

**REGULATION OF ASSET-BACKED SECURITIES IN KENYA: A  
COMPARATIVE ANALYSIS**

**BY**

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## TABLE OF CONTENTS

TABLE OF CONTENTS.....	i
DECLARATION OF ORIGINALITY .....	ii
DEDICATION.....	iii
LIST OF ABBREVIATIONS.....	v
SUMMARY .....	vi
ACKNOWLEDGEMENT .....	vii
Chapter One: Introduction .....	1
1.1. Background of the Study .....	1
1.2. Problem Statement.....	2
1.3. Research Questions.....	3
1.4. Literature Review.....	3
1.4.1. Books and Theses .....	3
1.4.2. Online Sources .....	4
1.4.2.1. Papers.....	4
1.4.2.2. Websites.....	5
1.5. Limitations .....	5
1.6. Research Methodology .....	5
1.7. Chapter Summary .....	5
1.8. Conclusion .....	6
Chapter Two: General Global Practice in Asset-backed Securities Transactions and Securitisations.....	7
2.1. Introduction.....	7
2.2. Securitisation.....	7
2.2.1. Benefits of Securitisation.....	7
2.3. The Securitisation Process .....	8
2.3.1. SPV Structure.....	9
2.3.2. True Sale .....	11
2.3.3. Credit rating .....	12
2.3.4. Set-off and Netting.....	13
2.4. Conclusion .....	14
Chapter Three: A Comparative Review of Kenya’s Regulatory Framework for Asset-backed Securities.....	16
3.1. Introduction.....	16
3.2. Kenya.....	16



3.2.1. Capital Markets Act .....	16
3.2.2. Capital Markets Regulations and Guidelines.....	20
3.2.2.1. Capital Markets (Asset Backed Securities) Regulations, 2007 .....	20
3.2.2.2. Draft Guidelines on Issuance of Asset Backed Securities .....	20
3.2.3. Other Legislation .....	21
3.2.3.1. Income Tax Act.....	21
3.2.3.2. Companies Act, 2015 and Insolvency Act, 2015.....	22
3.2.3.3. Stamp Duty Act.....	22
3.2.4. The Draft Movable Property Security Rights Bill, 2016 .....	23
3.2.5. County Policy Guide on Asset Securitization.....	24
3.3. Comparative Approaches to Securitisation Regulation .....	25
3.3.1. United Kingdom.....	25
3.3.1.1. True Sale and Bankruptcy-remoteness .....	25
3.3.1.2. SPV Structure.....	26
3.3.1.3. Taxation .....	26
3.3.1.4. Market Infrastructure .....	26
3.3.2. South Africa .....	27
3.3.2.1. SPV Structure.....	27
3.3.2.2. Bankruptcy-remoteness.....	28
3.3.2.3. True Sale .....	28
3.3.2.4. Taxation .....	29
3.4. Conclusion .....	29
Chapter Four: Opportunities for and Challenges to Reform.....	30
4.1. Introduction.....	30
4.2. Appraisal of Kenya’s Legal Framework.....	30
4.3. Opportunities for Reform.....	31
4.3.1. Preference for transfer by equitable assignment.....	31
4.3.2. Permitting choice in SPV entity.....	31
4.3.3. Tax Reform .....	31
4.3.4. Deepen the debt markets.....	32
4.4. Possible Challenges to Reform .....	32
4.5. Conclusion .....	32
Bibliography .....	33

## **DECLARATION OF ORIGINALITY**

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J. Mutugi Mutegi

Signature of supervisor:

.....

Prof Monray Marsellus Botha

## **DEDICATION**

To the enigma that was and still is Mutegi Kiriga Kabugu, and the equally astute Beatrice Karimi Mutegi.

## **LIST OF ABBREVIATIONS**

CMA – Capital Markets Authority

IOSCO – International Organization of Securities Commissions

IAS – International Accounting Standards

IFRS – International Financial Reporting Standards

CBK – Central Bank of Kenya

ABS – Asset-backed Securities

CRA – Credit Rating Agency

SPV – Special Purpose Vehicle

UNCITRAL – United Nations Commission on International Trade Law

LLP – Limited Liability Partnership

## **SUMMARY**

Kenya has had a substantive legal framework for asset-backed securities (ABS) since 2007 but is yet to see its first ABS issuance to date. The Capital Markets Act, Chapter 485A, Laws of Kenya, as well as the Capital Markets (Asset-backed Securities) Regulations, 2007 have been decried as being inadequate; but without significant study into the legal and regulatory inequities thereof.

ABS are securities that entitle investors to a return principally based on the cash-flows attributable to underlying securitised receivables. Such receivables may include mortgages, car and student loans, which when amassed may pose liquidity challenges to their originators. Thus an efficient ABS market would provide diverse wider financing options for originators and possibly ease access to credit.

This dissertation then seeks to investigate the failings of Kenya's regulatory landscape on ABS, with a focus on the intricacies of the true sale of the receivables, choice and structuring of special-purpose vehicles (SPVs), bankruptcy-remoteness of SPVs, taxation obligations and other legal and policy perspectives.

The review is compared against the lessons gleaned in Africa's largest securitisation market, South Africa, while recognising the difference in legal systems with Kenya. The United Kingdom is an additional comparator due to the common law similarities as well as the development of its capital markets.

The dissertation identifies key conflicts and ambiguities in Kenya's ABS framework, as well as critiquing current attempts at remedying them. Summarily, it provides an unexplored view into the potential workings of ABS as a source of finance in Kenya.

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## Chapter One: Introduction

### 1.1. Background of the Study

The Nairobi Securities Exchange is the largest bourse by market capitalisation in Eastern Africa and third in size in Africa<sup>1</sup> and arguably one of the most highly developed on the continent with a wide range of existing and emerging products. These financial products, including asset-backed securities, derivatives, real-estate investment trusts and more, demand adequate legislation and policy guidance that not only regulates but also promotes their development.<sup>2</sup>

With an in-depth understanding of the application of relevant laws and policies in the capital markets, an enhanced approach can then be adopted to promote the Kenyan capital markets and other frontier markets.

Asset-backed securities (ABS) are a product of securitisation; a process that entails the pooling and sale of receivables held by an entity to a bankruptcy-remote third-party called a special-purpose vehicle (SPV)<sup>3</sup> and the issuance of marketable securities by this entity to finance the purchase of the receivables.<sup>4</sup> Kenya's Capital Markets Act<sup>5</sup> defines ABS as:

- (a) any securities including promissory notes but does not include shares or entitlements under a collective investment scheme,
- (b) any rights or interests, debentures or certificates evidencing the legal, equitable or beneficial interest or entitlement of its holder to a share of the assets of a special purpose vehicle or entitlement to payment from such assets where payments or distributions of capital, income, principal or interest to investors accrue principally from the assets of the special purpose vehicle as a consequence of the establishment or operation of a securitisation transaction; and
- (c) any other right, interest, instrument of security or class of securities prescribed to be asset-backed securities.<sup>6</sup>

The securitisation process enables the original holder of the receivables (the “originator”) to get immediate funding from the sale of these assets to an SPV,<sup>7</sup> thus providing liquidity.<sup>8</sup> Securitisation also assists entities to meet capital adequacy requirements that may be demanded in their specific industries.<sup>9</sup> This is especially significant in the financial industry, for example, with banks and insurance companies, as seen by recent moves by regulators in Kenya's banking

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<sup>1</sup> Central Intelligence Agency ‘Kenya - CIA World Factbook’ available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ke.html>, accessed on 1st April 2016.

<sup>2</sup> International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (2003) 8.

<sup>3</sup> Bankruptcy-remote has can also be termed as “insolvency-remote”. Some scholars and judicial decisions differ on this; see D Muñoz, ‘Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 1): changing the focus on vehicle shielding’ (2015) 10 *Capital Markets LJ*, 5 (“Vehicle-shielding”). For the sake of consistency, the term “bankruptcy-remote” shall be used for this research.

<sup>4</sup> Locke, *Aspects of Traditional Securitisation in South African Law* (LLD Thesis, UNISA 2008) 29.

<sup>5</sup> Chapter 485A, Laws of Kenya (CMA Act).

<sup>6</sup> CMA Act, s 30H.

<sup>7</sup> Gullifer and Payne, *Corporate Finance Law: Principles and Policy* (2011) 35. (“Corporate Finance”)

<sup>8</sup> Ingram, ‘If securitization is dead, why do so many government schemes use it?’ (2009) 4(4) *Capital Markets LJ* 462, 465.

<sup>9</sup> Locke *Aspects* 3. See also Wood, *Project Finance Securitizations, Subordinated Debt* 2 ed (2007) 167-169.

and insurance sectors to raise their licensees' capital requirements.<sup>10</sup> These requirements in Kenya were met with vigorous capital raising initiatives across the board<sup>11</sup> but the issuance of asset-backed securities was starkly amiss.

## 1.2. Problem Statement

This absence sparks interest because Kenya has had enabling legislation for the issuance of ABS. The Capital Markets (Asset Backed Securities) Regulations<sup>12</sup> have been in force since 22<sup>nd</sup> October, 2007, being subsidiary legislation of the CMA Act.<sup>13</sup> However, practitioners and academics have posited that these legislation and regulations are a hindrance to ABS issuance in Kenya.<sup>14</sup> Given the complexity of these transactions, this hindrance may thus not only lie in the CMA Act and its regulations but also in other tax and commerce related laws.

Some academic studies into the Kenyan situation have indeed pinpointed the legal framework as a potential stumbling block.<sup>15</sup> Many obstacles observed fall within the ambit of economic rather than legal study and include accounting standards,<sup>16</sup> and the market's risk aversion.<sup>17</sup> Such observations, though revealing, do not provide a conclusive legal analysis of any existent obstacles or possible remedies thereto. Hence, this research affords a unique window through which to view the regulation and promotion of ABS in Kenya.

Given the globalised nature of capital markets<sup>18</sup>, benchmarking of domestic legislation and regulation against international best standards cannot be gainsaid. In so doing, it is however essential to keep in mind that such domestic regulation is distinguishable across jurisdictions and is usually based on latent factors such as historical development.<sup>19</sup> This necessitates benchmarking against relatable jurisdictions. Kenya, as a product of its British colonial history, has received portions of English law into its own<sup>20</sup> and a significant portion of statute law is based upon repealed or operational English statutes.<sup>21</sup>

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<sup>10</sup> Through the Finance Act, No. 14 of 2015, the Insurance Act has been amended to demand greater risk-based minimum capital requirements for licensed insurance companies. Similarly, the Second Schedule of the Banking Act (Chapter 488, Laws of Kenya) was amended in 2008 to require all licensed banks to gradually raise their minimum core capital to at least Kshs. 1 billion by 2012.

<sup>11</sup> For example, per the CMA, there were eight rights issues conducted by banks between 2008 and 2012; see CMA, *Annual Report and Financial Statement*, 2015.

<sup>12</sup> Legal Notice 184 of 2007 (ABS Regulations).

<sup>13</sup> The ABS Regulations were preceded by the amendment of the CMA Act through the Finance Act, No. 4 of 2004, which introduced section 33C (now further amended) into the CMA Act. This section empowered the Minister in charge to formulate the ABS Regulations.

<sup>14</sup> Mbugua, *Feasibility Study of Asset-backed Securities in Kenya: A Case of Nairobi Securities Exchange* (2014) 19-24; Waithaka and Ngugi, 'Factors Influencing Acquisition of Stressed Assets and Asset Securitization into the Financial Market in Kenya' (2013) 1(2) *International Journal of Economics and Finance* [http://www.ijse.org/articles/ijse\\_v1\\_i2\\_529\\_539.pdf](http://www.ijse.org/articles/ijse_v1_i2_529_539.pdf) accessed 31 March 2016.

<sup>15</sup> Mbugua at 19-20; Waithaka and Ngugi *Stressed Assets*.

<sup>16</sup> The most pertinent on this is IAS 39 on the recognition and measurement of financial instruments and its intended replacement by IFRS 9 by 2018; see Mbugua, 21.

<sup>17</sup> Waithaka and Ngugi *Stressed Assets*.

<sup>18</sup> IOSCO Principles, 3 and 18.

<sup>19</sup> *Ibid.*

<sup>20</sup> Judicature Act, Chapter 8, Laws of Kenya, section 3 states the applicable laws in Kenya include 'substance of the common law, the doctrines of equity and the statutes of general application in force in England on the 12th August, 1897'.

<sup>21</sup> For example, the newly enacted Companies Act (No. 17 of 2015) and Insolvency Act (No. 18 of 2015) are respectively based on the Companies Act, 2006 and Insolvency Act, 1986 of the United Kingdom.

The South African ABS regulation framework is the most developed in Africa. Further, the South African capital markets has seen several public issuances of ABS that have proffered improvements to the regulatory framework.<sup>22</sup> Other African capital markets have had or are in the process of preparing ABS issuances<sup>23</sup> but the scale of securitisation in South Africa is incontestable. This study, however considers the differences in legal systems<sup>24</sup> thus sifting learning points through a domestic context.

ABS offer an alternative from the Kenyan norm of treasury and corporate bonds, equities and real-estate investment trusts. In fact, it is arguable that considering recent bank collapses, usual corporate debt issuance can no longer be viewed as investments of minimal risk.<sup>25</sup> Hence, it is even more pertinent to investigate means of promoting alternatives thereto of which ABS are key.<sup>26</sup>

### 1.3. Research Questions

1. How does the regulation of asset-backed securities in Kenya compare to that applied in South Africa and the United Kingdom?
2. What weaknesses or hindrances face the issuance of asset-backed securities in Kenya's capital markets?

### 1.4. Literature Review

#### 1.4.1. Books and Theses

Philip Wood in 'Project Finance, Securitisations, Subordinated Debt' provides an in-depth breakdown of securitisations from an international finance perspective.<sup>27</sup> This detailed and recent analysis will be relied on in seeking an understanding of how securitisation operates not only in the comparative jurisdictions, but also in other international applications.

De Vries Robbé provides an equally in-depth detailing of the formulation and operation of not only basic forms of securitisation practice but also more innovative and complicated forms. However, in relying on this resource, this study shall limit itself to the more conventional forms

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<sup>22</sup> Saayman and Styger, 'Securitisation in South Africa: Historic Deficiencies and Future Outlook' (2003) 6(4) *SAJEMS* 744, at 751-753.

<sup>23</sup> Centre for Affordable Housing Finance in Africa, '2015 Yearbook - Housing Finance in Africa' (2015) [http://www.housingfinanceafrica.org/wp-content/uploads/2015/10/2015\\_CAHF-yearbook\\_22.10.2015\\_compressed.pdf](http://www.housingfinanceafrica.org/wp-content/uploads/2015/10/2015_CAHF-yearbook_22.10.2015_compressed.pdf), accessed 30 March 2016. Also Soudi and Cherkaoui, 'Morocco Experience in Islamic Finance between the Failure of the Past and the Promising Future' (2015) 4(3) *International Journal of Finance and Accounting*, 153.

<sup>24</sup> Kenya is a common law jurisdiction, whereas South Africa applies a hybrid system of English common law and Roman-Dutch law.

<sup>25</sup> For example, the placing in receivership of Imperial Bank Limited in October 2015 and Chase Bank (Kenya) Limited in April 2016 resulted in the suspension of listing and trading of both their corporate bonds. See Joint Press Release by Central Bank of Kenya and CMA on Imperial Bank Ltd, [https://www.centralbank.go.ke/images/docs/media/Press%20Releases/Joint\\_Press\\_Release\\_CBK\\_and\\_CMA\\_-\\_Imperial\\_Bank.pdf](https://www.centralbank.go.ke/images/docs/media/Press%20Releases/Joint_Press_Release_CBK_and_CMA_-_Imperial_Bank.pdf); Suspension of the Chase Bank (Kenya) Limited Corporate Bond Public Notice, <https://t.co/6w79UyWXGI> accessed 29 April 2016.

<sup>26</sup> 'Abil's demise could mean a new 'boom time' for securitisations' *MoneyWeb*, 2015 <http://today.moneyweb.co.za/article?id=398118#.VvpMXbZ94d> accessed 1 April 2016.

<sup>27</sup> Wood *Project Finance*.

of securitisation explored therein.<sup>28</sup> This is justified by the nascence of securitisation and ABS issuance in Kenya.

In *Corporate Finance Law: Principles and Policy*, the authors provide not only an understanding of securitisation and asset-based finance in the United Kingdom, but also more general aspects of debt financing that are applicable to this study.<sup>29</sup> This resource is then be applicable both for the general legal principles as well as specific provisions relating to the United Kingdom.

Dr Francois Wessels, in a recent comparative study into synthetic securitisations analyses the history of securitisation in South Africa, the pertinent legislation thereto, and the underlying principles applicable to them.<sup>30</sup> However, the applicability of Wessels' research to this study is qualified, given that he specifically focuses on synthetic securitisations with emphasis on collateralized debt obligations.<sup>31</sup> This contrasts with plain vanilla structures that this study focuses on, in light of the nascence of Kenya's ABS market.

For a more succinct South African perspective of securitisation, Dr Natania Locke in her unpublished doctoral thesis robustly reviews the regulation of securitisation in South Africa.<sup>32</sup> This includes a historical view culminating in the Securitisation Notice, 2008<sup>33</sup> and a comparative review of South Africa's position against law and practice in the United Kingdom. This provides a significant viewpoint through which the present study evaluates these two jurisdictions.

Additionally, Paul and Montagu give a concise examination of the regulation of capital markets.<sup>34</sup> Though published prior to the Global Financial Crisis, the principles espoused in this text are influential in understanding the building blocks of a securitisation transaction.

## 1.4.2. Online Sources

### 1.4.2.1. Papers

Charles Mbugua in a "Feasibility Study of Asset-Backed Securities in Kenya" analyses both the benefits and challenges facing ABS in Kenya's financial markets.<sup>35</sup> This empirical study indicates the legal framework in force at that time to be one of the hindrances but does not delve into the crux of these hindrances as this present study intends to. Moreover, subsequent enactments and amendments to law will arguably have changed the present position being investigated.

Muñoz also provides an incisive critique of bankruptcy-remoteness in the United Kingdom.<sup>36</sup> His review provides guidance to the comparative analysis undertaken against Kenya's legislation on the same matter.

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<sup>28</sup> de Vries Robbé, *Securitization Law and Practice – In the Face of the Credit Crunch* (2008).

<sup>29</sup> Gullifer & Payne *Corporate Finance*.

<sup>30</sup> Wessels, 'Synthetic Securitisation in South African Law' (unpublished LLD thesis, University of Pretoria 2016).

<sup>31</sup> *Ibid.*

<sup>32</sup> Locke *Aspects*.

<sup>33</sup> GN 2, GG 30628 (1 January 2008) 'Notice on Banks Act, 94 of 1990 – Designation of an activity not falling within the meaning of the business of a bank' (Securitisation Schemes), hereinafter 'Securitisation Notice, 2008'.

<sup>34</sup> Paul and Montagu, *Banking and Capital Markets Companion* 4 ed (2006).

<sup>35</sup> Mbugua above.

<sup>36</sup> Muñoz *Vehicle-shielding*.

The World Bank's 'Developing Kenya's Mortgage Market'<sup>37</sup> provides succinct exploration of securitisation as a means of funding property development in Kenya. This present paper will rely on various findings therein, particularly regarding ABS issuance as a means of financing property development.

#### 1.4.2.2. Websites

The Capital Markets Authority of Kenya (CMA)<sup>38</sup> and the International Organization of Securities Commissions (IOSCO),<sup>39</sup> both maintain up-to-date websites. They provide various regulatory documents including legislation, regulations and policy documents on them as well as regular updates of recent and upcoming developments that will collectively be relied on as primary information in this study.

### 1.5. Limitations

This study is limited to conventionally-structured asset backed securities, also referred to as vanilla structures.<sup>40</sup> This is premised on the nascent nature of ABS as a capital market product in Kenya, and would thus be the most probable form adopted before progressing to more innovative structures.<sup>41</sup>

Additionally, given the focus on the capital markets, this study examines public issuances of ABS specifically, while giving cognisance to private issuances.<sup>42</sup>

### 1.6. Research Methodology

This study entails qualitative research. Specific reference is given to relevant statutes, regulations and policy documents. Additionally, information gleaned from court decisions, academic journals, industry working papers and prospectuses of relevant ABS issuances will also be applied. Germane material from the internet and newspaper publications is relied upon as well.

### 1.7. Chapter Summary

Chapter Two gives a review of global practice in securitisation and ABS issuance to highlight the peculiarities therein. Chapter Three is devoted to Kenya's legislation and regulation of asset-backed securities whilst comparing it with the same in South Africa and the United Kingdom. Chapter Five summarises the strengths, weaknesses and opportunities for reform

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<sup>37</sup>The World Bank, *Developing Kenya's Mortgage Market (2011)* available at [http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Kenya\\_Expanding\\_Mortgage\\_Finance\\_May\\_2011.pdf](http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Kenya_Expanding_Mortgage_Finance_May_2011.pdf) accessed on 30 March 2016.

<sup>38</sup>Capital Markets Authority <http://cma.or.ke>, accessed on 30 March 2016.

<sup>39</sup>International Organization of Securities Commissions [www.iosco.org](http://www.iosco.org), accessed on 30 March 2016. Kenya, South Africa and the UK are all presently members.

<sup>40</sup>Robbé *Law and Practice* 6.

<sup>41</sup>Other forms are referred to as synthetic structures. See Robbé *Law and Practice* 97-195; Wessels above.

<sup>42</sup>For example, the Dutch investment firm Oikocredit International and the solar firm BBOXX have already completed the first phase of securitisation of off-grid solar assets. See <http://www.greentechmedia.com/articles/read/the-worlds-first-securitization-of-off-grid-solar-assets> accessed on 1 April 2016.

identified in Kenya's system. This informs the recommendations eventually made because of this study.

## 1.8. Conclusion

This study proffers a new perspective into Kenya's ABS framework, incorporating recent legal developments surrounding the matter. Across the paper, a utilitarian view is espoused, in striving for a regulatory system that brings maximum utility to society in the form of efficiency.<sup>43</sup> It is intended that not only will this study identify weaknesses, but also means of improving the very same system.

In beginning this quest, the following chapter will hence analyse the general practices and principles applied globally in securitisation transactions.

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<sup>43</sup> Penner, *McCoubrey & White's Textbook on Jurisprudence*, 4 ed (2008) 210 ("Jurisprudence").

## **Chapter Two: General Global Practice in Asset-backed Securities Transactions and Securitisations**

### **2.1. Introduction**

Asset-backed securities are innovatively able to free up illiquid capital held up on originators' balance sheets to spur greater investment.<sup>44</sup> Being a form of structured finance, they are a flexible financial engineering tool<sup>45</sup> whose unique attributes are tailor-made to investors' needs, providing a conduit for privately-held capital into the more fluid workings of the greater economy.

It is necessary to obtain a general understanding of the structuring of asset-backed securities (ABS) to review their utility and applicability in different markets and jurisdictions. Through the course of this chapter, an initial review of the securitisation process that births these securities will be done, followed by a review of the substantive intricacies of that process.

### **2.2. Securitisation**

Locke describes securitisation *inter alia* as the pooling and sale of homogenous groups of income-producing assets to a special purpose vehicle with this sale being financed by the sale of marketable securities.<sup>46</sup> Essentially, the securitisation process involves the isolation of illiquid assets and cash flows attributable thereto from the originator's balance sheet and their conversion into more liquid securities,<sup>47</sup> of which the most basic in form are asset-backed securities.

#### **2.2.1. Benefits of Securitisation**

Its primary purpose is to raise capital for the originating firm, preferably at a cheaper rate than other forms of finance.<sup>48</sup> This is pertinent for industries where capital requirements are strictly regulated such as banking and insurance industries. Such financial intermediaries are required to maintain capital buffers that are risk-weighted to the value of assets they periodically hold.<sup>49</sup> By offloading illiquid receivables from their balance sheets, such entities can add on debt commensurately; a more immediate form of financing.<sup>50</sup>

Additionally, ABS allow the transfer of underlying credit risk in the originated assets.<sup>51</sup> Relatedly, the credit rating of such assets, once isolated and securitised, may be higher than the rating of the originator as a whole. This presents an opportunity to obtain finance at less

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<sup>44</sup> Fabozzi and Kothari, *Introduction to Securitization* (2008) 4.

<sup>45</sup> *Ibid.*

<sup>46</sup> Locke *Aspects*, 29.

<sup>47</sup> Saayman and Styger, 746-747.

<sup>48</sup> Robbé *Law and Practice* 3; Wood *Project Finance* 118.

<sup>49</sup> The Basel Committee on Banking Supervision stipulates capital requirements as applied by individual banking regulators. The most recent version, Basel III, is quite rigorous on matters securitization; see <https://www.bis.org/bcbs/publ/d374.pdf> accessed on 25 July 2016. Also Robbé *Law and Practice* 405-430.

<sup>50</sup> Gullifer & Payne, *Corporate Finance* para 2.3.4.

<sup>51</sup> IOSCO, *Securitization and Securitized Debt Instruments in Emerging Markets – Final Report*, (2010) 8, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD334.pdf> accessed 26 July 2016 ('IOSCO Securitisation'); Robbé *Law and Practice* 30.

expense because lower credit ratings on securitised receivables would demand higher return for investors to compromise on the greater risk exposure and vice versa.<sup>52</sup>

Investors in the ABS also diversify their portfolios by providing a larger array of securities to choose from.<sup>53</sup> Securitisation has also been heralded as a means of increasing the availability and reducing the cost of credit; a key obstacle to economic growth that has been pinpointed by the Kenyan government.<sup>54</sup>

### 2.3. The Securitisation Process

This process begins with the formation of the bankruptcy-remote special-purpose vehicle (SPV) to which the receivables will be transferred. This will shield investors from the credit risk of the originator since, in the event of the originator's insolvency, it will not be possible to subject the SPV or its underlying assets to those bankruptcy proceedings.<sup>55</sup> Achieving bankruptcy-remoteness depends on the legal separation of the securitised asset from the influence of the originator's potential bankruptcy<sup>56</sup> and minimization of the insolvency risk of the SPV itself.

The risk of the SPV's insolvency will depend on the form it takes; either a company or a common law trust.<sup>57</sup> Ideally, the SPV should be newly formed to ensure that it does not have any previous creditors. In fact, the choice of company law or trust law as relates to the SPV has a very significant impact on the treatment of the SPV and its assets due to the key methods applied to ensure bankruptcy-remoteness.<sup>58</sup>

Once the SPV is formed, the receivables that meet the eligibility criteria that the originator may apply are pooled, with a key focus on the credit quality of the asset pool as well as applicable legal requirements.<sup>59</sup> The eligibility of future assets for securitisation differs across jurisdictions.<sup>60</sup> To this end, assets that are commonly subject to securitisation include commercial loans, mortgages, student loans, credit card arrears amongst others.

The SPV then floats securities and applies the funds received from investors to finance the acquisition of the receivables. These securities are diverse in structure and nature, but their common denominator is that the return thereon is linked to the future expected income of the securitised assets with additional interest.<sup>61</sup> There does exist a possibility that there will be a mismatch between the expected income from the receivables and the due payments to the ABS

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<sup>52</sup> See 2.3.3 below. Locke *Aspects* 32.

<sup>53</sup> IOSCO Securitisation, 8; Wood *Project Finance* 118.

<sup>54</sup> Central Bank of Kenya et al, *FinAccess Household Survey 2015*, 15-16 available at <http://dx.doi.org/10.7910/DVN/QUTLO2> accessed on 26 July 2016.

<sup>55</sup> Robbé *Law and Practice* 15; IOSCO Securitisation, 40.

<sup>56</sup> See 2.3.2 below.

<sup>57</sup> Gorton and Souleles. 'Special purpose vehicles and securitization' in University of Chicago Press *The risks of financial institutions* (2007) 549, 550. In some jurisdictions, limited liability partnerships (LLPs) may also be used; see 2.3.1 below.

<sup>58</sup> See 2.3.1 below.

<sup>59</sup> Robbé *Law and Practice* 12.

<sup>60</sup> Raines and Wong, 'Aspects of Securitization of Future Cash Flows under English and New York Law', (2002) (12) *Duke Journal of Comparative & International Law* 453, 453-454. See also Wood *Project Finance* 136.

<sup>61</sup> Segoviano et al, 'Securitization: Lessons Learned and the Road Ahead' (2013) *IMF Working Paper WP/13/255*, 13 <https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf> accessed on 25 July 2016.



holders. This can be remedied using various credit enhancement mechanisms<sup>62</sup> that will, for example, counter prepayment risks existent in debt receivables.<sup>63</sup>

The identified receivables will be transferred to the SPV in consideration for the funds invested in the floated securities, thus providing the originator with an immediate source of finance and offloading the securitised assets from its balance sheet. This is why securitisation is referred to as a form of off-balance sheet financing, the achievement of which is down to jurisdiction-specific tax, accounting and legal principles.<sup>64</sup> Nonetheless, a global acceptance in financial circles is that the transfer of the receivables to the SPV must qualify as a true sale.<sup>65</sup> The main reason for this is to avoid the recharacterisation of the transaction as a secured loan or an analogous transaction.<sup>66</sup> The exact requirements for a true sale may differ slightly between different jurisdictions.

An essential gear in the entire ABS mechanism is that of credit ratings. These are defined as an assessment regarding the creditworthiness of an entity or obligation, expressed using an established and defined ranking system.<sup>67</sup> Given the complexity of ABS, most investors, aside from sophisticated investors, may not be able to conduct due diligence on individual aspects of the ABS as they could with other capital market products.<sup>68</sup> As such, the ranking system provided by credit rating agencies is a substitute indicator of the underlying risk in an ABS structure.

This general understanding then warrants a more succinct exploration of key aspects of an ABS transaction upon which key decisions on origination, investment and regulation are made.

### 2.3.1. SPV Structure

The issuer SPV must be bankruptcy-remote from the originator for the securitisation transaction to be feasible. There means of achieving this differs for a common law trust or a company. The choice will depend on the legal ramifications of the law governing the transaction, especially whether the concept of trusts or analogous entities is recognised in a particular jurisdiction.<sup>69</sup>

As a trust, the assets to be securitised are transferred to the SPV under the control of the trustee held to the benefit of respective investors. Ideally, the number of trustees should not arouse allegations of the trust being under the originator's control. The trust deed may include protective provisions against insolvency risk such as non-petition clauses and trustees'

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<sup>62</sup> These include liquidity support, tranching, over-collateralisation, and letters of credit among others. See Locke *Aspects* 48-50; Robbé *Law and Practice* 67-72.

<sup>63</sup> Wood *Project Finance* 145.

<sup>64</sup> Robbé *Law and Practice* 19.

<sup>65</sup> The legal and accounting definitions of this differ. An accounting true sale requires achievement of off-balance sheet treatment per jurisdictional rules whereas a legal true sale occurs when legal passes without recourse. Robbé *Law and Practice* 19.

<sup>66</sup> Wood *Project Finance* 156-158; See 2.3.2 below.

<sup>67</sup> IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies – Final Report* (2015) 7 ('IOSCO CRA Conduct').

<sup>68</sup> White, *Statement on Asset-Backed Securities and Credit Rating Agencies*, accessible at <https://corp.gov.law.harvard.edu/2014/08/29/statement-on-asset-backed-securities-and-credit-rating-agencies>, accessed on 26 October 2016.

<sup>69</sup> For example, South Africa has not received the law on English common law trusts; see 3.3.2.1 below. Also Locke *Aspects* 38 and 85.

powers.<sup>70</sup> Given that there may be less statutory requirements to be adhered to, a trust in this aspect offers more structural flexibility.

Although the assets will be held in bulk, it will not be necessary to specifically identify the individual assets in which an investor holds a participation. Instead, under equity it suffices to indicate in the transactional documents the respective ratio that investors hold in the bulk.<sup>71</sup>

As a company, it is recommended that the issuer be “orphaned” from the originator. This is achievable by having the shares of the company SPV held by a charitable trust thus asserting independent control.<sup>72</sup> Paul and Montagu posit that the true determinant of whether the issuer is an orphan is through accounting and tax considerations, which again will determine whether a true sale of the assets is achievable.<sup>73</sup> Majority control by the originator of the shares in the SPV would make it a subsidiary capable of being affected by any insolvency proceedings against the originator.<sup>74</sup> Notably, this practice is common in the United States of America, but most credit rating agencies recommend against it.<sup>75</sup>

Other means of asserting control over the SPV in a manner that dissociates it from the originator would be to appoint independent directors, with neither past nor present association to the originator.<sup>76</sup> Also, clauses regarding voting to initiate voluntary insolvency proceedings for the SPV should be drafted into the SPV’s constitutive documents to limit such options to only the most exceptional circumstances.

As another shield against possible lifting of the corporate veil<sup>77</sup> in the event of originator’s insolvency, the SPV and originator should be ran as independent entities. All their commercial engagements, assets, and management operations should be conducted separately to avoid any legal uncertainties.<sup>78</sup>

Ideally, the issuer should be formed anew to ensure that it has no past obligations or claims against it, whether financially or through past labour relations. Relatedly, the issuer will usually not have any employees and will not be involved in any other activity except as a conduit in the transaction.<sup>79</sup> This may involve explicit stipulation in its constitutive documents of the specific purposes and ancillaries it has been incorporated to fulfil.<sup>80</sup>

It is also recommended that parties to the transaction, especially the investors, be required to accede to non-petition clauses embedded in the relevant transaction documents. These will affirm that they will not petition any court for the issuer’s insolvency. However, Robbé notes

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<sup>70</sup> Wood *Project Finance* 121-123.

<sup>71</sup> *Hunter v Moss* [1994] 1 WLR 452.

<sup>72</sup> Locke *Aspects* 39; Robbé *Law and Practice* 17.

<sup>73</sup> Paul and Montagu, 421;

<sup>74</sup> This under s 4(1) and 125 of Kenya’s Companies Act is acquired by ownership of majority voting rights or ability to appoint or remove a majority of the companies’ directors. Similar provisions are under s 2(2) and 3(1) of South Africa’s Companies Act, 2008 and s 254 and 255 of the UK’s Companies Act, 2006.

<sup>75</sup> Wood *Project Finance* 121-124.

<sup>76</sup> Robbé *Law and Practice* 17.

<sup>77</sup> See *op cit* note 151 below.

<sup>78</sup> *Ibid.*

<sup>79</sup> Locke *Aspects* 249.

<sup>80</sup> Robbé *Law and Practice* 17.

that such clauses should be considered case-by-case as they may not be enforceable in some jurisdictions.<sup>81</sup>

### 2.3.2. True Sale

Attaining a true sale of the receivables is key to achieving bankruptcy-remoteness. This is accomplished when the transfer of the receivables is effective against the insolvency of the originator and is not liable to recharacterisation as a loan secured upon those receivables.<sup>82</sup> This risk is existent because as compared to ordinary sale of goods and services whereby the parties' intent is transfer of ownership, in a securitisation process the underlying intent is that of providing finance,<sup>83</sup> which is more akin to a loan.

The means of achieving this true sale differs across the common law and civil law divide,<sup>84</sup> but the risks posed by not achieving a true sale apply across the spectrum. As per Wood,<sup>85</sup> a true sale will have the following characteristics:

- i) The originator should have no liability for the receivable once it is sold, aside from usual warranties for defects and no right to repurchase the receivables should be retained.<sup>86</sup>
- ii) The SPV should acquire exclusive control and ownership of the receivables. Aspects of control will be interpreted from the collective wording of the transaction documents. One key consideration is that the SPV receives all future payments on the receivables with no obligation to remit the same to the originator.<sup>87</sup>
- iii) In the event of the originator's insolvency, the transaction should not be vulnerable to being declared undervalue transactions, voidable or undue preferences and thus being set aside by the liquidator.<sup>88</sup> This arises from practice of selling the receivables at a discount or deferring payment, but the risk can be avoided by transferring the receivables at fair-value.<sup>89</sup>

It is recognised in practice that recharacterisation risk is more severe in civil law jurisdictions than common law ones.<sup>90</sup> As aforementioned, recharacterisation of the transaction as a secured loan would result in the originator being considered as retaining ownership of the receivables with the SPV only having a security interest therein.<sup>91</sup> In most jurisdictions, such legal interest

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<sup>81</sup> *Idem*, 18.

<sup>82</sup> Locke *Aspects* 141.

<sup>83</sup> *Idem*, 136.

<sup>84</sup> Common law jurisdictions rely on equitable assignments whereas many civil law jurisdictions, including South Africa, utilise cession. Locke asserts, in my view correctly, that the Securitisation Notice, 2008 interprets towards the use of delegation (akin to novation in common law jurisdictions), but admits that the non-requirement of notice in cession lends it more appropriate to use in securitisation; see Locke *Aspects* 321.

<sup>85</sup> Wood *Project Finance* 131.

<sup>86</sup> Locke *Aspects* 273. Repurchase rights signify retention of control over an asset.

<sup>87</sup> Wood *Project Finance* 156.

<sup>88</sup> These are generally referred to as claw-back risks. See Robbé *Law and Practice* 23.

<sup>89</sup> Locke *Aspects* 292.

<sup>90</sup> Wood *Project Finance* 159; Locke *Aspects* 358; See Chapter 3 for further discussion of this.

<sup>91</sup> Wood gives examples that generate recharacterisation risk as: operating the transaction contrary to the transaction documents; continued servicing by the originator that is not usual of other true sales; continued extraction of profits and access thereto which suggests non-exclusive control by the SPV; See Wood *Project Finance* above. Another practice that enhances recharacterisation risk is commingling of funds if the servicing originator fails to separate and treat payments on the receivables differently from non-securitised ones; See Robbé

in property must be registered for it to be enforceable. The nature of a securitisation would mean that such registration would not have occurred, rendering investors in the securitised assets as unsecured creditors in the insolvent originator's estate.<sup>92</sup>

A key problem faced in securitisation transactions is avoiding the administrative and financial burden of notifying individual debtors of the transfer of their claim. This is because the ideal transfer methods that secure bankruptcy-remoteness require individual notice, whereas those that do not require notice are more vulnerable insolvency claw-back into the originator's estate. For example, in common law jurisdictions such as Kenya, a novation or legal assignment would be good against all the world, but demand notification of the debtor.<sup>93</sup> To avoid the financial and administrative cost of such notice, equitable assignment is relied upon even though it is more likely to be recharacterised as a secured loan. Such an equitable assignment will be effective if a tangible intention to irrevocably transfer the receivables is evident.<sup>94</sup> In South Africa, the options available for transfer are delegation or cession, with the former requiring notification and consent as compared to the latter.<sup>95</sup>

If individual agreements with debtors contain clauses that bar transfer of the claim without notification, such receivables may not be ideal for securitisation.<sup>96</sup> This is because transfer thereof may be voidable, thus reverting them to the originator's estate and exposing them to insolvency risk. This risk underlines the significance of due diligence of each individual agreement; an underlying cost of the securitisation process that may be daunting for many originators.

### 2.3.3. Credit rating

Credit rating agencies are regulated in each jurisdiction that they operate. Globally, Fitch, Moody's and Standard and Poor's are the market leaders and recognised "gatekeepers" of the debt securities market.<sup>97</sup>

Institutional and sophisticated investors are the most common participants in the ABS market, and their mandates often restrict them from investing in products that are below a specified investment grade.<sup>98</sup> Hence, originators will seek to pool together receivables that attract the highest rating and structure the transaction to bolster the said rating.

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*Law and Practice* 25-26; For examples of the disastrous consequences of commingling funds and assets, see S Gibson, 'The Case for the Expanded Role of Trustees in Securitizations' (2004) 121 *Banking Law Journal* 387.

<sup>92</sup> Robbé *Law and Practice*, 26.

<sup>93</sup> Paul and Montagu, 422.

<sup>94</sup> Raines and Wong, 455. Equitable assignments will be perfected into legal assignments by issuing notice when perfection events are triggered.

<sup>95</sup> The concept of assignment does exist in South African commercial law and is described as "a combined cession and delegation"; see Christie, *The Law of Contract in South Africa* 6 ed (2011), cited in *Securicor (SA) (Pty) Limited & Others v Lotter & Others* [2005] 4 All SA 464 (E).

<sup>96</sup> These are known as non-assignment clauses in Kenyan law and *pacta de non cedendo* or non-cession clauses in South African law. Also Sunkel, *The pactum de non cedendo: A re-evaluation* (unpublished LLM thesis, University of the Western Cape 2009).

<sup>97</sup> Xia, 'Can Investor-paid Credit Rating Agencies Improve the Information Quality of Issuer-paid Rating Agencies' (2014) 111(2) *Journal of Financial Economics* 450, 456.

<sup>98</sup> By example, section 30 and 31 of the Retirement Benefits (Individual Retirement Benefit Schemes) Regulations, 2000, as read with Table G of the First Schedule thereto restrict all retirement benefits schemes in Kenya to investing only in investment grade-rated debt securities.

CRAs will issue initial and periodical assessments of the creditworthiness of the securities relying on information provided to them on the transaction structure.<sup>99</sup> The CRAs focus on whether a true sale has been achieved, the bankruptcy-remoteness of the SPV from the originator, SPV insolvency risk, and the effectiveness of credit-enhancement mechanisms. This is done through modelling of possible stress scenarios to determine how the transaction would subsist in adverse conditions.<sup>100</sup>

Investors demand a higher return on higher risk ABS, thus the originator will try to minimize this cost by enhancing the credit-worthiness of the ABS. This represents a significantly high transaction cost. Alternatively, credit enhancement such as using separate tranches of securities representing different risk-return trade-offs can be utilised. Any losses incurred will be borne by the lower tranches thus guaranteeing a higher credit rating for senior tranches. Lower tranches will thus carry a higher interest rate.<sup>101</sup>

It must be noted however that since the global economic crisis occasioned by the collapse of the sub-prime mortgage market, questions regarding liability and regulation of CRAs have gained momentum and rightly so. It has been argued that even though CRAs only issue a statement of opinion and not fact, the information and expertise available to them is not comparable to that of investors. This results in the CRAs' opinions being widely treated as factual, and calls have arisen for some form of liability or enhanced regulation to be ascribed to this development.<sup>102</sup> Admittedly, this should only be adopted if the utility to be gained therefrom surpasses the additional cost. Another approach worth considering is the utilisation of investor-funded CRAs as compared to issuer-funded ones that exhibit an inherent conflict of interest.<sup>103</sup>

#### 2.3.4. Set-off and Netting

ABS investors are keen on reducing the insolvency risk they are exposed to; this being the possibility of it occurring as well as exposure in the event its occurrence. Set-off of mutual obligations between the investors as creditors and the SPV as debtor and netting of financial exposures between them comes a long way in diminishing this credit risk.<sup>104</sup>

Set-off is defined as a form of payment involving discharge of reciprocal obligations to the extent of the smaller obligation, and is mandatory and exclusive.<sup>105</sup> It is essentially a debtor's right to secure payment on what is owed to them by reduction of their own liability to their creditor.<sup>106</sup> Netting on the other hand is cancellation of unperformed executory contracts between two parties and the eventual set-off of gains and losses on each.<sup>107</sup> The two mechanisms work hand-in-hand and are a central pillar of minimizing credit risk in the global financial system. However, both are recognised as risks to the holders of ABS as they may

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<sup>99</sup> Wood *Project Finance* 170-171. IOSCO replaced the word 'opinion' from the 2008 Report on Conduct of CRAs with 'assessment' in the final 2015 edition. This report clarifies that this does not represent "a changed view on the fundamental nature of a credit rating"; see IOSCO, 7.

<sup>100</sup> Wood *Project Finance* 171.

<sup>101</sup> *Idem*, 142; Robbé *Law and Practice* 67.

<sup>102</sup> Reisberg, 'The Future Role of Credit Rating Agencies in Contemporary Financial Markets - A Theoretical Perspective', *Corporate Finance Law in the UK and EU* (OUP 2011); Gullifer and Payne, *Corporate Finance* 559-561.

<sup>103</sup> Xia above.

<sup>104</sup> Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (2007) 8 ('Set-off and Netting').

<sup>105</sup> Gullifer and Payne, *Corporate Finance* 183.

<sup>106</sup> Goode, *Principles of Corporate Insolvency Law* 3<sup>rd</sup> ed (2005) 213.

<sup>107</sup> Wood, *Set-off and Netting* 4.

diminish expected returns if applied upon, thus credit enhancement provisions to counter them may be necessary.<sup>108</sup>

Historically, common law jurisdictions have vigorously defended the applicability of set-off in financial transactions and with the development and globalisation of financial markets, civil law jurisdictions have modified their law or shown some leniency towards the concept.<sup>109</sup> Thus, it is more established in common law countries. In Kenya, set-off is recognised and legally accepted as one of the trade and usages applicable to the bank-customer relationship, and is usually contracted into agreements.<sup>110</sup> In South Africa, the position as held in *Richter v Riverside Estates (Pty) Ltd*<sup>111</sup> is that the claims must be mutual (reciprocal), liquid and due. In England, set-off is explicitly recognised through the Insolvency Rules, 1986 and has been the subject of many a judicial decision.<sup>112</sup>

Regardless of such acceptance, a key debate that set-off raises is that of preferring the creditor holding mutuality of obligations, against the general body of creditors.<sup>113</sup> This preference must occur within the ambit of insolvency legislation, which clearly sets out the priorities to be followed upon insolvency. This hierarchy varies from jurisdiction to jurisdiction.

Consequently, debate arises on whether to form an SPV either as a company subject to this statutory hierarchy or a trust. Trusts (and analogous entities) in most jurisdictions operate in a separate or modified system of insolvency and in most cases, the hierarchy to be followed in event of insolvency is dictated by the promoters of the trust themselves. This will be explicit in the trust deed or other constitutive documents. As compared to the rigidity of a company regarding insolvency, a trust viewed in isolation offers more comfort to risk-averse investors and is therefore a key consideration not only for parties to the transaction but also for legislators and regulators seeking to provide an optimum environment for an ABS market.

## 2.4. Conclusion

Securitisation thus emerges as a multifaceted process whose key elements are spread across a variety of legal fields. Also, the differences identified between common law and civil law jurisdictions inform this study's caution in adopting any comparative practices, instead advising an understanding of the underlying circumstances in each jurisdiction.

The variety of receivables that can be securitised is heartening, given that the most common form globally (mortgages) is not well developed in Kenya.<sup>114</sup> Nonetheless, even other legal considerations that appear only contingent to the structuring process affect not only the creation but continued viability of an ABS scheme.

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<sup>108</sup> Locke *Aspects* 330.

<sup>109</sup> Wood, *Set-off and Netting* 11.

<sup>110</sup> Previously, Rule 100(2) of the Bankruptcy Rules recognised the right to insolvency set-off. The currently available format of the Insolvency Regulations, 2016 does not mention set-off, but is prone to amendment. Also *Barclays Bank of Kenya Ltd v Kephah Nyabera & 191 others & another* [2013] eKLR.

<sup>111</sup> [1946] OPD 209 at 224.

<sup>112</sup> Rule 4.90 of the Insolvency Rules, 1986 has been canvassed in key decisions such as *Stein v Blake* [1996] AC 243, *Re SSSL Realisations (2002) Limited* [2006] EWCA Civ 7, and *Daleri Limited v Woolworths plc* [2008] EWHC 2891 (Ch). These have reiterated the concepts of mutuality, set-off's automatic applicability and the ability of contracting parties to opt out of it.

<sup>113</sup> Moraes, 'The Mutuality of Assignment in Subordination' (2014) 5 *Corporate Rescue and Insolvency Journal* 187, 189.

<sup>114</sup> CAHF 2015 Yearbook, 103-106.

The key identified elements of an ABS issuance are bankruptcy-remoteness of the SPV and the achievement of the true sale of the receivables. Going forward, these two concepts will receive most focus, along with appurtenant concepts. Chapter Three will thus compare these factors within the respective regulatory landscapes of Kenya, South Africa and the United Kingdom.

## **Chapter Three: A Comparative Review of Kenya’s Regulatory Framework for Asset-backed Securities**

### **3.1. Introduction**

Kenya’s capital markets are significantly developed for an emerging economy, with an expanding range of products and active participation by foreign and local investors.<sup>115</sup> In its bid to grow into a financial hub,<sup>116</sup> Kenya has and continues to draw from the experiences of its contemporaries, amongst these being South Africa and the United Kingdom. The general structural and regulatory principles detailed in the preceding chapter are present in each of these jurisdictions, with variations to accommodate domestic legal systems.

This chapter investigates the nuances of those general principles, first in Kenya and then comparatively in the UK and South Africa. In each jurisdiction, specific focus will be given to the true sale of receivables, choice of SPV entity and its bankruptcy-remoteness, taxation and other pertinent matters. These will be the elements critical to ABS issuance as noted in Chapter Two.

This chapter will begin with an analysis of Kenya’s framework, centred around the Capital Markets Act<sup>117</sup> with subsidiary legislation and guidelines thereto being scrutinised as well. Henceforth, the key elements highlighted above will be analysed within the context of the UK and South African legal systems to distil learning points for Kenya’s developing market.

### **3.2. Kenya**

#### **3.2.1. Capital Markets Act**

The CMA Act provides for ABS in Part IVB of the Act. Initially defining what an ABS is,<sup>118</sup> the Act further defines key terminologies such as originator, issuer, securitisation and more, in conformity with conventional practice.

The Act captures the possibility of securitising not only tangible and intangible assets but also future ones where allowed under written law.<sup>119</sup> Section 30K of the CMA Act further clarifies that such assets must generate a cash flow, be legally originated, not bear any third-party encumbrances<sup>120</sup> and should comply with any other provisions of the Act.

The Act allows the direct origination of assets into the securitisation SPV or by means of a transfer to the SPV, with the proviso that a “true sale according to the laws of Kenya” must be achieved.<sup>121</sup> Thus, what constitutes a true sale per the laws of Kenya must be interpreted. This

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<sup>115</sup> Capital Markets Authority, *Annual Report and Financial Statement – 2015* (2016) 21; Oxford Business Group, *The Report: Kenya 2016 - Capital Markets* (2016) 2, available at <http://www.oxfordbusinessgroup.com/kenya-2016> accessed on 28 September 2016.

<sup>116</sup> Capital Markets Authority, *Capital Market Master Plan: 2014-2023* (2014) 17, 23, 41.

<sup>117</sup> Chapter 485A, Laws of Kenya (CMA Act).

<sup>118</sup> CMA Act, s 30H.

<sup>119</sup> *Ibid.* See also Sale of Goods Act (SoGA), s 7.

<sup>120</sup> The difficulty in ascertaining these encumbrances considering Kenya’s outdated registry system is arguably a key reason why movable property has not securitised before. See 3.2.4 below.

<sup>121</sup> CMA Act, s 30L(3).



must be done within the confines of Section 3(1) of the Judicature Act that sets out the sources of law in Kenya, with reference also to non-binding jurisprudence of relatable jurisdictions.

As per the Sale of Goods Act<sup>122</sup>, the property in specific goods is transferred when the parties to the contract of sale intend it to. This intention shall be deduced from the terms of the contract read as a whole, the parties' conduct and the circumstances of the transaction.<sup>123</sup> The transfer of property in a receivable when sold is its key differentiating factor from a secured transaction.<sup>124</sup> Section 19 of the SoGA, as read with section 20, has been applied consistently by the courts, with an unwillingness shown towards deviating from the letter of the contract and parties' wishes in keeping with the spirit of freedom of contract.<sup>125</sup> Thus recharacterisation risks in Kenyan law seem less severe in practice than in academia if unambiguous contracting is applied.

Nonetheless, it must be stated that a key hindrance to transferability of receivables under Kenyan law is the vague and fractured framework on security rights over personal property. The Chattels Transfer Act<sup>126</sup> is a colonial artefact primarily intended to handle transfer of agricultural produce<sup>127</sup> and hence is silent on the transfer of receivables. Other security interests are covered across a variety of legislation.<sup>128</sup> Registration usually involves the filing of the physical instrument creating the security interest, with prohibitive filing costs and bureaucratic access preventing third parties from ascertaining priority of claims on assets.<sup>129</sup> Further, the lack of clarity on novel instruments and limited recourse provisions aggravates this<sup>130</sup> adding to the ABS transaction risk.

Since no written law presently governs the transfer of receivables in Kenya, English common law and the principles of equity apply. The key methods applicable thereunder are equitable and legal assignment. Legal assignment, which transfers the entire interest in the property, must be in writing and with the obligor's express notification and consent.<sup>131</sup> An equitable assignment requires neither writing nor the obligor's consent and will only transfer the beneficial interest therein.<sup>132</sup> Evidently, this is a weaker form of security, but in a securitisation transaction it would be subject to stipulated perfection events, upon which written notice would be issued converting it into a legal assignment.<sup>133</sup>

The possibility of avoidance as a fraudulent transfer or an undervalue transaction is another hazard to true sales; also referred to as clawback risk. Under Kenya's previous insolvency regime these two transaction types were statutorily perceived as one: fraudulent preferences.<sup>134</sup> Such transactions would be caught if conducted within six (6) months of presentation of a

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<sup>122</sup> Cap 31, Laws of Kenya.

<sup>123</sup> SoGA, s 19.

<sup>124</sup> Muñoz *Vehicle-shielding* 11.

<sup>125</sup> *Aineah Likuyani Njirah v Agha Khan Health Services*, Civil Application No. 194 of 2009.

<sup>126</sup> Cap 28, Laws of Kenya.

<sup>127</sup> Mbaluka, 'A Critical Analysis of the Regulation of Personal Property Securities in Kenya' (unpublished LLM thesis, University of Nairobi 2012), 34.

<sup>128</sup> FSD Kenya, 'Securing credit for growth: The case for a new asset register in Kenya' (2014) 2; Mbaluka, 57.

<sup>129</sup> *Idem*, 4 and 10.

<sup>130</sup> Mbaluka, 52-56.

<sup>131</sup> *Forster v Baker* (1910) 2 KB 636, *Re Steel Wing Co. Ltd* (1921) 1 Ch 349.

<sup>132</sup> *Howard v Miller* (1915) AC 318, *Tailby v Official Receiver* (1888) 13 AC 523. The absence of a written instrument of transfer may also avoid stamp duty exposure.

<sup>133</sup> Robbé *Law and Practice* 22.

<sup>134</sup> Companies Act (repealed) Cap 486, Laws of Kenya, s 312.

bankruptcy petition. Under the Insolvency Act, 2015 the two are dealt with separately and with more clarity under sections 682 and 683.

Undervalue transactions will now be set aside if the consideration received is “significantly less than the value...of the consideration provided by the company”.<sup>135</sup> A further qualification is that the absence of good faith and no linkage to the business purpose should be proven, as well as absence of intent to benefit the company.<sup>136</sup> Here, the Court of Appeal’s position in *Mbuthia v Jimba Credit Finance Corporation and Another* is of guidance in saying:

‘[A] sale made at a fraudulent undervalue will be set aside. But the Court will not set aside a sale merely on the ground that it is disadvantageous, unless the price is so low as to be in itself evidence of fraud.’<sup>137</sup>

As such, the securitisation transaction parties in arriving at the consideration for transfer of receivables from the originator to the SPV must consider that the phrasing of the contract unambiguously mirrors the intent of the parties to avoid clawback in event of the originator’s insolvency. The labelling of the transfer as a ‘sham’ will be highly detrimental to the transaction.<sup>138</sup> A sham could be presumed for example if the value of the consideration is so nominal as to cast aspersions on the nature and intent of the transaction. The deferral of a purchase price can cause this, though surrounding circumstances must be considered.<sup>139</sup>

Similarly, the intention to prefer one creditor compared to the general body is a key factor highlighted for setting aside a transaction as a fraudulent preference.<sup>140</sup> Hence, the same should be considered to prevent avoiding of the transfer.

A key factor that will influence the bankruptcy-remoteness of the transaction in this regard is the time limitations within which a transaction may risk clawback as highlighted under section 684 of the Insolvency Act. To this end, transactions entered at least two years before onset of insolvency will be caught. In reading section 684(4), persons connected with the company will raise a presumption of preference if the transaction is entered with them. This as per the definitions of a person ‘connected with’<sup>141</sup> and ‘associates’ of a company<sup>142</sup> creates an enhanced clawback risk if any of the directors of the originator sit as directors of the SPV. This creates a further hurdle for originators desirous of maintaining some form of control over the SPV.

As regards choice of SPV structure, the CMA Act in contrast to the now defunct ABS Regulations explicitly favoured trusts over companies.<sup>143</sup> It was argued earlier that trusts provide greater leeway for parties to set out rights of set-off and priority in case of

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<sup>135</sup> Insolvency Act, s 682.

<sup>136</sup> *Ibid.*

<sup>137</sup> (1988) KLR 1.

<sup>138</sup> *Post Bank Credit Limited (In Liquidation) v Nyamangu Holdings Limited* [2015] eKLR contains a detailed explanation of such occurrences. See also *Ultimate Laboratories vs. Tasha Bioservice Limited* Nairobi HCCC No. 1287 of 2000; *Mugenyi & Company Advocates vs. The Attorney General* [1999] 2 EA 199.

<sup>139</sup> See Gikonyo, J’s discussion of the scope under which separate corporate personality may be struck down as an inequitable stratagem, device or fraud; *Litein Tea Factory Company Limited & another v Davis Kiplangat Mutai & 5 others* [2015] eKLR 17-22.

<sup>140</sup> Insolvency Act, s 683(5).

<sup>141</sup> Insolvency Act, s 2(4).

<sup>142</sup> Insolvency Act, s 2(1).

<sup>143</sup> Under section 30H of the CMA Act, an SPV is defined as ‘a securitisation trust established in accordance with a trust deed subject to the laws under which asset backed securities are issued.’ (Emphasis added). See also 3.2.2 below.

insolvency.<sup>144</sup> Nonetheless, a company SPV provides a statutorily predictable structure that may be preferred by some parties in securitisation transactions. Notably, the County Policy Paper on use of ABS and the draft Guidelines on Issuance of Asset Backed Securities<sup>145</sup> acknowledge that the choice of securitisation vehicle is advisable in an enabling framework.<sup>146</sup>

The structure of the SPV vehicle, even with achievement of a true sale, must also withstand attempts to pierce the corporate veil.<sup>147</sup> This challenge to bankruptcy-remoteness may arise where creditors conduct business with the originator and SPV as the same economic unit; the business processes and records of the two are commingled.<sup>148</sup> This is why it is urged that the originator and SPV should maintain separate books of accounts, wholly different names and other measures to lessen this risk.<sup>149</sup>

Credit rating requirements for ABS issuance are also reiterated under the CMA Act with the trustee of the SPV mandated to obtain and maintain such ratings.<sup>150</sup> Discretion is provided for the CMA to formulate further guidelines in this regard. Presently, there are three licensed credit-rating agencies (CRAs) in Kenya, whose services are applied to conventional debt securities.<sup>151</sup>

It is worth noting that IOSCO in 2015 revised its definition of credit rating to mean “an assessment regarding the creditworthiness of an entity or obligation, expressed using an established and defined ranking system.”<sup>152</sup> This is a departure from the prior definition of the same as an “opinion”, which the present Kenyan legislation mirrors.<sup>153</sup> It is the author’s opinion that Kenya should desist from adopting this change, considering the significant role CRAs play in ABS issuances. Learning from the recent global financial crisis, this seemingly slight change in terminology arguably diminishes CRAs’ responsibility for their role in issuing structured financial products.

A distinctive feature of the CMA Act is its classification of ABS issuances: restricted, limited restricted or unrestricted offers. Only unrestricted offers are open to the public. Restricted offers will only be made to ‘qualified’ investors whereas limited restricted offers will be made to ‘limited’ investors only. Limited investors are essentially all qualified investors with the exclusion of investors of public funds such as retirement funds, insurance companies, and collective investment schemes.<sup>154</sup>

Given the nascence of ABS in the Kenyan market this classification is worthwhile, allowing transaction parties to target investors who are most capable of understanding the risk-reward tradeoff applicable in such complex transactions. It may also assist in the tranching of securities in an ABS issuance, with respective tranches being offered to different classes of investors.

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<sup>144</sup> See 2.3.1 above.

<sup>145</sup> Hereinafter the draft ABS Guidelines. These were released for public comment on 29<sup>th</sup> August 2016.

<sup>146</sup> County Policy Guide, 8.

<sup>147</sup> Muñoz *Vehicle-shielding* 17-19.

<sup>148</sup> *Mradula Suresh Kantaria v Suresh Nanalal Kantaria* [2007] eKLR 5.

<sup>149</sup> Muñoz *Vehicle-shielding* 18.

<sup>150</sup> CMA Act, s 30W.

<sup>151</sup> These are Global Credit Rating Company, Augusto & Company Limited and Metropol Corporation Limited; see CMA, List of Licensees and Approved Institutions, available at <<https://perma.cc/K8C9-JSHA>> accessed on 26 July 2016.

<sup>152</sup> IOSCO CRA Conduct, 7.

<sup>153</sup> *Guidelines on the Approval and Registration of Credit Rating Agencies*, Gazette No. 8512 of 2001, para 1.1.

<sup>154</sup> CMA Act, s 30H.

### 3.2.2. Capital Markets Regulations and Guidelines

#### 3.2.2.1. Capital Markets (Asset Backed Securities) Regulations, 2007

The ABS Regulations, though seemingly robust, have been eclipsed by time. This is inferred from the noticeable divergence between the language and provisions of the Regulations and those of Part IVB of the CMA Act. The Capital Markets Amendment Act<sup>155</sup> that introduced Part IVB may be perceived as a reaction to ineffective Regulations that had not motivated any ABS issuance since 2007.

Further, the Draft ABS Guidelines explicitly state the CMA's regulatory position is that the ABS Regulations are rendered null and void<sup>156</sup> by the amendments that introduced Part IVB of the Act in 2013. As such, it is only necessary to identify potential stumbling blocks contained therein that may have hindered past ABS issuances.

First, the ABS Regulations showed an express preference for company SPVs, but gave leeway for the CMA to prescribe any other appropriate entity.<sup>157</sup> This lack of choice, given the enunciated advantages of the common law trust, was arguably restrictive. Further, the ABS Regulations insisted on legal, rather than equitable, transfer of title in the receivables.<sup>158</sup> This, though resulting in greater certainty of bankruptcy-remoteness, carries additional administrative and monetary burdens that may have dissuaded potential issuances. Additionally, Regulation 27 made an inexplicable requirement for the CMA to inform the appropriate Minister of its decision to approve or deny an ABS issuance application prior to informing the applicant. This unnecessary window of Governmental involvement, given Kenya's bureaucratic history would also be quite questionable to any transaction parties.

Summarily, the ABS Regulations were exceptionally lean considering the intricacies that bely an ABS issuance. This may have been perceived as a form of light-touch regulation to spur innovation, but also would create space for ambiguity. Though a good start, the recent moves to build on them are laudable.

#### 3.2.2.2. Draft Guidelines on Issuance of Asset Backed Securities

Section 30Z of the CMA Act as read with section 12A thereof permits the CMA to enact guidelines to facilitate the ABS market. In admitting the insufficiency of the ABS Regulations<sup>159</sup>, the CMA issued draft Guidelines on Issuance of Asset Backed Securities for public comment pursuant to further review. The Guidelines, if enacted, will serve as an interim standard that ABS issuances must achieve while new ABS Regulations are formulated.<sup>160</sup>

The key changes proposed include the acceptance of both companies and common law trusts as SPVs.<sup>161</sup> This is in line with international practice that encourages choice in SPV structure. However, in accepting company SPVs the CMA proposes that all such companies must be incorporated in Kenya.<sup>162</sup> This may pose as a hindrance to securitisation parties who wish to

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<sup>155</sup> No 48 of 2013, Laws of Kenya.

<sup>156</sup> The Guidelines assert that by the CMA Act supersedes the conflicting Regulations vide section 37. See Draft Guidelines, para 2.04.

<sup>157</sup> ABS Regulations, reg 6.

<sup>158</sup> *Idem*, reg 3 and 37.

<sup>159</sup> Draft Guidelines, para 2.03-2.04.

<sup>160</sup> Draft Guidelines, para 1.02.

<sup>161</sup> *Idem*, para 3.02, 6.03.

<sup>162</sup> *Idem*, para 6.04.

take advantage of taxation conditions in other countries. Nonetheless, in tandem with accepting both forms of SPVs, the CMA goes on to clarify that ABS may be issued as both equity and debt securities,<sup>163</sup> which offers greater variety to future investors.

The draft Guidelines also maintain the preference for true sale of receivables through legal rather than equitable sale.<sup>164</sup> The main motivation for this is stated as the lessening the risk of fraud due to multiple equitable sales of the same assets because the same does not require notification to be effective, as well as competing ownership claims.<sup>165</sup> It is submitted that the consequences of this restriction would render ABS issuance unfavourable for most potential originators. For example, banks would be required to send notices to each of their obligors and await individual consent; a herculean task to say the least. As posited by Locke, institutions will opt for ABS issuance over ordinary debt only when the cost of such issuance is significantly lower than corporate bond issuance.<sup>166</sup> It is the position in this paper that the CMA's proposal is prematurely restrictive, because the draft Movable Property Security Rights Bill, 2016<sup>167</sup> will probably alleviate the main motivation behind the restriction.

Other key proposals include that credit ratings will not be compulsory for limited restricted offers,<sup>168</sup> thus lowering a key cost implication. Such issuances are only open to specialist investors with minimal public exposure, who can conduct this due diligence themselves. In addition, periodic audits for limited restricted offers will only be required if so stated in the transaction documents.<sup>169</sup> The draft Guidelines are also insistent on the robust inclusion of limited recourse provisions<sup>170</sup> in transaction documents where applicable and the ascertainment of their legal validity as a further bankruptcy-remoteness safeguard.

These proposals, in sum, are a tremendous leap from the status quo and exhibit an impressive impetus to jumpstart Kenya's ABS market. However, it will be necessary that all the Guidelines' provisions reflect existent legislation, such as the recent Companies Act, 2015 and more.<sup>171</sup>

### 3.2.3. Other Legislation

#### 3.2.3.1. Income Tax Act

There are extensive tax incentives introduced over time to encourage ABS issuance. Key among these is the exemption in 2005 of any interest earned on asset-backed securities.<sup>172</sup> Further, clarity was added in the following year by the explicit exemption of the interest income generated on the cash-flows passed on to investors.<sup>173</sup> Relatedly, the interest income on any

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<sup>163</sup> *Idem*, para 7.01 and 7.02.

<sup>164</sup> *Idem*, para 12.04 and 15.03. This is a reiteration of s 30L(3) of the CMA Act.

<sup>165</sup> Draft Guidelines, para 15.04.

<sup>166</sup> Locke *Aspects* 16; Cowley and Cummins above.

<sup>167</sup> See 3.2.4 below.

<sup>168</sup> Draft Guidelines, para 13.01.

<sup>169</sup> *Idem*, para 25.03.

<sup>170</sup> *Idem*, paras 8.08, 8.17, 14.01.

<sup>171</sup> For example, paragraph 6.10 of the Guidelines does not seem to reflect the non-applicability of the *ultra vires* doctrine in the Companies Act, 2015. See 3.2.2.2 below.

<sup>172</sup> Legal Notice No. 51 of 2005.

<sup>173</sup> Part I(52) of the First Schedule of the Income Tax Act, amended by section 29 of the Finance Act, No 10 of 2006.

debt securities raising funds for infrastructure and social services are exempt if their tenor is at least three years.<sup>174</sup>

From the perspective of the Income Tax Act, these exemptions express outright desire for ABS issuance by assisting to achieve a tax-neutral environment that is favoured globally.<sup>175</sup>

### 3.2.3.2. Companies Act, 2015 and Insolvency Act, 2015

Aside from the provisions of these two Acts that have been analysed above, some related insight into the two is necessary. First, it must be noted that the accelerated manner of their passing and enactment has provided a window for the omission of vital provisions and inclusion of flawed ones.<sup>176</sup>

The absence of a claw-out insolvency provision applicable to certain transactions on capital markets, including aspects of securitisation is significant. Given the specialised nature and monetary value of the transactions involved, such a provision is essential to create safeguards not only for parties to the transaction but the economy too.

The Companies Act, 2015, as part of an entire legal revamp adopted from the UK's Companies Act,<sup>177</sup> did away with the *ultra vires* doctrine. Hence a company may conduct any objects it desires so long as they are not explicitly restricted under the articles of association.<sup>178</sup> A similar approach was adopted in South Africa in 2008.<sup>179</sup> Restriction of an SPV's objects is essential in enhancing bankruptcy-remoteness hence this development must be considered.

### 3.2.3.3. Stamp Duty Act

Legal Notice No. 105 of 2015 specifically exempted any documents executed in respect of securitisation transactions as approved by the CMA from payment of stamp duty.<sup>180</sup> This was a landmark shift in Kenyan ABS regulation, but the ambiguity in its wording is questionable. CMA approval of ABS issuances would occur after the registration of the documents transferring the receivables upon which stamp duty is due. Thus, stamp duty would have to be remitted prior to CMA's actual consent, rendering the current wording impractical. It is submitted that this should be amended to reflect transactional reality.

Nonetheless, the reasonable conclusion is that this exemption significantly reduces the transaction costs involved and makes ABS issuance a more viable financing option for originators.<sup>181</sup> Indeed, it is submitted that this alone was one of the greatest obstacles to ABS issuance since 2007.

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<sup>174</sup> Part I(51) of the First Schedule of the Income Tax Act.

<sup>175</sup> PWC, 'Securitisation - achieving tax neutrality' available at <https://www.pwc.com/gx/en/structured-finance/pdf/pwc-publications-securitisation-tax-neutrality.pdf>, accessed on 16 October 2016.

<sup>176</sup> The Finance Act, 2016 repealed s 975(2)(b) which was a rushed inclusion requiring thirty percent local ownership of all foreign firms. The author is aware of present efforts spearheaded by the Attorney-General's Office and the Business Registration Services Board to fine tune this and related legislation.

<sup>177</sup> Part V, Companies Act of 1989.

<sup>178</sup> Companies Act, s 28.

<sup>179</sup> See 3.3.2.1 below.

<sup>180</sup> In accordance with s 106 of the Stamp Duty Act.

<sup>181</sup> Bhattacharya and Fabozzi, *Asset-Backed Securities* (1996) 29.

### 3.2.4. The Draft Movable Property Security Rights Bill, 2016

This draft Bill was formulated through a multi-sectoral consultative process<sup>182</sup> seeking to modernise the use of movable property as security in business transactions. This would include securitisation of receivables. It proposes to do this by coalescing the presently disjointed legal framework<sup>183</sup> on such security rights and creating a Registrar to centrally record and coordinate transfers of security rights amongst transaction parties.<sup>184</sup>

If enacted it would repeal outdated legislation<sup>185</sup> while providing details on set-off rights.<sup>186</sup> It could also clarify applicable laws in disputes on grantors or location of collateral<sup>187</sup> and the priority of competing security rights<sup>188</sup> on which prior written law was vague or silent. Most of the provisions of the Bill if enacted will be derogable or variable by contracting parties, in an evident nod to the classical foundation of contractual freedom. Nonetheless, diligent and *bona fide* exercise and performance of rights will remain paramount.<sup>189</sup>

Under clause 9, it proposes to expressly recognise that identifiable proceeds of any asset will be included under the security right. Presently, this must be determined by dint of case law since existing legislation is silent on the matter. Further, clause 11 proposes that security rights in receivables will still be effective regardless of contractual limitations thereunder. This may conflict with consumer protection legislation, which clause 4(4) already states will be paramount. In addition, Part III of the draft Bill deals with the effectiveness of security rights against third parties. It proposes that such effectiveness will only exist upon filing of written notice with the Registrar.<sup>190</sup>

One of the most pertinent changes that this Bill may introduce is the shift from a transaction-registration to a notice-registration filing system.<sup>191</sup> The present transaction-registration system requires one to file the actual instrument that creates a security interest for assessment, generating additional costs and delays. Also, a single notice will be filed as notification of multiple transactions relating to one grantor-creditor relationship, as compared to the present situation where each transaction must be recorded individually.<sup>192</sup> A notice system will operate on a prescribed set of forms and prescribed information thus lowering presently prohibitive costs.

The creation of such a centralised electronic database would also alleviate the information asymmetry that enhances the risk exposure of transaction parties.<sup>193</sup> With the proposed ease of

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<sup>182</sup> The parties involved include the Kenya Treasury, the Kenya Law Reforms Commission and FSD Kenya <http://www.klrc.go.ke/index.php/bills/583-movable-property-security-rights-bill-2016> (accessed 21 September 2016).

<sup>183</sup> See 3.2.1 above.

<sup>184</sup> Draft Security Rights Bill, clause 19.

<sup>185</sup> *Idem*, clause 94. The Chattels Transfer Act and portions of the Companies Act and Stamp Duty Act may be repealed.

<sup>186</sup> *Idem*, clause 61.

<sup>187</sup> *Idem*, Part VIII. This portion of the Bill will be non-derogable or variable by contract; see clause 5.

<sup>188</sup> *Idem*, Part V.

<sup>189</sup> *Idem*, clause 5.

<sup>190</sup> *Idem*, clause 15.

<sup>191</sup> FSD Kenya above, 8.

<sup>192</sup> Draft Security Rights Bill, clause 21.

<sup>193</sup> FSD Kenya, 8.

confirming any existent security interests on assets and receivables, the cost-benefit comparison of structuring and maintaining an ABS scheme will significantly improve.

The effort to introduce this legislation will greatly assist ABS market development and commercial transactions as a whole. The greater certainty it will generate, if enacted, will eliminate various transactional costs that exist presently and lessen risks due to lack of clarity on property rights.

### 3.2.5. County Policy Guide on Asset Securitisation

In 2014, the CMA formulated the Policy Guide on Capital Markets Funding by County Governments through Asset Securitization;<sup>194</sup> a policy paper on potential capital-raising opportunities for Kenya's county governments. The County Policy Guide recognises that county governments, inheriting the financial obligations of their predecessor local authorities, are hard-pressed to take up more debt.<sup>195</sup>

In recognition of this, the Policy Guide points out that county governments possess a wide range of securitisable receivables. These include regular and predictable cash-flows ideal from parking fees, land rents and other levies.<sup>196</sup>

The Policy also identifies stumbling blocks posed by related legislation. The stringent qualification the Public Finance Management Act attaches to the constitutional requirement for national government guarantees on county government borrowing may restrict forms of ABS issuance.<sup>197</sup> In addition, possible ABS issuance by state corporations may also be hindered by their lack of clarity on powers to form SPVs<sup>198</sup> that are inherent in the securitisation process.

The Policy Guide, in benchmarking against initial ABS offers in various markets, emphasises the need for national government support in rolling out initial ABS offers.<sup>199</sup> This will be a means of demonstrating the potential of ABS in capital raising. A laudable policy proposal is that of CMA taking up the supportive role of providing templates to assist in the structuring of such products.<sup>200</sup> Given that county governments are not expected to have exceptional financial expertise such a move would assist them significantly.

Ultimately, the initiative to formulate the County Policy Guide is commendable and exhibits the drive to enhance Kenya's capital markets. Achieving this especially through innovative methods, like ABS issuance by county governments, would be a robust boost. Any initial attempts, coupled with the requisite legislative amendments will require keen regulations and governmental assistance to ensure smooth execution, and good foundation for future issuances.

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<sup>194</sup> Capital Markets Authority, *Policy Guide on Capital Markets Funding by Country Governments through Asset Securitization* (2014). Hereinafter 'County Policy Guide'.

<sup>195</sup> *Idem*, 2.

<sup>196</sup> *Idem*, 17.

<sup>197</sup> Section 58, Chapter 412C, Laws of Kenya. This effects Article 212 of the Constitution of Kenya, 2010.

<sup>198</sup> The CMA is seeking an amendment to the State Corporations Act, Cap 446 to provide this clarity; see County Policy Guide, 11 and 14.

<sup>199</sup> Governmental support for initial ABS issuances are highlighted in Malaysia and Brazil; *Idem*, 8-9 and 13. See also the growth of USA's mortgage-backed securities market with governmental support through FannieMae and Freddie Mac; See Saayman and Styger above.

<sup>200</sup> County Policy Guide, 14.



### 3.3. Comparative Approaches to Securitisation Regulation

#### 3.3.1. United Kingdom

The United Kingdom's legal framework was and remains a key comparator and benchmark for related laws in Kenya due to the latter's colonial history. The UK does not have a singular piece of legislation to regulate ABS but rather diverse legal principles are pieced together to coordinate structuring, issuance and maintenance of these securities. Several of them are key and directly relatable to Kenya's regulatory framework.

##### 3.3.1.1. True Sale and Bankruptcy-remoteness

Primarily, UK has the Law of Property Act, 1925 that codifies various common law and equitable principles on property rights especially those regarding legal and equitable assignments. This lies in contrast with Kenya which is forced to rely on the substance of English common law and doctrines of equity<sup>201</sup> as well as their interpretation by Kenyan courts of record. The Law of Property Act is primarily involved with rights in land, but Part IV thereof deals with choses in action, which applies to receivables. This is in contrast with Kenya's Chattels Transfer Act which does not apply to many choses in action that are securitisable<sup>202</sup> thus causing ambiguity.

Section 136 of the Law of Property Act provides the characteristics of a legal assignment, including the need for written notice by the assignor and the fact that such assignment is "subject to equities having priority" above it. Section 137 further clarifies on various equitable interests and their priorities. In the UK's case, this provides essential clarity and certainty when structuring ABS transactions, which Kenya would be best advised to similarly adopt.

However, it must be noted English law uses a piecemeal registration system for security rights that was adopted by Kenya. Company charges must be registered at the Companies House<sup>203</sup> and Lands Registry.<sup>204</sup> It is submitted that the structural efficiencies in England have mitigated the disadvantages that come with such a system, and UNCITRAL's notice-transaction system proposed in Kenya remains superiorly efficient.<sup>205</sup>

Recharacterisation risks under the UK framework bear near-seamless uniformity with that of Kenya; Kenya only differing in the relative paucity of specific case-law. In both jurisdictions, the intention of the parties is held paramount with a variety of English decisions holding that the entirety of the transaction and the parties' conduct will be considered.<sup>206</sup> It is worth noting that these decisions are of guiding value before Kenyan courts, and may be referred to in the event of disputes.

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<sup>201</sup> *Ibid.*

<sup>202</sup> *Supra*, 3.2.

<sup>203</sup> Companies Act, 2006, Part 25. It is not compulsory to present the original instrument.

<sup>204</sup> Land Registration Act, 2006, Part 5. The original instrument must be lodged at the Registry.

<sup>205</sup> UNCITRAL, 'Guide on the implementation of a security rights registry' (2014) available at <http://www.uncitral.org/pdf/english/texts/security/Security-Rights-Registry-Guide-e.pdf>, accessed on 20 September 2016.

<sup>206</sup> *Re George Inglefield* [1933] Ch 1; *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148.

### 3.3.1.2. SPV Structure

The choice of SPV form is open to transaction parties in the UK. Public limited companies and limited liability partnerships (LLPs) are utilised widely, with trusts being employed in other parts of the structure.<sup>207</sup> This variety is essential in attaining the advantages sought by the securitisation parties. Similarly, the use of limited recourse provisions is highlighted both by practitioners and scholars<sup>208</sup> as being vital to enhancing bankruptcy-remoteness, while coupled with the use of independent directors. Codifying such requirements and making them legally compulsory would assist ABS issuance in a frontier market such as Kenya.

### 3.3.1.3. Taxation

An exceptional element of UK's framework is the Taxation of Securitisation Companies Regulations, 2006. Predictability of taxation and its implication on the waterfall of payments to the ABS investors is essential.<sup>209</sup> These Regulations were enacted to provide such certainty. Instead of imposing tax on the accounting profit, SPVs in ABS transactions have tax levied against their retained profit; a more consistent and predictable measure.<sup>210</sup> This level of certainty can be contrasted against the Kenyan experience of ambiguity of the taxman's treatment of new capital markets products.<sup>211</sup>

ABS issuance in the UK also benefits from a broad exemption from both stamp duty and stamp duty reserve tax,<sup>212</sup> subject to qualifications regarding the amount of interest accruing to the notes.<sup>213</sup> This incentive and detailed clarity is useful to promoting securitisation, as was seen by the resultant peaking in UK securitisations in the late 1980s.<sup>214</sup> Kenya has recently introduced analogous exemptions and time will show if a similar market reaction will follow.

### 3.3.1.4. Market Infrastructure

A common clause in ABS prospectuses in the UK is that liquidity cannot be guaranteed especially in the event of market uncertainty.<sup>215</sup> In various schemes, the existence of secondary liquidity facilities is usually pointed out to boost investor confidence in the existence of market choice, given that such illiquidity can sometimes diminish the value of issued securities.<sup>216</sup> Kenya faces similarly illiquid debt markets, and liquidity mechanisms such as this would boost ABS investor confidence.

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<sup>207</sup> Possible structures include the ownership of issuer SPV's shares by a charitable trust, to enhance bankruptcy remoteness. Virgin Money, 'Gosforth Funding 2016-1 plc Offering Circular', 3 and 47, available at [http://uk.virginmoney.com/virgin/investor-relations/2016/2/Offering\\_Circular.pdf](http://uk.virginmoney.com/virgin/investor-relations/2016/2/Offering_Circular.pdf), accessed on 16 October 2016 (hereinafter 'Gosforth Funding-1').

<sup>208</sup> *Op cit* note 73, 174.

<sup>209</sup> PWC above, 3.

<sup>210</sup> Taxation of Securitisation Companies Regulations, 2006, reg 10.

<sup>211</sup> For example, the taxation of Kenya's first Real Estate Investment Trust was marred with uncertainty. See STANLIB Kenya, 'STANLIB Fahari I-REIT Initial Public Offer Prospectus' (2015) 81.

<sup>212</sup> Finance Act, 1986, s 78(7) as amended.

<sup>213</sup> *Ibid.*

<sup>214</sup> Pyke and Freeman, 'Mortgage-backed securitization in the United Kingdom: The background' 5 (1994) *Housing Policy Debate* 307.

<sup>215</sup> Gosforth Funding-1, 12.

<sup>216</sup> *Ibid.*

### 3.3.2. South Africa

South Africa's securitisation market is the oldest and most robust in Africa, having its first issuance of commercial paper in 1989.<sup>217</sup> Its strong financial sector and hybrid legal system provides adequate points of comparison between its framework and that of Kenya

Pursuant to the Securitisation Notice, 2008, public issuance of asset-backed commercial paper is regulated in South Africa. This duty is vested under the South Africa Reserve Bank, whose mandate it is to oversee the enforcement of the Banks Act.<sup>218</sup> The main purpose of the Securitisation Notice is to exempt SPVs in ABS issuance from being considered as carrying out the business of a bank since they accept money from the public.<sup>219</sup> Such exemption will only be achieved by an SPV if the issuance is authorised by the Registrar of Banks in writing, the securities issued under the scheme are equal to or greater than an initial principal value of R1 million and that specified disclosures are made in the placing document.<sup>220</sup>

The above measures are the result of consistent regulatory improvements aimed at enhancing risk management but also deepening the ABS market.<sup>221</sup> For example, the value of denominations above has been reduced over time to allow smaller originators to come to the market. In fact, initially only banks were permitted to be originators.<sup>222</sup> Kenya's regulators can heed this as a learning point on not restricting the type of originators on the Kenyan market.

#### 3.3.2.1. SPV Structure

The trust concept is recognised in South Africa by dint of the Trust Property Control Act<sup>223</sup> but its attributes are slightly different and not as developed as those of the English common law trust applicable in Kenya.<sup>224</sup> Hence, trusts are not extensively used in ABS transactions with limited liability companies being the go-to entity, in spite of both being permitted under the Securitisation Notice, 2008.<sup>225</sup>

Interestingly, South Africa has faced a similar diminution of the *ultra vires* doctrine as Kenya, with companies able to exercise capacity as that exercised by a juristic person and as expressly limited by the company's memorandum of incorporation.<sup>226</sup> In keeping with the doctrine of constructive notice, South Africa requires a company whose memorandum of incorporation contains restriction on its capacity or ability to amend its constitutive documents to precede its name with the initials 'RF'.<sup>227</sup> This signifies a ring-fenced company and serves as notice to third parties that the company's objects are still restricted somewhat. This tool is very welcome

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<sup>217</sup> Locke *Aspects* 16. N van Vuuren, 'The awakening of securitisation in South Africa', available at <http://www.sasf.co.za/aboutsecuritisation/The%20awakening%20of%20securitisation%20in%20South%20Africa.pdf>, accessed on 16 October 2016.

<sup>218</sup> No. 94 of 1990.

<sup>219</sup> Securitisation Notice, 2008, para 2(1).

<sup>220</sup> *Idem*, para 14(1)(b).

<sup>221</sup> Locke *Aspects* 259-279.

<sup>222</sup> *Idem*, 411.

<sup>223</sup> No. 57 of 1988.

<sup>224</sup> Nel, 'The Trust as Special-Purpose Institution' *Obiter* 34 (2013) 111. Robbé asserts that the choice in common law and civil law jurisdictions is skewed towards trusts and companies respectively, see Robbé *Law and Practice* 16; Wood *Project Finance* 121.

<sup>225</sup> Securitisation Notice, 2008, para 1.

<sup>226</sup> Companies Act, 2008, s 19(1)(b).

<sup>227</sup> Companies Act 2008, s 15(2)(b) read with s 11(3)(b). See also Knight, 'Keep it simple and set it free: The new ethos of corporate formation' in Mongalo, *Modern Company Law for a Competitive South African Economy* (2010) 38.

in a securitisation scenario and a similar amendment to section 28 of Kenya's Companies Act should be considered.

### 3.3.2.2. Bankruptcy-remoteness

Under the Securitisation Notice, 2008 and other preceding notices, key factors to bankruptcy-remoteness have remained constant. These include the application of non-recourse provisions against the holders of ABS themselves against the SPV and of the SPV against the originator. These limitations on control have been proposed in Kenya's ABS Guidelines and are step forward. In addition, an originator is prohibited from directly or indirectly controlling more than 20% of the SPV's issued share capital.<sup>228</sup> This caters for the much-decried lack of "skin-in-the-game" from a prudential perspective<sup>229</sup> while still assuring bankruptcy-remoteness. Kenya's ABS Regulations indicated a threshold of ten percent, but it remains to be seen if that will change.<sup>230</sup>

### 3.3.2.3. True Sale

True sale opinions are mandatory per the Securitisation Notice, 2008 and must clearly indicate the divestiture of rights, obligations and risk as well as achievement of off-balance sheet treatment<sup>231</sup> without which the Registrar's consent cannot be granted. True sale of receivables in South Africa is usually achieved by out-and-out cession of the title to the receivables to the cessionary (SPV).<sup>232</sup> Similarly to the principles of equity applied in Kenya, the cessionary only obtains as good a right as that possessed by the cedent.<sup>233</sup> Cessions of real rights in property must be registered at the Deeds Registry<sup>234</sup> but prior to the out-and-out cession of such right no registration is necessary. An out-and-out cession will be less prone to recharacterisation risks, in which the intention of parties is the key factor in this legal determination<sup>235</sup>. Hence, in a *bona fide* out-and-out cession such risks are diminished.

A key observation highlighted by Locke in assessing ABS transactions in South Africa is the omission of non-assignment clauses (*pacta de non cedendo*) in the initial documents creating the receivables.<sup>236</sup> Permission to cede such interests without customer notification is usually incorporated contractually. This lowers a key due diligence hurdle for originators and adoption of the same would be recommendable for Kenyan originators, while keeping in mind any underlying consumer protection obligations.<sup>237</sup> Further, non-petition clauses (*pacta de non petendo*) have been upheld consistently in South Africa,<sup>238</sup> unlike the uncertainty accorded to

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<sup>228</sup> Securitisation Notice s 4(2)(p)(i)(A).

<sup>229</sup> Levitin, 'Skin-in-the-game: Risk retention lessons from credit card securitization' 81 (2013) *George Washington Law Review* 813.

<sup>230</sup> ABS Regulations, reg 5.

<sup>231</sup> Securitisation Notice, 2008, s 4(1)(c).

<sup>232</sup> This is contrasted to a cession *in securitatem debiti* in which the cedent retains a reversionary interest, giving the cessionary possession but not ownership of the claim. The nature of security will also depend on the parties' intent. See *Grobler v Oosthuizen* 2009 (5) SA 500 (SCA) 11.

<sup>233</sup> This is based on the *nemo plus iuris* rule; Sunkel above, 12.

<sup>234</sup> Chief Registrar's Circular 11/2014. This Circular was withdrawn by Chief Registrar's Circular 14/2014, thus the situation remains uncertain as reforms are awaited.

<sup>235</sup> In *Hülse-Reuter v Götde* 2001 (4) SA 1336 (SCA) at 1346A–D, the Court upheld a judicial reluctance to disregard corporate personality, only exercising it in the most unusual circumstances.

<sup>236</sup> Sunkel above; Locke *Aspects* 270.

<sup>237</sup> This is embodied in the Consumer Protection Act No. 46 of 2012.

<sup>238</sup> See *Total South Africa (Pty) Ltd v Bekker NO* 1992 (2) SA 617 (A) at 626F–G.

them in both Kenya and the UK. Hence, their utilisation in structuring documents to enhance bankruptcy-remoteness is commonplace.

#### **3.3.2.4. Taxation**

Taxation incentives are also quite robust in South Africa to ease ABS transactions. The transfer of receivables from the originator to the SPV is considered a sale of goods and services to which the Value-added Tax Act applies to, but the same is exempted from payment of VAT.<sup>239</sup> Kenya is at par on this as it treats issuance of securities as an exempt supply.<sup>240</sup>

Similarly, the securities issued are exempt from securities transfer tax under the Securities Transfer Act.<sup>241</sup> Stamp duty exposure is also diminished by exempting liability thereto for ABS listed on a financial exchange and the transfer of mortgages which are a key ABS segment.<sup>242</sup> Kenya has recently adopted this approach as well.<sup>243</sup>

### **3.4. Conclusion**

It is evident that there is a regulatory impetus to establish an ABS market in Kenya, but existing challenges have yet been surmounted. The Capital Markets Act has been recently amended, and the new draft Guidelines if enacted may broadly change the existing landscape. However, it is submitted that the CMA's insistence on particular concepts are self-defeating, and until these are corrected, the ABS market may become ineffectual if not stagnant.

The regulatory frameworks of South Africa and the UK point out successes that Kenya can learn from. Particularly, the means of achieving a true sale has been critically achieved whilst maintaining integrity and consumer protection obligations. Taxation is evidently a vital component of an ABS transaction but Kenya will need to provide clarity on this going forward.

The differences in historical development of ABS markets in each jurisdiction are key, as well as the peculiarities of each legal system. Such nuances have been considered in the observations and recommendations made in the following chapter.

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<sup>239</sup> No. 89 of 1991, s 12(a) as read with s 2(1)(c).

<sup>240</sup> Part II of First Schedule, Value Added Tax Act, No. 35 of 2013.

<sup>241</sup> Securities Transfer Tax Act, 2007, s 1.

<sup>242</sup> Income Tax Act, s 24J.

<sup>243</sup> See 3.2.3.3 above.

## Chapter Four: Opportunities for and Challenges to Reform

### 4.1. Introduction

This study has focused on Kenya’s attempts at jumpstarting its ABS market. The lack of ABS issuances since 2007 has offered a learning point into the need to adopt a multi-sectoral participatory approach,<sup>244</sup> especially regarding its complexity.

A general inadequacy in the relevant legislation and a lack of coherence thereto has hence been observed. Comparison with relatable jurisdictions has similarly revealed points of improvement that Kenya would be best placed adopting. This final chapter summarises not only those weaknesses but achievements made and makes proposals for further reform. Finally, hindrances to such attempted reforms will be touched on.

### 4.2. Appraisal of Kenya’s Legal Framework

This study has shown that Kenya’s ABS legislation has been contradictory and ambiguous. The CMA Act has conflicted with the threadbare ABS Regulations since being amended, supercession clause notwithstanding.<sup>245</sup> The lag in guidance from the CMA has been aided by the temporary ABS Guidelines but even these in their draft stage exhibit a regulatory stance that may end up being inimical to ABS issuance.<sup>246</sup>

Nonetheless, the present framework appreciably mirrors global best practice. The essential components of a true sale, bankruptcy-remoteness, credit ratings and more are laid out. For clarity, the strengths and weaknesses of Kenya’s present framework are summarised below.

**Table 1:**

<b>Strengths</b>	<b>Weaknesses</b>
Clarity on bankruptcy-remoteness and recharacterisation risks	True sale can only be achieved through legal assignment
Securitisation of future receivables is permitted	Historical contradictions on permitted SPV types
Recognition of the common law trust	Ambiguity of key stamp duty exemption is disincentivising
A modernised companies and insolvency regime	Illiquidity of debt markets is unattractive
	Bureaucratic and outdated movable property security rights system

In potential reforms gleaned from the comparative review above, it must be insisted that foreign approaches should not be transplanted without consideration of surrounding factors. Particularly, South Africa’s hybrid legal system incorporates civil law elements into its commercial practice that are not directly analogous to Kenya’s common law system. Further, South African law does not permit the securitisation of future receivables, in stark contrast with the Kenyan position.

<sup>244</sup> World Bank, the Treasury, and Attorney-General’s Office, county governments have now been collaborating with the CMA in crafting this framework. *Op cit* note 186.

<sup>245</sup> *Idem*, paras 2.03 and 2.04.

<sup>246</sup> *Supra* at 3.5.

The UK regulatory system, though very relatable, must still be treated with caution. Years of experience and domestic factors are at play in this system, thus replication must be understood in this light.

Nevertheless, Kenyan transaction parties would be best advised to pick best practices not only from these two jurisdictions but any other relevant ones. This in particular could relate to adapting and adjusting relevant transactional documents like prospectuses, until such a time that Kenya's market develops to rely on itself.

### **4.3. Opportunities for Reform**

As observed in Chapter Three, there are ongoing reform exercises such as the draft ABS Guidelines and other proposed legislation. Primarily, the enactment of these should be fast-tracked but the flaws contained therein and those not addressed by them are detailed below.

#### **4.3.1. Preference for transfer by equitable assignment**

Kenya should expressly legislate equitable assignments as the preferred method of achieving a true sale of receivables. As this study has shown, the consistent trend of requiring legal assignment of receivables has burdened originators with obtaining written consents from every individual obligor. The cost and impracticality of this in practice is apparent, and goes against the norm in other leading securitisation markets.

The doubts regarding fraud and perfection of security expressed by the CMA in the draft ABS Guidelines will be cured by the passing and enactment of the Movable Property Security Rights Bill.<sup>247</sup> Hence fast-tracking this vital legislation is vital to developing Kenya's ABS market. Relatedly, the key properties of both legal and equitable assignments should be codified into statute to provide certainty and predictability.

#### **4.3.2. Permitting choice in SPV entity**

The norm identified in comparative jurisdictions is that transaction parties have a choice between different SPV forms. Kenya has however hovered uncertainly between preferring common law trusts to limited liability companies.

This study proposes that not only should both be permitted, but also limited liability partnerships (LLPs) should be an SPV choice. The extensive use of LLPs in the United Kingdom provides greater leeway to transaction parties; especially given the unique taxation properties it brings to the table.<sup>248</sup>

#### **4.3.3. Tax Reform**

The structuring of an ABS transaction is fraught with tax obligations and the numerous statutes and legal notices issued year after year can be confusing. Some of these are ambiguous<sup>249</sup> while others are restrictive due to the additional cost they bring.

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<sup>247</sup> Supra at 3.5.

<sup>248</sup> Limited liability companies experience double tax exposure, with corporate tax as well as income and withholding tax on distributions to shareholders. LLPs are 'transparent' for tax purposes with the only tax burden on the partners themselves. See Income Tax Act, s 3(2)(a)(i) and 4(b).

<sup>249</sup> Legal Notice 105 of 2015 above.

It is proposed that Kenya should mirror the UK's approach<sup>250</sup> and distil the entire tax treatment of ABS transactions into a single regulatory document. This would necessitate the hands-on engagement of the Kenya Revenue Authority, another recommendation to do away with the uncertainty observed with the introduction of other innovative financial products.

#### **4.3.4. Deepen the debt markets**

Kenya's debt markets are relatively illiquid, with improving yet dismal turnover. Given that most ABS are debt securities in nature, illiquidity lessens the exit options that potential investors would have and renders ABS unattractive.

This study then proposes that Kenya moves to introduce the position of market-makers in its debt markets to enhance liquidity. Such parties would, as they have in UK and South Africa, serve as the willing buyer or even seller when actual counterparties are unwilling or absent in the market structure as presently is the case. Additional regulatory support, such as a discount window facility from the Central Bank of Kenya or primary dealers where applicable could be useful in sustaining liquidity.<sup>251</sup>

#### **4.4. Possible Challenges to Reform**

This research reveals that any reform to Kenya's ABS framework is far-reaching and involves a substantial amount of legislation. Amendments thereto would have an extensive impact on the transactions and systems they relate to, and collective reform could prove quite the task. It is thus advisable that any reforms are not rushed, but phased in nurturing political goodwill to ensure necessary institutional structures are in place.

It is also imperative that the CMA adopts a collaborative strategy, incorporating stakeholder input. The participation of the Central Bank, regulators of the insurance and pension industry, county governments should be enhanced where possible.

#### **4.5. Conclusion**

This study has progressively analysed Kenya's ABS regulatory framework, picking out its strengths and weaknesses. Arguably, a lot of effort has been put in to jump start the ABS market, but the stumbles made therein remain a hindrance. The reforms suggested above are based on international best practice and envision the ability of Kenya achieving its desired financial hub status.<sup>252</sup>

Access to credit remains a challenge in Kenya, but ABS undoubtedly offer an alternative source of funding for both the public and private sector. Specifically, in the new county-focused development space,<sup>253</sup> ABS will face even more prominence. The utility to be gained from the efficient working of this system could potentially result in economic growth and greater social development.<sup>254</sup> Structured finance sits on a pedestal in any modern capitalist society thus Kenya should do its best to raise ABS accordingly to that position.

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<sup>250</sup> Taxation of Securitisation Companies Regulations, 2006.

<sup>251</sup> Arnone and Iden above.

<sup>252</sup> Capital Market Master Plan, 17, 23, 41.

<sup>253</sup> As adopted in the Constitution of Kenya, 2010.

<sup>254</sup> Penner *Jurisprudence*, 210.



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