COSTS OF COLLATERAL IN KENYA

OPPORTUNITIES FOR REFORM

SEPTEMBER 2009

KENYA BANKERS ASSOCIATION

Growth Fin
financing for growth

FSD Kenya
Financial Sector Deepening

This report was commissioned by Growthfin, a programme of Financial Sector Deepening (FSD) Kenya, in partnership with the Central Bank of Kenya and the Kenya Bankers Association. The study was carried out by ShoreBank International Limited (SBI), and Walker Kontos Advocates,. The team consisted of Jose E Mantilla, ShoreBank International, and Peter M Mwangi and Jennifer W Kibaara, Walker Kontos. The team carried out the study in Nairobi, Kenya, from April 15th through May 12th 2009.

WALKER KONTOS

SHOREBANK INTERNATIONAL

The report was commissioned by FSD Kenya. The findings, interpretations and conclusions are those of the authors and do not necessarily represent those of FSD Kenya, its Trustees and partner development agencies.

FSD Kenya
Financial Sector Deepening

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA) and Agence Française de Développement (AFD).

Table of Contents

Tables and Figures

TABLES

FIGURES

Abbreviations

CBK	Central Bank of Kenya
CRB	Credit Reference Bureau
FSD	Financial Sector Deepening
GDP	Gross Domestic Product
ICA	Investment Climate Assessment
IMF	International Monetary Fund
KBA	Kenya Bankers Association
KRA	Kenya Revenue Authority
KSH	Kenyan Shillings
RLA	Registered Land Act (Cap. 300 Laws of Kenya)
RTA	Registration of Titles Act (Cap. 281 Laws of Kenya)
SMES	Small and medium enterprises
SACCO	Saving and Credit Cooperative
VAT	Value Added Tax

Definition Of Terms

Chattel: Any tangible, movable property.

Conveyance: Transfer of an interest in immovable property from one person to another. This may be by way of sale of the property, leasing the property, or by mortgaging it as security for a loan obtained from a bank or financial institution.

Creation and perfection of security: The entering into of a contract by both the borrower and the lender by which the borrower provides his assets as collateral for a loan facility to be made available to him. These assets may be sold by the lender in the event of default. This exercise involves the drawing up of the necessary documents that set out the rights and obligations of both parties.

Debenture: This means a debt, and, when supported by a charge over assets, means an instrument created over the assets of a company as security for a debt.

Encumbrance: A right to or interest in property that prohibits the owner of that property from freely transferring it.

Enforcement of security: The selling off of an asset by the bank in the event of default by the borrower in repaying the loan amount made available to him upon giving the asset as security.

Injunction: A judicial remedy awarded to halt a particular activity. A preventive measure to guard against future injuries, rather than a remedy for past injuries.

Lien: A charge, hold or claim upon the property of another party.

Non-performing loans: A loan on which the debtor has ceased to make payments for a period of ninety days or more.

Perfection of security: The registration of security in various registries by the borrower and bank so as to give notice to the public of the existence of the security. This is done to guard against fraud and give priority to creditors in the event of default and selling off of the security.

Personal security: Security created over tangible, movable property as compared to security created over land which is real security.

Receiver & receivership: A remedy available to a creditor whereby property is placed under the control of a receiver, a neutral person, so as to preserve it for the benefit of affected parties.

EXECUTIVE SUMMARY

INTRODUCTION

Credit has been called the lifeblood of a modern economy, as it is crucial in the growth of enterprises, and enterprise growth is essential to the growth of employment and the overall economy. In many developing countries, including Kenya, bank lending is a prime source of credit to enterprises. However, the credit relationship between banks and enterprises is inherently risky, and in order to mitigate these risks, banks all over the world use collateral.

Collateral is the security given by a borrower to a lender, which (in the event of default or as otherwise agreed) is used by the lender to recover the amount borrowed by selling it off for the proceeds. Collateral is a principle of sound banking practice and is one of the criteria for assessing risk under prudential guidelines.

Collateralisation is the process by which this security given by the borrower is created and/or formalised in favour of the lender. In most advanced economies, both collateralisation and realisation of security are quick, predictable and efficient processes. The situation in Kenya, however, is different. The process of collateralisation as well as realisation of security is lengthy, bureaucratic, inefficient and unpredictable. The recurring theme is the phenomenal level of cost involved in the collateral process.

There are costs incurred during the identification, valuation, creation and perfection of collateral as well as in the subsequent monitoring and realisation process. The costs involved invariably lead to increased costs of borrowing. Collateralisation therefore becomes a major deterrent to financial growth as the time and cost involved in the process means only a small fraction of potential borrowers are able to access finance.

OBJECTIVES

FSD Kenya under its Growthfin programme commissioned ShoreBank International (SBI) and Walker Kontos to undertake a study to identify and document the collateral process and determine the costs associated with each step involved, in Kenya. The study provides answers to the following questions:

- What is the addition in cost and time to the borrower and/or lending institution of the existing system of acquiring, controlling, foreclosing and disposing of collateral in Kenya?
- What is the estimate of the cost of collateral to the total lending cost in Kenya?
- How much do collateral requirements inhibit potential borrowers in Kenya?
- What are the legal and extra-legal constraints which hinder the collateral process in Kenya?
- What can be done to streamline the collateral process and ease the burden of costs in Kenya?

METHODOLOGY

The consultants conducted a series of interviews with diverse classes of borrowers and lenders, as well as members of professional bodies and professionals who are well versed in industry problems regarding collateral. The team interviewed Government officials who regularly deal with filing and registration of collateral. To augment the interview process, the consultants partnered with Synovate, a Nairobi based research firm which surveyed 100 randomly selected small and medium enterprises (SMEs) located in Nairobi, with the following sectoral breakdown: 10% agro-sector, 20% manufacturing and 70% service. Also, the team conducted off-site research using tables and data from the Access to Finance section of the Kenya Investment Climate Assessment produced in June 2008 by the Finance and Private Sector Development Group of the World Bank's Africa Region.

FINDINGS

The results of this study confirm that the collateral process in Kenya is flawed and as a result is characterised by high costs. The following challenges inhibit the ease of collateralisation in Kenya:

- *Weak and dispersed legal framework:* there are more than 20 statutes regulating the creation and perfection of collateral. The laws lack uniformity and result in a convoluted conveyance system. For example, freedom to contract has been severely curtailed by the statutes that inhibit property rights through archaic procedures and regulations. In addition, stamp duty is expensive both in its direct cost and in the method of its collection;
- *Weak and dispersed registry system:* there are many registries, which are manual, inefficient, uncoordinated and inconclusive. This situation has been exacerbated by the practice of using the registries as tax collectors;
- *Weak enforcement procedures:* the judicial system has been a major hindrance to lenders' ability to raise security. There is a mix of slow judicial processes;
- *Restricted scope of security instruments:* lenders have not been innovative in considering other forms of collateral. There is a tendency to rely on traditional all-asset debenture and legal mortgages at the expense of less costly and more innovative financial products.

The flawed collateral process affects the demand for finance as an increasing number of borrowers have difficulties meeting the collateral requirements. The process also negatively affects lenders as they have to compete vigorously for the small crop of borrowers who do meet the stringent criteria for collateral. Lenders also have to contend with the costly realisation process. All these problems add risk to the business of lending and borrowing.

5.0 CONCLUSION AND RECOMMENDATIONS

Under well-designed and well-operated collateral processes, both lenders and borrowers benefit from the pledging of collateral, resulting in limited legal claims, a reduction in informational asymmetries, limited excess borrowing, lower financing costs and increased credit in the economy. The report puts forward a number of recommendations aimed at reforming the three main components of the collateral process: creation, perfection and enforcement of security.

The Government is urged to prioritise the necessary reforms, some of which are on-going, as a major contributor to financial sector development in Kenya.

Chapter 1

COLLATERAL

1.1 THE IMPORTANCE OF COLLATERAL

Credit has been called the lifeblood of a modern economy[1]. Access to credit is a key determinant in the growth of enterprises, and enterprise growth is essential to the growth of employment and of the overall economy. In many developing countries, including Kenya, bank lending is a prime source of credit to enterprises.

The preferred approach to mitigating the risk inherent in a credit relationship between a lender and borrower is usually through the use of collateral. Both lenders and borrowers benefit from the pledging of collateral using well-designed and well-operated collateral processes. Legal claims are reduced when the secured creditor is allocated the assets pledged as collateral or the proceeds of the sale of assets, which eliminates the need for extensive litigation or the receivership or liquidation of companies. Information asymmetries are reduced when the borrower's risk preferences are limited by the implied loss of valued assets. Secured credit reduces the risk of excessive borrowing as borrowers are restricted by the amount of collateral owned. Finally, borrowers that pledge collateral are granted a lower financing cost.

In many developing countries, the collateral process is hampered by legal, regulatory and operational constraints. When the option of collateral is limited, two scenarios typically develop:

1. The cost of loans makes capital equipment more expensive for entrepreneurs relative to their counterparts in industrial countries, and, consequently, businesses postpone buying new equipment or finance it incrementally out of their own limited savings.
2. Credit is rationed by lenders and therefore is limited to the larger and more established firms. Small businesses, in particular, are limited by the scarcity of financing, and the lack of new investment dampens productivity and limits income levels in the overall economy.

The economic impact of the collateral process is illustrated in a comparison between the well-functioning collateral process in the United States and the very limited collateral process in Argentina. In the United States, 70% of loans are secured in a system with well-maintained credit registry records. Total loans exceed the Gross Domestic Product (GDP); all economic sectors are included in financing and have access to competitively priced loans.

However, the Argentinean example provides the other extreme, where nearly 90% of bank loans are unsecured. The total loans equal less than a quarter of the GDP, and large sectors of the economy are excluded from financing.[2] While the vast differences in the financing environments are not due exclusively to the collateral processes, creditor rights, the size of credit markets and financial development are positively correlated.[3]

The collateral process must balance the rights and obligations of both lender and borrower. Weak collateral processes that favour borrowers increase the cost of credit to borrowers and limit borrowers' access to credit. A process that overly strengthens collateral rights encourages excessive reliance on collateral and weakens the lenders' incentives to evaluate the future prospects of new projects fully. The United States' sub-prime mortgage crisis[4], provides a stark illustration of this problem. The appreciating value of the underlying collateral in an inflated domestic property market encouraged banks to rely entirely on collateral, rather than on comprehensive screening or analysis. Additionally, strong creditor rights can actually lead to a reduction in total debt, as borrowers opt to reduce their borrowings due to the increased risk of losing assets.[5]

1.2 PRINCIPLES OF AN EFFECTIVE COLLATERAL PROCESS

The collateral process and surrounding legal and operational environment include three main components:

- The **creation** of security interests;
- The **perfection** of security interests, including public knowledge of their existence and priority; and
- The **enforcement** of security interests.

Obstacles to effective collateral processes affect each of these three components. Increasing difficulty, expense, and uncertainty related to the **creation** of security interests prevent public understanding of the **perfection** of security interests and cause the **enforcement** of security interests to be slow and expensive.

Countries with effective collateral processes, such as the United States and the United Kingdom are those that have implemented reforms to address the fundamental obstacles described above, including:

- Amending laws to permit a greater variety of security interests in a wider range of transactions by a broader group of people;
- Making registry records public and accessible to all, searchable by debtor, asset or lender, and with little or no cost. This often entails restructuring public registries or allowing private registry services to compete with the existing public registries; and
- Speeding up enforcement processes and decreasing the cost by changing laws to permit private parties to contract for non-judicial repossession

1 IFC, Credit Bureaus Enabling Economic Growth and Prosperity, 2007.
2 World Bank principles
2 La Porta, Rafael, Florencio Lopez de Silanes, Andrei Schleifer, and Robert W Vishny Legal determinants of External Finance, Journal of Finance 52, 1131-1150.
3 Vikrant Vig, Access to Collateral and Corporate Debt Structure: Evidence from a natural experiment.
4 In 2007
5 In 2007

and sale, and, where possible, allowing private parties to contract for repossession and sale without court or government intervention.

However, although a globally applicable set of reforms is available, effective collateral processes must respond to national needs and problems and be rooted in a country's broader cultural, economic, legal, and social context. Effective collateral systems must recognise that transparency, accountability, and predictability are fundamental to sound credit relationships. Investment and the availability of credit are predicated on the perceptions of risk and the reality of risks.

Credit delivery is handicapped not only by a lack of access to accurate information on credit risk, but also by unpredictable legal mechanisms for debt enforcement, recovery and restructuring. Therefore, the legal and institutional mechanisms to be adopted must align incentives and disincentives across a broad spectrum of market-based systems that are commercial, corporate, financial, and social. This calls for an integrated approach to reform, taking into account a wide range of laws and policies in the design of effective collateral processes, as well as effective insolvency and creditors' rights systems more broadly.[6]

1.3 KENYA'S FINANCIAL SYSTEM

Kenya's financial system is more developed than in most countries in the Sub-Saharan Africa region, and compares favourably to other emerging nations of similar development levels. It comprises 43 commercial banks, of which 11 are partly or wholly owned by foreign financial institutions. Deposit-taking micro-finance institutions regulated by the Central Bank of Kenya (CBK) were legally permitted as of May 2008, and the Association of Micro-finance Institutions estimates that approximately 12 institutions will seek licences in the near future; the same association estimates that approximately 450 additional institutions do not take deposits but engage in lending activities.

Whereas many other African emerging economies have experimented with state owned banking systems, the private banking sector has been a mainstay of the Kenyan economy from the 1950s to date. Furthermore, foreign banks have always accounted for a substantial portion of the assets of the Kenyan banking system. Kenya also has a number of savings and credit co-operative societies (SACCOs) to which many Kenyan workers and farmers belong and which have become important avenues for mobilisation of savings.

The Kenyan economy is well monetised, and bank regulations are generally adequate and flexible. The regulator (CBK) is well respected. Reserve requirements are low at 5% and there are no interest rate controls.[7] Although there remains a provision in the Banking Act for CBK approval of change in charges levied by banks. Managerial human capital at both local and foreign banks is impressive, with outstanding professionals in some institutions.

The country has a significantly diversified financial structure, including insurance and capital market institutions. Kenya, unlike many other African countries, has many of the elements needed for the development of a vibrant financial market.

Kenya's economic history is more stable than the histories of many emerging economies, lacking very severe bouts of inflation, banking sector collapse or major crises that harm public confidence in financial institutions. The most significant historical crisis took place in the late 1980s and early 1990s, when Kenya experienced a bout of high inflation, loss of control of the money supply, and the failure and/or distress of several banks and non-bank financial intermediaries. Despite this auspicious structural environment, credit is a low percentage of GDP and the ratio has remained relatively stagnant in recent years.

BANK MARGINS

A recurring issue mentioned during the course of this study was the concern over perceived high bank spreads in Kenya. An analysis conducted by the International Monetary Fund (IMF) in a 2005 Financial Sector Stability Assessment of East Africa indicated that the large spreads are caused by three factors:[8]

- *A relatively large share of non-performing loans (NPLs)* – As of June 2008, NPLs comprised 7.1% of total advances, with a portion concentrated in state owned banks. NPLs have been a concern of the banking system for many years, though the concern has decreased in recent years.
- *High profit margins* - Kenyan banks have relatively high profit margins on lending. A certain percentage of this can be attributed to "captive clients", clients who are loyal to the bank, and do not hold accounts with or take loans from other banks, and lower competition (further explained in the section related to all asset debentures).

  A percentage of this margin can be directly related to difficulties of using collateral. The absence of efficient judicial procedures to facilitate loan recovery may also increase the margins.
- *High operating costs* - Overhead costs are the most important component of interest rate spreads, accounting for 6 to 8 percentage points of the spread. This high overhead cost is related to low productivity and overstaffing. Kenyan banks have more employees for a given amount of assets, loans and deposits than other banks in emerging market countries,

6 The World Bank. *Principles For Effective Insolvency And Creditor Rights Systems (Revised)* (2005)

7 The cash reserve requirement was set at 4.5% with effect from July 2009 by the CBK's Monetary Policy Committee.

8 Martin Cihak and Richard Podpiera. *Bank Behavior in Developing Countries: Evidence from East Africa*, IMF Working Paper 05/129 (June 2005).

Table 1: Bank productivity in Kenya

Bank Productivity (In thousands of US Dollars)				
	Net interest per employee	**Assets per employee**	**Loans per employee**	**Deposits per employee**
Kenya	36	581	295	458
State-owned banks	23	303	187	222
Local private banks	31	577	317	447
Foreign banks	50	770	349	625
Emerging market countries	60	2040	911	1620

Source: Beck and Fuchs (2004) as cited in IMF Working Paper 05/129 page 16.

and net interest revenue per employee is very low in comparison to banks in other countries with similar financial systems (see Table 1 above).[9]

9 In 2008 net interest per employee - 52, Assets per employee - 598, loans per employee - 319 and deposits per employee - 471. Calculated based on data from CBK Bank Supervision Annual Report 2008.

Chapter 2

COST OF COLLATERAL IN KENYA

This chapter aims to give a comprehensive representation of the current environment for the collateral process in Kenya. It outlines the steps required in the collateral process and identifies the time and costs incurred for each process. As mentioned in the previous section, the collateral process has three main components: creation, perfection and enforcement of security. This section will provide a clear assessment of achieving each component by highlighting:

- The steps taken to secure a loan;
- The time and cost incurred for each step; and
- The constraints to each of the components.

Practical examples will be used to provide a better understanding of the collateral process.

2.1 CREATION AND PERFECTION OF COLLATERAL

Creation and perfection of collateral occurs when a borrower who has an interest in property, or who holds the power to transfer the interest, transfers it to a lender as collateral in exchange for a loan facility. (Property is used in the widest meaning of the word here - anything that can be possessed.) A value is ascribed to the collateral that is sufficient to support a contract.

The contract gives the lender certain rights in respect of possession and sale for the purpose of recovering the amount of the debt should there be a default by the borrower. The collateral created needs to be registered to facilitate ascertainment of the interest created. Registration is therefore a vital process in the creation and perfection, as well as enforcement, of collateral.

Collateral in most cases is *immovable property*, *an asset* or a *chattel*. Table 2 below indicates the processes undertaken in the creation and perfection for each of these forms of collateral, taking into account the time and cost incurred as well as the constraints encountered during each stage.

Practical examples – Creation and perfection of collateral

Let us now look at two specific scenarios. The first is based on the transfer (purchase) of commercial property where a mortgage will be created in favour of the lender. As a result, the transfer and mortgage will be registered simultaneously at the Land Office. This means that stamp duty on the transfer (4% of the value) will be payable in addition to the stamp duty amount on the mortgage (0.2% of the mortgage amount). The second scenario is an asset purchase loan by a company where the asset is the collateral.

Scenario 1 - Charge on a building in Nairobi for KSh 10,000,000

Table 3 shows the five stage process that is required to secure immovable property. These stages include: a search, documentation, obtaining the completion documents, stamping, valuation, and registration. Each stage includes various steps, most of which are undertaken at the Land's Office.

Table 2: Stages in the registration of a security

Secured loan on immovable property (registered at the Land Registry)				
1. Companies search				
▪ Searches at the Companies Registry can be carried out by the interested party or by a registry official. ▪ Requires the physical presence of the person carrying out the search and can only be carried out in Nairobi. ▪ Process takes 1 to 3 working days, depending on the availability of the file. ▪ Cost of search is KSh 200.	Max cost	KSh 200	Max time	3 days
2. Search of title at the Land Registry				
▪ Searches at the relevant Land Registry can be carried out by the interested party (physical inspection) or by a registry official (government officer undertakes the search and delivers a report which is often merely a copy of the title). ▪ Requires the physical presence of the person carrying out the search. The Registry in which to conduct the search will depend on the law governing the specific land and where the title is held. Can either be in Nairobi or Mombasa or the relevant District (if title is subject to the Registered Land Act (RLA)). ▪ Search certificate issued by the Land Registrar. This is conclusive and the government guarantees title (guarantee takes the form of compensation). ▪ On average this process takes about 5 working days. However, if the file or title is misplaced or not available, it may take an indeterminate amount of time. ▪ Search fees are KSh 205 for land under the Registration of Titles Act (RTA) and KSh 100 for land under RLA. ▪ In addition, the borrower must present a valuation report to the lender. This report will also include a valuer's search on the title to the property.	Max cost	KSh 205	Max time	5 days

3. Documentation

- Perfection of documents prior to registration takes 5 days.
- Documents must invariably be prepared by external lawyers, resulting in additional cost.
- Cost of documents depends on the scale of fees set out in the Advocates (Remuneration Amendment) Order, 2009. Amount payable depends on the value of the transaction

To facilitate registration of the transfer or encumbrance, the following completion documents are required:

3.1 Proof of current land rent and rates

i) Rates clearance certificate

- Issued by the Local Authorities upon payment of a fee of KSh 5,000 (Nairobi).
- Valid for 30 days.
- Need to physically visit the Municipal Council (with supporting documents) to prove that rates have been paid to them before the certificate is issued.
- Process needs to be pushed along by the interested party or it will not be completed.

ii) Land rent clearance certificate

- Issued by the Land Registry upon payment of a fee of KSh 250.
- Need to physically visit the Registry (with supporting documents) to prove that rent has been paid and to see through the process.
- Takes about 14 working days if the correspondence file relating to the property is available; if missing the period is indeterminate.
- Four officials within the Land Registry must sign off; delays can occur if these persons are not available.

iii) Consent of the Commissioner of Lands

- Required under the RTA and the RLA if land is leasehold. Not required under the Government Lands Act (GLA).
- Cost is KSh 250.

iv) Land control board consent

- Required where the land in question is agricultural. Imposed by the Land Control Act. The Land Control Board meets once a month in the relevant District to approve the consent at an official cost of KSh 250.
- In practice, the cost is KSh 5,000.
- Requires the physical presence of the person requiring the consent.

Max cost	KSh 10,500	Max time	30 days

4. Stamp duty (Stamping)

- The rate is 0.2% of the mortgage or secured amount.
- In the case of simultaneous transfer of property, the rate is an additional 4% of the price declared in the transfer.
- For property situated in rural areas, the rate is 2% of the value.
- The payment process takes 6 days and involves the assessment, issue of an instrument number against which to make payment at a bank, and subsequent confirmation by the Kenya Revenue Authority to the Land Registry that the stamp duty has been paid, upon which the stamped documents are released to the presenter.
- If there is a transfer of property involved, the stamp duty paid on the transfer instrument (amount declared) needs to be verified by a Government valuer, who needs to visit the property in question. This process can take 21 working days subject to the availability of the valuer and transportation.
- In practice, the property owner arranges for transport as well as supporting documents to hasten the process of verification. This reduces the time to about 5 working days.
- All stamping is done at the Land Office.

Max cost	4.2% of secured amount	Max time	27 days

5. Filing/Registration

- Registration of the security instrument takes place at the Land Office. The exercise takes 7 working days assuming the counterpart title (which is kept at the Land Office) is available as well as the relevant deed file relating to the title. If unavailable the process will take significantly longer.
- The application for registration has to be accompanied by the original document of title, charge documents, rates clearance certificates, rent clearance certificate, consent and valuation for stamp duty. Except for the Rates Clearance Certificate (Municipal Council) the other documents must have been previously obtained from the Land Registry itself.
- The cost incurred is KSh 250 per instrument
- If the property is owned by a company the particulars of the instrument constituted as collateral have to be filed with the Companies Registry within 42 days of the date of the instrument.
- The Companies Registry issues a Certificate of Registration.
- Filing fees per instrument at the Companies Registry are KSh 600.

Max cost	KSh 850	Max time	7 days

Secured loan on an asset (registered at the Companies Registry)

1. Companies search

- Searches at the Companies Registry can be carried out by the interested party or by a registry official.
- Requires the physical presence of the person carrying out the search and can only be carried out in Nairobi.
- Process takes 1 to 3 working days depending on the availability of the file.
- Cost of search is KSh 200.

Max cost	KSh 200	Max time	3 days

2. Documentation

- Perfection of documents prior to registration takes 5 days.
- Documents must invariably be prepared by external lawyers, adding to the cost.
- Cost of documents depends on the scale of fees set out in the Advocates (Remuneration Amendment) Order, 2009. Amount payable depends on the value of the transaction.

Max cost		Max time	5 days

3. Stamp duty (Stamping)

- The rate is 0.2% of the mortgage or secured amount.
- Process takes 4 working days.
- Stamping done at the Land Office.

Max cost	0.2% of secured amount	Max time	4 days

4. Filing/Registration

- Particulars of the instrument constituting the collateral have to be filed with the Companies Registry within 42 days of the date of the instrument.
- The Companies Registry issues a Certificate of Registration.
- The process takes 3 working days assuming the file is available and current annual returns have been filed. Time taken may be considerably longer when current annual returns have not been filed by the company. The Companies Registry obliges the lender to procure these from the company prior to registration.
- Filing fee per instrument at the Companies Registry is KSh 600.

Max cost	KSh 600	Max time	3 days

Chattels mortgage (registered at the Companies Registry)				
1. Companies search				
▪ Not Possible: Searches cannot be carried out as the registration is of documents and not encumbrances, making it impossible to carry out a search for chattels.				
2. Documentation				
▪ Perfection of documents prior to registration takes 5 days. ▪ Documents must invariably be prepared by external lawyers, adding to the cost. ▪ Cost of documents depends on the scale of fees set out in the Advocates (Remuneration Amendment) Order, 2009. Amount payable depends on the value of the transaction.	Max cost		Max time	5 days
3. Stamp duty (Stamping)				
▪ The documents are stamped for a fee of KSh 200.00. ▪ The process takes 4 working days. ▪ Stamping done at the Land Office.	Max cost	KSh 200	Max time	4 days
4. Filing/Registration				
▪ Documents are filed at the Companies Registry ▪ The process takes 1 working day. ▪ The cost is KSh 50.	Max cost	KSh 50	Max time	1 day

Under this scenario, the cost of creating and perfecting the collateral is 6.7% of the loan amount, which must be paid prior to the loan disbursal (and thus is generally not financed). The most significant costs are legal fees, stamp duty and bank commissions.

Scenario 2 – Asset purchase loan for KSh 5,000,000 (by a company)

In the scenario depicted in Table 4, **a specific debenture** is created, conferring a fixed charge on a particular asset of the company. The charge is expressed to cover all monies due by the company to the lender including future and contingent liabilities (such as interest on the loan). The debenture will be registered at the Companies Registry. There are five stages in this scenario: a search, valuation, documentation, stamping, and registration. Some stages are undertaken at the Companies Registry while some are undertaken at the Land Office.

Under this scenario, the cost of creating and perfecting an encumbrance is 4.19% of the loan amount, which must be paid prior to the loan disbursal. The most significant costs are professional fees, including fees for lawyers, valuation of the asset and the service agreement. The service management cost is normally required by lenders in Kenya to maintain the asset properly where the asset used as security is equipment.

In the majority of cases, lenders prefer to take an **all asset debenture** over a company. If the all asset debenture is created in this scenario, it will confer a fixed and floating charge over all the assets of the company. These charges are expressed to cover all monies due by the company to the holder, including future and contingent liabilities. If the company has immovable properties, a legal charge supplemental to the debenture will be created simultaneously with the debenture. The debenture will be registered at the Companies Registry while the legal charge will be registered at both the Companies and Land Registries.

An all asset debenture will attract the following additional costs: KSh 850 towards registration of the legal charge at the Companies and Land Registries; KSh 72,500 towards legal fees; and KSh 15 towards stamp duty. (The actual amount of stamp duty payable is nominal at KSh5 because the charge is supplemental to the debenture. The practice is however to prepare documents in triplicate and each copy attracts stamp duty of KSh 5.) The time required would not vary greatly and the costs would increase for the first transaction (5.65%), but would be significantly lower in future transactions. This is because new loans would fall under the all asset debenture already created, since the instruments are usually drawn as continuing securities to secure current and future advances.

Table 3: Time and cost of registering a charge on a building in the Nairobi central business district

Loan amount - KSh 10,000,000			
Process undertaken	**Costs incurred (KSh)**	**Percentage of loan amount (%)**	**Time taken (Working days)**
Search at the Land Registry RTA RLA	 205 100	 0.00205 0.001	7
Documentation			
Legal fees (as per fee schedule) Other costs and disbursements (typical disbursements include telephone charges, transport, photocopying etc) Value added tax (VAT)	125,000 4,500 20,720	1.25 0.05 0.21	5
Rates Clearance Certificate Rent Clearance Certificate Consent	5,000 250 250	0.05 0.0025 0.0025	14
Stamp duty on charge Bank charges	20,010 100	0.20 0.001	3
Stamp duty on transfer (inclusive of bank charges)*	400,110	4.00	3
Valuation by a Government valuer including transport and ancillary charges	1,500	0.02	21
Registration	250	0.0025	7
Total (Cost of creation and perfection of security)	**577,995**	**5.78**	**60**

* Stamp duty on transfer occurs only if the loan is taken for the purchase of the building (collateral). If the collateral is owned by the borrower therefore cost of perfection and registration is KSh 177,995.

From the information above, it is evident that the current environment for the creation and perfection of security is governed by a legal, regulatory and operational framework that is wanting and in dire need of reform. Streamlining the above mentioned processes by putting in place appropriate frameworks will quicken the processes and in turn reduce the costs incurred significantly. Recommendations on some of the constraints currently experienced in the collateral process are highlighted in Chapter Six.

Table 4: Time and cost of registering an asset purchase loan

Loan amount - KSh 5,000,000			
Process undertaken	**Costs incurred (KSh)**	**Percentage of loan amount (%)**	**Time taken (Working days)**
Search at the Companies Registry	200	0.004	2
Documentation			
Legal fees on debenture Disbursements VAT (16%) Valuation charge Service agreement	62,500 4,500 10,720 45,000 75,000	1.25 0.09 0.21 0.90 1.50	5
Stamping the debenture Bank charges	10,005 100	0.20 0.002	4
Filing of Form 214 at the Companies Registry and receipt of mortgage	1200	0.02	5
Registration of the charge at the Lands Registry	250	0.01	5
Registration	250	0.01	7
Total (Cost of creation and perfection of security)	**209,475**	**4.19**	**28**

2.2 ENFORCEMENT OF COLLATERAL

In Kenya, enforcement of collateral is dependent on the remedies afforded by the instrument creating the encumbrance. Table 5 illustrates the enforcement scenarios for the two examples set forth above, under non-litigious circumstances and under the more common litigious circumstances.

In scenario 1, where the loan is for immovable property, the mortgage instrument would probably have incorporated a statutory power of sale. This is a less expensive and quicker recovery process. The statutory power of sale allows lenders to realise security by private sale or by public auction without involving the courts. Courts often disallow (through the granting of injunctions) the exercise of the statutory power of sale in the mortgage instrument following applications by borrowers. Courts in most cases sanction the lender for reasons such as simple procedural errors and misinterpretations. When this happens lenders are forced to opt for a judicial sale. The judicial sale is a common second scenario for enforcing real estate.

In scenario 2, where the loan is for the purchase of equipment with a specific **debenture**, there would be one mechanism: the appointment of a receiver or a receiver and manager to enforce the specific asset. The process would be nearly identical for an **all asset debenture**, except that the receiver and manager would normally take on all managerial functions at the company in order to pay back the lender.

Table 5: Time and cost of enforcing security in Court

a) Statutory power of sale (on immovable property as per scenario 1) - Non-litigious
1. Conditions to be satisfied before power is exercised
▪ Upon default, 3 months' notice to repay has to have been issued and there has to have still been default. ▪ Arrears of interest for at least two months. ▪ Breach of some covenant in the mortgage instrument or in the applicable Act.
2. Exercising of the power of sale
▪ A valuation is carried out by a valuer at a cost of KSh 37,700. This takes about 4 working days. ▪ An auctioneer is instructed to effect the sale by public auction. ▪ Sale is by public auction unless a court allows for a private sale. ▪ The auctioneer writes to the owner of the property giving 45 days notification of the sale. ▪ Upon expiry of 45 days, the auctioneer is required to give at least 14 days' notice of the sale to the borrower. ▪ The auctioneer publishes two advertisements in the newspapers at a cost of KSh 40,000. ▪ Subject to the valuation, the property may be sold at market value. If not, it must be sold at the forced sale value. ▪ If after the sale the debt is not fully discharged, the lender is further entitled to file for a suit for the recovery of the balance. ▪ The amount to be paid to the auctioneers (per schedule) will be KSh 127,000. ▪ The legal fees payable will be KSh 175,000.
▪ Total cost: KSh 379,700 ▪ Total time: 150 days
Litigious
▪ Occurs when the borrower moves to court seeking an injunction restraining the lender from exercising its statutory power of sale. ▪ Cost of filing an injunction is approximately KSh 3,705. ▪ The court may grant an injunction against the lender pending the hearing and disposal of the substantive suit. ▪ The hearing and determination of the suit may take between 3-5 years. The legal cost in this case will be KSh 350,000.
▪ Cost: KSh 353,705 ▪ Time: Approximately 4 years
b) Judicial sale - Litigious
1. Conditions to be satisfied before power is exercised
▪ Upon default, 3 months' notice to repay has to have been issued and there has to have still been default. ▪ Arrears of interest for at least two months. ▪ Breach of some covenant in the mortgage instrument or in the applicable Act.
2. File application in court
▪ Application is made by the lender to the court for an order for sale of the mortgaged property. ▪ Cost of filing is KSh 800. Additional KSh 200 for commissioning a supporting affidavit. KSh 10 for each annexure. ▪ In most cases the lender files an application under certificate of urgency. Orders by the judge in most cases are given the same day for an inter-parties hearing within 14 days at a cost of KSh 165.

c) Judicial sale - Litigious
If the lender makes an ordinary application the hearing date given is dependent on the court diary, which in most cases will provide a date a month or two months away. The 14 day period allows the other parties to be served and prepare their submissions. The parties are expected to serve the other parties in the suit and to file their submissions in court 3 full business days before the inter-parties hearing. The cost of filing is KSh75 for the skeletal arguments and KSh 75 for the list of authorities. The hearing of the application on average takes about 12 months. When the matter is heard the judge gives a date for the ruling at his discretion. On average this date is 21 working days after the hearing.
▪ On the ruling date, the judge either allows the application or dismisses it and gives direction on the issue of costs. ▪ If the application is allowed the order has to be extracted from the court registry. The official cost is KSh 165. ▪ If not allowed the lender will obtain a copy of the uncertified ruling at a cost of KSh 30 per page and this takes about 2 working days. If he wants to appeal he will obtain a certified ruling at a cost of KSh 60 per page and this takes about 4 working days. ▪ If allowed the lender goes ahead to sell the property. The legal cost payable is KSh 100,000. ▪ During the hearing process, either party may seek a stay of execution pending determination of another suit. This further delays the process and leads to additional costs. The hearing may take 3 years at a legal cost of KSh 150,000.
▪ Cost: KSh 300,000 ▪ Time: 5 plus years

Table 6: Appointment of a receiver (of an asset as per scenario 2) - Non-litigious

1. Conditions to be satisfied before power is exercised
▪ Not possible: Searches cannot be carried out as the registration is of documents and not encumbrances, making it impossible to carry out a search for chattels
2. Appointment of receiver
▪ A deed of appointment is issued to the receiver and he is deemed to be the agent of the borrower ▪ The receiver's role is to sell the asset but he may also collect income relating to the property. ▪ The proceeds are applied towards discharging the mortgage debt, the receiver's fees, any prior encumbrances and any accrued interest due to the principal. ▪ A valuation of the asset is carried out. ▪ Advertisement is made of the asset's sale at a cost of 40,000. The asset is sold for the highest bid price. ▪ Takes approximately 60 days at a cost of KSh 65,000 to the valuer, KSh 500,000.00 to the receiver and KSh 100,000 towards legal fees.
▪ Total cost: KSh 705,000 ▪ Total time: 150 Days
Litigious
▪ The borrower may move to court seeking an injunction restraining the receiver from taking over the affairs of the borrower. The cost for filing an injunction application is approximately KSh 3,705 and is borne by the borrower. ▪ The court may grant an injunction against the lender pending the hearing and disposal of the substantive suit. ▪ The hearing and determination of the suit may take between 3-5 years. The legal cost in this case will be KSh 350,000.
▪ Cost: KSh 353,705 ▪ Time: Approximately 3-5 years

Summary of total time and cost for recovery

As shown in Table VI, collateral enforcement in Kenya is a lengthy and expensive process. Lenders fear they will be prejudiced by court processes due to the ease with which courts grant injunctions which are used by borrowers to stop or delay recovery of an asset. One of the greatest controversies surrounding the process is that the asset pledged remains in the hands of the borrower during the lengthy court processes. Assets often depreciate in value or are lost or destroyed, so that even if the court rules in favour of the lender, the lender is unable to dispose of the asset at the value owed.

Table 7: Time and cost of enforcing recovery in Court

	Total Cost (KSh)	Total Time
Statutory power of sale		
Non-litigious	379,700	Approx 6 months
Litigious	353,705	Approx 4 years
Judicial sale		
Litigious (by definition)	300,000	5 + years (can last up to 10 years)
Appointment of receiver		
Non-litigious	705,000	Approx 6 months
Litigious	353,705	5 plus years

Receivership

A receiver is appointed to recover a charged asset held by a company or to protect lenders by preserving company assets as part of liquidation procedures. A receiver can either be appointed by the court or in accordance with the security instrument. A court appointed receiver is an officer/agent of the court. Once a receiver has been appointed, the company directors' powers to deal with the assets of that company are suspended and taken over by the receiver. The court will appoint a receiver when: the principal and/or interest are in arrears; the company is being wound up without the lender's consent; or the security is in jeopardy. This power is provided for by statute[11] and only occurs when creditors file a petition to wind up a company.

A receiver appointed under the debenture or charge (encumbrance or security) instrument is deemed to be an agent of the borrower, making the borrower solely responsible for the receiver's acts and defaults unless the security instrument proves otherwise. The effect of the receiver's appointment is twofold: any floating charges "crystallise" (in effect become fixed) and the directors' powers to control the company are suspended as the receiver takes over the management function. The employees' contracts are not terminated by the appointment of the receiver.

A receiver may be appointed to realise the specific assets which were pledged. In the case of an all asset debenture, the receiver may also realise all the assets of a company. Often the security instrument provides that the lender may appoint a "receiver" or a "receiver and manager". A receiver and manager has the extra powers of managing the company's business so as to enhance the realisation prospects, particularly when the company is a viable enterprise. The receiver is obliged to distribute the proceeds of realisation to creditors in accordance with the priorities set by law.

As detailed above, receiverships tend to be costly and often lead to the winding up of the company. A High Court judge recently commented that appointing a receiver or a receiver and manager over a company is to give the company "the kiss of death".[12] As a result, courts often give injunctions restraining the receivers from taking over a company, which often leads to a dissipation of the charged assets as the company continues to operate during the lengthy judicial process.

[10] Sections 74 & 77 of the RLA, and Sections 69, 69A & 69B of the TPA.
[11] Section 63(d) of the Civil Procedure Act (Chapter 75, Laws of Kenya) and Order XL of the Civil Procedure Code.
[12] Ringera J in the case of Jambo Biscuits (K) Limited v Barclays Bank of Kenya Limited & Others [2001] LLR 1381

Chapter 3

CONSTRAINTS TO THE COLLATERAL PROCESS

The previous section highlighted the fact that the **creation** and **perfection** of collateral in Kenya is a slow and costly affair, which is compounded by the additional time, cost and probable lack of recovery during **enforcement**. Kenya falls short of the ideals for the collateral process as described by the World Bank research bulletin: "A competitive business and corporate sector is built on the foundation of strong property rights, ease of company formation, corporate governance, the availability of flexible collateral mechanisms to support the availability of credit, and reliable insolvency systems to minimise lender's risk and encourage the rehabilitation of viable firms in financial difficulty."[13] This section will delve deeper into the constraints to the collateral process currently affecting Kenya.

3.1 WEAK AND DISPERSED LEGAL FRAMEWORK

The laws governing the creation, perfection and enforcement of security interests should facilitate a timely and cost-effective collateralisation process. In Kenya, there are more than 20 principal statutes relating to or impacting on the creation and perfection of security interests. The key statutes are outlined in Table 7 .

Table 7: Laws relevant to the collateral process in Kenya

1	Indian Transfer of Property Act, 1882
2	Law of Contract Act (Chapter 23, Laws of Kenya)
3	Registered Land Act (Chapter 300, Laws of Kenya)
4	Registration of Titles Act (Chapter 281, Laws of Kenya)
5	Government Lands Act (Chapter 280, Laws of Kenya)
6	Land Titles Act (Chapter 282, Laws of Kenya)
7	Sectional Properties Act (Act No. 21 of 1987)
8	Limitation of Actions Act (Chapter 22, Laws of Kenya)
9	Companies Act (Chapter 486, Laws of Kenya)
10	Evidence Act (Chapter 80, Laws of Kenya)
11	Stamp Duty Act (Chapter 480, Laws of Kenya)
12	Registration of Documents Act (Chapter 285, Laws of Kenya)
13	Banking Act (Chapter 488, Laws of Kenya)
14	Traffic Act (Chapter 403, Laws of Kenya)
15	Land Control Act (Chapter 302, Laws of Kenya)
16	Chattels Transfer Act (Chapter 28, Laws of Kenya)
17	Advocates Act
18	Notaries Public Act
19	Arbitration Act (Act No. 4 of 1995)
20	Agriculture Act (Chapter 318, Laws of Kenya)

There is no uniform code for the regulation of security interests in property due to the multiplicity of laws. This results in inconsistencies in the framework which are particularly evident in land statutes, as described below. Inconsistencies also exist in priority rights, as different laws require different registration procedures with varying time frames. Additionally, many of these statues contain provisions which set different procedures for dealing with similar cases, making the overall process cumbersome, expensive and complex.

Lack of uniform land code and estates in land

According to the Kenyan lenders who were interviewed, real estate is not the preferred form of collateral, contrary to best practice in many other countries. As detailed previously, this is partly due to the expense of the mortgage process, but can predominantly be attributed to the multiplicity of land statutes as well as differing estates in land.

There are more than five land statutes in Kenya. Each statute was introduced by the British colonial government at different periods of the colonial era. The intention was to develop a superior land statute which would be applied uniformly across the country, but this was not successfully developed and all five statutes have been retained to date. Consequently, three pieces of land can be next to each other but one parcel may be subject to the provisions of the Government Lands Act, one may be subject to the provisions of the Registered Land Act and another may be subject to the provisions of the Registration of Titles Act.

Another colonial legacy is the existence of two estates in land (land rights), freeholds or leaseholds, depending on where the land is located and when it was adjudicated. Freehold land is the least restricted interest in land and is usually known as "absolute ownership" of land or "fee simple" in other jurisdictions. Leasehold land is usually owned by the government as head lessor. The government then grants an interest to the lessee for a term subject to conditions set out in the instrument. That interest granted is a lease and is usually for a term of between 50 and 99 years, although there are incidences of longer terms. The person or organisation that is granted the lease can hold, occupy and use the land on agreed terms which include the payment of rent.

A leasehold is a lesser interest in land than a freehold as it is held for a set time and the person who has the leasehold never "owns" the land absolutely. Leasehold titles do not have an automatic right to a new term. When the expiry date for the lease is near, the lessee has to formally apply to the government as head lessor for extension; this is a lengthy and costly exercise involving fresh survey plans and approvals from various government and local authority departments. For this reason, most lenders do not as a rule accept as security a lease which has a balance of less than 20 years.

[13] *http://www4.worldbank.org/legal/legps.html.*

Convoluted conveyancing process

As a result of the differences in statutes and estates in land, the conveyancing process in Kenya contains unnecessary technical differences. For example, the primary security interest created under the Government Lands Act is an English mortgage. An English mortgage operates as a transfer of the property to a mortgagee subject to the equity of redemption, which allows for a transfer back to the owner upon payment.

The security interest created under the Registered Land Act is a charge, which operates only as an encumbrance on the title to be discharged upon payment. No transfer is envisaged in a charge scenario. The creation, perfection and enforcement procedure for the security instrument varies from one statute to the other, with technical differences in each case that often determine the validity and enforceability of the instruments.

Weak property rights

The Kenyan Constitution maintains that property rights are fundamental. Each land statute has clear provisions regarding the sanctity of a title to private property. This resonates with international principles on the inviolability of private property rights, such as the United Nations Charter and The Declaration of Human Rights. However, in practice, despite the constitutional and other statutory pronouncements to the contrary, the integrity of a title to property cannot be taken for granted and the collateral process often includes a long and costly process of evaluating several legal and non-legal facts.

Corruption and abuse of power

In Kenya, there is a long practice of allocating public land in disregard of the procedures set forth in law. There have been frequent incidents where land and other assets have been fraudulently transferred with the active cognisance of the very officials vested with the duty of protecting property rights in the institutions responsible for land administration. This practice is facilitated by the use of physical files which can and do get misplaced or altered with no audit trails.

It is not unusual for two titles to exist for the same property with different owners listed. This state of affairs makes lenders rather uncomfortable, as illustrated by a lender who mentioned in an interview with our team that he was cautious in taking immovable property as collateral because it "could move".

The practices in question are amply described in reports prepared by commissions established by the government. The *Report of the Commission of Inquiry into the Illegal and Irregular Allocation of Public Land* contains various recommendations that have yet to be implemented but which would have far-reaching consequences on land ownership in Kenya. Such experiences as those detailed in the reports erode public confidence on the sanctity of title deeds.

Violation of property rights by statutes

There are Kenyan statutes which appear to encroach on the rights of a person to alienate private property freely. For example, the Land Control Act restricts "dealings" with agricultural land. Dealings is defined to include sales of agricultural land (including sales by chargees), mortgages, charges, leases, transfers of shares in a private company which owns agricultural land, other transfers, etc. Under the Land Control Act, any dealing with agricultural land is void unless the consent of the relevant Land Control Board has been obtained. Consent has to be obtained within six months of the agreement to create the interest.

Each district has a Land Control Board which sits once a month and charges a fee for applications made. The Land Control Board has sweeping powers and the land owner has a very limited scope of appeal if the decision is not favourable. The bureaucratic and unpredictable decision-making process of the Land Control Boards has made agricultural land less attractive to lenders as collateral, and there are areas where banks will not consider taking agricultural land as security.

Equally alarming is the number of statutes in Kenya which inhibit a property owner's right to enter into a contract and to alienate private property. Under the Law of Contract Act, a contract relating to the sale or alienation of an interest in land has to meet special execution and attestation procedures. There are special rules regarding the preparation and execution of instruments within and outside Kenya. These rules increase the cost and add time to the collateral process and in some cases make it impossible for certain borrowers to access credit due to the non-availability of persons who can be witnesses to the execution process. For example, in order for a bank to have a power of sale, the charge or mortgage must contain a certificate from an advocate of the High Court of Kenya, who has to explain certain sections of the law to the charger or mortgagor.

Laws restricting freedom to contract

In addition to limitations on contracting, there are also limitations on who can draft contracts. Section 34(1) of the Advocates Act of Kenya provides that no "non-qualified person" (i.e. a person who is not an advocate) shall, either directly or indirectly, take instructions, draw up or prepare any document or instrument:

a. relating to the conveyancing of property; or

b. for, or in relation to, the formation of any limited liability company, whether private or public; or

c. for, or in relation to, an agreement of partnership or the dissolution thereof; or

d. for the purpose of filing or opposing a grant of probate or letters of administration; or

e. for which a fee is prescribed by any order made by the Chief Justice under section 44 of the Advocates Act; or

f. relating to any other legal proceedings; nor shall any such person accept or receive, directly or indirectly, any fee, gain or reward for the taking of any such instruction or for the drawing or preparation of any such document or instrument.

Similar limitations are placed on the individuals who can perform other services commonly required in the collateral process, such as valuers (appraisers) and auctioneers. Currently, receivers do not need specialist qualifications. The only restriction on acting as a receiver is that one cannot be bankrupt. In practice, however, receivership tends to be a complex affair which may involve litigation, managing companies and accounting, as statutory returns need to be filed. This has resulted in creditors appointing receivers mainly from partners of audit firms. Additionally, a new Insolvency Bill provides that a receiver will need to have certain qualifications and be a member of a new board of Insolvency Practitioners.

The argument has been set forth that restrictions which promote the use of accredited professionals protect the public and lead to higher professional and ethical standards. However, such needs must be considered against a backdrop of strict set fee structures which are obligatory for use by the relevant professionals. The fees charged by advocates, company secretarial firms, valuers, auctioneers and estate agents tend to have minimum scale fees which are in some cases beyond the reach of borrowers and increase the cost of the collateral process significantly.

The need for professional and qualified help is important in a country where, as indicated above, the legal framework is in need of reform and where property rights are weak and confusing. However, this cannot apply to all cases. Some matters, such as the drafting of non-complex security documents, should be done using simple do-it-yourself forms provided by the institutions as part of the loan process. Even for those cases where the public trust is best served by the required use of professionals, the freedom to contract should not be curtailed by a profession-wide fee structure with minimum rates.

Chattels: Absence of personal security legislation

The creation, perfection and enforcement of collateral owned or held by individuals is another example of the weak or dispersed legal framework. Currently, there is no credible personal security legislation in Kenya. The only two pieces of personal security legislation are the Chattels Transfer Act and the Hire Purchase Act. These statutes are outdated and not comprehensive.

The Chattels Transfer Act regulates security by individuals and partnerships (which, in practice, includes business names). While the process for the creation of encumbrances is relatively straightforward, it fails in the perfection (registration and priority) of these encumbrances. Under the Chattels Transfer Act, the security instrument itself is registered, instead of the assets encumbered, and the chattels mortgage has to be refreshed every five years. In practice, this means that priority rights (which lender should get what) are not clear and enforcement is often difficult as the assets may never be found. There are many instances where borrowers hide or cannibalise the charged assets and there is little the lender can do.

In spite of this, registration of chattels is very common and is growing as many lenders, particularly micro-finance institutions, opt for chattels mortgage (registration is relatively quick and inexpensive) due to the "moral" pressure it creates. However, lenders have countless stories of dishonest borrowers who enter into simultaneous chattels mortgages by pledging the same assets with a number of institutions, and then hide the assets so as not to lose them. This practice is made possible by the fact that it is impossible to search the chattels mortgage registry by borrower or by asset.

The Hire Purchase Act, treated in more detail in section 3 of chapter 5, also acts as a personal security statute (though this is not its intended purpose) as it lays a framework for instalment purchases with rules as to where ownership of the assets lies.

Companies: Exhaustive list of registrable interests

The Companies Act of Kenya is based on the now repealed 1948 Companies Act of England. The Kenyan Act commenced in 1962 and has undergone several changes, though the core of the Act is still moulded along the lines of the old English Act. This Act is outmoded and ill-equipped to handle the vicissitudes of 21st century financial instruments. One person interviewed by our team described it as an eighteenth century law on large public English enterprises forced to regulate modern Kenyan small and medium enterprises.

Section 96 of the Companies Act of Kenya contains a limited list of the security interests which a company is obliged to register; consequences for failing to register include the collateral becoming void as against a liquidator. To the extent that registration of security interests is what confers priority, this list limits the scope of the security interest which a borrower can create. Thus, the wealth of common law, the plethora of security instruments in existence and even some "modern" financial instruments are limited.

Floating charges

A floating charge is a security interest over fungible assets that a company may possess, such as inventories, livestock, accounts receivable and flower and tea production, regardless of the state of the assets (incorporated into other goods or sold for cash) or their location. This type of charge is of great importance in modern economies where companies are actively transforming their inputs and where fixed assets may not be an important part of the balance sheet. For SMEs, these types of charges are vital, as they normally do not hold real estate and are limited in terms of other assets. This type of charge effectively allows

companies to pledge say 20 head of cattle as collateral, instead of specific identified cows that may be sold or die.

In Kenya, the concept of floating charges is reasonably well-defined and well-known. However, it is not popular with lenders for the following reasons:

- Unlike fixed charges, the floating debenture is defeated by the rights of the preferential creditors. The defeated priority rights of floating charges in Kenya, include taxes, employees and holders of fixed charges. Thus, in the event of liquidation, holders of floating charges are treated only slightly better than unsecured creditors;
- Floating charges have a hardening period during which the charge can be challenged by a liquidator;
- The tracing rights of the debenture holder over proceeds from the sale of floating charge assets are limited to payments made into a specific account.

Stamp duty as a deterrent to creating security interests

Stamp duty is a large component of the cost of collateral. In addition to the cost, the archaic physical collection process and procedures further complicate the collateral process.

- The stamp duty payable for a transfer of a property situated in municipalities or urban councils is 4% of the consideration;
- For property situated in rural areas, the rate is 2% of the consideration;
- Where the same property is being offered as a mortgage, the purchaser has to pay additional stamp duty of 0.2% of the amount of the mortgage.

These amounts are imposed according to the provisions of the Stamp Duty Act and are paid to the Commissioner of Domestic Taxes at the Kenya Revenue Authority. The collection process takes place physically, and is managed in part by the Land Registry.

It takes six working days to complete the payment of this duty and several stages are involved:

- Assessment of duty payable at the Land Registry;
- Payment of duty at a commercial bank citing the serial number;
- Relay of the payment information to the Kenya Revenue Authority, which then confirms to the Land Registry that they have been paid.

The instruments lodged a few days earlier are then stamped and released for registration. Where a transfer is involved, a Government Valuer is then (after the payment of tax) required to travel to the property and physically inspect and value it, in order to confirm the amount of duty paid or to call for an additional amount. This determination is made regardless of the purchase price actually paid. This process can take a significant amount of time as the Government Valuer does not usually have comparable data or transportation and has a number of properties to visit. It is thus common for the Government Valuer to rely on documents and information provided by the purchaser or owner of the property, often including private valuation reports, and for that same purchaser to arrange transportation to the site. This state of affairs causes undue delay and expense in addition to enabling abuse and corruption.

The commonly held view of many practitioners in Kenya is that the stamp duty represents the highest outlay for taking collateral and that this impedes borrowing along with playing a significant role in determining the structure of collateral offered to a lender. In addition, the stamp duty process is seen as bureaucratic, suspect and unfair, as the weight of the duty is usually borne by one person. In most jurisdictions, stamp duty is not a flat rate and is responsive to the circumstances. It varies depending on the property or interest generated, by whom and for what purpose.

3.2 WEAK AND DISPERSED REGISTRY SYSTEM

Most types of security instruments require registration (lodgement of particulars relating to the security) or filing (the lodgement of the security instrument itself or a copy of it) as a requirement of perfection.[14] Registration is key to the collateral process in that it makes public the existence of an encumbrance to other lenders, eventual purchasers of encumbered assets and the general public, and sets priority rights regarding which creditor should have first access to an asset.

Priority of security interests is, according to the law, determined not by the date of the instrument but by the date of registration or filing. Thus, failure to register or file may facilitate fraudulent activities. In reformed financial systems, registries are searchable by asset, debtor and sometimes by lender. At the minimum, registries should contain:

- An asset register which notes the identity of a particular asset as well as the registered rights to the asset;
- A register of the debtor which gives details of all security interests - both general and specific - created by a debtor. The security instruments must be those which the law requires the debtor to file or register.

Multiplicity of registries

There are a multiplicity of registries, including: the Companies Registry, the Land Registry, the Ship Registry, the Aviation Registry, the Co-operative Societies Registry, the Registry of Societies, the Chattels Registry, the Registry of Business Names, the Motor Vehicle Registry, the Trade Marks Registry, and the Registry of Shares. Generally, Kenya's registries are disparate and do not facilitate searches by asset; even the Land Registry (immovable property)

[14] Goode, Roy. *Commercial Law*, page 650.

has limitations on searches by plot. Despite the existence of a Registrar General there does not appear to be a policy decision to reform the registries by encouraging uniformity, synergy and symmetry of information through reducing the number of registries or by sharing information.

Manual procedures

The majority of the registries are manual. Physical files are kept in specific locations, and changes to the files are made manually as new documents are added to the files. The system does not have an audit trail and it is common for files to be misplaced, often due to misplacing or plain loss.

Currently, the Companies Registry is the most advanced in terms of automation and, according to users, the system is much improved in recent years. However, the automation process merely mirrors the physical system, including preparation of all documents manually and then scanning these into the system. While this is undoubtedly superior to having only a physical file, it does not simplify or re-engineer the procedures as needed. Changes to the procedures are complicated by the need of the registry to comply with public sector hiring, procurement guidelines and limited statutory reforms which constrain the scope for action.

Incomplete and unreliable search methods

A reformed registry should be able to facilitate the obtaining of prompt and up-to-date information on the asset or the debtor. Apart from the logistical challenges posed by a manual system, the integrity of the registries is further compromised by missing records and files, tattered documents, incomplete or incorrect information, incidents of fraud and document tampering, and weak monitoring of compliance rules.

For example, an application to the Companies Registry for an official search on a debtor company will produce a report that does not include references or details of the security interests created, if any, by the company. To obtain this information, one is obliged to visit the Companies Registry for a physical inspection of the file, which relies on the assumption that the records kept are up to date. As such, there can never be complete certainty that all registered encumbrances have been identified during a search.

The Land Registry has many incidents of lost or misplaced titles and files. Generally, it takes weeks to obtain an official search (when possible). There is a growing trend for new titles to be registered (often after some form of indemnity is given by the "owner") to replace title deeds which the registry has misplaced. The Chattels Registry only files security interests on individuals, yet it is "housed" at the Companies Registry. Though the Chattels Registry is now gaining some independence (separate staff and quarters) there has been no policy decision to modernise and register encumbrances to allow for searches, which would improve on the current process of simply noting or filing chattel instruments.

Priority rights compromised

The main incentive for lenders to perfect their security is to ensure that they have priority in the event of default and/or realisation. As indicated above, each registry is independent and the statutes establishing them are separate and distinct.

The rules and requirements the registries present further complicate the collateral process, as each registry has different registration and priority rules. For example, the Companies Registry requires a security instrument to be registered within 42 days of its creation. The Land Registry requires an instrument to be registered within 30 days of its creation. The Chattels Registry requires registration of a chattel's instrument within 21 days of execution. In addition, and as noted above, the chattels mortgage is also required to be refreshed after five years.

These differences become critical when a company creates a charge or a mortgage over a property.

- A charge or mortgage created by a company is required by law to be registered both at the Land Registry and the Companies Registry to ensure priority rights.
- There are several instances where registration in one of the registries has been completed but there has been a delay in effecting registration in the other registry, thereby creating concern as to the priority rights of the interest created.
- In Kenya, interest in land is conferred by registration. The Land Registry is the specialist registry for registration of interests over immovable property. The requirement for registration at both the Land and the Companies registries may therefore not be necessary. Apart from causing confusion when one registration is delayed, the requirement for dual registration is neither time nor cost effective. The validity of an instrument which is duly registered by a company at the specialist registry should not be impaired by a delay in registering the same instrument in a non-core registry.
- A request for an official search from the Land Registry creates a window of 14 days during which an instrument can be registered in priority to any other instrument. There is no such rule at the Companies Registry. Indeed, a charge or mortgage by a company, though registered at the Land Registry, would be void against a liquidator if not registered at the Companies Registry within the statutory period of 42 days. That said, a lender who has delayed registering an instrument at the Companies Registry within these 42 days can apply to the High Court for an extension of the period for registration but only if the delay is caused by reasons set out in the Companies Act. A further complication to this is the requirement that company annual reports be up to date prior to registration of the security. Lenders are thus in the situation of seeing

their priority rights eventually weakened by a procedure to which they are not parties and over which they have no control.

Registries as tax collectors

All registries in Kenya collect revenue and registration fees for the government. Fees are not a source of revenue for the registry but rather a source of indirect revenue for the state; registry operation costs are supplied out of the state's budget. Registries may collect substantial fees, but that revenue cannot be used to improve services. Moreover, each registry has its own procedures and fees. Although the registries perform similar duties and are government registries, they charge registration fees at different rates.

3.3 WEAK ENFORCEMENT MECHANISMS

As indicated in the loan examples above, the realisation process in Kenya is slow and expensive. Even in instances of uncontested realisations, the lender has to issue notice of more than three months in the case of immovable property. The lender or other enforcer is also often required to obtain consent to facilitate a sale, which makes the success of the process dependent upon independent (or sometimes not so independent) public officials. In the event that the matter becomes contentious, the recovery process is hampered by the costly and procedural judicial process.

Injunctions

The first line of defence of many borrowers when faced with the threat of repossession of an asset is an injunction. An injunction is a judicial remedy issued at a court's discretion. It may either prohibit or restrain a party from performing a certain act (prohibitive) or require the respondent to perform certain actions in preparation for court.

An injunction may be sought as a final remedy or at a preliminary stage before trial (an interlocutory/interim injunction). In most cases during debt recovery, an interim injunction is sought pending the outcome of trial.

In determining whether to grant an interim injunction, the courts apply three principles:

1. That the claimant can show that there is a serious issue to be determined;
2. That the court considers where the balance of convenience lies. Important things to consider will be:
   a) the court's ability to quantify likely damages;
   b) the sufficiency of the claimant's cross-undertaking in damages (if the defendant is successful at trial); and
   c) the sufficiency of the defendant's financial resources to compensate the claimant (if the claimant is successful at trial);
3. If there is no imbalance, then the status quo is preserved.

In theory, the court must be satisfied that the claim is not frivolous or vexatious and should not attempt an in-depth assessment of either party's case and the likely outcome of the infringement proceedings at trial. In practice, borrowers routinely obtain injunctions from courts restraining the lenders from enforcing their rights of recovery. This discreditable practice is highly prevalent despite the statute[15] being fairly clear on the nature of statutory power of sale, statutory notice and the remedies to an aggrieved party. Courts have argued that in trying to be just, they have faced difficulty in getting lenders to justify the hefty interest rates and penalties routinely imposed on borrowers upon default, which often causes confusion over the amount actually owed.

Though there have been cases where the courts have resolved not to grant indulgence to defaulting borrowers, in most cases injunctive relief has been granted, and borrowers are aware that their chances of avoiding the loss of the pledged asset via the courts is very high. As a consequence, lenders prefer to renegotiate and find alternative ways of arriving at settlements with borrowers, upon the understanding that the courts are highly unlikely to provide them with redress.

Despite the reasonable principles enumerated above, courts routinely create an imbalance between borrowers and lenders by permitting borrowers to continue to enjoy the pledged assets while not repaying the loans, thus placing lenders at a disadvantage due to their not being able to recover the monies loaned or the assets they hold as collateral.

Arbitration

Kenya has a modern arbitration law and a well-functioning system of alternate dispute resolution mechanisms. These have had an effect in reducing some of the case load on the commercial court system. However, these mechanisms are not used for land or lending. The experience in Kenya is that an arbitration clause in a mortgage does not assist the recovery process, as there is a perception that arbitration does not enforce contracts but rather tries to reconcile or negotiate a resolution. Consequently, lenders prefer to have their right to realise not made subject to an arbitral process.

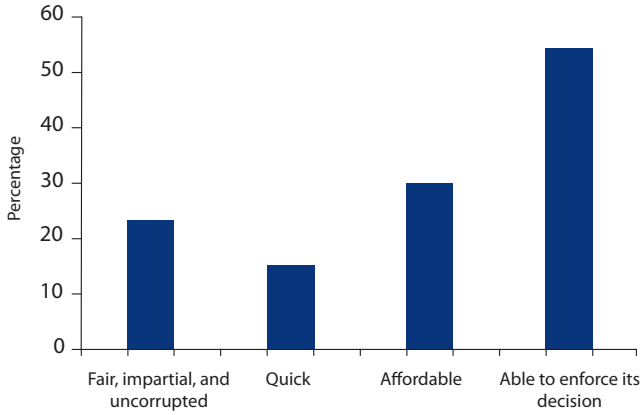
Court system

Commercial courts have been established to expedite the realisation process, but this has been ineffectual as the courts sit only in Nairobi and there is a shortage of judges and judicial officers. This has resulted in a severe backlog of cases, resulting in cases taking a minimum of three years up to a maximum of ten years before resolution. Furthermore, there is a general perception among lenders that the courts will not resolve in their favour, and that, if they do, it will be too late for any meaningful recovery to take place, as assets will have been sold, lost or damaged.

[15] Sections 74 & 77 of the RLA, and Sections 69, 69A & 69B of the TPA.

Figure I illustrates the perception of the court system by Kenyan enterprises; only 15% classify the system as quick and 21% as impartial. While a majority believes that the court system is able to enforce decisions, in the case of lenders, this enforcement will seldom result in an actual recovery of monies or sellable assets.

Figure 1: Courts malfunctioning: percentage of firms that consider the court system



Sources: Kenya 2008 Investment Climate Assessment[16], World Bank Group; page 35

3.4 THE ALL ASSET DEBENTURE

The all asset fixed and floating debenture is much favoured by lenders in Kenya because of the influence it affords to them in relation to the debtor company and other creditors, over enforcement, reorganisation of the debtor company, etc. Under such a debenture, the borrower commits to discharge all obligations and liabilities, whether actual, accruing or contingent, present and future, or owing or incurred to the holder of the security. The borrower pledges (places a security interest) over any and all assets that the company may hold at present or in the future, including real estate (specific encumbrances that need to be separately registered at the Land Registry), fixed assets, fixtures, cash, and anything else whether in the balance sheet or not (goodwill, trademarks, etc). The enforcement of such a debenture in the case of default is the appointment of a "receiver and manager" who will oversee the winding down of the company in order to repay the lender, with complete loss of power by managers and directors.

Lenders are best protected (some would say only protected) when a company seeking credit enters into an all asset debenture. While this institution clearly favours lenders, it is arguably therefore detrimental to borrowers who are less protected, and imposes a cost to the economy in terms of less credit, reduced financial sector competition, and the winding down of productive enterprises that might otherwise stay in business, generating further loss of employment and economic loss. This type of instrument is commonly used, as described in interviews with lenders and companies. 64% of companies surveyed responded that they had been required to provide an all asset debenture in order to obtain credit, as shown in Table 8 below.

Table 8: Percentage of individuals that have had to provide an all asset debenture to obtain financing

Have you had to provide an all asset debenture in order to obtain credit?				
	Agro-sector	Manufacturing	Service	Total
Yes	56%	50%	68%	64%
No	44%	50%	32%	36%

Source: Synovate survey, author's compilation

Once an all asset debenture is given to a particular institution, the only way that a new institution can lend money to the company is with the authorisation of the original holder of the debenture and the institution's willingness to share the encumbrance. Smaller financial institutions are often willing to share such a debenture with other lenders, but, as expressed in lender interviews, it is evident that this willingness is less prevalent in larger institutions.

Table 9: Percentage of individuals that have had restricted borrowing from other banks

Under an all asset debenture, have you been able to obtain loans from other banks?				
	Agro-sector	Manufacturing	Service	Total
Yes	20%	14%	38%	34%
No	80%	86%	62%	66%

Source: Synovate survey, author's compilation

66% of the companies surveyed were not able to obtain credit from other institutions, as shown in Table 9 below. This lack of competition, heightened as banks tend to specialise in certain products (and charge lower rates on those products), results in companies paying a higher interest rate.

This lack of competition is further evidenced by the responses of companies surveyed; 81% had accounts at two banks or less, while 43% had accounts at only one bank. Additionally, 61% of companies surveyed had a relationship with the main bank that was over eight years old. As the relationship with the bank aged, 66% of companies reported no change in the terms of their collateral relationship.

The over-reliance on the all asset debenture, while required by lenders due to the state of the collateral process in Kenya, is limiting competition and the

[16] For the purposes of the tables and figures, and due to the extensive use of this source, the Kenya 2008 Investment Climate Assessment, World Bank, will be referred to as the ICA.

benefits to borrowers, who are not receiving lower interest rates or collateral requirements.

3.5 BANKING REGULATION

The regulatory environment for banks and credit in Kenya is adequate and does not impose undue burdens on the system. The Banking Act does not expressly oblige institutions to lend against collateral except in the case of employees and other officers and associates. Mortgage finance institutions are also required to lend against security in accordance with the Banking Act, though recent amendments have introduced further flexibility to these types of institutions.

Prudential guidelines focus on risk classifications of assets and provisioning. They are geared towards risk-weighting of assets for capital adequacy purposes. Whilst the lender is not obliged to lend against security, the guidelines do provide that where securities are obtained, they should be perfected in all respects, namely:

- Duly charged and registered;
- Adequately insured;
- Valued by a registered valuer;
- Perfected in all other areas specified in the letter of offer of the facility.

Chapter 4

IMPACT OF KENYA'S COLLATERAL PROCESS ON ENTERPRISE: ACCESS TO FINANCE

In order to assess fully the impact of the collateral process, it is necessary to review its impact on firms in Kenya. The team commissioned a survey, executed by Synovate,[17] of 100 randomly selected small and medium enterprises headquartered in Nairobi, with the following sectoral breakdown: 10% agro-sector, 20% manufacturing and 70% service. This roughly corresponds to the breakdown of the Kenyan economy, which shows 24% agriculture, 17% manufacturing and 60% services. The agriculture area was reduced and larger agro-industry concerns were focused on rather than smaller agriculture concerns in order to better capture the part of the sector which is able to obtain credit.

Additionally, the team used tables and data from the Access to Finance section of the Kenya Investment Climate Assessment (ICA) produced in June 2008 by the Finance and Private Sector Development Group of the World Bank's Africa Region. In 2007, the World Bank conducted a survey of 781 firms in Nairobi, Mombasa, Nakuru and Kisumu. Approximately 60% of surveyed firms were in the manufacturing sector, a sector particularly dependent on bank financing, 19% of the firms were retail, with the rest from the service sector. For information on micro-enterprises, an additional 124 micro-firms (with four employees or fewer) were also included in the sample.

4.1 FINDINGS

Access to and cost of finance

In the ICA study, a large percentage of firms cited access to and cost of finance as a major problem, including 36% of small, medium, and large enterprises and 76% of micro-enterprises in the manufacturing sector. In addition, a higher proportion of formal non-manufacturing firms reported finance as a major or severe impediment to firm operation and growth: 48% of retail firms and 41% of service firms.

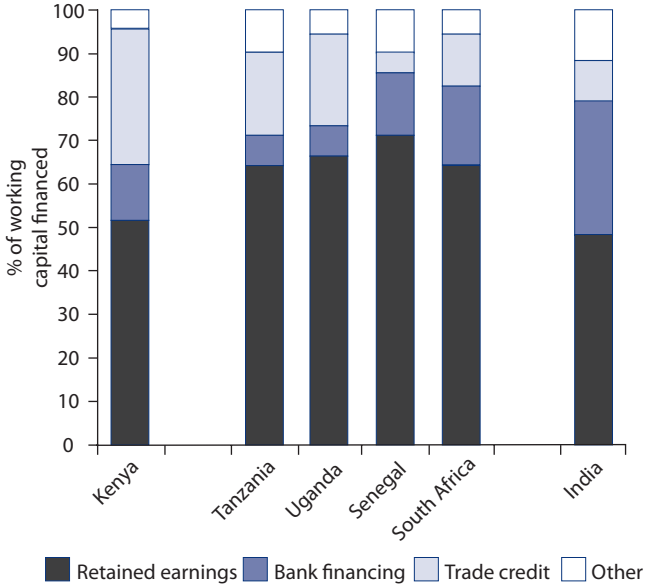
When comparing Kenyan firms to an international selection, Kenya scores better than neighbouring countries but falls substantially below South Africa, India and China. 23% of firms in China and 15% in India reported finance as a major or severe impediment, while 41% of firms in Tanzania, 55% in Senegal, and 60% in Uganda

As reported, Kenyan firms have difficulties accessing finance from banks and must revert to alternative financing sources. Manufacturing firms in Kenya finance 51% of working capital and 59% of new investments with retained earnings. This is considerably lower than in other African comparators, indicating that Kenyan firms have greater access to external sources of finance. Bank financing covers 14% of working capital, which is slightly lower than in South Africa. Trade credit fills in the gap in working capital financing. 31% of the working capital needs of Kenyan firms are financed by trade credit, the leading source of working capital external to the firm. The share of working capital financed by trade credit in Kenya is higher than in any of the comparator countries. Trade credit contributes only 12% and 9% of working capital requirements in South Africa and India, respectively. These results are shown in Figure 3 below.

Figure 2: Enterprises (SMLEs) reporting finance as a serious impediment - international comparison

Source: ICA page 58. Note: Cross-country comparisons are only for manufacturing enterprises

Figure 3: Sources of finance for working capital - international comparison, manufacturing sector



Source: ICA page 61

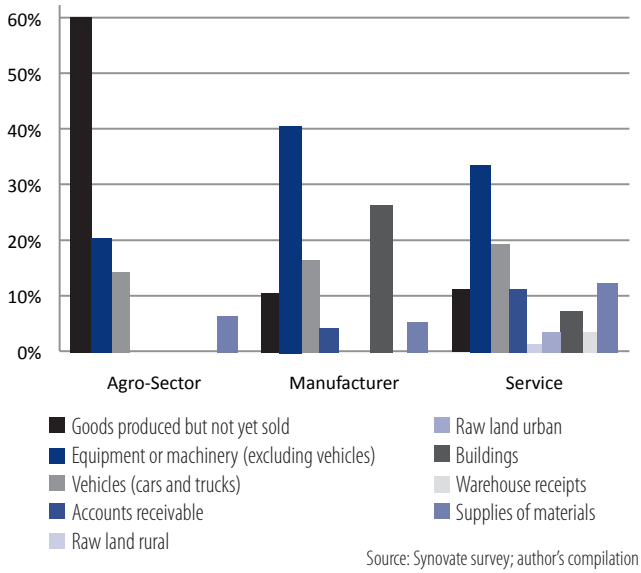
[17] Refer to Annex I: Survey Methodology.

The importance of trade credit in the Kenyan economy is further highlighted by the fact that the Credit Reference Bureau (CRB) Africa Limited created brisk business by offering the commercial service of capturing and selling data on unpaid bills and invoices. It is somewhat surprising that the banking sector has been slow in taking advantage of this by exploring firm linkages or even sharing information more aggressively with the trade sector. A caveat to the importance of trade finance is that the survey is representative of only the manufacturing sector, which due to the strong links within the local Asian business community (heavily represented in this sector) can develop strong trade finance ties despite weaknesses in the legal environment.

In terms of bank credit, it is important to understand the problems that firms perceive when applying for credit. In response to the survey, only 10% of micro-enterprises did not seek a bank loan because it was not needed, compared with 38% of small and 60% of medium and large firms. This suggests that smaller firms have fewer options in terms of financing and a greater need of access to bank credit. Micro-enterprises are also more likely to be turned down for credit due to collateral requirements: 43%, in comparison to 12% of small firms and 7% of medium and large firms. This is partly due to the prevalence of fixed assets as collateral, the use of all asset debentures, and the lack of enforcement mechanisms for chattels mortgage, which is an important way of collateralising microloans.

Together with collateral requirements, the application process itself is considered a major barrier by micro and small firms. Many small firms complained about interest rates: more than one quarter of small formal firms, as distinguished from their informal counterparts, and one-sixth of medium and large firms fail to apply because of unfavourable interest rates. Less than 5% of firms across the entire size distribution reported loan size and maturity as deterrents to accessing external finance. This suggests the absence of any rationing of credit. Finally, 11% of small formal firms find the application process complicated. These results are shown in Table 10.

Figure 4: Types of assets accepted as collateral



Source: Synovate survey; author's compilation

Table 10: Reasons for not applying for a loan or line of credit

Reason	*Micro*	*Small*	*Medium and Large*
No need for loan	10%	38%	60%
Application procedures are complicated	24%	11%	6%
Interest rates are not favourable	13%	26%	17%
Collateral requirements are unattainable	43%	12%	7%
Size of loan and maturity are insufficient	5%	3%	2%
Did not think it would be approved	2%	5%	1%
Other	2%	5%	7%
Sample size	*92*	*231*	*216*

Source; ICA Page 70. Note: Includes manufacturing and non-manufacturing enterprises

Types of assets accepted as collateral

Further analysis of the types of assets accepted as collateral confirms that in the manufacturing sector there is a preponderance of equipment (40%), buildings (26%) and vehicles (16%) as guarantees. Interestingly, in the agro-sector crops are commonly accepted as guarantees. Accounts receivable and inventories are often accepted as collateral by all sectors. However as noted earlier, banks often require an all asset debenture, which includes all present and future assets a firm may have. 64% of firms surveyed had posted such a debenture as collateral, with the highest percentage in the service sector (68%) and the lowest in the manufacturing sector (50%).

The main conclusion to be drawn from this is that Kenyan banks accept a broader range of assets, as shown in Figure 4 below, in contrast with many other emerging markets. This is most likely due to a level of sophistication in the Kenyan financial system; as well, challenges in using real estate as collateral have motivated banks to look for alternatives. The limitations of real estate are illustrated by the rarity of the acceptance of land, either in rural or urban settings, as collateral.

Rejection rates

Rejection rates were surprisingly low for micro-enterprises: only 13% of loan applications were rejected. The corresponding rejection rate for small enterprises was 21% and 12% for large firms.

Although the sample sizes used for this analysis are too small to be conclusive, it is worth exploring reported reasons for loan rejections, which are set out in Table 11 below. Inadequate collateral is the most frequently cited reason for loan rejection among small formal firms. For medium and large firms, incompleteness of loan applications accounts for nearly half of all loan rejections. Given the low rejection rates, it is surprising that application rates are not higher. One plausible explanation is that self-selection in applications produces a high-quality pool of loan applicants.

Table 11: Reasons for loan rejections

Reason	*Small*	*Medium and Large*
Collateral or cosigners unacceptable	59%	19%
Insufficient profitability	6%	6%
Problems with credit history or report	18%	6%
Incompleteness of loan application	6%	44%
Concerns about level of debt already incurred	0%	19%
Other objections	11%	6%
Sample size	*17*	*16*

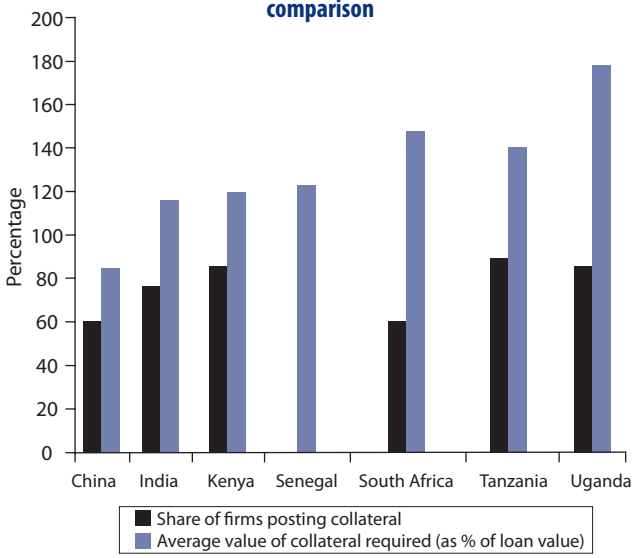
Source: ICA page 69 Note: Includes manufacturing and non-manufacturing enterprises

Collateral requirements

"Almost 90% of firms with loans were required to post collateral, this percentage being among the highest of all comparator countries. The average value of collateral requirements is 110% of the loan value, which is low compared with other countries. This low value is due to two factors, one being that the CBK Prudential Guidelines on Risk Classification of Assets and Provisioning do not obligate a certain percentage of coverage, as compared to the Page 2 of 4 common practice in other countries. The guidelines on Risk Classification of Assets and Provisioning are intended to ensure that all assets are regularly evaluated using an objective internal grading system consistent with the Guidelines, and state that "Classification ratings of loans do not depend on the amount or quality of collateral pledged. Collateral is regarded as a secondary source of repayment, and therefore is only used in assessing the amount of loan loss provision required for non-performing loans."

Another reason for the low value of security is that due to legal technicalities, lawyers recommend that the amounts posted as collateral approximate the actual value of the loan.

Figure 5: Collateral requirements – International comparison



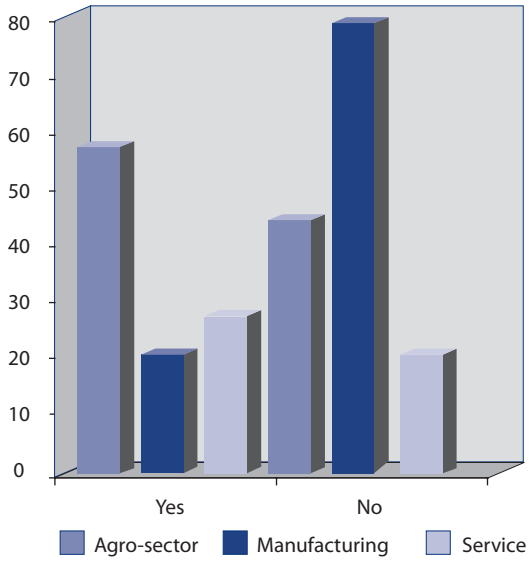
Source: ICA page 64

A higher value of the security created would give rise to a disparity, leading to possible liquidation claims against the banks and financial institutions by the borrowers, claiming that the loan amount received from the bank is not the loan amount applied for and approved, and the bank should be obligated to advance more money to the borrower to meet the excess of the security created."

As has been mentioned, it is costly and time-consuming to create and perfect collateral in Kenya. It takes an average of 90 days for mortgage collateral and more than 21 days to perfect a security interest in equipment, not including the time taken to approve the loan and the collateral in each case. Each process costs over 5% of the loan amount, an expense which often must be pre-paid by the borrower. While this would presumably deter borrowers, over 71% of respondents indicated that they have not abandoned the process despite the cost or time needed.

There are variances between sectors: agro-sector firms were the most likely to abandon the process due to cost, with 56% indicating this decision. Surprisingly, the percentage of firms who have abandoned the process because of time restraints was lower, even though the opportunity cost is very high. However, as happens in other countries where processes are slow, one would expect companies to incur debt ahead of needs in order to have funds available as opportunities arise. Figure 6 below sets out the percentage of firms that have abandoned the loan process because of the costly or time-consuming nature of collateralisation.

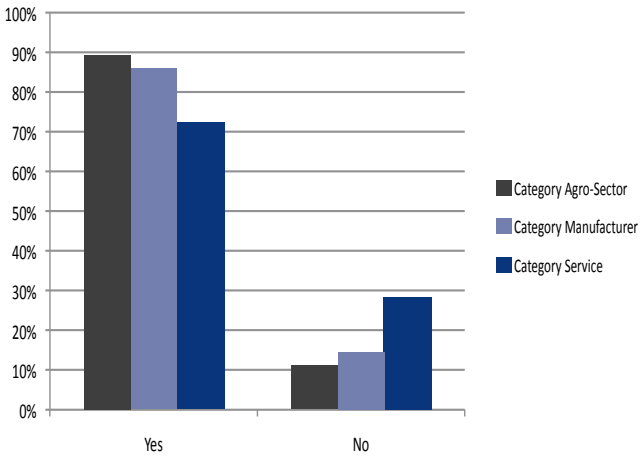
Figure 6: Abandoned loan process due to the cost or time of collateralisation



Source: Synovate survey, author's compilation.

Banks can be flexible in the timing of loan disbursement, thereby reducing the lead time required. In 24% of cases in all sectors, firms reported receiving funds prior to the perfection of security being completed. Figure 7 below sets out the percentage of firms that have had to wait for collateral registration before disbursement of loans.

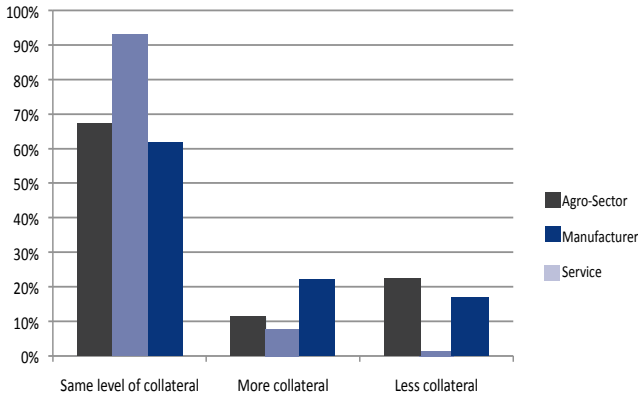
Figure 7: Disbursement having to await registration of collateral



Source: Synovate survey, author's compilation.

A worrying aspect is that the benefits of collateral are not accruing to borrowers. As explained before, one of the benefits of collateral is that the borrower can expect his/her interest rate to be lower in a secured loan environment and the collateral requirements to actually be reduced as the lender–borrower experiences and relationship grow. This is not developing, probably due to the usage of all asset debentures, which by controlling a firm's assets over time reduces the need for loan by loan collateral, thereby reducing competition and the need to reassess the borrower-lender relationship. Figure 8 shows that the level of collateral remains static over time.

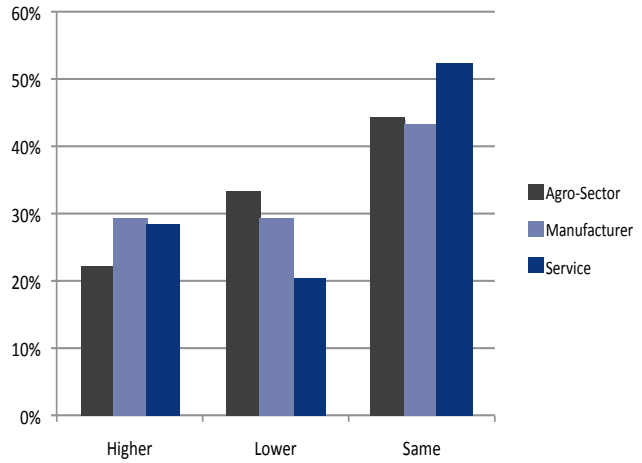
Figure 8: As relationship with bank has grown, need for collateral in renewing loan



Source: Synovate survey, author's compilation.

Figure 9 below illustrates that the rate of interest does not vary with collateral. Firms perceive that they will pay the same interest rate regardless of whether they provide collateral, or the type of collateral they provide. This corresponds with the high cost of enforcing collateral, making banks unsecured lenders in practice.

Figure 9: Rate of interest with collateral provided



Source: Synovate survey, author's compilation.

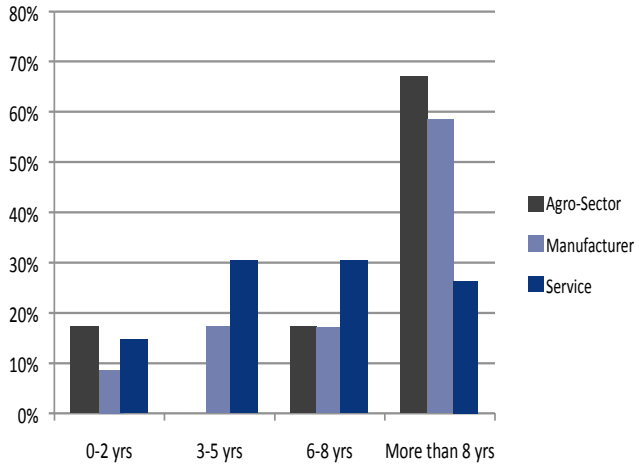
Figure 10 and Figure 11 illustrate the lack of competition in the sector due to the collateral process.

Figure 10 shows the length of the banking relationship (from a credit perspective). Most relationships are over eight years old. An argument can of course be made that what is shown is consumer loyalty, or the value of relationships between banks and borrowers. However, experience in other markets tends to show that where there is the ability to readily move facilities, the cost of borrowing is a major influence.

Figure 11 portrays the number of banks that companies have loans with. In a competitive system where banks specialise in different products and thus are able to offer lower interest rates, one would expect companies to have credit relationships with a number of financial institutions. This is not the case in Kenya, often because firms are bound to only one bank due to an all asset debenture.

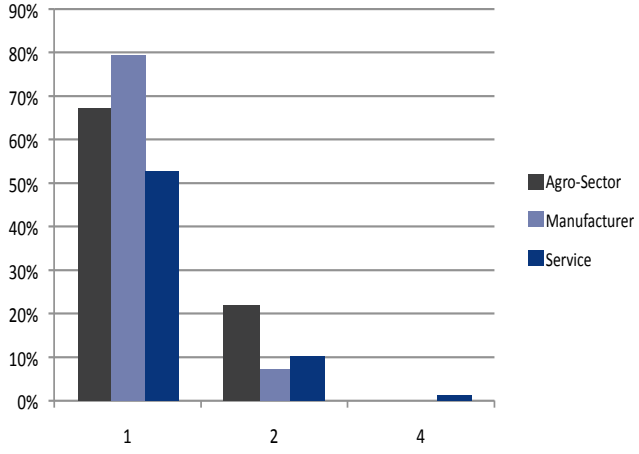
In summary, the survey of firms conducted by ICA and Synovate shows the positive and negative aspects of financing in Kenya. There are few substantial restrictions on credit and companies have access to a wide variety of sources, including trade finance; as well, banks accept a wide variety of assets as collateral and are not fixated on real estate (common in many other countries). Collateral is expensive to create and perfect in Kenya, but these costs in time and money are already factored into the decision-making process by companies, and few companies abandon loan processes due to these costs. However, the over-reliance on all asset debentures is considerably reducing competition. Companies mostly engage with one bank (on the loan side) and enter into very long relationships, which does not translate into lower collateral requirements or lower loan rates.

Figure 10: Number of years relationship held with bank



Source: Synovate survey, author's compilation.

Figure 11: How many banks does your business have a loan with?



Source: Synovate survey, author's compilation.

Chapter 5

NON-TRADITIONAL/UNCONVENTIONAL FORMS OF COLLATERAL

Alternative collateral products are valuable, and can benefit the system by allowing access to credit to different sectors and easing the burden of collateral, even in fully reformed collateral systems. This is especially important for the SME sector. The following sections contain brief descriptions of some alternative forms of collateral.

5.1 FACTORING AND INVOICE DISCOUNTING

The purchase or discount of accounts receivable is heavily dependent on an adequate and inexpensive framework for assignment of securities and collateral.

Factoring is the selling of a company's accounts receivable at a discount to a factor (company specialising in that business), which then assumes the credit risk of the account debtors (purchasers of the original merchandise), generally without recourse, and receives cash directly from the debtors as these debtors pay. Because factors own the accounts receivable they will generally take control of managing the accounts receivable function and will receive the payments for the invoice. The factor generally buys a tranche of accounts receivable from pre-determined customers and not from individual invoices.

Invoice discounting differs from factoring in that invoices are not sold but rather discounted with full recourse to the seller of the original merchandise. In most cases, the buyer of the merchandise is not aware that the seller has discounted the invoices, as the transaction is entirely between the discounter and the seller of merchandise. The selling company continues to collect its own debts, generally into its own accounts, and performs its own credit control functions. The invoice discounter checks regularly to see that the company's debt collection procedures are effective.

As with factoring, the invoice discounter will first perform strict checks on the company and its customers. It will then agree to advance a certain percentage of the total outstanding accounts receivable (for the accepted buyers), and, in return, will demand a monthly fee for the service and interest on all amounts advanced. As accounts receivable rise or fall, the amount extended to the company will also rise or fall.

In Kenya, invoice discounting and factoring often function differently in practice. A number of institutions will discount invoices, but, rather than the wholesale agreements common in other countries, these are discounts of individual invoices. As with factoring, invoice discounters will generally take control of the accounts receivable function, with the buyer paying directly into the invoice discounters' accounts. The most important difference between this and the international model is that this is a per-invoice exercise, and, therefore, is time consuming and relatively low volume.

Two major issues have impeded the development of these products in comparison to international or local wholesale standards. The first and most important is the lack of an adequate legal structure. Despite the fact that Kenya is a common law country and as such can use precedents from other common law countries, local courts must first accept that precedent. This could be a very costly process for the first factor test case of the system. How would local courts interpret the rights of a factor in a receivership when the holder of an all asset debenture has priority? The holder of an all asset debenture may have to authorise the factoring deal initially, as it in effect carves out assets from under him/her. How are the buyer and other lenders notified that accounts receivable have been assigned? How would the registration and notification process work?

The second major challenge is stamp duty. Would the factor pay stamp duty at the 0.20% rate on assignment as security? Or would he/she have to pay at 2% as a conveyance of sale? In addition to these questions, there are concerns regarding how the CBK would interpret the purchase of tranches of accounts receivable with respect to its tangible collateral guidelines. Additionally, in the absence of an effective and well informed credit reference bureau, an adequate monitoring system must be implemented, particularly when considering the major risk that the factor assumes: that of the buyer who is not a direct client and whose credit information is harder to come by.

These are issues which can be resolved, and have been resolved in many other common law countries. However, due to slow-moving courts and uncertain outcomes, a local legislative framework that clarifies the above issues and fosters the development of wholesale invoice discounting or factoring would be preferable.

5.2 CREDIT BUREAUS

When assessing risk, a customer's credit reputation, or his/her willingness to pay as demonstrated by his past payment history, is equally as important as his/her capacity to pay. Historically, banks relied extensively on their relationship with a customer as a pre-condition to establishing a credit facility. That ability has diminished considerably with the expansion of services and client numbers. However, within the Eastern African community and in Kenya, credit reputation is still the first form of collateral for banks.

Credit referencing is not fully developed in Kenya. Many civil code countries have developed public credit registries, normally at the central bank, while common law developed private credit registries that gathered positive information (data on time payments and fulfilment of agreements). In Kenya, a company called Credit Reference Bureau (CRB) Africa Limited was established in 1990 and for many years provided a service to businesses by which they could check unpaid bills and invoices, in effect collecting only negative information. Despite Kenya's status as a common law country, CRB Africa Ltd was unable to develop into a fully fledged credit bureau as it faced resistance from industry players to the principle of information sharing. The Banking (Credit Reference Bureau) Regulations 2008, were gazetted in July

2008 and became operational on 2nd February 2009. Three applications for Licences under the regulations have been received by the CBK. The applicants include CRB Africa Limited, Metropol East Africa and Compuscan (South Africa). The CBK issued an approval in principal to CRB Africa in August 2009 to establish a credit reference bureau after meeting the statutory requirements.

In terms of information, the system adopted by Kenya only obligates financial institutions to report negative information, allowing positive information as voluntary reporting. Furthermore, negative information is based on non-performing loans (90 days overdue), preventing habitual late payers from being caught. The current regulations only cover institutions Licenced under the Banking Act. Credit information sharing for deposit taking micro-finance institutions is covered under the Micro-finance Act. However, further amendments are proposed under the Micro-finance Act in the Finance Bill 2009 to compel deposit taking micro-finance institutions to share information on non-performing loans. Currently, only one deposit taking micro-finance institution, Faulu Kenya is operational. The Kenya credit information sharing initiative will take a modular approach, starting with banks moving to deposit taking micro-finance institutions and SACCOs, and then other credit providers.

In the East African Community, only Uganda has a credit reference bureau (CRB) up and running. In Africa, only South Africa that has a well established credit information sharing system. A joint task force of the Kenya Bankers Association (KBA) and the Central Bank of Kenya (CBK) has hired a project manager who will be responsible for the Kenya credit information sharing initiative and will be based at the KBA. The project manager's role will be to lead, coordinate and drive all the implementation activities. The primary outcome will be the implementation of an operating credit information sharing environment in Kenya in two years.

Under normal circumstances, a complete database with sufficient positive and negative information and coverage of a majority of banking customers takes around eight years to build. With the asymmetries of information built into the Kenyan system relating to positive and negative information, this time frame may be increased. CBK has actively worked to remove the obstacles that will arise. If the information templates are built around the provision of all loan payment information, including credit line or loan amount, usage, balance, and on time and late payments (15 days after missing a payment), then the built-in asymmetries in data may be overcome.

5.3 HIRE PURCHASE

Hire purchase is a type of instalment credit which is a prime source of commercial credit at reduced costs in many Commonwealth countries. Under this mechanism, the hirer agrees to take the goods on hire at a stated rental price, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hirer acquires the property (goods) immediately on signing the hire purchase agreement, but the ownership or title is transferred only when the last instalment is paid. Generally hire purchase laws specify that:

1. The owner delivers possession of goods to a person on condition that person pays the agreed amount in periodic instalments;
2. The property in the form of goods is to pass to that person on the payment of the last of the instalments;
3. That person has a right to terminate the agreement at any time before the property passes to them.

Under a typical instalment sale, the property passes to the purchaser when the contract is signed and the seller establishes a lien or other encumbrance that includes the costs to establish security and recover in the case of non-payment. Hire purchase has proven successful in other areas because ownership remains with the seller until the last instalment is paid, thus eliminating the cost of establishing a security and limiting the cost of recovery to repossession. Hire purchase in Kenya, though relatively common and well known, has not had the economic impact (particularly in financing enterprises) that it has had in countries such as Australia and New Zealand. One reason for its limited impact in Kenya is that the Kenya Hire Purchase Act has provisions that reduce its attractiveness. These are mainly:

1. After two thirds of the instalments have been paid the owner loses the right to recover possession of the goods, except by suit, thus bringing it to the same level as an unsecured loan.
2. The rights of the owner to repossess are curtailed from the onset by limiting his/her right to enter the premises of the hirer to recover his/her goods.
3. The right to terminate the agreement on the part of hirer with little penalty (difference between one half of the sale price and sums paid), in effect leaving the owner with a depreciated asset while only recovering half its value.

Given market familiarity with the instrument and the fact that it eliminates the cost of securing the asset as well as substantially reducing the cost and time of recovery, the Kenya Hire Purchase Act should be amended to encourage the use of hire purchase as a financing mechanism. Additionally, in many countries, hire purchase agreements also allow hirers to include the assets in their balance sheets and depreciate them for tax purposes, in addition to allowing the deduction of the interest component of the instalment.

5.4 LEASING

Leasing is similar to hire purchase in that both are financial facilities which allow a business to use an asset over a fixed period in return for regular payments. The business customer chooses the equipment it requires and the finance company buys it on behalf of the business. There are two principal types of leasing: operating leasing and finance leasing.

Operating lease

The fundamental characteristic of an operating lease is that ownership never passes to the business customer. It is an arrangement whereby a firm can obtain the use of certain fixed assets for which it must pay a series of contractual, periodic and tax deductible payments. The leasing company, rather than the business using the equipment, claims the capital allowances, although the business customer can deduct the full cost of lease rentals from its taxable income as a trading expense.

The leasing company will lease the equipment, expecting to sell it second-hand at the end of the lease or to lease it again to someone else. It will, therefore, not need to recover the full cost of the equipment through the lease rentals. This type of leasing is common for equipment where there is a well-established second-hand market (e.g. cars and construction equipment). The lease period is usually two to three years though it can be longer, and is always less than the working life of the machine.

Operating leases are a fast growing segment in Kenya, though targeted mostly at large or corporate firms due to the tax benefits. Their popularity among SMEs will depend heavily on the availability of good credit information and the growth of secondary markets for equipment.

Finance lease

The finance lease is very similar to the hire purchase alternative. In this case, the leasing company recovers the full cost of the equipment, plus charges, over the period of the lease. Although the business customer does not own the equipment, they are responsible for the risks and rewards associated with ownership and in most countries they are responsible for maintaining and insuring the asset.

Some countries allow the business to show the leased asset on their balance sheet as a capital item and depreciate it, while in others the asset will remain in the books of the lessor. In the latter case, the lessee is generally allowed to deduct the full payment for tax purposes. In both cases, when the lease period ends the leasing company is usually obligated to sell the asset to the lessee at a nominal value, generally equivalent to one extra instalment payment.

Finance leasing is not widespread in Kenya due to tax legislation. The Kenyan tax authorities will "claw back" the deduction of the instalments if the asset goes on the books of the business, in effect creating a tax disadvantage for the product. Thus, Kenya, through mistakes in the Hire Purchase Act, has reduced the attractiveness of that instrument, and, through tax treatment, has discouraged the use of finance leases.

This has the heaviest impact on the finance options for SMEs, the parties most interested in purchasing business assets in instalments and then owning them at the end of the lease period. Additionally, the World Bank's Investment Climate Report indicates that Kenyan plants and equipment are generally outdated, overvalued, and inefficiently used, and that investment levels in new equipment are low. Total factor productivity for Kenyan firms would increase with higher investment in equipment, which would be enabled by financing vehicles promoting hire purchase and finance leasing.

5.5 WAREHOUSE RECEIPTS

A warehouse receipt is a document that provides proof of ownership of commodities that are stored in a warehouse, vault, or depository for safekeeping, and may be negotiable or non-negotiable. Most warehouse receipts are issued in negotiable form, making them eligible as collateral for loans. Warehouse receipts also guarantee the existence and availability of a commodity of a particular quantity, type and quality in a named storage facility.

A warehouse receipt may show transfer of ownership for immediate delivery or for delivery at a future date. Rather than delivering the actual commodity, negotiable warehouse receipts are used to settle expiring futures contracts. Warehouse receipts systems are generally perceived as a means of improving access to credit, hence their descriptive title "inventory credit system". While their products are stored in the warehouses borrowers may use the receipts issued by the warehouses to obtain loans from commercial banks using their products as security.

Regulated warehouse receipt systems are helping to combat persistent problems in agricultural marketing and credit systems in sub-Saharan Africa. While floating charges (where the legal system permits) may fulfil this gap for larger commodity firms, a well functioning and regulated warehouse receipt system can simultaneously help make agricultural marketing more efficient and improve access to finance for smaller firms.

The availability of secure warehouse receipts may also allow owners of inventory to borrow in currencies for which real interest rates are lower, particularly if loans are made against inventory of an export commodity. This would be of benefit in Kenya and Uganda, where coffee stocks are often financed in pounds sterling.

This industry is in its infancy in Kenya, with the recent establishment of the first warehouse facility, the Nakuru Wheat Silos, and the launch of a financing scheme against warehouse receipts by Equity Bank. However, the lack of enabling legislation is a factor that will undermine the continued development of this industry.

In 2007, FSD partnered with the East African grain council to support the establishment of a viable and sustainable warehouse receipts system. Although in 2008, the government intervened in the maize sector causing a market distortion that adversely affected the progress of this project. Much was achieved and the project is back on track.

Chapter 6

CONCLUSION AND RECOMMENDATIONS

The Kenyan collateral process is broken; it fails to protect lenders and conveys little benefit to borrowers. The collateral process not only affects bank margins, it is actually imposing substantial economic costs on enterprises in the form of less credit (and thus lower employment and economic growth), less competition and higher overall interest rates.

A review of the legal environment surrounding collateral shows a highly fragmented system with twenty different laws, some of which limit the types of assets that may be pledged, and others the types of encumbrances that may be created. They also impose different mechanisms and time frames for perfecting collateral, wrecking havoc in the system of priorities (and thus adding to court delays as judges may have to sort out who has priority).

Additionally, the process of perfecting collateral is incredibly convoluted, particularly (but not only) in the Land Office. For example, in order to obtain a land rent clearance certificate from the Land Office which is necessary to register collateral, the owner is required to show proof that he/she has paid land rent to the same office for his/her property! The registration process in itself is expensive and burdensome, not only due to the many steps and their cost but also due to the incidence of stamp duty, which in Kenya is relatively high. Probably just as damaging as the rate is the convoluted process that tax payers are subjected to in order to pay.

The registration process is also fragmented, with various registries, each with different procedures and formats and with no information sharing. Searches range from difficult to impossible as they must be manually performed at a registry itself. Of more concern is the fact that files get lost, or papers within them may be replaced with no audit trail. This is of more concern in the Land Registry than in the Companies Registry, a situation that is probably due to the larger rent seeking opportunities at the Land Registry. But this leads to a situation where immovable property in Kenya (i.e. real estate) may in fact move. Registration in the Companies Registry is by name, and searches by asset are not possible, further limiting the benefits of the registries. In the case of chattels only the encumbrance document is registered with no possible way to determine the assets pledged, unless the actual document is recovered in the search and read.

While there are elements of Kenya's financial system that are well-developed, the barriers and challenges in the collateral process greatly impact and limit the level of development and success in the larger economy and financial system. Each step of the collateral process is problematic and deters lenders from utilising the collateral system, instead forcing lenders to rely on all asset debentures. Consequently, this limits competition and access to finance, greatly restricting small business and entrepreneurial growth. Alternative products, including hire purchase, leasing and factoring, have been very successful in other parts of the world, but have had limited impact in Kenya because of legal restrictions or tax consequences.

As stressed throughout this report, a properly functioning collateral process will help the Kenyan financial system achieve its full potential and will have a significant impact upon job creation and economic growth.

The following recommendations will resolve or alleviate the current constraints to the creation, perfection and realisation of security interests in Kenya.

CREATION OF SECURITY INTERESTS

1. Unified code of law for immovable property

As noted in the section on constraints to the collateral process, there are currently five land statutes dealing with immovable property in its various forms in Kenya. There should be one unified code of law relating to immovable property, as it is imperative that land, both urban and rural, becomes a viable source of collateral. Under a unified code, certainty of title would be easier to establish and guarantee. Moreover, the conveyancing process should be simplified and standardised, with information available to all parties, in order to create a unified national property market. Ultimately, this unified property market would make it easier to establish the ownership and value of property and thereby facilitate the use of land as collateral.

2. Land tenure system

The above unified code would also include a reform of the current land tenure system. Ideally, the new tenure system should eliminate leasehold and convert all properties to freehold, establishing a system of property taxes (applicable to all properties) to replace the Land Rent, which is currently payable only by leaseholders.

3. Repeal the land control act

Under a unified code, the Land Control Act would be repealed. However, even if a unified land tenure system is not politically possible, the Land Control Act should nevertheless be repealed, as it restricts the freedom to contract and the encumbrance process. The Agriculture Act already regulates the manner in which the owner of agricultural land is supposed to deal with the land.

4. Establish personal security legislation

The Chattels Transfer Act is currently the only statute that addresses personal security legislation. This Act should be reformed, retaining the same name for marketing purposes, but creating a streamlined and transparent system for non-corporate movable assets. Given the use of common law in Kenya, it may be convenient to base this reform on Chapter 9 of the United States Uniform Commercial Code.

5. Reform of corporate security instruments

Section 96 of the Companies Act of Kenya contains a list that limits the security interests which a company is obliged to register. This list should be eliminated,

allowing for common law encumbrances to take precedence and thus widening the scope of financial instruments available to a corporate entity.

Research for this study revealed that a new company law is under review. This new law should take into account the above widening of instruments. However, even if this law is not passed, the deletion of this list should be undertaken. Given that this new law is still under consideration and presents an opportunity for substantial reform of company legislation, we recommend that it be based on modern company legislation, taking as reference company laws of various jurisdictions.

6. Reform of floating charges

Currently, the floating charge is subordinate to the fixed charge due to the preferential creditors having priority as well as the hardening period in the event of liquidation and receivership. For an agricultural economy with growing agro-export sectors, the weakness of a floating charge limits the use of crops and other export products as collateral. This should be remedied by making the floating charge rank equally in terms of priority with the fixed charge. The ongoing exercise of reforming the Companies Act offers an opportunity to include this reform of the floating charge.

7. Reform of tracing rights

Currently, secured creditors with specific or floating charges lose priority rights over proceeds of sale unless the proceeds are deposited into a specific account. Therefore, upon sale of encumbered assets, lenders, for practical purposes, become unsecured creditors (unless the borrower has deposited the proceeds in a segregated account). The reform of both the Companies Act and the Chattels Transfer Act should specifically allow secured creditors to retain priority rights over such proceeds of sale regardless of the destination of the funds.

8. Standardised encumbrance forms

The reform of the various statutes should allow for simple do-it-yourself encumbrance forms for most non-complex security interests. It should also not be necessary for these forms to be signed before special witnesses, as there should be a presumption of due execution by the borrower. It should be incumbent on the parties to elect when and whether to seek legal or other advice prior to and during execution of documents.

9. Freedom to engage professionals

Currently, Kenya imposes the requirement to hire different types of professionals (advocates, valuers, insurers, estate agents, auctioneers, etc.) throughout the collateral process. Furthermore, these professionals are normally required to adhere to a strict schedule of charges which increases the expense of the collateral process. The parties to the transaction should be free to elect when and whether to seek professional services or advice. Furthermore, the schedules of charges applicable to the different professions should establish a ceiling on charges, but not a floor, in effect allowing parties to freely negotiate terms of engagement. A completely free market for charges would be preferable in an environment of strong consumer protection laws.

PERFECTION OF SECURITY INTERESTS

10. Stamp duty

The current stamp duty is costly, unfair and cumbersome. It needs to be either substantially reformed or replaced. One option would be to replace the stamp duty with a tax on bank debits. The benefits of this tax would be immediacy and ease of collection, the lack of forms or any other bureaucratic procedures, fairness (those who spend more pay more) and fiscal gains.

An observation of CBK data on bank withdrawals for 2007 shows that this tax levied at a rate of 0.20% would bring in revenue of approximately KSh 4.6 billion per year as opposed to current stamp duty revenue, which is approximately KSh 2 billion. The implementation of this type of tax requires a simple law and a few lines of code in bank software, allowing for a very quick implementation.

Alternatively, the Stamp Duty Act could be reformed to make it more responsive to circumstances by establishing low rates that depend on the property or interest being created, by whom and for what purpose. In addition, the process of paying stamp duty needs to be revised to allow for non-physical presence, immediate payment and receipting.

11. Single registry

There is currently a multiplicity of registries for encumbrances, all of which are manual, require physical documentation and do not share information. There should be a unified registry for encumbrances, to be set up as an autonomous institution. In this regard, the country can leverage the existence of the Register General and thus create such a registry with less effort.

This new registry system would need to be freely accessible or viewable by anyone, preferably over the Internet, and should be searchable by debtor, asset, and lender. Rather than the full security agreements, only the necessary information about the security interest should be filed, including:

- Notice of its existence, with identification (names and addresses) of the parties;
- Full description of the collateral asset(s) or floating charges (for identification purposes);
- Value secured (entire asset or specific amount);
- Date and time of filing.

Additionally, the registration system should do away with physical visits to the register, thus eliminating the risk of paper or file manipulation and increasing

the security of data. Most importantly, such a unified registry would harmonise priority rights. In Annex III, a summary of the requirements to establish a properly functioning registry is presented.

ENFORCEMENT

12. Court system for repossession

The current procedures for repossession are not effective as courts readily grant injunctions allowing borrowers to stop the realisation process pending the resolution of a dispute. While the litigation continues, the borrower is able to enjoy the asset. This has in many cases resulted in the asset being lost and/or dissipated, making the lender unable to recover, if at all, the amount owed. To overcome this, the team suggests the following solution: Strengthen the out-of-court system for repossession. The statute already covers the events of default and repossession; therefore such repossession needs to proceed only upon court notification and not approval, which would normally require a hearing process. In the case of the need for injunctions, for these to be granted, the borrower would need to deposit with the court the asset or the principal amount owed until the case is determined. This would ensure that no party benefits when real disputes occur.

13. Alternative dispute resolution mechanisms

Lenders shy away from alternative dispute resolutions as, under the current form, these typically do not enforce repossession. It would appear that currently arbitrators seek to mediate between the parties rather than enforce the contract. Therefore, alternative dispute resolution mechanisms should obligate fulfilment of contractual obligations, particularly in terms of enforcement of security.

14. Increase in number of specialised commercial courts

Commercial courts have been established to expedite commercial disputes. After initial success, these courts have began to experience backlogs as the courts sit only in Nairobi and have a shortage of judges and other judicial officers. There is therefore a need to increase the number of judges and judicial officers, as well as to establish regional commercial courts. An additional area that could be explored is the creation of separate courts to deal with debt recovery within the commercial court system.

15. Strengthen alternative products

Alternative products, such as hire purchase, leasing, factoring and warehouse receipts, have proven to be very successful in other parts of the world, but in Kenya they are plagued by legal difficulties (either a base framework or lack of one) and by tax consequences.

- **Hire Purchase Act/** It is recommended that the current Hire Purchase Act be amended to remove the pitfalls outlined. A new Hire Purchase Act would borrow from more refined hire purchase statutes such as the New Zealand Hire Purchase Act. A reform of this nature would allow for instalment credit to grow.

- **Leasing/** There are a number of issues that affect the development of this product. Firstly, tax benefits are greatly limited. KRA will claw back tax benefits derived from the instalment if the asset is transferred to the lessor, impeding the development of finance leasing. As a recommendation, KRA needs to review its tax regulations in order to assure that leasing is a viable product, particularly for SMEs, while still preventing the leasing from being utilised as a tax elusion mechanism. The lack of credit history information also restricts leasing for the SME market. Therefore, the development of the credit information industry will aid this market. A third issue is the fact that the lack of specific legislation may put lessors at a disadvantage as the courts may use hire purchase provisions to determine how leasing should operate. Consequently, while not essential, a leasing statute may allay many of these fears and permit the industry to grow.

- **Invoice discounting and factoring/** There are a few companies engaging in retail invoice discounting on a per invoice basis. The wholesale or actual sale of blocks of accounts receivable requires an adequate legal structure which is currently absent in Kenya. An additional area of concern is the impact of stamp duty on factoring transactions, as there are different interpretations as to what the actual stamp duty would be and the impact of a flat rate on the cost of a short-term product. The elimination of stamp duty would be advantageous to this product. In the absence of that, KRA will need to enable specific stamp duty for this product.

- **Warehouse receipts/** The lack of an appropriate legal environment is the single most important constraint to the growth, creation and acceptance of warehouse receipts in Kenya. In order for a warehouse receipt system to be viable, the legal system must support warehouse receipts as secure collateral. The pertinent legislation must meet several conditions:

  a. Warehouse receipts must be functionally equivalent to stored commodities;

  b. The rights, liabilities, and duties of each party to a warehouse receipt (for example, a farmer, a bank, or a warehouse employee) must be clearly defined;

  c. Warehouse receipts must be freely transferable by delivery and endorsement;

  d. The holder of a warehouse receipt must be first in line to receive the stored goods or their fungible equivalent on liquidation or default of the warehouse; and

e. The prospective recipient of a warehouse receipt should be able to determine, before acceptance, if there is a competing claim to the collateral underlying the receipt.

- **Credit Information system.** A legislative amendment and regulations have been put in place to enable the licensing of credit bureaus. However, the asymmetries of information contained in the law may hamper the development of an adequate credit referencing industry. The current law allows negative information to be freely shared (at a non-performing loan level). The law also allows banks to report positive information but does not insist on it. Credit information sharing for deposit taking micro-finance institutions is under the Micro-finance Act. Further amendments have been proposed under the Act in the Finance Bill 2009, to compel deposit taking micro-finance institutions to share information on non-performing loans. These are obstacles that may delay the development of the industry. The best solution would be to combine reform in the law with reform in the practice of lending. This latter reform is aimed at making reference to the personal credit history of a borrower a key factor in determining credit worthiness. The CBK may want to guide the industry in this area of sharing positive and negative information through instructions and manuals.
- FSD has partnered with the KBA and the CBK to support the sustainable influential of a credible credit information sharing system. The two-year project (2009-10) aims to provide capacity building to institutions providing and using credit information and educate the public about the efficacy of the new system and how it is in their interest for lenders to share their information both positive and negative.

REFERENCES

- Central Bank of Kenya. (2008). *Statistical Bulletin*. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2008). *Bank supervision annual report*. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2006). *Prudential guidelines for institutions licensed under the banking act*. Nairobi: Central Bank of Kenya.
- Čihák, M., & Podpiera, R. (2005). *Bank Behavior in Developing Countries: Evidence from East Africa*. Washington DC: International Monetary Fund.
- Fleisig, H., Safavian, M., & de la Peña, N. (2006). *Reforming collateral laws to expand access to finance*. Washington DC: The International Bank for Reconstruction and Development / The World Bank.
- Foreign Investment Advisory Service (FIAS), World Bank Group. (2004). *Accelerating reforms to improve the commercial legal frame and remove administrative and regulatory barriers to investment.* World Bank.
- Goode, R. (2004). *Commercial Law (3rd Edition ed.)*. London: Penguin books.
- Larossi, G. (2009). *An assessment of the investment climate in Kenya.* Washington DC: The International Bank for Reconstruction and Development/ World Bank.
- Microfinance Risk Management, L.L.C. (2008). *The potential for credit scoring for SME lending in Kenya*. Nairobi: FSD Kenya.
- Sacerdoti, E. (2005). *Access to bank credit in sub saharan Africa: Key issues and reform strategies.* Washington DC: International Monetary Fund.
- Safavian, M., Fleisig, H., & Steinbuks, J. (2006, March). *Unlocking Dead Capital.* (S. Smith, Ed.) Viewpoint , pp. 1-4.
- Steijvers, T., Voordeckers, W., & Vanhoof, K. (2008). *Collateral, relationship lending and family firm.* Small Business Economics .
- Vig, V. (2006). *Access to collateral and corporate debt structure: Evidence from a natural experiment.* Job market paper, London Business School, London.
- World Bank. (2005). *Principles for effective insolvency and creditor rights systems.* Washington DC: World Bank.

ANNEX I

SYNOVATE SURVEY METHODOLOGY

Based on previous business to business studies, Synovate had a list (Managing Director contacts and organisation telephone numbers) of 152 SMEs. From this list, 100 SME names were randomly selected to fit predetermined sector quotas of 10% agro-sector, 20% manufacturing, and 70% service. A structured questionnaire was provided by the authors of the report to be administered in English.

Using a Computer Assisted Telephonic Interviews (CATI) system, two firms were then selected for the pilot interview. This pilot interview was to check on questionnaire comprehension and flow, while feedback necessitated additional explanation for those questions that were not clearly understood.

Field work for the main survey commenced on 24 April 2009 with three CATI interviewers administering the survey. However, owing to tight deadlines, difficulties getting some of managers on the telephone (owing to an upcoming holiday), perceptions that the study was sensitive and insistence on viewing the questionnaire before participating, it was decided that direct contact be included as part of the survey method. Six high level face to face interviewers were trained and appointments were booked for direct contact interviews. Overall, out of the 100 interviews completed 10% were carried out through CATI while 90% were through direct contact. Field work was completed on 30 April 2009, and data was captured and tabulated by 5 May 2009.

ANNEX II

LIST OF PERSONS INTERVIEWED

Table 6: Time and cost of enforcing recovery in Court

Organisation	Contact	Title
Companies Registry	Bernice Gachegu Patrick Njoroge	Registrar General ICT Manager
Investeq Capital	Dan Awendo	Chief Executive
Fina Bank	Josephine Mutunga	Head of Risk
Tysons Limited	Samuel O. Odeimbo Stephen O. Omengo	Director Senior Valuer
Association of Micro-finance Institutions (AMFI)	Benjamin F. Nkungi	Chief Executive
Biashara Factors Limited	Beatrice Obara Nicholas Chepkoiwo Lydiah A. Owiti	Chief Executive Accounts Manager Legal Officer
Housing Finance	Katherine W. Kiarie	Credit Manager
Credit Reference Bureau	Wachira Ndege	Group Chief Executive
Faulu	Anne Kimari	Head of Finance
Bank of Africa	Jean-Geo Pastouret Anne Kahindi Ronald Marambii	Deputy Managing Director Legal Officer Head of Credit
KEPSA – Kenya Private Sector Alliance	Dorris Olutende	
KAM – Kenya Association of Manufacturers	Lilian A. Odhek	Asst. Executive Officer
Equity Bank	Shadrack Mwendwa	Risk Analyst
General Motors East Africa Limited	Titus Wangila Nganga	Credit Controller East Africa
Barclays Bank of Kenya Limited	Joseph W. Kimani Lennox Mugambi	Business Development Manager Acting Head Asset Finance

ANNEX III

REGISTRATION SYSTEM

A reformed Registration System has to be public – that is, one that can be accessed or viewed by anyone, preferably over the Internet.

What to file: **Not** the entire security agreement or even a substantial extract. **Just** the necessary information about the security interest, including the following:

1. Notice of its existence with identification (names and addresses) of the parties.
2. Full description of the collateral asset(s) (for identification purposes),
3. Value secured (entire asset or specific amount).
4. Date and time of filing.

Filing less information eases concerns about allowing greater public access to the filing system, lowers filing costs, and simplifies the registration system. While this abbreviated information may not tell a potential lender enough to decide whether to accept a potential borrower's property as collateral, the notice filing system gives the lender the information needed to inquire privately about additional details in loan contracts. If potential borrowers refuse to supply that information, lenders are free to refuse their loan application.

The system should allow for advance filing or "blocking" – maintaining a temporary file until the security documents are prepared and the loan is disbursed, so that priority can be assured.

Filing forms should be carried out by the interested party and forms should be submitted without the need for a lawyer. The registration itself does not need a lawyer. The preparation of legal security documents (which are not registered) is another matter.

The costs should be low. For example, the costs in the United States run from a minimum of the equivalent of KSh 200 to a maximum of KSh 1,200 depending on the amount of the security.

The database should be Internet based, as this reduces the cost of the network, plus computers, plus systems. The monthly cost to run such a database, including renting of the Oracle system and unlimited space would not exceed United States dollars (US$) 800.00. Total programming costs should not exceed US$20,000. This reduces costs and frees personnel for other uses. For example, the registry in El Salvador has 1000 employees and is manual, while California, the 10th largest economy in the world, has an Internet based registry and 12 employees.

The system should allow for searches by anyone, which could be an extra source of revenue, though searches should be either very cheap or free. A person should be able to search:

1. By borrower.
2. By asset or collateral.
3. By lender.

All registries should be linked. Preferably there should be one nationwide registry for all, so that the database and search cost is optimised.

FSD Kenya
Financial Sector Deepening

info@fsdkenya.org • www.fsdkenya.org
FSD Kenya is an independent Trust established to support the development of inclusive financial markets in Kenya
4th Floor Kenya Re Towers • Off Ragati Road, Upper Hill • P.O. Box 11353, 00100 Nairobi, Kenya
T +254 (20) 2718809, 2718814 • **M** +254 (724) 319706, (735) 319706