Unpacking Investment Banking

BY RICHARD MANGI

Introduction

As we continue with our series that is focusing on understanding the role of major players in the capital markets and investment in general, today's interview was on the role of Chengetedzai Depository Company. I sat down with the Chief Executive officer of the company, Campbell Vincent Musiwa (CVM) and below is a summary of the interesting and insightful interview I had with CVM.

CHENGETEDZAI DEPOSITORY COMPANY –INTERVIEW (16/05/2017)

RM: ***Who is Chengetedzai Depository Company ("CDC") and what is your primary mandate?***

CVM: CDC is a Central Securities Depository ('CSD') which won a tender to establish the first central depository in Zimbabwe. The CDC platform went live in the year 2014. The primary role of the depository is to cater for the post-trade function for financial securities. This involves the clearing and settlement aspect of exchange traded transactions as well as the over-the-counter (OTC) trades. CDC maintains an electronic register for securities such as bonds, derivatives and equities, which are the most common. Basically, any instrument that can be stored safely on the CSD becomes a security. The CSD therefore facilitates the transfer of ownership of the securities between parties and provides electronic safe keeping of securities. All trades satisfactorily concluded are cleared and settled on the CSD platform.

RM: How are investors benefiting from the services offered by CDC that they were not enjoying before you came into being?

CVM: The main benefit is that the operating environment has become much safer compared to the past. In the physical environment, securities can be stolen, defaced or manipulated. The processes put in place by CDC have provided security through the various independent parties that are involved including transfer secretaries and custodians; hence, whatever comes on the CSD platform is authenticated, safe and secure.

Secondly, the issue of the reduction in the settlement cycle has improved the settlement process. Previously, settlement in Zimbabwe was based on a T+7 cycle (with T being the trading day which represents day zero, and the sum thereof representing the total days until settlement). In reality, actual settlement was more than the advocated T+7, with some reported cases of settlements taking up to 6 months. At the time the CSD was implemented, most countries were operating on a settlement timeframe of T+3. In our initial stage of implementation we reduced the settlement cycle to T +5 and with effect from 2 May 2017 the time frame was further reduced to T+3. This has effectively mitigated liquidity and counterparty risk.

There has also been a notable reduction in settlement risk through the introduction of Simultaneous Delivery Versus Payment. This in simple terms denotes a cash on delivery mechanism which ensures that cash as well as the shares are available before any transaction is concluded.

Additionally, prior to the introduction of the CSD, there was laxity in market discipline. We have now significantly improved the market discipline through the introduction of a Penalties Framework which penalizes any participants not adhering to the set Business processes. This has had a remarkable effect on market efficiency as evidenced by the fact that since the introduction of the Penalties Framework only 3 defaults have occurred in the market.

The creation of the CSD platform also ushered the introduction of an Automated Trading Platform (ATS) by the Zimbabwe Stock Exchange. Brokers can now trade from the comfort of their office. The ATS is a platform that caters for automatic online trading of shares using price-time priority order matching to obtain the best price for investors. Thus, the market benefits from more transparency and efficient pricing of securities, reduced bank charges, time-saving and lower costs related to travelling to the exchange's location. Broker expenses have also declined as a result of decreased back-office staff as everything can now be done automatically from the trading platform.

There has been further reduction of risk through the use of Central Bank money which is one of the most secure ways of settlement as recommended by the International Organization of Securities Commissions (IOSCO). When the CSD was introduced we commenced settlement through our commercial banks using CBZ Bank, Stanbic Bank and ZB Bank as settlement banks. However, international best practice dictates that this function be handled at Central Bank level due to stringent controls and the demand on clearing banks to place collateral security with the Central Bank.

RM: ***What instruments outside of equities would you like to see being traded more in the local financial markets and what is CDC doing to encourage trading of these?***

CVM: We would like to see Fixed Income instruments cleared and settled on the CSD. On the 26th of April 2017 we had the first bond listed on the ZSE and the same will be cleared and settled on the CSD. Getbucks Financial Services Limited issued a Bond of USD5,4 million which will increase gradually to USD30 million over the next three years. Our desire is to see more Fixed Income instruments such as bonds being listed on the ZSE which will be cleared and settled on our platform. We have started talking to stakeholders regarding the on-board of more of these products. In the long term, we would want to also bring onboard Treasury Bills as these are common for funding infrastructure projects in other countries. We also hope to see a commodities exchange whose warehouse receipts will be traded on the exchange, cleared and settled on the CSD. This will ultimately improve liquidity in the market. In terms of financial inclusion we would like to see retail investors opening accounts and trading securities, inclusive of bonds, on mobile and internet platforms.

RM: ***What could be done to improve the current difficult investment environment?***

CVM: One of the difficulties being faced in Zimbabwe relates to the low trading volumes on the Stock Exchange, with one of the main reasons being the lack of participation by the foreign investors. Foreign investors are exiting the market, due to challenges in the failure to remit share sales proceeds as well as dividend payouts. We also want to see an overall reduction in transaction costs. The overall transaction costs at 4,136 %, with a flat fee of 1% for capital gains which is calculated on the value of trade and not on the gain, is still considered expensive in relation to other regional levies.

Currently, the GMB issues warehouse receipts in a physical form, but in the long run we would want to see these being automated and also traded by farmers who can also utilize these as collateral when borrowing from banks, which ultimately can improve liquidity through discounting.

Improved transparency within the capital market will go a long way in making our market more attractive.

RM: ***What other fees are charged within the transaction fee?***

CVM: CSD receives a levy of 0.1% per transaction leg, the Zimbabwe Stock Exchange ('ZSE') has a similar fee of 0.1% per transaction leg, the brokers charge 0.92%, the Investor Protection Fund which is under the custody of the Securities and Exchange Commission of Zimbabwe ('SECZ') receives 0.025% and SECZ receives 0.16% of the transaction value. Taking into account capital gains tax, the overall costs of buying and selling comes to 4,136 %.

RM: ***CDC's work is important in ensuring trades happen. What is CDC doing to improve market efficiency?***

CVM: The reduction in the settlement timeframe to T + 3 has greatly improved efficiency. We envisage that in the medium term we will migrate from a T +3 to a T+2 settlement timeframe.

When we moved to the use of central bank money last year, we also changed our Delivery Versus Payment ('DVP') model from DVP model 1 to DVP model 2. In DVP model 1, there is settlement of gross amounts and gross equities between common parties, as opposed to DVP model 2 which utilizes netting off of cash whilst shares are settled on a gross basis. Before the end of the year the CSD will be migrating to the DVP model 3 which will introduce both the netting off of cash and securities.

SECZ will soon be spearheading a massive awareness campaign which will involve all key market participants as a measure of improving accessibility to the Zimbabwean Capital markets. The participants will go on a country wide campaign to encourage participation by the retail investors who will be given access to open accounts and to trade on the local bourses. We are also emulating what is happening in Kenya, Ghana and Nigeria in respect of financial inclusion. In Kenya, they came up with an instrument called M-Akiba specifically to cater for indigenous retail investors' participation on the Stock market through the use of mobile platforms. The success of this project was overwhelming as the offer was fully subscribed before the closing date. This demonstrates how retail investors can actively participate in the capital market and assist in the building of the country's infrastructure.

RM: ***Give us some statistics on the usage of the central depository? Are you happy with the levels of participation in the financial markets? Have we seen an upward trajectory of trades going through your platform since 2014?***

CVM: There has been a notable increase in investor participation in other markets that introduced a CSD; however, this has not been the case for Zimbabwe as trades are actually decreasing. When we initially went live in 2014, ZSE trade volumes were in the region of USD 39 million per month and in the following year monthly trades came down to an average of USD 22 million. In the year 2016, we recorded an average of circa USD16 million trades and we are presently projecting an average of USD12 million per month in trades for the year 2017. This has a lot to do with the economic fundamentals. We have opened 15,000 accounts since going live in 2014, with 92% attributable to the local investors and 8% to foreigners. In terms of value, foreigners are actually the biggest investors. Shares placed on the CSD, as at 30 April 2017 were valued at USD 1.75 billion against a market capitalization of USD 4.198 billion. The dematerialisation statistics are envisaged to improve due to other initiatives being undertaken to encourage large financial institutions to place their shares on the CSD. Given the custodial model that we introduced, a number of investors still feel it will be expensive to come onto the platform. However, we have come up with a model that will cater for the needs of the institutional investors who might want to come and place their shares on the CSD for safekeeping as opposed to trading.

RM: ***Is it not mandatory for shares to be dematerialised?***

CVM: No, it is not. What is mandatory is that all trades must be undertaken on the exchange. If any investor wants to trade he or she must bring securities on the CSD through the dematerialization process. In the event that, after a disposal of shares, someone would like to convert the remaining shares into a physical certificate, this can be achieved through a process called rematerialized. Naturally, we do not encourage the rematerializing process as our view is that the CSD is a much more secure environment.

In other countries they have come up with laws that will compel investors to dematerialize their shares irrespective of whether or not they are going to be traded. In Zimbabwe, this law is not yet in place. The average dematerialization ratio across all the ZSE listed counters is currently 34%. If we look at the top 20, they are above 43%. We have 14 counters that have gone above the 50% dematerialization ratio. Trades that have been processed live on the CSD platform are 20,264 in volume with a total value of USD909 million since we started.

RM: ***Financial inclusion is a big topic currently, what role are you playing in improving financial market access to those who don't have access presently?***

CVM: At inception we adopted the custodial model where the Know Your Customer ('KYC') services are dealt with at custodial level. However, we observed that there was low participation from the ordinary investors as they could not afford the monthly custodial service fees. In that regard, we introduced a Broker Controlled model which allows an individual to go straight to a broker who is approved by CDC to open accounts and to trade on the Exchange. A number of Brokers have registered with us and are for carrying out the KYC checks on customers and to open accounts on behalf of retail investors. The investor is not charged for this service unless they trade, and upon trading a nominal fee of USD2.00 is charged.

We provide informative seminars where schools come to learn about the activities of the CSD. This is normally followed by a visit to the ZSE were the investors are also shown how the ATS platform operates.

The introduction of a mobile trading platform will go a long way in addressing the issue of financial inclusion.

RM: ***In view of the fact that the local market is faced with low market and investor activity, what is the minimum level of shares that should be traded on the ZSE that would ensure sustainability of the operation?***

CVM: After an extensive downsizing of our operations and assuming that we are relying on the ZSE trades alone, we would require a market turnover of USD25 million per month in order to break even. The exchange is however trading below this level. Our focus, in conjunction with other players in the market is to revive the commodities market which will play a pivotal role in increasing volumes and ultimately, revenues. We are also actively working on broadening our product range through the introduction of Fixed Income products

RM: ***What funding mechanisms are in place to fund operations of the company? What capital expenditure is required to put CDC at par with other African depository companies?***

CVM: The initial capital injection came from the shareholders and went a long way towards the provision of working capital as well as funding of the acquisition of hardware and software. The shareholders have subsequently participated actively in rights issues to grow the business. A Government directive to ensure that a minimum stake of 51% of the company is owned by quasi government saw some key financial institutions become part of the shareholding structure. Going forward, in the absence of an active market, we do not envisage further rights issues but perhaps some tradable and redeemable quasi-debt instrument which will not be convertible in order to avoid dilution. It is important to note that in most countries, the CSD is funded by the government and in other cases by multilateral institutions. These institutions have funded both the system and the hardware infrastructure. In our case we self-funded, which is quite remarkable. CSDs are mostly geared towards building a strategic and affordable key market infrastructure and have a long gestation period.

We implemented a system which came from a vendor who was able to show case a number of AAA rated CSD installations. The system in place is robust and capable of meeting any demand. There are some areas that are highly specialized that will require some level of customization and thus will require capital outlay in the future. We believe that the infrastructure that we have put in place is world class and this is evident from the A-rating that we received from Thomas Murray, the global CSD rating agency.

The need to maintain and secure additional hardware for our infrastructure will remain a critical aspect of our strategic focus.

RM: ***If an issuer wants to list a security on the CDC platform in Zimbabwe, what is the procedure?***

CVM: The company's Board of Directors are required to pass a resolution in terms of Section 17 of the Securities Act, authorizing the issue of securities in dematerialized form or allowing the conversion of certificated securities into dematerialized securities. SECZ came up with this requirement as the Companies Act did not have any provision for uncertificated shares nor the dematerialization process. Thereafter, CDC, the issuer and their transfer secretary will be required to enter into a tripartite agreement governing the relationship between the parties. Once the agreement has been signed the company will submit its KYC documents for approval to the CSD. A once-off onboarding fee of USD1,000 is charged and ZSE will issue an International Securities Identification Number (ISIN) that is unique to the security.

RM: ***How are Zimbabwe's financial markets and the CSD placed vis-à-vis regional and global counterparties with regards to the use of technology?***

CVM: We are a member of the Africa and Middle East Depository Association ('AMEDA') which meets every 6 months. AMEDA provides a platform for sharing of ideas and is one of the 5 global bodies representing the World Forum of CSDs. The global body meets once every 2 years. This has helped CDC in terms of implementation and strategy formulation. The implementation of the CSDS is driven by the need to adopt and adhere to international best practices. Technology wise, we are lagging behind in terms of giving investors access via the internet, something that we are currently working on. The A-rating given to us by Thomas Murray, in my opinion is most commendable and places CDC amongst a number of well-run CSDs, regionally and globally.

RM: ***Is there scope for CSDs to integrate in the SADC region?***

CVM: The Committee of SADC Stock Exchanges ('CoSSE'), of which the ZSE is a member is actively looking at issues relating to regional standardization as well as the integration of operations within SADC for the facilitation of cross border trades. The CSD is not a member of CoSSE but has actively participated in some of the dialogue relating to the standardization and integration of the regional CSDs and Exchanges.

RM: ***In many markets we have more issuers coming on to the market. What do you think is the biggest challenge facing the economy, in general and the financial markets in particular that is preventing the same from happening in Zimbabwe?***

CVM: The main challenges for the financial markets include delistings, limited growth opportunities for listed companies, the informalisation of the economy and the foreign currency shortages particularly in the area of remittances. Some listed companies are being forced to delist due to financial constraints. Due to the prevailing economic challenges there are limited growth opportunities for small companies growing into large companies, resulting in a low number of new listings. The informalisation of the economy has also negatively impacted on the profitability of the formal businesses as some companies have lost customers to the less regulated and cheaper informal sector.

More issuers, especially foreign companies, need be lured to come onto the capital market through processes that encourage the ease of doing business. This can be augmented by mechanisms and policies that encourage local savings and investment.

RM: ***As an important pillar of the country's financial markets, what role do you see CDC playing in the economy and for ease of doing business over the next 2-5 years?***

CVM: We have put in place a world-class financial infrastructure working with a vendor who has a foot print spanning over 50 countries. The vendor has key strengths in terms of integrating a wide variety of financial products as well as linking infrastructures to central banking and other external systems. Going forward, we want to ride on this experience to put in place a robust platform which will allow a number of exchanges, local and external to clear and settle their trades on the CSD. We want our infrastructure to attract foreign investors. If we look at America for example, they do not allow their local investors to invest in countries that do not have CSDs. We have now opened up possibilities for other restricted markets to look favourable at investing in Zimbabwe.

The CSD will also be at the forefront of efforts to broaden the capital market as the company leverages on its infrastructure to introduce new products within the market. This will further enhance the companies' fundraising abilities.

RM: ***What has CDC as an organization learnt in the last few years that will inform the organisation in the years going forward?***

CVM: When implementing any project, it is important to first understand how others have done their projects, establish what mistakes have occurred, what where the successes and then try to improve on what you have learnt in order to get a better product. There is a need to be very systematic during the planning process. All stakeholders must be involved to ensure that whatever is implemented in a project of this magnitude is acceptable to all market participants. Market feedback and stakeholder engagement have helped us immensely in our implementation processes and in determining the best way of moving forward.

RM: ***Any other areas you would want to sensitise the market about in respect of CDC?***

CVM: There are certain products we would like the market to be aware of, such as the pledging system that we have implemented which is well articulated fully on our website. The Borrower will instruct the CSD to pledge the shares to the Lender whereupon the CSD will lock the shares and quarantine the shares from trading on the ATS. The shares will only be unlocked when the lender confirms in writing that the borrowed funds have been fully paid. We are actively developing new products will keep the market informed of the new developments. At the moment we are working on the introduction of the lending and borrowing facility within the system.

RM: Thank you so much Campbell for sharing with us and the investing public on the functions of CDC, the journey it has travelled so far and the big plans you have going forward. We wish you all the best in your endeavors.

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