study used the Pearson correlation and the panel data multiple regression analysis.

While the Pearson correlation measures the degree of association between variables under consideration, the regression estimates the relationship between the impact of investment banking and economic growth. Furthermore, in examining if the investment banking is significantly different from that of economic growth, the Chi-Square Test statistics was used

### 4.1 Descriptive statistics

**Table 4.1 Evaluation of Investment Banks, 2011**

	<b>Average commission fee charged by the investment banks in Kenya</b>	<b>The total number of investment banks in Kenya within the year</b>	<b>The total value of stocks traded or transacted within the year</b>	<b>The trading cycle within the investment market to measure the microstructure of investment markets</b>	<b>Overall evaluation</b>
<b>NIC Capital Securities</b>	4.44	3.33	3.65	4.66	4.22
<b>Equatorial Investment</b>	4.88	3.34	4.22	5.33	4.13

<b>Bank</b>					
<b>ABC Capital</b>	<b>2.81</b>	<b>2.13</b>	<b>2.75</b>	<b>3.36</b>	<b>2.89</b>
<b>Sterling Investment Bank</b>	<b>3.66</b>	<b>4.11</b>	<b>3.58</b>	<b>4.22</b>	<b>3.16</b>
<b>Standard Investment Bank</b>	<b>4.553</b>	<b>4.22</b>	<b>3.22</b>	<b>0.922</b>	<b>2.679</b>
<b>Reliable Securities</b>	<b>1.522</b>	<b>1.344</b>	<b>0.96</b>	<b>1.399</b>	<b>3.647</b>
<b>Suntra Investment Bank</b>	<b>1.7466</b>	<b>1.354</b>	<b>0.67</b>	<b>1.388</b>	<b>3.974</b>
<b>Renaissance Capital Kenya</b>	<b>1.663</b>	<b>1.146</b>	<b>0.93</b>	<b>1.398</b>	<b>4.687</b>
<b>Faida Investment Bank</b>	<b>4.553</b>	<b>4.22</b>	<b>3.99</b>	<b>0.922</b>	<b>3.767</b>
<b>Equity Investment Bank</b>	<b>4.99</b>	<b>3.08</b>	<b>4.45</b>	<b>5.08</b>	<b>4.63</b>
<b>Kestrel Capital (East Africa)</b>	<b>2.81</b>	<b>2.13</b>	<b>2.75</b>	<b>3.36</b>	<b>4.89</b>
<b>African Alliance Investment Bank</b>	<b>3.66</b>	<b>4.11</b>	<b>3.58</b>	<b>4.22</b>	<b>3.16</b>
<b>Apex Africa Investment Bank</b>	<b>4.99</b>	<b>3.08</b>	<b>4.45</b>	<b>5.08</b>	<b>3.63</b>

<b>Dyer &amp; Blair Investment Bank</b>	<b>2.81</b>	<b>2.13</b>	<b>2.75</b>	<b>3.36</b>	<b>3.84</b>
<b>African Alliance Kenya Securities</b>	<b>3.66</b>	<b>4.11</b>	<b>3.58</b>	<b>4.22</b>	<b>3.33</b>
<b>Afrika Investment Bank</b>	<b>4.553</b>	<b>4.22</b>	<b>3.22</b>	<b>0.922</b>	<b>2.653</b>
<b>Genghis Capital</b>	<b>1.522</b>	<b>1.344</b>	<b>0.96</b>	<b>1.399</b>	<b>2.622</b>
<b>Drummond Investment Bank</b>	<b>3.66</b>	<b>4.11</b>	<b>3.58</b>	<b>4.22</b>	<b>3.16</b>
<b>Kingdom Securities</b>	<b>4.553</b>	<b>4.22</b>	<b>3.22</b>	<b>0.922</b>	<b>1.677</b>

The findings in Table 4.1 indicate that NIC Capital Securities, Equatorial Investment Bank, Renaissance Capital Kenya, Equity Investment Bank and Kestrel Capital (East Africa) have the most overall investment performance. This better performance means that they also contribute highly to the economic growth through advancing of investment loans and securities to the public sectors.

Table 4.2 relates investment banking indicators with the economic growth measure. It shows significant relationship between the two. The correlation coefficients for economic growth are much higher than those of investment and saving rate.

**Table 4.2 Relationship Between Economic Growth Indicators and Banking Investment Indicators**

Variables	GDP	INV	SAVING
COM	0.478	0.183	0.120
INV	0.133	0.192	0.015
MRT	0.421	0.101	0.096
CYC	0.262	-0.053	-0.042

Regression results indicate a significant relationship between economic growth and investment banking variable but not with the non-investment banking variable. More specifically, investment banks and the average commission fee charged by the investment banks in Kenya are highly significant. When the total number of investment banks in Kenya within the year is considered the study find significant relationship with the overall measure of economic growth and also with the trading cycle within the investment market to measure the microstructure of investment markets while the economic factors were GDP and Deposit/GDP (savings).

The economic growth model performed better when other factors are included. The non-financial factors that showed significant relation include the average commission fee charged by investment banks in Kenya, the number of investment banks at a given period in an economy and the trading cycle within the investment market to measure the microstructure of investment markets. The findings shows that the higher the level of investment the higher the level of economic growth. Keeping cost of doing business low and strengthening the infrastructure will increase economic growth.

**Table 4.3 Regression Results - GDP Growth Model**

Vanables	GDP	INV	SAVING
Constant	-0.212	-0.044	-33.283
GDP	0.307	0.305	0.408
COM	0.503	0.503	0.272
INV	-0.506	-0.331	-0.414
MRT	0.313	0.205	0.490
CYC	0.4556	0.2998	0.3668
R2	0.4058	0.4037	0.4812
Adj-R2	0.3552	0.3530	0.4120
F	8.0243	7.9549	6.9566

**Table 4.4: Summary Statistics of Regression Model**

Statistic	GDP	INV	SAVING
R-squared	0.948	0.79	0.71
Adjusted R-squared	0.937	0.77	0.70
F-statistic	90.79	45.34	59.59
Probability(F-stat)	0.000	0.000	0.000
DW statistic	1.877	1.12	<u>1.39</u>

The R2 is a measure of the goodness of fit of the investment banking-sectoral indicators variables in explaining the variations in economic growth. This means the variables jointly explain about 95% of the variation in the economic growth

Thus these variables collectively, arc good explanatory variables of the economic growth in Kenya The null hypothesis of F-statistic (the overall test of significance) that the R2 is equal to

zero was rejected at 1% as the p-value was sufficiently low. Secondly the D.W. statistic was about 1.88 implying that there was no serious evidence of serial correlation in the data

**Table 4.5 Relationship Between Investment Banking and Economic Growth (GDP) - Correlation**

<u>Variable</u>	<u>Economic growth (GDP)</u>
Average commission fee charged by the investment banks in Kenya- Pearson Correlation	0.732 0.00<)
Sig. (2-tailed)	23
N	
The total number of investment banks in Kenya within the year- Pearson Correlation	0.702 0.024
Sig. (2-tailed)	23
N	
The total value of stocks traded or transacted within the year- Pearson Correlation	0.622 0.016
Sig. (2-tailed)	23
N	
The trading cycle within the investment market to measure the microstructure of investment markets- Pearson Correlation	0.644 0.033
Sig. (2-tailed)	23
N.	

The analysis above shows that average commission fee charged by the investment banks in Kenya has the strongest positive (Pearson correlation coefficient =.732; P value 0.000) influence on economic growth. In addition, the total number of investment banks in Kenya within the year as well as the total value of stocks traded or transacted within the year are positively correlated to economic growth (Pearson correlation coefficient =.702 and .622).

Further the study compounded the four sub-factors into the major variable (impact of investment banking) and the economic growth and carried out a correlation for the two. The study findings are as shown below



**Table 4.6 Investment Banking Versus Economic growth**

	<u>Economic growth</u>
Investment banking measures- Pearson Correlation	0.772
Sig. (2-tailed)	0.000
N	23

A Pearson coefficient of 0.772 and p-value of 0.000 show a strong, significant, positive relationship between investment banking and economic growth. Therefore basing on these findings the study rejects the null hypothesis that there is no relationship between investment banking and economic growth and accepts the alternative hypothesis that there exists a relationship between investment banking and economic growth

## CHAPTER FIVE

### SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

#### 5.0 Introduction

The objective of this chapter is to discuss the findings, reach conclusion and make necessary recommendations from all the qualitative and quantitative analysis presented in chapter four

The chapter is structured into five sections as follows: section 5.1 summarises the research objectives and the analysis, section 5.2 presents the theoretical and empirical findings, section 5.3 covers the conclusion while section 5.4 and 5.5 covers the sections for recommendations and suggestions for further study.

#### 5.1 Summary

The multiple regression analysis has shown that investment banking is not only related to the economic growth, but they also influence the economic growth in Kenya significantly IZlyor, (2009) argued that well capitalized investment banking have a stronger influence on economic growth The analysis revealed that the total value of stocks traded or transacted within the year is the most robust and important factor influencing economic growth. The results showed that a 1% increase in the total value of stocks traded or transacted within the year could result in 0.076% increase in economic growth

This was statistically significant at 1% (5 464) confidence level. The same statistically significant and positive impact was found in the sample of small and medium investment banks,

and large investment banks. Similar results were also found by Neceur (2003) when evaluating the determinants of economic growth in Tunisia. Suffian and Chong (2008) also reported the same results after examining the impact of investment banking on the performance of GDP in Philippines.

This result means investment banking should focus on improving their capital levels in order to improve their investment support in the country. This will enable the investment banks, not only to be cushioned against exogenous shocks, but also to take full advantage of business opportunities as they come and increase their profitability in process. Thus this finding provides support to the argument that well capitalized investment banks face lower cost of bankruptcy and lower need for external funding especially in emerging economies where external borrowing is difficult and costly. It also provides evidence that supports the CBKs move to gradually increase capital levels by 2012.

The trading cycle within the investment market to measure the microstructure of investment markets was also found to be the next critical factor influencing economic growth. The study found that a 1% increase in the trading cycle within the investment market to measure the microstructure of investment markets could result in 0.068% increase in economic growth and this finding was statistically significant at 1% (-16.972) level. Flamini et al (2009) and Neceur (2003) also found the same results for SSA and Tunisian investment banks respectively. The importance of the number of investment banking in a given year cannot be over emphasized in this study. The descriptive analysis of this factor showed that the number of investment banking contributes as high as 65.84% of the overall GDP on average in the country. It is therefore

obvious that a lot needs to be done to increase the number of investment banking in the economy to improve the economy. The strong negative impact of CIR indicates that investment banks are not able to pass all their operating cost to customers which may be an indicator of the competitiveness and lack of market power in the sector

## **5.2 Conclusion**

The main objective this study was to determinate the impact of investment banking on the economic growth in Kenya Panel data from 2006 to 2011 of 23 investment banks was analyzed using multiple linear regressions method. From the discussion of the findings above, it can be concluded that the investment banks indicators are the most significant factors influencing the economic growth in Kenya. The study revealed that efficient investment banking in the general economic growth are those that strive to; improve their capital bases, reduced operational costs, improve assets quality by reducing the rate of non-performing loans, employ revenue diversification strategies as opposed to focused strategies and keep the right amount of liquid assets. Indeed the descriptive analysis of these factors by number of investment banking showed that large investment banks perform better than the small and medium investment banks hence the superior in the general economic performance

## **5.3 Policy Recommendations**

Thus it can be recommended that economic growth in the Kenya is largely driven by investment banking performance. Another important finding is the average commission fee charged by the investment banks in Kenya This factor had a positive effect of 0.017 (2.456), statistically significant at 5% confidence level. It was statistically significant in large investment banks and

in the small and medium investment banks. Investigating the relative importance of investment banking on the profitability of banks operating in developed, advanced emerging, secondary emerging and frontier markets, Uzhegova (2010) also found that income diversification leads to increased profitability and the general improvement in economic growth.

This means that investment banks that diversify their source of revenue between, interest income, fees and commissions, foreign exchange activities and other, are more beneficial to economic growth than that largely depend on a single source of income. This is line with argument that diversification provides a stable and less volatile income, economies of scope and scale, and the ability to leverage managerial efficiency across products (Chiorazzo *et al*, 2008).

#### **5.4 Limitations of the Study**

Time was a major constrain in undertaking this study. This left out valuable contribution from the respondent's views who are involved in the day-to-day duties in these investment banks. This was mainly as a result of failure to collect primary data on the experiences of investment bank managers. However it has taken into account other views alongside theoretical analysis. Financial resources was a limiting factor as it would have been prudent to employ a number of assistants in collecting data for at least ten years period.

Citing prior research studies forms the basis of literature review and helped to lay a foundation for understanding this study though there was hardly any earlier local scholar on this study topic hence self-reported data is limited by the fact that it rarely can be independently Verified.

Limited Access to information and resources of Gross Domestic Product measured as the real GDP value generated within a given year; average commission fee charged by the investment banks in Kenya, the total number of investment banks in Kenya within the year; the total value of stocks traded or transacted within the year this study depends on having access to people,

organizations, or documents and, for whatever reason was limited However the research collected all the secondary data that was accessible to the researcher

### **5.5 Suggestions for Further Studies**

There is need for further studies to carry out similar tests for a longer time period. A similar study should also be carried out on MFIs with cost as the proxy for economic growth to try and assess whether the impact of MFIs on economic growth in Kenya is drastically altered by the change of variables.

Given that a good chunk of the studies touch on investment and economic growth, there is need to ascertain the relationship between each independent variable themselves such as Gross Domestic Product measured as the real GDP value generated within a given year; average commission fee charged by the investment banks in Kenya; the total number of investment banks in Kenya within the year; the total value of stocks traded or transacted within the year; the trading cycle within the investment market to measure the microstructure of investment markets.

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## **Appendix I: List of Investment Banks**

### **Investment Bank**

1. Renaissance Capital Kenya
2. Dyer & Blair Investment Bank
3. Kestrel Capital (East Africa)
4. CFC Stanbic Financial Services
5. Standard Investment Bank
6. African Alliance Investment Bank
7. Faida Investment Bank
8. African Alliance Kenya Securities
9. Apex Africa Investment Bank
10. Dry Associates
11. Afrika Investment Bank
12. Suntra Investment Bank
13. Sterling Investment Bank
14. Genghis Capital
15. NIC Capital Securities
16. Equatorial Investment Bank
17. Reliable Securities
18. Durmmond Investment Bank
19. ABC Capital
20. Kingdom Securities
21. NIC Capital
22. Equity Investment Bank