THE POTENTIAL FOR MORTGAGE SECURITISATION IN KENYA: PROSPECTS FOR SETTING A REGULATORY FRAMEWORK

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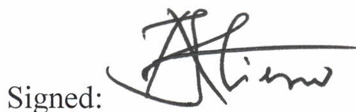
DECLARATION

I ODUOR JACKLINE PAULINE ATIENO do hereby declare that this thesis is my original work and has not been submitted and is not currently being submitted for a degree in any other university.

Signed: 

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DEDICATION

To Edwin, Tony and Adrian.

List of abbreviations

ABS	Asset Backed Securities
CAT	Cost Assess and Terms
CMA	Capital Markets Authority
FSA	Financial Services Authority
GSE	Government Sponsored Entity
HFC	Housing Finance Companies
ITPA	Indian Transfer of Property Act
JSE	Johannesburg Stock Exchange
Kshs.	Kenya Shillings
MBS	Mortgage Backed Securities
MFI(s)	Monetary Finance Institution(s)
MIRAS	Mortgage Interest Relief At Source
NHB	National Housing Bank
NHC	National Housing Corporation
NSE	Nairobi Stock Exchange
PTCs	Pass Through Certificates
R	Rand (South African Rand)
Rs	Rupees (Indian Rupees)
RLA	Registered Land Act
RTA	Registration of Titles Act
REMICs	Real Estate Mortgage Investment Conduits

SEC	Securities Exchange Commission
SMF	Secondary Mortgage Facilities
SMM	Secondary Mortgage Market
SMMEA	Secondary Mortgage Market Enhancement Act
SPV	Special Purpose Vehicle
UK	United Kingdom
USA	United States of America
VAT	Value Added Tax

Introduction

Kenya is grappling with severe housing shortage caused by increased population growth, rapid urbanization and rising expectation from a growing middle class with discriminating needs and tastes[1]. Many people may just want good affordable houses for rent, while others want to purchase or put up their own houses. Not many people however can afford to purchase a house outright. Consequently, to actualize the dream of owning a house at all many with an income, resort to housing finance in the form of mortgages obtainable from banks and other financial institutions.

The woes of those in pursuit of a home do not end at the fact that a chance to own a home through a mortgage arrangement is proffered: there is a restriction as to how much and to how many people a Monetary Financial Institutions (MFIs), for example, a bank, may lend money to purchase a house since a mortgage infers longterm lending against shortterm deposits. As a result, housing finance is often rationed through stringent screening process and is therefore expensive. In sum, the result is that both demand and supply of housing finance is severely constrained in Kenya[2]. If the housing finance (mortgage industry) is to be revived as an avenue through which Kenyans can acquire homes, a way must therefore be found, among other things, through which long term mortgage lending is backed by longterm deposits and cash flow[3].

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[1] *Warren Brown, Kimberly Tilock and Ezra Anyango, "The Enabling Environment for Housing Finance in Kenya", Civis, Cities Alliance, Cities Without Slums, Issue 4 <http://www.isted.com/villes-developpement/cities_alliance/kenya.pdf> last accessed on 5th October, 2006*

[2] *ibid*

[3] *ibid*

A number of countries have fashioned ingenious ways of financing long-term mortgages with long-term deposits, creating a healthy balance[4]. In this regard, mortgage securitization has emerged globally as an important technique for bundling assets and segregating risks into marketable securities. Securitization, which is the conversion of a pool of assets with a regular and predictable cash income, such as mortgage repayments or credit card receivables into a security or marketable instrument allows the bank to 'sell' a large number of its assets (for example, mortgage loans) to a large number of individuals/institutions which would otherwise not be attractive as individual purchases[5].

In both developed and some developing countries, mortgage securitization offers potential alternative to the traditional primary mortgage systems and is clearly a paradigm that ought to be seriously considered locally if Kenya is to meet its soaring housing demands. By adopting this new method, institutional investors with long-term liabilities are potentially important source of funds for housing loans more effectively than short-funded depository institutions. Mortgage securities can therefore tap these new funds for housing resulting in increased housing affordability, better flow of funds to the housing sector and better allocation of the risk inherent in housing finance.

The quest to deal with the housing problem in Kenya is a recurrent theme in government policy and development plans. A survey of relevant government policies and development plans indicate that its objective since independence has been to provide

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[4] *For Example USA, U.K., India and South Africa*

[5] *Neil van Vuuren, "The Awakening of Securitization in South Africa", <http://www.vinodkothari.com/south_africa_article.pdf> last accessed on 4th October, 2006*

adequate shelter for all, both in the urban and rural areas[6]. Infact the government has considered the introduction of a Secondary Mortgage Market (SMM) by developing and expanding the capital market. While acknowledging the importance of banks, building societies, pension schemes and cooperatives to the housing sector, the government has also recognized that the constraints of finance, land availability and the riot of laws involved in building regulations impede the growth of this sector[7].

Despite the government's clarity in articulating issues related to housing, shortage continues to be acute. With investors charging dearly in order to recoup expenses and also make a profit, housing is inevitably expensive. To ensure affordable housing we must therefore look at mortgage financing, which should not only be widely available but also cheap and tailored to individual needs.

Statement of the research problem

Since banks have most of their capital base as shortterm deposits, existing mortgage systems are inadequately equipped to deal with existing demands that continue to soar everyday. Lack of favourable long term financing is the main factor inhibiting the government's housing agenda to provide adequate and cheap housing both to urban and rural populations. In this regard, to the extent that affordability of housing can be enhanced through a secondary mortgage system, a study into the prospect of establishing one is long overdue. Nevertheless, in the absence of a legal regulatory framework that is informed by successful experiences from other jurisdictions, any such development will

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[6] *Kenya Government Sessional Paper No. 10 (1966), Government Printer, Nairobi*

[7] *Warren Brown et al, Supra note 1*

remain a mirage. It is in the context of limited formulation of the current mortgage systems and the lacunae in regulatory systems that this study is poised.

Focus and objectives of the study

To address the rationale for mortgage securitization to fund housing in Kenya and its practicality, this thesis proposes to inquire into the present nascent status of mortgage securitization in Kenya, to determine its potential and to attempt to outline the necessary legal and regulatory infrastructure to be instituted in order to found a boisterous system. In this regard, the thesis proposes to undertake a survey of the current legal framework (if any) and to explore the prerequisites that underlie the successful re-engineering or introduction of a feasible and effective regime. To meet these ends, the thesis will undertake a comparative review of the legal regulatory framework adopted in other jurisdictions: the United States of America (USA), United Kingdom (UK), India and South Africa through short case studies.

Ultimately, the study will, drawing from the local situation, and deriving orientation from these forerunner initiatives, make policy and legal reform recommendations from both the theoretical and practical perspective to ensure a successful mortgage securitization in Kenya.

Significance of the study

It is hoped that this study will constitute an important contribution in an area that is only in its formative stages and thus completely lacking in scholarship and academic comment.

Secondly given that Kenya is grappling with the problem of housing, it is hoped that this work will constitute a contribution in outlining a way in which access to housing finance may be increased thereby lessening somewhat this troubling state of affairs. Ultimately, this work will serve as a contribution in outlining a legal regulatory regime to manage the current mortgage systems with increased benefits to finance institutions, aspiring homeowners as well as government.

Literature survey

The subject of securitization of mortgages has evoked scant comment in academic literature. This is perhaps attributable to the fact that in many countries, securitization of mortgages is in its formative or trial stages. Paucity of literature on the subject is starker with respect to Kenya, where there is no published work on this subject. The importance of this study in advancing a local perspective to this subject is therefore apparent from the start. The works reviewed below are solely by authors from other jurisdictions. Despite this, their relevance to this research is evident, especially from a comparative perspective.

The book by Vinod Kumar Kothari[8] provides background information on the development of the mortgage markets, the institutional and framework issues that need to be addressed. It is an internationally acclaimed book on the subject of Securitization and will form part of the primary reference materials in this dissertation. The book by Grosh[9] examines the public enterprise in Kenya using the indicators of efficiency, profitability and consumer

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[8] *Vinod Kothari, Securitization: The Financial Instrument of the New Millennium, 2nd Edition (Calcutta, India: Academy of Financial Services, 2003)*

[9] *Barbara Grosh, Public Enterprise in Kenya: What Works, What Doesn't, and Why, (1991), Boulder, Colo:Lynne Rienner Publishers*

prices. Of particular focus in her study is the performance of the financial sector. She does not however specifically cover mortgage systems. The book by Lusztig and Schwab[10] and that by Brigham et al[11] covers various aspects of financial management within the context of Canada. The relevance in these works is the discussion on sources of funds (short term and long term).

Further contribution in the form of articles is more specific to various aspects of securitization. Gangwani's article[12] provides a background for modeling and analyzing mortgage-backed securities. It starts from the point that innovations and increasing complexity in mortgage-backed securities warrant a thorough understanding of the nuances behind these securities. Gangwani's second article[13] introduces certain basic concepts about securitization and discusses the accounting, tax, regulatory and other developments affecting securitization in the US.

The paper prepared by Michael Lea and Loic Chiquier[14] discusses the dynamics in the sector of secondary markets in provision of adequate housing, considered a major aspect of human development. Sridhars[15] contribution is a discussion paper on nascent state of the securitization market in India, its potential and attempts to identify what needs to be done

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[10] *P. Lusztig and B. Schwab, Managerial Finance in a Canadian Setting, (3rd Ed.) (1983), Toronto, ON, Buttersworth*

[11] *E.F.Brigham, A.L.Kahl and W.E. Rentz, Canadian Financial management: Theory & Practice, (1982), Ontario Canada*

[12] *Sunil Gangwani "MBS Structuring: Concepts and Techniques", The Securitization Conduit Vol. 1 No. 3 1998 <http://www.asset-backed.com> last accessed on 4th October, 2006*

[13] *'Speaking of Securitization' vol 3 Issue 4-1 July 20 1998*

[14] *Michael Lea and Loic Chiquier, "Providing long-term financing for housing: the role of secondary markets", paper prepared by the Office of Development Studies, Bureau for Development Policy, UNDP*

[15] *V Sridhar, "Securitization in India - Opportunities & Obstacles", A Discussion Paper PGP 2002, IIM Calcutta <http://www.vinodkothari.com/india_article_iimc.pdf> last accessed on 4th October, 2006*

by various stakeholders in this market for securitization to grow to its full potential in India. Vandell's[16] paper tracks the progress of mortgage securitization in the U.S. while examining the factors that have facilitated or constrained its progress and to focus on those events that created problems while outlining the lessons for Japan as it embarks on the road towards mortgage securitization.

Methodology

The research shall mainly be library based with documented facts on this subject being explored. The study adopts both critical and active research methods. As the subject under consideration is of particular pertinence to the current Kenyan experience, this study is not of academic interest only.

Limitations of the study

In an attempt to formulate a securitization framework for Kenya, recourse is made to approaches in a number of countries that have already instituted the same. In drawing from these experiences, this study does not propose to discuss exhaustively the mechanisms under consideration. In the case study approach taken, selected cases will merely serve to anchor the analysis, and may not adequately represent an ideal approach, as reference will be made appropriately to other experiences.

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[16] *Kerry D. Vandel, "Securitization of the U.S. Mortgage Market: Progress and Pitfalls, with Lessons for Japa", Presentation for the Seventh Annual International Land Policy Forum October 31 2000 <http://www.tochi.nla.go.jp:88/forum/vandell_fe.html> last accessed on 4th October, 2006*

Further, given that there is a dearth of literature at national level on this subject, the study will, by comparative approach, draw considerably (or rather entirely) from securitization experiences elsewhere.

Overview of chapters

This study consists of five chapters. Excluding this proposal, **Chapter one** discusses the importance of housing. It also investigates the problems facing the housing sector in Kenya. To do this, this chapter will evaluate the performance of the primary mortgage market. The chapter also introduces the basic concepts that underpin the study, for example, housing finance, mortgage securitization, primary and secondary mortgage markets.

Chapter two will endeavour to outline the basics of Securitization. It traces the origins of Securitization in the United States of America. It also examines the necessary elements of Securitization, its benefits and pitfalls and the mechanism of a simple Securitization transaction.

Chapter three discuss the legal and regulatory peculiarities of mortgage securitization. The legal and regulatory issues involved in Mortgage Backed Securitization transaction are elaborated in detail. This chapter informs the next two chapters and acts as a reference point for the discussions.

Chapter four discusses mechanisms of mortgage securitization in select number of countries. In this regard, we analyze the legal, regulatory and structural issues in the

operation of secondary mortgage markets in these jurisdictions. This will facilitate discussion in the next chapter in which we seek to apply the approaches to mortgage securitization to Kenya.

Chapter five will consist of a summary of the presentation by highlighting the issues related to mortgage securitization and housing in Kenya. In particular, this chapter, informed by chapter three, the legal and regulatory issues in Securitization transaction within the framework of Kenyan property law, banking law, bankruptcy and tax regimes and other extant capital market laws and regulations. General and specific policy and legal reform recommendations to actualize mortgage securitization will be made. Conclusions drawn from the entire study will be outlined.

CHAPTER ONE

HOUSING AND HOUSING FINANCE

1.1 Introduction

As a foundation to the gist of the thesis, this chapter outlines the importance of housing. It then proceeds to define housing finance and the various ways of financing housing. Further, it investigates the problems that bedevil the housing sector in Kenya and evaluates the performance of the primary mortgage market in Kenya. To lay a foundation for latter chapters, it introduces the basic concepts that underpin the study, including primary and secondary mortgage markets.

1.2 Importance of Housing

The importance of housing to human life cannot be overemphasized. The requirement of shelter for human continued existence can be traced far back to our cave living ancestors and housing is still essential for human survival with dignity. As society has evolved, adequate housing now forms one of the basic human necessities and has come to be associated with the enjoyment of other fundamental human rights. With the adoption of The Universal Declaration of Human Rights in 1948 the right to adequate housing[17] joined the body of international human rights law. Since then, many international conventions and instruments

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[17] *Article 25.1 "Everyone has the right to a standard of living adequate for the health and well-being of himself and his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control".*

have reaffirmed the right to housing in their specific contexts. These international conventions and treaties relate to such diverse rights as the right against all forms of racial discrimination, the rights of children, women and workers include:-

i) The International Convention on the Elimination of all forms of Racial Discrimination (1965)[18],

ii) The Convention on the Rights of the Child, adopted by the United Nations General Assembly on 20 November 1989[19],

iii) The Declaration of the Rights of The Child (1959)[20],

iv) The International Convention on the Elimination of All Forms of Discrimination Against Women (1979)[21],

v) The International Labour Organisation Recommendation No. 115 concerning Worker's Housing (1961)[22],

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[18] *Articles 5 "In compliance with the fundamental obligations laid down in article 2 of this Convention, States Parties undertake to prohibit and eliminate racial discrimination in all its forms and to guarantee the right of everyone, without distinction as to race, colour, or national or ethnic origin, to equality before the law, notably in the enjoyment of the following rights: ...(e) in particular ...(iii) the right to housing".*

[19] *Article 16.1 "No child shall be subjected to arbitrary or unlawful interference with his or her privacy, family home or correspondence, nor to unlawful attacks on his or her honour and reputation" and Article 27.3 "States Parties in accordance with the national conditions and within their means shall take appropriate measures to assist parents and others responsible for their child to implement this right and shall in case of need provide material assistance and support programmes, particularly with regard to nutrition, clothing and housing".*

[20] *Principle 4 "The child shall enjoy the benefits of social security. He shall be entitled to grow and develop in health; to this end special care and protection shall be provided to him and his mother, including adequate pre-natal and post-natal care. The child shall have the right to adequate nutrition, housing, recreation an medical services"*

[21] *Articles 14.2 "States Parties shall take all appropriate measures to eliminate discrimination against women in rural areas in order to ensure, on a basis of equality of men and women, that they participate in and benefit from rural development and, in particular, shall ensure to such women the right ... (h) to enjoy adequate living conditions, particularly in relation to housing, sanitation, electricity and water supply, transport and communications"*

[22] *Section II (Objectives of National Housing Policy) paragraph 2 "It should be an objective of national (housing) policy to promote, within the framework of general housing policy, the construction of housing and related community facilities with a view to ensuring that adequate and decent housing accommodation and suitable living environment are made available to all workers and their families" and Section III*

vi) The International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families (1990)[23], and

vii) The International Covenant on Economic, Social and Cultural Rights (1969)[24].

One basic provision which threads through the above conventions and instruments is the right to housing. Without a right to housing many other basic rights will be compromised including the right to family life and privacy, the right to freedom of movement, the right to assembly and association, the right to health, among others. Housing therefore forms the basis of enjoyment of all other human rights.

Homelessness in children, for example, may lead to child abuse with these children growing up in an atmosphere of moral and material insecurity without which they cannot realize their full potential. Inadequate shelter, such as slum dwellings, are often underprovided with utilities such as water and sewerage, roads, health and policing services. Lack of proper waste disposal facilities in these slums, for example, poses serious health hazard to the population. In this regard therefore the impact of housing extends beyond the individual who live there to the whole community. Good quality housing improves the quality of our lives

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(Responsibility of Public Authorities), paragraph 8.2. "The responsibilities of the central body should include formulating worker's housing programmes, such programmes to include measures for slum clearance and the re-housing of occupiers of slum dwellings"

[23] *Articles 43 "Migrant workers shall enjoy equality of treatment with nationals of the State of employment in relation to ...(d) access to housing, including social schemes, and protection against exploitation in respect of rents"*

[24] *Article 11.1 "The States Parties to the present Covenant recognize the right of everyone to an adequate standard of living for himself and his family, including adequate food, clothing and housing and to the continuous improvement of living conditions. The States Parties will take appropriate steps to ensure the realization of this right, recognizing to this effect the essential importance of international cooperation based on free consent"*

while poor quality housing can lead to such social problems as ill health, family breakup and criminal acts[25].

Other than as the basis for the enjoyment of other basic human rights and improving the quality of lives, housing is also important for being a store of wealth. This is because, housing as an asset, usually appreciate, over time and, the house owner may use the resulting equity in his housing stock for later consumption or as security for future development in both housing and non-housing activities.

1.3 Housing trends in Kenya

Kenya is facing an acute housing shortage attributable to increased population growth, rapid urbanization and rising expectation from its growing middle class[26]. Rapid urbanization is placing an enormous strain on an already stretched urban infrastructure, housing stock, and services, resulting in the proliferation of informal housing settlements. Brown *et al* estimate[27] that 60% of Nairobi's population live in slums.

Adequate housing is a factor of two main components; access and prices. Access connotes the availability of housing when and where required. However even where there is availability (access) of housing, it comes with a price tag, most of the time a hefty one. Many Kenyan households may just want decent affordable houses to lease, while others want to

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[25] *The World Health Organisation (WHO) concept of 'healthy housing' covers the provision of functional and adequate physical, social andmental conditions for health, safety, hygiene, comfort and privacy. Inadequate dwelling conditions such as mould growth, infestation, inadequate lighting may trigger direct health effects. Housing environment impacts on health through poor quality urban planning.*

[26] *Warren Brown et al, Supra note 1*

[27] *ibid*

purchase or put up their own houses. Not many however have the wherewithal to purchase a house outright. Consequently, to actualize the dream of owning a house at all, many with an income resort to housing finance in the form of mortgage loans obtainable from banks and other Non-Bank Financial Institutions (NBFIs) hereinafter together referred to as Monetary Financial Institutions (MFIs). A mortgage loan, or simply a mortgage, is a loan secured by the collateral of some specified real estate property, which obliges the borrower to make predetermined series of payments[28].

While incomes and house prices are major determinants of housing affordability two other factors deserve special mention as they play a role in housing affordability. These are Mortgage terms and Government intervention. Mortgage terms affect access to loans. Many MFIs make as a condition for loan qualification:-

i) proof of adequate, regular and dependable income;

ii) satisfactory collateral with proof of ownership;

iii) down payment of a percentage of the house purchase price;

iv) predetermined repayment period and amounts.

This therefore means that there is a stringent screening process exposing the lender and the borrower to undue expense[29]. The eventual result is that loans are therefore not readily given to willing applicants. Consequently MFIs have bigger overheads, brought about by a lengthy

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[28] *Laurie S. Goodman and Frank J. Fabozzi, Collateralised Debt Obligations, (New Jersey: John-Wiley & Sons Inc. 2002), 72*

[29] *Warren Brown et al, Supra note 1*

screening process, and make fewer loans, because only few people can pass the minimum threshold, the interest rates tend to be high for the MFIs to achieve a profit margin.

Most MFIs in Kenya prefer to lend for a short term[30] and in this way expose themselves to minimal risk. Fear of inflation and lack of long term pricing benchmarks[31] also keep mortgage maturities relatively short. This in turn leads to heavy and burdensome, most importantly, unaffordable, mortgage repayment instalments.

Government intervention may be in the form of:-

i) Tax incentives to the housing industry stakeholders, that is, home developers and buyers, and MFIs and borrowers. Tax incentives which lighten the financial burden of the housing industry players ensure affordability of housing units;

ii) Establishment of Housing Finance Institutions to cater for low income earners;

iii) Legal provisions that strengthen the mortgage default provisions. The presence of adequate foreclosure laws is one of the key components of the legal system underpinning the housing finance system and is a necessary condition for convincing MFIs to lend to house buyers.

As it currently stands, the Kenyan housing sector is confronted with numerous problems attributable to a number of factors among these; lack of finance, availability or lack of suitably serviced land and riot of laws regulating, in one way or the other, this industry.

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[30] *Standard Chartered Bank of Kenya Limited,Housing Finance Company of Kenya Limited and Barclays Bank of Kenya Limited have recently (2006) introduced mortgage repayment period of upto 20 years. These are the longest repayments periods so far on offer in the Kenyan market.*

[31] *The importance of benchmarks in Securitization is discussed at chapter 2 of this thesis.*

Kenya is a signatory to the International Covenant on Economic, Social and Cultural Rights, by which state parties covenanted to take appropriate steps to ensure the realization of the rights of everyone to among others, '*adequate standard of ... housing*'. While it is still a subject of debate on whether this right requires the state to build housing for the entire population, it is now agreed that the states must intervene in housing issues[32]. The Government also intervenes to correct market failures[33], ensure or improve standards and to meets its political and economic goals.

1.4 Housing Finance

Adequate housing then clearly comes at a dearer cost, and so few would be able to afford (access) quality housing. The gap between quality and access is bridged by housing finance. Housing finance may be defined as the money we use to build and maintain the nation's housing stock; the money we need to pay for housing in the form of rents, mortgage and loan repayments[34]. Housing finance exist to make quality housing affordable[35].

Traditionally, mortgages are financed by deposits the MFIs gathers from savings from households and other enterprises. The MFIs makes loans to homebuyers, acting therefore as the originators of the loan, the funder of the loan and the servicer of the portfolio. Instead of

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[32] *In 1992, the United Nations appointed a Special Rapporteur to promote the realization of the right to adequate housing. In his first report to the world body in 1993 the Special Rapporteur pointed out that the human right to adequate housing did not require the State to build housing for the entire population or to provide housing free of charge. It certainly did demand that the State undertake a series of measures indicating policy and legislative recognition of each of the constituent aspects of that right. Human Rights and Equal Opportunity Commission Sydney, September 1996*

[33] *The Government of Kenya, through the NHC, is now embarking on housing projects in Langata, Nairobi and Mamboleo, Kisumu in a bid to increase housing units available in the towns.*

[34] *Warren Brown et al, Supra note 1*

[35] *Peter King, Understanding Housing Finance, (London: Routledge, 2001), 6*

funding mortgages from MFIs deposits, an alternative exists where specialized institutions exist to facilitate flow of funds to the MFIs. These institutions, referred to as Secondary Mortgage Facilities (SMF), often government-owned, make collateralized[36] loans to MFIs to be used for solely for retail mortgage lending. A third approach to home financing is the Secondary Mortgage Market (SMM). This as this study shows in the latter chapters, involves the sale of Mortgage Backed Securities (MBS).

The use of any of these financing mechanisms depends on the stage of development of a country's financial markets as well as supporting government policies. For example, housing finance usually develops as a retail activity if the banking system can meet the mortgage credit demand or if the capital market sources of funding are not cost effective while the issuance of securities, the SMM, will depend on the existence of well developed capital markets.

The central role of finance in development generally and by extension, in the growth of a robust housing sector has recently been articulated by the Nairobi Stock Exchange (NSE) thus[37] "…..There is no denying the significant role that finance plays in the development of modern societies….. National performance is now conventionally measured, not according to the number of doctors, engineers, locomotives or pork bellies a country produces, but according to the extent to which it is able to restate such physical artefacts in financial

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[36] *This means secured. The MFI has to provide adequate security to the SMF for the loan.*

[37] *"Nairobi Stock Exchange Financial Institutions Committee", Reforming Kenya's Financial Sector for Economic Recovery: Proposal on Policy Interventions towards the Establishment of a Sustainable Financial System in the Banking, Finance and Capital Markets in Kenya <http://www.nse.co.ke> last accessed on 5th October, 2006*

terms". Housing finance is therefore an important factor in the housing sector[38]. This means that the Kenyan economy must now move to restate the housing finance sector in financial terms.

In Kenya, MFIs are usually deposit taking institutions. A mortgage loan from the MFIs generally infers long term lending against short term deposits. There is usually therefore limited finance available for onward lending to willing borrowers for housing and other capital requirements. Lack of, or limited finance has been said to have had the effect of causing the stagnation and the rot now visible in the housing sector in the country[39]. Proliferation of informal settlement is indicative of the fact that many people, especially the poor lack access to financial institutions and financial products tailored to their needs.

If housing finance (mortgage industry) is to be revived as an avenue through which Kenyans can acquire homes, a way must be found, among other things, through which long term mortgage lending is backed by long-term deposits and cash flow in order to lower costs and increase the funding available to housing finance[40].

The government, through the National Housing Corporation (NHC) had previously exercised control and leadership on the formal housing sector having been the main player in the

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[38] *Jay Sa-Aadu, "Housing Finance systems in Africa: Perspectives, policies and strategies in the next millennium", Shelter Net Bulletin, No. 15 <http://www.pdf.dec.org/pdf_docs/PNACB768.pdf> last accessed on 4th October, 2006*

[39] *Economic Recovery Strategy for Wealth and Employment Creation 2003-2007, prepared by the Government of Kenya (GOK) June 2003, 43*

[40] *Warren Brown et al, Supra note 1*

provision of housing in urban areas[41]. NHC served, for a long time, as an instrument of government policy in the housing sector. This is sadly not the case anymore. NHC's failure has been explained by Okpala[42] who raises cautions with respect to the stability and institutional memory of the predominantly government controlled formal housing finance sector in African countries.

1.5 Land

Housing infers land. Land in turn connotes three broad components[43] that is:-

(i) the physical structure or layout schemes with the functional relations that include, roads, sewerage and drainage facilities;

(ii) the services components namely water supply, sanitation services, power and energy supplies, community services; and

(iii) facilities such as education and health facilities, amongst others.

Land issues in Kenya are quite emotive. High demand by competing interest groups, government bureaucracy, the riot of laws in the land sector and the frequently changing land policies have not helped matters much. Further it is an uphill struggle to claim a stable and secure title in land. In Kenya land is registered systematically and not upon application of

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[41] *A.J. Odera (CEO NHC), Infrastructure finance: Arranging a housing bond – a case study on NHC, (a keynote speech delivered at the ASEA Conference, Nairobi by 23- 25, November, 2004).*

[42] *D.C.I. Okpala, "Financing Human Settlements Development", (Think piece commissioned by he Norwegian Ministry of Environment as part of the preparations for the 12th session of the Commission on Sustainable Development (CDS 12), New York 14-30 April, 2004), <http://www. odin.dep.no/filarkiv/203311/NR9__habitatFinancing.pdf> last accessed on 5th October, 2006*

[43] *ibid*

parties. Registration is in three phases: adjudication, that is, the ascertainment of existing customary land rights; consolidation, that is, aggregation of fragmented holdings which may involve landholders exchanging dispersed plots for adjacent plots; and registration, that is, recording of titles over consolidated plots.

Land adjudication, consolidation and registration have not been completed in most of the country. Clarissa and Klaus in a World Bank study[44] notes that only 15% of land in Kenya is covered by land titling and cadastral system. The study also notes that registration of a title takes upwards of 6 months up to 10 years. Most people therefore live on land without any documentation of title. De Soto[45] observes with respect to land holding in much of Africa and other developing countries that "…about 85% of urban land parcels in developing countries and between 40% and 53% of their rural land parcels are held in such a way that they cannot be used to create capital ... the total latent value of the real estate held but not legally owned by the poor in the developing world and in transition countries is in the order of about US$9.3 trillion".

It is widely accepted throughout the world that the registration of land rights improves access to formal credit as it is a source of collateral for large loans. Where the ownership of assets is difficult to trace and validate and has no recognisable governing set of rules, the assets has little economic use as the cannot be used to obtain surplus value through multiple

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[44] *Clarissa Augustinus and Klaus Deininger, "Innovations in land tenure, reform and administration in Africa", UNDP-International Land Coalition Workshop: Land Rights for African Development: From Knowledge to Action, Nairobi, <http://www.undp.org/drylands/lt-workshops> last accessed on 4th October, 2006*

[45] *De Soto, Hernando, The mystery of Capital: Why Capitalism triumphs in the West and Fails Everywhere else, (2000) 6 New York, Basic Books, 2*

transactions because of their unfixed nature and this uncertainty leaves too much room for misunderstandings, faulty recollections and reversal of agreements[46].

However, the requirement for secure title as collateral for loans and land related investments has come under serious doubt in recent times[47]. Firstly, poor households do not usually need large loans since they do not have adequate income to amortise such loans. For small loans other collateral other than land is usually adequate. Such collateral may be in the form of letters from the employers or evidence of a regular salary. Secondly, the emergence of innovative community based finance institutions that provide loans based more on credit worthiness, for example, Grameen Bank in Bangladesh, even makes the use of registered land titles as collateral irrelevant.

For the case of households seeking large loans from financial institutions, it is an undeniable fact that these institutions do require collateral security in the form of registered titles to landed property. It is therefore understandable that financial institutions are unwilling to gamble their money in such circumstances of insecure tenure. It is noted that despite potential for a microfinance sector, 'virtually every component of the enabling environment—from land security to affordability to financial legislation—restricts, rather

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[46] *Raymond Talinbe Abdulai, Is land title registration the answer to insecure and uncertain property rights in sub-Saharan Africa?,RICS Research paper series Volume 6, Number 6 April 2006 last accessed on the 20tth September, 2007 at <www.rics.org>*

[47] *Migot-Adholla, S.E., F. Place and W. Olusch-Kosura (1994) 'Security of tenure and land productivity in Kenya'. In J. Bruce and S. E. Migot-Adholla (eds). (1994) Searching for land tenure security in Africa. Iowa: Kendall/Hunt.*

than encourage, both the potential demand and the potential supply of housing finance'[48]. This reasoning can aptly apply to the entire housing sector, encompassing the existing primary mortgage market.

1.6 Mortgage Market

Mortgages are the main housing finance mechanism. Mortgage markets can either be primary or secondary. Since this study focuses, in the main, on the viability of introducing a secondary mortgage market in Kenya, the state of the primary mortgage market that necessitates and informs such proposal for reform is of paramount importance.

1.6.1 The Primary Mortgage Market in Kenya

The state of the housing sector described above is partly attributable to scarcity of finances to fund the housing sector and partly due to how the available housing finance mechanisms (primary mortgage market) are formulated and operated. Given that 'strategies for financing investment in shelter have to address the central issue of mobilizing a steady flow of long term finance'[49], the structure of these mechanisms is of utmost importance.

Formal sources of housing finance such as building societies, housing or mortgage banks, savings and loan associations and others are weakly institutionalized and have suffered the mismanagement the general finance sector has experienced[50]. Owing to the absence of a

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[48] *Warren Brown et al, Supra note 1*
[49] *D.C.I. Okpala, Supra note 41*
[50] *Between the years 2001 and 2003 two Kenyan Banks, Daima Bank and Euro Bank, collapsed. Two other insurance companies, Lakestar Insurance and Stallion Insurance were also put under statutory management in the same period and subsequently liquidated.*

SMM or any form of liquidity facility, the mortgage instruments of these MFIs are generally illiquid[51]. The underdevelopment of the primary mortgage market hampers the ability of these institutions to diversify their portfolio and manage risks better. Also as indicated above, MFIs in Kenya, as in other developing countries[52], also function in chaotic and uncertain legal frameworks of doubtful property rights title and tenure.

The traditional mortgage model illustrated by Annexture 1[53] is based on portfolio lending in which one MFI performs all the major functions: originating a mortgage to a homebuyer, servicing it (primarily collecting and processing payments from borrowers and record-keeping) and performing all the risk and portfolio management functions, including funding. The MFIs may purchase a few services from third-party vendors, such as appraisal and credit reporting[54]. The MFI in question may be depository institutions such as commercial banks, savings and loan associations, building societies; contract savings institutions; or special mortgage banks. In Kenya, these will be those institutions which are habilitated by law to lend money for these purposes[55].

The traditional mortgage arrangement has its advantages. These include institutional simplicity since only one institution performs all of the functions, and the ability to provide multiple services to clients. The disadvantage of the primary mortgage mechanism is

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[51] *Illiquidity reflects the difficulties of converting cash into assets and assets into cash or the cost of trading assets in the market.*

[52] *De Soto, Supra note 44*

[53] *Annexture 1, See Appendix*

[54] *Loic Chiquier, Olivier Hassler and Michael Lea, "Mortgage Securities in Emerging Markets", <http://www.housing finance.wharton.upenn.edu/2006 Program Readings/Module 5/A> last accessed on 4th October, 2006*

[55] *S. 3 Banking Act Chapter 488 of the Laws of Kenya*

inefficiency, particularly when depository institutions are lenders, since depositories typically have higher cost ratios than capital market funded lenders and inherent mismatches that generate liquidity risk and interest rate risk[56].

Liquidity risk arises because mortgage loans are long term and deposit liabilities are short term. Chiquier *et al*[57] conclude that commercial banks have traditionally shunned mortgage lending because of liquidity risks which still confront specialized depository institutions such as building societies also affect them. Alternatives to housing finance must therefore be explored in the SMM.

1.6.2 Secondary Mortgage Market (SMM)

The SMM is a market in which mortgages trade[58]. Such a market involves the sale and purchase of the mortgage portfolio. Secondary markets can exist for both whole loans and MBS[59]. According to Chiquier *et al*,[60] the simplest and oldest version of a SMM is the purchase and sale of whole loans among MFIs. Although whole loan sales exist in many countries, they are typically not large or widespread because credit risk assessment is costly and the heterogeneous nature of mortgage loans makes it difficult to develop liquidity in the market[61].

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[56] *Loic Chiquier et al, Supra note 54*
[57] *ibid*
[58] *ibid*
[59] *Mortgage-backed securities are instruments backed by pools of mortgages. The simplest MBS is the pass-through security in which investors receive pro-rata shares of the cash flows (scheduled principal, prepayments and interest) from the mortgage pool*
[60] *Loic Chiquier et al, Supra note 54*
[61] *ibid*

There is no SMM in Kenya in the nature of MBS to expand the array of products that may be available to potential investors and to generally expand the housing finance sector. The three major pre-requisites for the development of SMM are an adequate primary market infrastructure, an adequate legal and regulatory infrastructure and an adequate capital market infrastructure[62]. This thesis will interrogate the potential of Kenya's primary mortgage market to support a SMM[63]. To enable the SMM, the primary mortgages income streams have to be securitized. Securitization entails certain legal and regulatory issues which are the subject of this thesis.

1.7 Conclusion

The quest to deal with the problems bedeviling the housing sector in Kenya, and particularly in providing adequate housing is a recurrent theme articulated in government policy and development plans. A survey of relevant government policies and development plans indicate that its objective since independence has been to provide adequate shelter for all, both in the urban and rural areas[64]. While acknowledging the importance of banks, building societies, pension schemes and cooperatives to the housing sector, the government has also recognized that the constraints of finance, land availability and the riot of laws involved in building regulations impede the growth of this sector[65].

Despite the government's clarity in articulating issues related to housing and housing finance, shortages continue to be acute. To ensure affordable housing we must therefore look

[62] *ibid*
[63] *Chapter 3*
[64] *Economic Recovery Strategy for Wealth Employment Creation, Supra note 38*
[65] *Warren Brown et al, Supra note 1*

at restructuring mortgage financing, not only to make it more widely available but also cheap and tailored to individual needs. In fact, the government has considered, and set trail for the introduction of a SMM and ABS securities by a recent amendment of the Capital Market Act[66].

[66] *Legal Notice Number 4 of 2004 inserting section 33(C) of the Capital Market Act*

CHAPTER TWO

SECURITIZATION

2.1 Introduction

The focus of this chapter is securitization. The chapter will briefly outline the historical development of Mortgaged Backed Securitization in the USA. To put in place the vocabulary for the Mortgaged Backed Securitization transaction, the parties to a securitization transaction are defined. The study will thereafter outline the major prerequisites for the establishment of an SMM which is necessary to support a Mortgaged Backed Securitization transaction and the resulting MBS. The broad types of MBS, the process of a Mortgaged Backed Securitization transaction and the benefits and pitfalls of a Mortgaged Backed Securitization transaction conclude this chapter.

2.2 Precursor initiatives to Securitization

Arner[67] states that securitization in its broadest meaning refers to the process of transforming traditional forms of bilateral, illiquid financial relationship (e.g., loans) into freely tradable market instruments (i.e., securities). This is sometimes referred to as structured financing. In this broad meaning, securitization has been a key trend in financial markets over the past thirty years, as finance has moved away from traditional bank lending to capital markets[68].

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[67] *Douglas Arner, "Emerging market economies and government promotion of securitization", 12 Duke J. of Comp. & Int'l L. 505 <https://www.law.duke.edu/journals/djcil/articles/djcil12p505.htm> last accessed on 4th October, 2006*

[68] *ibid*

More frequently, however, securitization as used in this thesis is used to refer to a specific form of financial transaction in which assets (typically loans or other receivables and possibly even any future stream of revenue) are packaged together and used to collateralize or 'back' an issuer or an issue of securities.

Structured financing has been carried out in history with different levels of success. Mortgage funding existed in Europe as far as 200 years ago in Germany. *Pfandbriefe* is a traditional German mortgage instrument created by the executive order of the Fredrick the Great of Prussia in 1769. *Pfandbriefe* are asset backed bonds but unlike the modern securitization the assets remain on the issuing bank's balance sheet. Its designated mortgage or public loan assets serve as an undifferentiated pool of collateral for all mortgages at once[69].

In Denmark, the history of securitization goes back to the Eighth Century when the British set fire to Copenhagen. In the rebuilding of their city, borrowers needed funds, and thought they would stand a better chance if they came together with a joint liability. The structure of Denmark's mortgage is similar to the present Pass-through securitization[70].

Securitization traces its history to the United States of America (USA). Before the Great Depression[71] in the USA, Savings and Loan Institutions used to finance their mortgages from retail deposits. This was not possible in the depression as there was no more than a trickle of

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[69] *Vinod Kothari, Supra note 8, 655-656*

[70] *See types of MBS at 2.6*

[71] *The Great Depression refers to the period between 1929 and 1933 and was preceded by the stock market crash and later a deterioration of households' balance sheets leading to a negative effect on consumption. The stock market crash fuelled a banking crisis in the USA.*

deposits. Securitization was developed to create a Secondary Mortgage Market. It has been since used by virtually every industry as a financing tool. It is estimated that USA Corporations do in excess of $450 billion in structured financing transactions each year[72]. Many countries are currently adopting this instrument to enhance the performance of their mortgage markets and financial sector[73].

2.2.1 Historical Development of Mortgage Backed Securitization in the USA

Mortgage Backed Securitization traces its origin in the USA. Traditionally, Savings and Loan Institutions had raised funds either through loans or the issuance of corporate securities to market investors. Generally, the loans were secured or unsecured obligations transacted through other financial institutions. The securities took the form of either equity or debt, which include short-term commercial paper and long-term obligations.

The USA government established the Federal Housing Administration (FHA) in the 1930 to insure residential mortgage loans, made to lower income Americans, against default. The Veteran Administration (VA) established a similar programme that guaranteed loans made to home purchasers who served in the USA military. In 1938, the Federal National Mortgage Association (Fannie Mae) was established to buy and sell mortgage loans insured by FHA. The government therefore created a mechanism to transfer surplus capital to areas deficient in necessary housing funds by Fannie Mae issuing corporate debt to fund their purchase of

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[72] *Kensington & Ressler LLC, "Treatment of securitized transactions in bankruptcy", <http://www.kensington-ressler.com/securitization.htm> last accessed on 4th October, 2006*
[73] *Chapter Four*

loans from originators, thus boosting the lenders' capacity to make new loans while concurrently connecting housing finance and capital markets.

In 1968 Fannie Mae was split into two with the formation of Government National Mortgage Association (Ginnie Mae). Fannie Mae was thereafter privatized and worked on market-quoted loans while Ginnie Mae carried out Mortgage Backed Securitization functions for the government housing programmes under the FHA and the VA. Ginnie Mae issued the first USA MBS in 1970 for investment purposes. In 1970 the Federal Home Loan Mortgage Corporation (Freddie Mae) was formed to provide securitization function for mortgages outside of the FHA and VA.

Mortgage Backed Securitization has since emerged globally as an important technique for bundling assets and segregating risks into marketable securities. A number of countries have fashioned ingenious ways of financing long-term mortgages with long-term deposits, creating a healthy balance thus supporting the existing primary mortgage markets.

2.3 Parties to a Mortgage Backed Securitization transaction

Parties to a Mortgage Backed Securitization transaction are the originator, the obligor, the Special Purpose Vehicle (SPV) and the investor. Some of these parties exhibit certain peculiar features which affect on the legal requirements of a securitization transaction[74].

[74] *Vinod Kothari, Supra note 8, 88*

The originator is the entity assigning receivables in a securitization transaction. Securitization transaction implies that the originator is a bulk issuer of receivables. Real estate finance companies, car rental companies, credit card companies, electricity companies, water companies, gas companies and telephone companies are some of the companies best suited as originators in a securitization transaction. The financial might of the company is not paramount in a securitization transaction[75], but because a company in the brink of insolvency may cast blight on the securities issued by the SPV this fact is sometimes considered crucial by rating agencies. The originator's organizational capacity to service the receivables is however of importance because the originator usually acts as the servicer of the MBS. In a MBS transaction the originator is usually the MFIs.

The SPV is a legal entity formed with the special purpose of acquiring and holding the receivables for the sole benefit of the investors. The SPV must be made 'bankruptcy remote' by organizing the as a single purpose entity holding and maintaining interest in the securitized portfolios. To further make it bankruptcy remote, the SPV usually does not have any employees and in that case must therefore subcontracts all its administration by way of Administration Agreements with various service providers.

Securitized products have been favoured by institutional investors such as pension funds, banks and insurance companies. Small and retail investors shun securitized products

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[75] *This is because the credit worthiness of the MBS may be enhanced by providing a bond insurance to guarantee scheduled payment of principle and interest on the securities.*

especially if there is no liquid secondary markets and more so where the securitization feature is a new one.

Obligor refers to the debtor from whom the originator has a right to the receivables. The right usually arises out of a contract between the obligor and the originator. For example, in an MBS transaction, the obligor is the mortgage borrower. In a transfer of the receivables between the originator and the SPV, the debtor may or may not be informed[76]. Omission to inform the obligor as is discussed hereunder has legal implications.

2.4 Elements of Mortgage Backed Securitization

In order for a SMM to exist there must be in place certain fundamentals. Firstly, there should be in existence a vibrant Primary Mortgage Market. Secondly, because the mortgage instruments need to be made into tradeable securities, there must be in existent a legal mechanism to do so. Third, a capital market must be in place to provide a forum for the seller and buyer of the resulting MBS. This study now proceeds to determine the specifics within each of these three SMM prerequisites.

2.4.1 Primary Mortgage Market

The Primary Mortgage Market infers several elements; the volume of mortgages, the mortgage instrument, the underwriting of mortgages, the servicing of mortgages and the availability of information to the investor. These are considered in turn hereunder.

[76] *The legal provisions on whether notice to obligor is mandatory or not has legal impact on the Mortgage Backed Securitization transaction and the resulting MBS are discussed in Chapter 3.*

i) Mortgages must be attractive investments for the MFIs. This entails that the interest rates on mortgages must be market determined and provide investors with a positive, real, risk-adjusted rate of return. This means that the mortgage rate must be sufficient to cover the investor's marginal funding cost, the risks of mortgage investment and the administrative cost of servicing mortgages and MBS. In other words, the investors must be able to recoup their investment and also make a profit.

ii) Successful mortgage securitization requires that there should be a thriving primary mortgage industry. The size of the primary mortgage market is important. Arner[77] notes that the key underlying element necessary for securitization of mortgages is the existence of sufficient numbers of mortgages of predictable quality. In this regard, the mortgage market must be sufficiently developed to produce a significant volume of loans to justify the up-front costs of secondary market infrastructure.

iii) The other key primary market characteristic identified by Chiquier et al is standardization of the mortgage instrument. Standardization of mortgage instrument means that the characteristics of mortgages should be uniform. These characteristics include rate adjustment features on variable-rate loans, amortization schedule, and term. Further, the documents must spell out payment obligations (dates, amounts, terms of interest rate adjustments on variable-rate loans, obligations for taxes and insurance) and procedures to be followed in the event of default. Standardization of mortgage instruments is important in order to reduce the transaction costs of

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[77] *Vinod Kothari, Supra note 8, 88*

evaluating mortgage loans and the processing costs of issuing and administering MBS. Further standardized documentation must be available for all loans[78].

iv) The underwriting of mortgages should be comprehensive and consistent[79]. Underwriting involves the appraisal to determine the value of the property through examination of the sales prices of similar properties, construction costs of new properties and market conditions and trends. Underwriting is important as it establishes guidelines to ensure that a borrower has the ability and the willingness to repay the debt and that the property provides sufficient security for the mortgage[80]. Underwriting is important for the investor in analyzing the risk of any given portfolio of loans.

v) The existence of independent servicers of mortgages is a critical component of a viable SMM. Servicers collect mortgage payments and remit these payments periodically to the investor or to the conduit[81]. Servicers are additionally the main repository of information on the mortgage loans. They are therefore required to maintain accurate and up-to-date information on loan balances, status and history and provide timely reports to investors.

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[78] *Loic Chiquier et al, Supra note 54; note that typical documentation includes the mortgage note describing the mortgage obligation, the deed conveying ownership to the lender as security for the repayment of the mortgage, the application, the property appraisal and the borrower credit report.*

[79] *ibid*

[80] *ibid*

[81] *Conduits are specialised institutions that purchase mortgages from a number of different lenders to issue MBS*

vi) In order for the economy to produce a sufficient number of mortgages necessary for securitization, there must be linkages between the various MFIs and investors. This therefore means that information sharing is key. Cost, accessibility, availability and clarity, constitute the relevant facets of informational requirements of securitization. Information is important in risk assessment and cost reduction. For example, historical performance data on mortgage payments (e.g., default and prepayment) is crucial because it aids in the assessment of risk while that standardization of mortgage instruments is an important step in reducing the information costs to investors. Chiquier *et al*[82], aver that the attractiveness of mortgages and MBS depends on the ability of investors to understand the instruments and quantify their risk and return potential.

2.4.2 The Capital Markets

Capital markets are the stock markets and money markets in which institutions raise capital by issuing equity or debt securities to investors[83]. The existence of capital markets is one of the prerequisites of a SMM. This is because the MBS are traded to investors via the capital markets. There are a number of key factors that affect the potential of capital markets to sustain a SMM. These include[84]:-

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[82] *Loic Chiquier et al, Supra note 54*

[83] *Reforming Kenya's Financial Sector for Economic Recovery: Proposal on Policy Interventions towards the Establishment of a Sustainable Financial System in the Banking, Finance and Capital Markets in Kenya, NSE 1990*

[84] *Loic Chiquier et al, Supra note 54*

i) The existence of benchmark yields particularly on long term government securities that define a market rate against which yields on other instruments can be compared. The existence of bond markets presupposes a wholesale credit market made more efficient and reliable as a source of funds by a host of well functioning institutions and market players. In this regard, it is observed that the more sophisticated the investors and the more developed the government bond market, the greater likelihood of success in developing a mortgage securities market[85]. Underdeveloped bond markets narrow the economy's choices in raising capital leading them to rely on the banking system. In such countries, issuance of simple bonds by a centralized entity may be necessary to create a market initially before issuance of more complex mortgage pass-through securities could then be introduced.

ii) The existence of market makers to provide liquidity. Liquidity may be defined as the willingness of the stock market participants to engage in trades[86]. Liquidity of a capital market is perhaps the most important consideration in assessing its capability to sustain a SMM. A narrow investor base does not also augur well with the introduction of a SMM. The investor base may be expanded by: promotion of mutual funds, insurance companies and pension funds to play a greater role in the capital markets; strengthening the equity market infrastructure by better management of risk in clearing and settlement and the adoption of better trading methods.

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[85] *ibid*

[86] *Rose W. Ngugi, "What defines liquidity of the stock market? The case of the Nairobi Stock Exchange", KIPRA Discussion paper No. 29 December 2003*

iii) The existence of a regulatory body providing oversight of security issues. Capital markets need laws that strengthen their operation and regulation. Regulatory power is usually by an enabling law to clarify the nature of claims of capital market players. A regulatory body cannot enforce rules and regulations when the empowering law is inadequate.

iv) The existence of rating agencies that can help investors understand the characteristics of the instruments and their relative creditworthiness. Ratings are assessments of expected loss or probability of default and thus reflect an actuarial notion of credit risk[87]. Rating is a crucial element in all MBS transactions as it provides information on the likelihood of an issuer being in a position to meet all payments relating to an issue (interest and repayment) in full and on time. For example, Ginnie Mae MBS are backed by the full faith and credit of the USA Government and like treasuries, are considered to carry no credit risk. Securitization allows MBS to be structured so as to achieve a credit rating that can be higher than that of the issuer[88].

2.4.3 Legal and regulatory infrastructure supporting securitization

Mortgage Backed Securitization entails the existence of a functioning system of finance based upon real estate. A housing finance system cannot function without a proper legal and regulatory framework[89]. In Mortgage Backed Securitization there is therefore a confluence of

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[87] *Ingo Fender and Janet Mitchell, "Structured finance: complexity, risk and the use of ratings", BIS Quarterly Review, June 2005 <http://www.bis.org/publ/q+rpdf/r-qt0606f> last accessed on 5th October, 2006*
[88] *This is one of the advantages of Securitisation*
[89] *Loic Chiquier et al, Supra note 54 noting that successful housing finance system is premised on a well developed legal and regulatory structure*

financial system regulation and real estate regulation. For transactions involving asset sale or pledging (i.e., as collateral), transferability of security interests is an imperative factor. Indeed, the centrality of legal-regulatory systems in securitization cannot be overemphasized given that legal, regulatory and tax rules may affect the sale, assignment or other conveyance of assets by originators to the SPV[90].

The European Securitization Forum has, with respect to the legal, regulatory and tax framework of securitization advised that it should be one:-

i) that enables asset originators to sell or otherwise convey a broad range of assets to SPVs (including provisions on issues of creation, transfer and perfection of ownership);
ii) that provides for a bankruptcy and insolvency regime that ensures certainty and predictability in the method of isolating transferred assets from the bankruptcy of the estate of the seller; and
iii) that permits the creation and recognises the status of SPVs[91].

The legal-regulatory framework must be one that can ensure that various claims in the securitization transaction are enforceable against the relevant parties. In view of the fact that the primary concern for investors is their security interest, it must be clear in their regard how

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[90] *Mathilde Franscini & Tamara Schillinger, "European Mortgage Markets' Securitisation Process", (MSc in Banking and Finance Thesis University of Lausanne, 2001) <http://www.hec.unil.ch/cms_mbf/master_thesis/0012.pdf> last accessed on 5th October, 2006*

[91] *"The European Draft of Securitisation Framework", <http://www.europeansecuritisation.com/newsBISrpt.shtml> last accessed on 4th October, 2006*

enforceable their claim on the collateral is in the event of default. Enforceability in a mortgage transaction, according to Chiquier *et al*[92], depends on the clarity of land title, the ability to establish the priority of liens on the collateral, which requires an effective title and lien registration system, and the ability to enforce foreclosure and repossession within a reasonable time period.

It is noted that an additional legal concern for investors is the solvency of the seller, servicers or other third parties such as credit enhancers or trustees. In the event of insolvency, payments to investors may be delayed while a court reviews the merits of various claimants. Thus, the rights of investors to the cash being collected by the SPV on their behalf are important. Also, investors should be able to monitor the financial condition of servicers. Investors may demand the right to "pull" or transfer servicing if the solvency of a servicer becomes impaired, avoiding the hazards of the servicer's diverting cash flow, delaying payments or inadequately collecting loan payments[93].

Apart from investor-specific provisions, the regulatory environment in general must be supportive of a secondary mortgage market. In this regard it is noted that capital requirements on mortgages and MBS must reflect the relative risks and ensure a 'level playing field', one that does not favour certain institutions or instruments[94].

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[92] *Loic Chiquier et al, Supra note 54*
[93] *ibid*
[94] *ibid*

Tax laws must be reflective and supportive of market realities. In this regard, the ability to sell assets in a tax-efficient manner, avoiding double taxation at both the SPV and investor level for example, is an important consideration. Kothari[95]observes with respect to securitization that it is not a business, but a transformation of assets into securities and in the absence of specifically enacted principles, a general body of tax law may not be either enough or efficient to treat securitization transactions with the neutrality they deserve.

2.5 Mechanics of Mortgage Securitization

Mortgage Backed Securitization is commonly effected through the issue of bonds or pass-through certificates by the SPV. A Mortgage Backed Securitization transaction securitizes immobile objects such as, commercial buildings and residential homes mortgages.

Securitization involves the conversion of a pool of assets with a regular and predictable cash income, such as mortgage repayments or credit card receivables into a security or marketable instrument which allows the bank (or the financing institution) to 'sell' a large number of its assets (e.g. mortgage loans), which would otherwise not be attractive as individual purchases[96].

Mortgage Backed Securitization process involves origination, grouping and funding of loans thereafter structuring and rating of the new mortgage assets. These are discussed hereunder.

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[95] *Vinod Kothari, Supra note 8, 655-656*
[96] *Neil van Vuuren, Supra note 5*

The best entity to act as originator in Securitization is one having an abundance of receivables. Receivables refer to anticipated cash flow from the underlying transactions. In a securitization transaction involving mortgages, the receivables are therefore the mortgage instalments repayments. Origination refers to the process of creating receivables. Receivables are created through prior contracts. In the case and an MBS the underlying contract is the mortgage contract. MFIs are best placed to originate a mortgage securitization. The MFIs will then select the receivables to be securitized by doing a due diligence of the receivables as per agreed criteria[97]. This is important where the mortgages are not of the same quality whether as to the amounts, the financial position of the borrowers or even the insurance cover.

The MFIs then creates a legal entity known as a Special Purpose Vehicle (SPV). The SPV may be in the form of Limited Liability Company, a trust, a partnership or even a subsidiary of the Originator. These selected receivables are then transferred to the SPV who then becomes the owner of these receivables.

The securities to be issued by the SPV are usually rated by a rating agency. Rating is essential for securitization. Rating is crucial where there are a number of private (corporate) securities increases as envisaged within a vibrant securitization scheme. This is due to the fact that such instruments are unsecured, which will require that investors are protected. It may be necessary that independent rating agencies be established to avoid the possibility that

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[97] *The criterion depends on the required rating of the resulting MBS. If the MFI wants to issue 'AAA' rated MBS then they must choose first class loans not prone to prepayment and default risk.*

where originators (such as banks) conduct their own rating, they select all the best loans (asset bundles) for investment. In order to get favourable rating, the SPV can provide credit enhancement to the securities.

Credit enhancement provide a degree of protection to investors against loss resulting from the underlying portfolio of assets. Credit enhancement may either be internal or external to the securitization transaction. Credit enhancement may be in the form of[98]:-

i) Third Party Guarantees. Third party guarantees usually in the form of an insurance policy purchased from an insurance company;

ii) Senior-Subordinate (Sr-Sub) structure. In a Sr-Sub structure at least two classes of securities are created based on the priority of payment to each class. Losses resulting from the first class are allocated to the subordinate class. Because of the priority of distributions over the subordinate class, the senior class receives a high credit rating;

iii) Over-collateralization. The assets put under a pool can be of grater value than is needed to support the contractual payments so that the investor is protected in the event of a shortfall in expected payments. The excess collateral is often held in a subordinated tranche or special account.

iv) Cash Collateral Account. A cash deposit can be held in a special account that can be used for payments in the event of a shortfall in cash from receivables.

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[98] *Ashok Kumar Verma, "Securitization: Future of Structured Financing for Indian Railways", last accessed on 4th October, 2006 <http://www.vinodkothari.com/south_africa_article.pdf>*

Investors - pensions funds, insurance companies, unit trusts - purchase beneficial interest in the receivables by paying the SPV the present value of the receivables. The SPV may issue certificates or debt instruments stipulating the dates of repayment. These are called Mortgage Backed Securities (MBS). MBS are marketable instruments akin to other capital market security. The SPV may also create mechanisms for the transfer of the MBS amongst investors. The proceeds from the issuance of the MBS provide the funds by the SPV to pay the purchase price of the assets.

The originator company continues to service the obligors by collecting the receivables into an escrow account. The receipts are drawn by the SPV who passes these on the investors.

2.6 Types of Mortgage Backed Securities (MBS)

MBS are classified according to the manner the securities are bundled and sold to investors. These include Pass-Through Obligations, Collateralized Mortgage Obligations and Pay-Through Obligations[99]:-

i) Pass-Through Obligations

As the name implies, this structure passes through all cash flows-the monthly principal and interest payments, less a serving fee from a pool of mortgage loans to holders of the securities in proportion to share ownership in the SPV. The SPV in a Pass-Through transaction is merely a collective device.

[99] *Loic Chiquier et al, Supra note 54*

MBS document issued in a Pass-Through transaction are called Participation Certificates. These certificates represent an ownership interest in the underlying assets and thus in the resulting cash flow. Principal and interest collected on the assets are "passed through" to the security holders; the seller acts primarily as a servicer. The major disadvantage of the Pass-Through structure is the erratic and unpredictable cash flow structure which coincides with the payments on the underlying receivables. Consequently if the underlying receivables are paid every month, the investors are paid every month. This also imposes a heavy servicing burden to the SPV.

ii) Pay-Through Obligations[100]

Pay-Through structures are a development of the Pass-Through structure. In a Pay-Through structure, the SPV is not a passive conduit, but receives, reinvests and pays the money. Therefore in a case of pre-payments of receivables, the SPV receives the payment but reinvests the receipts as it reconfigures it to the payment schedule to the investor. In this case therefore the cash inflow need not be matched to the cash out-flow. These structures allow the payment stream of the underlying assets to be reconfigured to appeal to a broader range of investors.

iii) Collateralized Mortgage Obligations (CMOs)[101]

CMOs are an improvement of Pay-Through structure. Whilst CMOs have the advantage of no mismatch of receipts and payments, they also enable the investor to choose the tenure of

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[100] *Vinod Kothari, Supra note 8, 94*
[101] *Mathilde Franscini et al, Supra note 90*

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their investments. CMOs are debt instruments in form of bonds. CMOs may comprise a number of tranches of bonds issued against specified mortgage collateral. Those tranches are related securities that are offered at the same time but have different risk, reward, and/or maturity. CMO allow for the issue of varied and complex securities.

2.7 Benefits of Securitization

The benefits of securitization can be discussed from the issuer's and investor's perspectives. Securitization offers several benefits to an issuer. Some are discussed hereunder:-

i) Securitization offers the perspective of providing a vehicle for transforming relatively illiquid, individual financial assets into cash. Using securitization MFIs can make their assets suitable for sale in the capital markets. The higher yield associated with the securities attract investors who are willing to bear the associated credit, prepayment and liquidity risks.

ii) Securitization enables the mortgage lender to transfer the credit risks associated with underlying assets, thus enabling the bank to hold less regulatory capital. The requirement by MFIs to hold minimum regulatory capital is usually imposed by regulatory authority and is one of the ways by which MFIs are regulated. Securitization enables the MFI to sell off some of its on-balance sheet assets removing them from the balance sheet. This reduces the capital the MFI is required to hold for regulatory purposes.

iii) Securitization facilitates better asset liability management by reducing market risks resulting from interest rate mismatches. MFIs are subject to interest rates risk caused

by the differentials in the rte of interest at which they borrow their money and on-lend to their customers. When mortgages are securitised the MFI makes an instant spread on the basis of the fixed rate at the point of sale to the SPV avoiding the exposure to interest rate risk.

iv) Securitization enables more efficient financing. For some private-sector institutions, securitization is used to lower the firm's weighted-average cost of capital. This is possible because equity capital is no longer required to support the assets and highly rated debt can be issued into deep capital markets with investor demand driving down financing cost[102].

v) With regard to the balance sheet, by removing assets from the balance sheet (de-recognition of assets), 'securitization can enhance managerial control over the size and structure of a firm's balance sheet'[103]. This in turn 'can improve gearing ratios as well as other measures of economic performance [for instance return on equity]'[104];

vi) securitization equally enables the issuer to recycle assets more frequently and thereby improve earning.

vii) Finally, transparency may be improved since securitization results in identifiable assets in the balance sheet.

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[102] *"European Mortgage Securitisation: A Valuer's Guide", <http/: www.tegova.org> last accessed on 4th October, 2006*

[103] *ibid*

[104] *ibid*

For investors securitization provides an avenue for relatively risk-free investment. The credit enhancement provides an opportunity to investors to acquire good quality assets and to diversify their portfolios. The Valuers' Guide[105] summarises these as:-

i) Securitization enables investors to make their investment decisions independently of the credit-standing of the originator, and instead to focus on the degree of protection provided by the structure of the SPV and the capacity of securitised assets to meet the promised principal and interest payments, and

ii) It also creates more complete markets by introducing new categories of financial assets that suit investors risk preferences and by increasing the potential for investors to achieve diversification of benefits.

2.8 Problems of Securitization

Securitization, though an advantageous alternative to traditional fundraising, is not without attendant risk. Reddy[106] articulates the caution with which securitization should be handled in order to avoid detrimental effects to the sector and those concerned. He notes that:-

i) The securitization process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater, the more complex the activity. It is felt that the main risk a bank may face in a securitization scheme arises

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[105] *ibid*

[106] *Y.V.Reddy, "Securitization in India: Next steps", (a keynote speech at the Seminar on Government Securities Market, in Chennai, on April, 17, 1999) last accessed on <http://www.rbidocs.rbi.org.in>5th October, 2006*

if a true sale has not been achieved and the selling bank is forced to recognise some or all of the losses if the assets subsequently cease to perform.

ii) Also, funding risks and constraints on liquidity may arise if assets designed to be securitised have been originated, but because of disturbances in the market, the securities cannot be placed.

iii) There is also a view that there is at least a potential conflict of interest if a bank originates, sells, services and underwrites the same issue of securities.

Kensington & Ressler[107] in considering the potential problems that may arise when a 'borrower' becomes a debtor in a bankruptcy case have observed that since structured finance transactions were initially developed to enhance the marketability of debt securities by offering more certainty to investors, any [judicial] action that deprives investors of this certainty will adversely affect the marketplace for these offerings. They note further that [in the USA], bankruptcy courts sometimes re-characterize these transactions thus jeopardizing their effectiveness, and that such inconsistent treatment [by courts] deprives investors of predictability and consistency promised by securitization and which is crucial in security markets. The view is held in this regard that uncertainty about how courts view the transaction will reduce, if not eliminate, the market for these securities[108].

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[107] *Kensington & Ressler LLC, Supra note 72*
[108] *Vinod Kothari, Supra note 8*

2.9 Conclusion

Mortgage securitization offers potential alternative to the traditional primary mortgage systems and is clearly a paradigm that ought to be seriously considered locally if Kenya is to meet its soaring housing demands. By adopting this new method, institutional investors with long-term liabilities are a potentially important source of funds for housing loans more effectively than short-funded depository institutions. Mortgage securities can therefore tap these new funds for housing resulting in increased housing affordability, better flow of funds to the housing sector and better allocation of the risk inherent in housing finance.

Mortgage Backed Securitization transaction is a synergy of financial regulation and real estate regulation. Moreover in a Mortgage Backed Securitization transaction, the parties have capacities which have to prescribed by law. It is therefore in this context that the study moves to next discuss the legal and regulatory issues in a Mortgage Backed Securitization transaction.

CHAPTER THREE

LEGAL AND REGULATORY ISSUES IN A SECURITIZATION TRANSACTION

3.1 Introduction

Legal and regulatory issues affecting Securitization are often not very well defined in most countries largely because of the fact that securitization is a relatively new phenomenon in the financial and legal scene. Further Mortgage Backed Securitization represents a delicate balance between pure financial transaction and real estate transfers each of which has been singly regulated. MBS markets are a composite of fixed (housing) and portfolio (MBS) investments. Thus for MBS market to function well a delicate balance between the two must be struck. Securitization therefore presents a merging of previously divergent laws and regulation, calling for a new line of thought. This Chapter outlines some of these legal and regulatory issues generally.

3.2 Peculiarities of a Securitization transaction that contribute to legal and regulatory issues

There are several reasons that make securitization unusual hence the need for a legal and regulatory regime set apart solely for securitization transaction. Mortgage Backed Securitization poses a challenge to the law in the following manner:-

i) As noted in the introduction of this chapter, Mortgage Backed Securitization is a merger of previously divergent regulatory regimes. There is therefore a need for convergence of regulation in securitization.

ii) Moreover, Mortgage Backed Securitization being a creation of the 20th Century, and adapted to technology, the laws and rules of the 19th Century cannot quite fit the scenario. For example, contract and stamp duty regulation which trace their roots to the 19th Century business environment sometimes do quite fit securitization in the 20th Century which is often a paperless transaction carried out in context of e-business.

iii) In the process of Securitization[109], while there is a transfer of receivables as between the originator and the SPV, the originator is, for all intent and purposes, to a third party still involved in the underlying mortgage transaction, that is, as a servicer. These third parties may be a bankruptcy court which may recharacterize the securitization transaction.

iv) The nature of the underlying transaction[110] is important for the securitization transaction. Some underlying contracts make for a better securitization than others. Further the securities issued by the SPV are backed, not by the expected capacity to repay of a private corporation or public sector entity, but by the expected cash flows from specific assets of the underlying transaction[111].

v) The parties involved in the Securitization transaction also pose legal challenges to the law.

These are discussed hereunder.

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[109] *Discussed in Chapter Two*
[110] *The Mortgage transaction and underlying land law issues – Discussed variously in Chapter One and Five*
[111] *"Securitization: A Public policy tool?", OECD (1995) (New Zealand) <http://www.iir.com.au> last accessed on 10th August, 2006*

3.3 Specific Legal and Regulatory Issues

3.3.1 The Underlying Transaction

The underlying contract between the obligor and the originator gives rise to the receivables. The legal issues that arise from the receivables include the nature of the underlying contract giving rise to the receivables and the relationship between the receivables and the investors.

Firstly, it is imperative that the underlying contracts should be non-executory contracts. Executory contracts are those that compel the originator to certain responsibility to the obligor. Such responsibilities may be in the form of after sale services or guarantees. This causes the originator to have residual interest in the SPV which may cause a recharacterization of the securitization transaction.

Secondly, receivables form the backbone of the Securitization transaction. They must therefore be chosen with special care. Some assets make better receivables than others. Such assets are those which ensure cash flow over time, which cash flow is steady and easy to identify. In a Canadian case[112] the court ruled that the receivables must be identifiable with certainty as '…a fluctuating state of affairs is inconsistent with the certainty required in commercial matters'. Securitization creates multiple relationships therefore certainty in the right of the obligor to the purchaser is a crucial factor which underline that of the obligor to the investor.

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[112] *Canada Trustco v. Port O'Cal Hotel Inc. (1996) 27 D.L.R (2nd) 147 (S.C.C.)*

Third, for there to be a requirement for securitization at all, the payment of the receivables should be periodic and not one time-off payment. The maturity period of the receivables must be such that they assure a medium term security or be of a revolving nature. This ensures that the securities pose a worthwhile investment for the Investors.

Further, the receivables must be homogenous in nature such as loans which exhibit same maturity and risk features. Such receivables should be of an economically viable size. Mortgage Backed Securitization, for example, must have as it underlying transaction, mortgages and not car sales receivables.

3.3.2 True Sale

One of the features of securitization is that repayment of securities is based on the assets transferred by the originator to the SPV. Therefore, the most important legal structure for securitization is to ensure that the transfer of assets by the originator is a legally perfect transfer[113]. This is referred to as a true sale. The fact of true sale is important in securitization because the originator transfers certain receivables but apparently, to a third party, such receivables are still within the originator's manifest control as it continues to collect and service the same.

The meaning and effect of a true sale has been the subject of case law in the United Kingdom (UK). USA and Canada. In its ruling that the transfer of receivables was to be regarded as a

[113] *Vinod Kothari, Supra note 8, 497*

true sale, the UK court set three important conditions indicative of a true sale rather than financing in the case, *George Inglefield*[114], as;

i) In a transaction of sale, the Vendor is not entitled to get back the goods sold by returning to the purchase money that has been passed between them. That is to say, in a usual sale of receivables, the transferor cannot re-acquire the receivables by returning the money he has received.

ii) In a transaction of sale, the purchaser is entitled to make a profit on the asset bought.

iii) If the purchaser does not realize the full price that he paid for the same, he cannot look to the seller for the balance.

Several factors have been recognized to mar the definition of a true sale. One of the prominent cases on the subject of true sale is the USA case of *The Major's Furniture Mart*[115]. The facts of the case were as follows. Major's Mart was a furniture vendor, often selling on credit to its customers. In order to finance itself, it entered into an Agreement with Castle Credit whereby it sold its account receivables to Castle. The sale was with full recourse and Major's had to guarantee full performance of the account. Castle had the right to refuse the purchase of any particular account. The price paid by Castle for each account was "the unpaid face amount of the account exclusive of interest less a fifteen per cent 'discount' and less a further ten percent of the unpaid face amount". Under this agreement Major's sold a huge chunk of receivables to Castle during 1973 to 1975. Major's sued Castle for the return of the amount realized under the accounts and the amount actually funded by Castle.

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[114] *Re George Inglefield Limited (1933) Ch. 1. In this case a trader sold goods on hire purchase to its customers. The hired goods along with the receivables were bought by a finance company. The question to be determined by the court was whether the transfer of receivables was to be regarded as a true sale.*

[115] *Major' Furniture Mart v. Castle Credit Corp. 602 F. 2d 538 (3d Cir. 1979)*

In order to decide whether Major's had a claim to the differential money collected by Castle, the court had to examine whether the agreement was in reality a sale of receivables or a financing arrangement. The court noted the following elements of recourse provided by Major's:-

i) Major's retained all conceivable risks of uncollectibility of these accounts;

ii) Major's warranted that the customer's meet the criteria set forth by Castle;

iii) Major's performed credit checks to make sure the criteria was met;

iv) Major's guaranteed that the accounts were enforceable legally and fully collectible;

v) Major's was to indemnify Castle out of a reserve account for losses sustained due to customer default; and

vi) Major's was to repurchase any account in default for more than 60 days.

The court concluded that this was a case of collateralized borrowing and not a true sale noting *inter alia* "Guarantees of quality alone, or even guarantees of collectability alone, might be consistent with a true sale, but Castle attempted to shift all risks to Major's and incur none of the risks or obligations of ownership. It strains credulity to believe that this is the type of situation…in which there may be a 'true sale of accounts...although recourse exists".

The fact isolated by the court in this case was that an agreement that provides for recourse, more often than not mars, a true sale. This is especially so when the recourse is an 'economic

recourse' requiring the vendor to finance any deficit in the price. The agreement must demonstrate a difference between a sale and mere money lending.

A second factor that may mar a true sale is the language of the parties. The language of the parties is critical and therefore a contract that clearly states that the effect thereof is true sale between the parties will more often than not be upheld by the Court. Courts exist to give effect to contract between parties. The courts will only honour the intent of the parties and this must be clearly demonstrated.

A third factor that mars a true sale is the residual interest of the vendor. In most Securitization, the originator services the SPV. In such cases, for the ordinary observer, the originator retains control of the assets for all intents and purposes. This can however be mitigated if the seller acts like an agent for the SPV like any other agent would; if the originator receives a collection agent fee that represents an arm's length fee for these services; and if the SPV reserves the right to appoint any other person as a collection agent.

Another factor that may mar a true sale is deferred consideration. If the seller is entitled to a further price or defers his price for the residual profit of the purchaser, this translates to the seller having residual interest as discussed above.

Recharaterisation occurs when a sale has been marred and cannot be given effect as a sale but is instead interpreted to be a financing or loan transaction.

3.3.3 Assignment of Receivables

In a securitization transaction the manner of the transfer of receivables between the originator and the SPV is crucial. The process of transfer of receivables between the originator and the SPV must be fast and cost friendly. The assignment of must be for substantive and must be legally binding. The legal system must consequently one that recognizes the transfer and gives the advantage of speed and saving.

In order to complete a securitization transaction, the transfer of receivables between the originator and the SPV must be legally binding. The procedure for transfer must also follow the laid down procures of the law. In common law there are three methods of transferring legal rights in receivables; assignment, novation and sub-participation or participation[116].

Assignment is a legal conveyance of rights in a receivable[117]. Assignment is an assertion of the seller's right in the receivable and do not require the consent of the debtor. Novation, unlike an assignment, is consensual and is usually by way of a tripartite agreement involving the seller, buyer and debtor. Novation is mostly found in civil law jurisdictions and is regarded as the only proper means of assigning receivables. In a subparticipation, the transferor allows the transferee, by agreement, to participate in the benefits of the contract with the transferor. A declaration of trust is another way in which the benefit of a contract may be assigned to a transferee. However in this case there is no transfer of the legal rights but only of beneficial interest.

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[116] *Y.V.Reddy, Supra note 103*

[117] *Eugene G. van den Berg and Annelies Jacobs, "Structured and Corporate Finance; South Africasn Securitisation Regulatory Developments", <http://vinodkothari.cm/eugenesarticles.pdf> last accessed on 4th October, 2006*

An assignment requiring notice and where there is omission to notify the debtor is referred to as an equitable assignment. Equitable assignment comes along with several legal difficulties. An equitable assignment does not infuse the assignee with a right of action against the debtor. Any right of action contemplated by the assignee must be in conjunction with the assignor. This creates unnecessary dependence on the originator.

Equitable assignments also expose the transferee to priority problems. In case the transferee re-transfers the debt and the second transferee notifies the debtor, the second transferee will get priority. Further any court ruling on the validity of an equitable transfer has to be based on facts.

Easy, fast and efficient transferability of loans is vital in a securitization transaction. The ability to trade a receivable without permission of the obligor began the foundation for USA Securitization market[118]. In some jurisdictions notification to the debtor is a necessary requirement to perfect the assignment of a debt. Any requirement of notice therefore creates an unnecessary fetter in the completion of a securitization transaction as it is logistically difficult. Notification, when mandatory, is important because it prefects the transfer. Notice also establishes priority over any subsequent assignee.

Substantive transfer of receivables is also important in view of the fact of bankruptcy of the originator. In order for a transaction to constitute a substantive transfer the whole of the

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[118] *Frederick Feldkamp, "Asset Securitization: The Alchemist's dream", International Financial Law Review, London 2000 <www://www.iflr.com> last accessed on 4th October, 2006*

receivables must be transferred. If a loan repayment schedule calls for 120 monthly repayments, the seller must transfer all the 120 monthly repayments. A seller cannot purport to transfer only 60 of these 120 tranches. A fractional transfer creates a joint interest of the transferor and transferee in the asset creating a residual claim by the seller in the asset. It is trite law that a joint right can only be exercised jointly. In such a case therefore both the obligor and the SPV will have to initiate a joint action for any remedy each may want to claim against the assets. Incomplete transfers also cause priority problems just like those of equitable transfers.

3.3.4 Stamp duty[119]

Stamp duty is a tax payable on the document effecting a transaction. Any assignment of debt, whether an actionable claim or not, has to be in writing. This conveyance attracts stamp duty. Stamp duty is also important as it seals the contract.

Stamp duty is an antiquated tax as it belongs to that age when commercial transactions were authenticated by the seal of the stamp of the state[120]. Securitization transactions are often carried out in paperless environment. In such a case therefore it would indeed be difficult to emboss a stamp duty impression on a paperless transaction.

Stamp duty is reckoned on the nominal values of the assets being transferred by the instrument or on the consideration paid for the transfer of the assets. The amount levied is

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[119] *Stamp duty is a form of tax levied on documents. Typically, a physical stamp must be attached to or impressed upon the document to denote that stamp duty has been paid before the document becomes legally effective.*

[120] *Vinod Kothari, Supra note 8, 540*

provided by law. Since securitization involves a sizeable amount of receivables, this amount chargeable in stamp duty may end up to large sum of the securitization transaction expenses. In such cases there is likelihood to avoid paying this duty.

Since stamp duty is payable on the instrument, it can be avoided by making use of the following devices: making oral assignments, having assignments electronically executed and having incomplete offers for sale. However each of these scenarios pause other legal difficulties associated with incomplete transfers which we have noted before.

Securitization of receivables may also be revolving and one document signed at present may involve future substitution of receivables over a period of time. This pause legal uncertainty with the requirement of upstamping at every revolution.

The requirement to stamp instruments also affect the investors certificates in the SPV. Each time an investor transfers his certificate to another, he may be called upon to pay stamp duty on the instrument of transfer.

3.3.5 The Special Purpose Vehicle (SPV)

The SPV is essentially a conduit between the many investors and the, usually, single originator. The SPV holds the undivided investors interest in the receivables. Some legal considerations of the SPV include[121]:-

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[121] *Vinod Kothari, Supra note 8, 560*

i) The mode and ease of formation of the SPV. SPV may be organized as a limited liability company, a partnership or a trust. The choice of the mode of incorporation of the SPV would be limited by the ease of such formation, required minimum capital, costs of formation and ease of winding up the company after formation.

ii) The scope of the SPV activities. The incorporation documents of the SPV must limit the purpose of the SPV to acquiring assets, issuing securities and other obligations pursuant to these main ones. Limiting the SPV to the barest of activities associated with securitization is important to protect the SPV from exposure to insolvency due to carrying on business unrelated to the securitization. Limiting the objects of the SPV is also important as these documents are the 'public face' of the SPV. They also serve to remind the directors or other officers of the SPV as to the objects of the SPV.

iii) The fiduciary responsibilities of the SPV. The role of the SPV is usually in the nature of deposit receiving institution. Most jurisdictions have laws which regulate companies that hold themselves out to receiving money on behalf of named or unnamed beneficiaries. This is often the preserve of banks. To warrant this public trust banks are usually regulated in the manner of their formation, management and even dissolution. Further banks usually pay hefty licenses fees and are subject to a myriad rules as to their operation. This therefore means that the SPV cannot operate with the existing rules as its mandate is limited.

iv) The SPV's remoteness from the originator. The originator more often than not incorporates the SPV. However, the SPV and the originator are two different legal entities. The ownership structure of the SPV is important and must be structure in such a way that the SPV does not become the subsidiary or holding company of the originator and the courts may not consolidate the two entities. Some general tests which may lead the court to consolidate two apparently different entities were enunciated in the USA case of *Fish v. East*[122] as:

- The parent owns all or the majority of the capital stock of the subsidiary,
- There are common directors and officer,
- The parent company finances the subsidiary,
- The parent is responsible for the incorporation of the subsidiary,
- The subsidiary has grossly in adequate capital,
- The subsidiary has no independent business from the parent,
- The subsidiary is commonly known or referred to as the subsidiary of the parent,
- Directors and officers of the subsidiary do not act independently but take directions from the parent, and
- The formal legal requirement of the subsidiary as a separate and independent corporation are not observed.

The main risk associated with consolidation of the SPV and the originator is that the regulatory authorities may treat the two entities as one for purposes of tax and judicial pronouncements and bankruptcy. Remoteness from the originator also protects the SPV

[122] *114, F. 2d 177 (10th Cir. 1940)*

against clawback[123]. Secondly, consolidation may nullify the requirements of a true sale since one cannot make a true sale to oneself.

Remoteness must so complete that even where the court ‘lifts the veil’ of the SPV it cannot in any way consolidate it with the originator for tax and bankruptcy. Delinking the SPV from the originator may be accomplished by incorporating ‘separateness covenants’ in the incorporation documents of the SPV. Remoteness of bankruptcy can also be assured by a non petition clause in any agreement between the SPV and its business creditors whereby the creditors agree not to file or join in any filing of bankruptcy proceedings against the SPV.

v) Bankruptcy remoteness of the SPV. Bankruptcy remoteness, sometimes referred to as Bankruptcy proofing, refers to the process of structuring the SPV so that chances of its bankruptcy are reduced[124]. Bankruptcy remoteness may be assured by completely reducing the networth of the SPV. This pre-pauperises the SPV and diminishes its networth in the eyes potential creditors who seek to initiate bankruptcy proceedings against the SPV. Bankruptcy proofing can also be achieved by the SPV beneficially conveying all its assets to the investors through issuance of pass through certificates or granting security interest over all its assets for the benefit of investors.

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[123] *Clawback refers to the legal provisions which entitle an authority, normally the courts, to treat a transfer of assets, even though legally made, as void and therefore ‘claw back’ or reclaim the assets already transferred.*
[124] *Vinod Kothari, Supra note 8, 562*

3.3.6 Legal Rights of the Investor

Securitization presents a multifaceted face to the investor: the investor and the originator; the investor and the SPV; the investor and the obligor; and the investor as holder of 'security'.

The investor's relationship with the originator is shielded by the SPV. Any right by the investor against the originator is exercisable in the name of the SPV and not by the investor directly. The relationship of the investor and the obligor is also shielded by the SPV. Any action against the obligors by the investor can only be by the SPV.

The SPV stands in a fiduciary capacity as against the investors as it holds the receivables for the benefit of the investors. If the SPV is incorporated as a trust, the investor is a beneficiary of the trust and as such the investor has the right of a beneficiary of a trust such as; right to rents and profits, right to execution of the trust, right to execution of the trust. The trustees of the SPV may be held personally liable by the investor incase of dereliction of duty. If the SPV is incorporated as a company, the securities issued may be in the nature of participation certificate (akin to shares) or be in the nature of bonds and so the right of a shareholder or bond holder under company laws apply.

An investor can have rights as holder of 'security' depending on the nature of the MBS issued by the SPV. Participation Certificates issued in a Pass-Through transaction are akin to the regular equity or ownership certificates. Where MBS are issued under a Collateralized Mortgage Obligation transaction or Pay-Through transaction, they take the nature of debt

instruments. Shareholders and Debt Instrument holders have different right against the principal.

3.3.7 Legal Nature of Future Flow Securitization

In a future flow transaction, the originator transfers not necessarily present income but a stream of cashflow which will be dedicated to making payments to investors before the cashflow reach the originator. A mortgage company may based on its past performance wish to securitize future 'unsold' mortgages. Generally, in a future flow transaction, if a framework exists that will give rise to cash flow in future, the cash flow from such framework is an ideal candidate for a securitization transaction.

Even with the uncertainties attaching to future flow securitization, they have continued to grow because they usually allow the originator to borrower more at low costs by reducing his overall cost of funding the income stream.

Future cash flow by its very nature raises several legal concerns. The Latin maxim *nemo dat quod non habet* means that one can only transfer an existing right. An attempt to assign future property may operate as an agreement to assign which must be supported by consideration if it is to be binding. Money payable in future under an existing contract is not necessarily future property, and a disposition of the right to receive such money may be an assignment and not an agreement to assign[125]. In the case of *Tailby v. Official Receiver*[126] the

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[125] *G.H. Treitel, The Law of Contract, 11th ed, Sweet & Maxwell 2003 683*
[126] *188313 App.Cas.23*

House of Lords held that an assignment of future debt was ascertainable, if the contingency on which the money is payable is within the control of the creditor. If however the contingency is not within his control, the disposition is prima facie an agreement to assign.

Future flow transactions retain a large measure of dependency on the originator and this makes then more prone to rechacterization than any other securitization transaction. This therefore means that they require more rigid regulation if they are to be part of the securitization framework.

3.4 Conclusion

The legal and regulatory issues raised in this chapter present grey areas which may require clarity before the introduction of Mortgage Backed Securitization in an economy. While these legal and regulatory issues in securitization may seem insurmountable, other jurisdiction have incorporated specific legal rules for securitization transactions whilst others have made securitization specific rules separate from their other corporate laws. Most counties have however managed to regulate securitization by fusing existing laws and making new pronouncements to suit the nature of securitization transaction. The next chapter present case study of some of these jurisdictions.

CHAPTER FOUR

FOLLOWING THE TRAIL: LESSONS FOR KENYA FROM PRECURSOR SECURITIZATION EXPERIENCES

4.1 Introduction

This chapter briefly discusses mechanics of Mortgage Securitization in selected countries. Its also analyzes the legal, regulatory and structural issues in the operation of the SMM in these jurisdictions. This will facilitate discussion in the last chapter of this thesis in which we seek to apply these approaches to mortgage securitization to Kenya.

4.2 United States of America (USA)

The USA is credited for popularizing the now globally renowned instrument of securitization, more specifically the Mortgage Backed Securitization. As indicated above[127] the early origin of Mortgage Backed Securitization can be traced to the 1934 National Housing Act in the USA. Mortgage Backed Securitization was entrenched in 1938 after the collapse of the housing credit market during the Great Depression[128]. Mortgage Backed Securitization as known today began in 1968, with the first sale of pools of Residential Mortgage Backed Securities (RMBS) through 'Ginnie Mae'[129]. Although there are non-state players in the market, the RMBS market is largely dominated by the government.

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[127] *Chapter 1*

[128] *Andrea Saayman, & Paul Styger, "Securitisation and bank liquidity in South Africa", <http://www.sba.muohio.edu/abas/2000/SECURI~1.pdf> last accessed on 4th October, 2006*

[129] *Kerry D Vandell, Supra note 16*

The US Federal government has not only actively promoted Securitization but is a major participant in the residential MBS market. As we noted, the USA secondary mortgage market is basically government supported. Kothari notes that the USA model of issuing RMBS through government agencies has been extremely successful in promoting housing finance, and consequently, housing.

USA support has been through state agencies, Ginnie Mae, Fannie Mae and Freddie Mae, as well as through legislative initiatives. In the 1980s, Kothari[130] notes that Securitization deals received ample legislative support from Government. In 1983, the Securities and Exchange Commission[131] (SEC) made the benefits of shelf registration available to mortgage-related securities. In 1984, Congress adopted the Secondary Mortgage Market Enhancement Act (SMMEA), which provided for the exemption of highly rated MBS from the registration requirements of most state securities laws and made them eligible for investment for certain regulated entities[132].

Later in 1986, as part of the Tax Reform Act, Congress enacted new tax legislation permitting the creation of Real Estate Mortgage Investment Conduits (REMICs)[133]. These enabled the issuance of multi-class, pass-through securities. In 1994, the SEC amended SMMEA to provide an exemption from state securities laws for highly rated securities

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[130] *ibid*

[131] *SEC was formed under the Securities Exchange Act of 1934 to protect investors, maintain fair orderly and efficient markets and facilitate capital formation.*

[132] *The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) amended 12 USC 24(7) and allows national banks to purchase and hold "mortgage related securities" without any statutory limitation*

[133] *REMICs direct the cash flow into separately traded securities called classes. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.*

backed by certain lease receivables and small business loans similar to the exemption already enjoyed by MBS.

Vandell[134] notes that through the 1970's and early 1980's, the residential MBS market expanded into the quasi-governmental secondary market institutions to privately-insured (typically larger) 'conventional' residential mortgages, and finally to non-conventional 'jumbo' (very large), and 'sub-prime' (lower credit quality) loans offered through private issuers, known as 'conduits'. The non-agency market originated in 1977 with the first Securitization by the Bank of America. Kothari[135] states that the USA secondary mortgage-market presently runs with a combination of the agency-backed[136] securities and non-agency securities, also known as private label securities.

The non-agency market is mostly responsible for non-conforming loans[137]. These loans might either be 'jumbo' loans, that is, loans of a higher amount that qualifies under the conformity standards, or they are B or C category loans, also called *sub prime* loans, in the sense that they do not comply with the underwriting standards of the agencies as to debt to income ratio, borrower history among other conditions. Non conformity may also mean that loans have been bought without documents required for credit screening, or the documentation was not complete[138].

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[134] *Kerry D Vandell, Supra note 16*
[135] *Vinod Kothari, Supra note 8*
[136] *'Agency' refer to the 3 governmental institutions, Fannie Mae, Ginnie Mae and Freddie Mae*
[137] *Conforming loans are those loans that meet the prescribed criteria, essentially with respect to loan size and the underwriting standards. Conforming loans are usually bought by the agencies, which in general do not buy non-conforming loans.*
[138] *Vinod Kothari, Supra note 8, 276*

Non-agency originations consist of loans being taken to the capital market either by larger originators directly, or by larger Securitization specialists who buy out portfolios of smaller originators or retailers. As opposed to the agency backed market, these are then taken to the capital market with credit enhancements. In the agency backed market, credit enhancements are not required as the agencies themselves guarantee repayment[139].

4.3 The United Kingdom (UK)

The UK, the largest Securitization[140] market in Europe pioneered the use of mortgage Securitization in Europe with the first transaction of MBS issued in January 1985. The market grew rapidly in the latter 1980s as several USA based banks entered the UK market and the housing market expanded substantially. More recently, there has been a 35% growth since the year 2000[141].

Despite the significant development of mortgage Securitization in recent years in the UK, MBS still account for less than 5% of total mortgage balances[142]. The main reason for this is that banks in the UK have long been able to raise cheaper funding from customer deposits than asset-backed bonds would give them. This has left smaller financial institutions that specialize in non-conforming mortgages as the main source of mortgage-backed issuance[143]. Secondly, as opposed to the USA RMBS where government guarantees support the

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[139] *ibid, 275*

[140] *Y.V.Reddy, Supra note 106, notes that the UK Securitization market is the second largest after the USA market*

[141] *Christine Whitehead, Allan Holmans & Kofi Karley, "The potential for mortgage securitisation in mortgage backed securities in the UK", summary of findings funded by the Office of the Deputy Prime Minister <http://www http://www.landecon.cam.ac.uk/LEreport2000_02.pdf> last accessed on 4th October, 2006*

[142] *ibid*

[143] *In the UK's housing finance system, In the traditional mortgage model category, depository system (building societies and commercial banks) dominates*

secondary market and back over 80% of all mortgage originations, the UK has developed a secondary market for mortgages that has operated without government guarantees[144]. Third, the UK mortgage market is famous for its innovation in mortgage products some of which do not favour the certainty required in securitization.

A relatively recent product in this market is the flexible mortgage which is proving popular with borrowers. The key feature of this type of loan is flexibility of payments: borrowers can pay more or less than their regular monthly payment and even take payment holidays for a few months. To the extent that the borrower has paid more than his scheduled amortization, he is often permitted to redraw (or borrow back) overpayments up to scheduled outstanding, or original advanced, amount, subject to certain conditions[145]. It is noted that this type of mortgages have developed largely in response to changes in the demographics of the UK, with less job stability, more temporary workers and increased mobility meaning income and circumstances can be changeable[146].

There has been recent change in this state of affairs that has given impetus to RMBS growth dictated by high housing prices and low rates and the selectivity of customers as to the banks of choice for their deposits[147]. Securitization process is now well understood by UK banks that are looking to diversify their funding sources. Moreover, innovative mortgage products, such as the country's new flexible mortgages, continue to foster and create a favourable

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[144] *Peter Chinloy & Isaac F Megbolugbe, "Real estate markets in the United Kingdom: Implications for the US", <http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_0503_chinloy.pdf> last accessed on 4th October, 2006*

[145] *ibid*

[146] *ibid*

[147] *ibid*

borrowing climate. UK MBS issuance to date has been almost exclusively at floating rates, but this trend could change.

The UK government undertook tax reforms to assist the development of Mortgage Securitization in the early years of 2000. Franscini & Schillinger[148] note that Mortgage Interest Relief At Source (MIRAS) has been one of the most powerful tax incentives in UK. Indeed, home ownership increased tremendously throughout the UK in the 80s.

Another issue for Securitization transactions relates to stamp duty, payable at a rate of 3.5% to 4% of the transaction sum. This high enough to give people the incentive to avoid paying stamp duty. This means that stamp duty is not normally paid as most Securitization transactions are often structured as equitable assignments and not perfected legal transfers. With regard to withholding tax, some UK securitizations are structured initially as inter-company loans to a group company (the SPV) to avoid problems of withholding tax. Kothari notes that no withholding tax is charged in case of interest payments to SPVs located in countries with which the UK has a double tax avoidance treaty such as the Netherlands[149]. With regard to Value Added Tax (VAT), it s not applicable to the sale receivables, but applies to servicing fees.

In the UK, the Bank of England has played a leading role in evolving guidelines for banking and other authorized institutions in its loan transfers and broad areas of Securitization

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[148] *ibid*

[149] *Vinod Kothari, Supra note 8, 159*

including residential mortgages, credit cards, consumer loans, commercial real estate and student loans[150]. Currently, the Financial Services Authority (FSA) sets out the policy on Securitization and loan transfers.

Although different types of Securitization structures have been able to evolve relatively free of legal restrictions, as long as they are not expressly prohibited by existing statutes, the UK mortgage industry is facing the prospect of government regulation[151]. It is noted that in January 2001, the government announced that mortgage sales would be brought under the jurisdiction of the Financial Services Authority (FSA). It also would set benchmark CAT (Cost, Access and Terms) standards for mortgages[152].

This is part of the legal framework provided by the Financial Services and Markets Act of 2000, under which the FSA is the unique regulator. In June 2001, the FSA issued its draft *Interim* Prudential Sourcebooks (IPSBs) for building societies (CP51) and banks (CP52). These set out the prudential framework until such a time when the new *Final* Prudential Sourcebook will be introduced. One of the consequences of the FSA's Securitization rules will be the establishment of new obligations for any building society involved in Securitization.

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[150] *Y.V.Reddy, Supra note 106*
[151] *ibid*
[152] *ibid*

4.4 India

Kothari notes that despite the fact that Securitization is of recent origin, there have been deals that exhibit both diversity as well as market maturity[153]. The first widely reported Securitization deal in India dates back to 1990 when Citibank securitized auto loans and placed a paper with GIC mutual fund[154]. Since then, a variety of deals have been undertaken. Reddy also notes that whilst there is no authentic data on the magnitude of Securitized debt in India, there is evidence to justify the conclusion that Securitization in India has been growing steadily[155]. It is recorded that as at June 2002, Credit Rating and Information services of India rated the size of the Indian Securitization market at over One Hundred and Seventy Two Indian Rupees (Rs. 172 billion)[156].

Reddy notes further that National Housing Bank (NHB) has made efforts to structure the pilot issue of MBS within the existing legal, fiscal and regulatory framework. Under the proposed Securitization transaction, mortgage debt shall be transferred/assigned/sold to NHB by Housing Finance Companies (HFC) (originator) pursuant to an agreement/contract in the 'debt simplicitor form'. The NHB will act as an issuer of pass through certificates (PTCs) and as a trustee on behalf of the investors[157]. Kothari notes that RMBS is now a standard and

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[153] *Vinod Kothari, Supra note 8, 226*
[154] *Y.V.Reddy, Supra note 106*
[155] *ibid*
[156] *Vinod Kothari, Supra note 8, 226*
[157] *Y.V.Reddy, Supra note 106. There are concerns, according to Reddy, that there will be a conflict of interest if NHB, a regulator also acts as a trustee. He notes however that the Reserve Bank of India is involved in the review of the ownership, regulatory and supervisory framework of the development financial institutions*

stable market in India with several players coming out with repeat issuance, either through the apex financing body National Housing Bank (NHB), or directly[158].

Securitization in India has largely operated under the regulation of the Reserve Bank of India (RBI). The RBI laid out certain governing principles applicable to RMBS in India in order to ensure a healthy development of the Indian Securitization market. However several issues still posed a challenge to the securitization transaction in India.

The first relates to stamp duty. Stamp duty is a state subject in India. Under statutory assignment, Securitization involves transfer of mortgaged debt, which can be effected only by means of an instrument in writing. Every instrument by which property, whether movable or immovable is transferred attracts *ad valorem* stamp duty. Typically, the rate of stamp duty ranges from 0.5 per cent to as high as 4 to 10 per cent of the value of transaction. Thus, the process of Securitization becomes too expensive. Sridhar[159], observes that stamp duties on transfer of assets in securitization can often make a transaction unviable. According to Reddy[160] while five Indian states have recognized the special nature of securitization transactions and have reduced the stamp duties for them, other states still operate at stamp duties as high as 10%. For transfer of secured receivables, the Working Group of the Reserve Bank of India recommended a uniform rate of 0.1% duty on all Securitization transactions.

[158] *Vinod Kothari, Supra note 8, 226*
[159] *V. Sridhar, Supra note 106*
[160] *ibid*

Secondly, the Transfer of Property Act, according to some legal views, has held that assignment of a debt should be in whole and not a part assignment. Further, both the Transfer of Property Act and the Sale of Goods Act hold that only a property currently in existence is capable of being transferred. Reddy laments that these laws impede development of Securitization in future receivables as transfer of future property does not fall under the definition of debt[161].

Third, it is opined that some provisions of the Income Tax Act, 1961 are reported to have an impact on Securitization. For instance, Section 60 of the Act, contemplates transfer of income without transfer of assets which are the source of the income. In such a case, the income so transferred is chargeable to income tax as the income of the transferor and is included in his total income[162]. This opens the securitization transaction to double taxation at least on the account of the transferor/originator.

Fourth, Reddy[163] articulates the view that the existing set of foreclosure laws are said to increase the risks of mortgage backed securities by making it difficult to transfer property in cases of default. An efficient foreclosure law is undoubtedly the key to the success of secondary market operations.

Lastly, there is a view that a SPV structured as a company under the Companies Act may come under the definition of non-banking financial companies and hence is subject to prudential norms.

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[161] *ibid*
[162] *ibid*
[163] *ibid*

In 2002, a new law, The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Ordinance was promulgated [164]. The Ordinance defines[165] securitization to mean 'acquisition of financial assets by any securitization company or reconstruction company from any originator, whether by raising of funds by such securitization company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise'.

The new law which came in force on the 21st June of 2002 now settles certain issues which were an obstacle to the securitization transaction. With the new law in place the future of securitization in India is great. Some of these provisions are discussed hereunder.

Firstly, the Ordinance settles the manner of formation of an SPV, the Securitization Company[166]. The Securitization Company can therefore only be formed by registration under the Companies Act, 1956 for the sole purpose of securitization[167].

The legal difficulties in transfer of assets to the SPV, which hithertofore require notification of the obligor can now be circumvented by a general notification by gazettement of the transfer of assets and registration of the securitization transaction with the Registrar[168].

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[164] *Securitisation, Asset Reconstruction and Enforcement of Security Interests Incisive commentary on the law and rules with comprehensive introduction to securitisation, asset reconstruction and enforcement of security interests 2003 edition <http://vinodkothari.cm/eugenesarticles.pdf> last accessed on 4th October, 2006*
[165] *Section 2(z)*
[166] *Section 2(za)*
[167] *Section 2(za) and Section 3(1)*
[168] *Section 20*

Further where there is no notification to the obligor, the originator receives any payment due thereunder as trustee for the SPV[169].

The Ordinance also makes provisions to make the SPV bankruptcy remote. Firstly, the Ordinance provides that the SPV should be a single purpose company. Secondly, the Ordinance disqualifies the SPV from acting as a manger, receiver or agent of any person if such acting may give rise to pecuniary liability[170].

4.5 South Africa

South Africa leads in our continental level in the area of securitization generally and Mortgaged Backed Securitization in particular. This is mainly attributable to a relatively sophisticated securitization environment that boasts of modest development of the factors relevant to securitization[171]. The first securitization[172] concluded in South Africa, as in the USA, was aimed at securitizing mortgages. Since then, Van den Berg notes that substantial development has taken place regarding the application of securitization on trade receivables, properties, future rebate flows, future cross-boarder flows and CLO's. Recent developments are geared toward the listing thereof on the Bond Exchange of South Africa (BESA)[173]. Van Vuuren notes that although until fairly recently, securitization was an uncommon concept in South Africa, as the South African capital markets emerged into the new millennium, the

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[169] *Section 6(3)*

[170] *Section 10*

[171] *Simon Stockley notes that South Africa's mortgage market is sophisticated and mature. The market amounts to over R300billion. This market, which by 2003 was dominated by 4 big banks, is supported by a sound legal structure in which title and title & foreclosure as a remedy are guaranteed*

[172] *On 5th December, 2001, The International Finance Corporation made Rand 15 million investment in MBS issued through South African Home Loans (SAHL).*

[173] *Neil van Vurren, Supra note 5*

years 2001-2003 have shown some significant development in the securitization industry. Investors' need for alternative and innovating investment products are expanding and the new Securitization regulations under the Banks Act[174] that was published in 2001, have brought certainty to the industry, opening the doors for a variety of players. Optimism is expressed that the still relatively small sector is developing a similar sophistication to some of the world's largest markets, and is poised for further growth[175].

According to van den Berg, the regulatory environment in South Africa is classified into direct and indirect legislation. The direct regulatory environment is controlled by The South African Reserve Bank, which promulgates securitization regulations and commercial paper regulations.

Directly, Securitization was regulated by two separate Government Notices: Government Notice No. 153[176] and Government Notice No. 2172[177] (previous regulations). These regulations created uncertainty amongst originators and especially amongst banking originators. In terms of these regulations, it is a contravention of the Banks Act to operate the business of a bank without registration as a bank or as a branch of a foreign bank.

Secondly, ABSs do not have a definition in legal terms. However, the characteristics of asset-backed securities belong to "debenture" and therefore are commercial paper regulations an important cornerstone of securitization in South Africa. The definition of commercial paper under the regulations include debenture. Commercial paper regulations regulate the

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[174] *Act 94 of 1990*
[175] *Neil van Vurren, Supra note 5*
[176] *Published in the Government Gazette No. 13723 on 3 January 1992*
[177] *Published in the Government Gazette No. 16167 on 14 December 1994*

conditions applicable on the issuing of asset-backed securities by the SPV. The regulation designates the issuing of commercial paper as an activity, which is not limited to the business of a bank provided that the prescribed conditions are met. Both banks and non-bank entities can issue commercial paper. However, commercial paper can only be issued for raising working capital and the proceeds of the commercial paper may not be utilized in the granting of credit directly or indirectly [except for customary credit]. This is an important feature that forms part of the definition of "the business of a bank" in terms of the Banks Act. Where commercial paper is issued and the proceeds are used in granting loans, such an activity contravenes the Banks Act. Only a registered bank can issue commercial paper [debt paper] and use the proceeds in granting loans.

According to Neil van Vuuren[178], the trigger for the accelerated development of the Securitization market in South Africa was mainly due to a change to the law in December 2001 by the South African Reserve Bank. The new regulations have revamped Securitization in South Africa in a number of ways. In terms of the new Securitization regulations published in Government. Notice 1375[179], the operation of a Securitization scheme is not regarded as 'the business of a bank', provided that the conditions set under the regulations are complied with[180]. This is commonly referred to as the 'Securitization exemption'. Another main aspect of the legal change was to allow banks to fulfill multiple roles in a Securitization transaction. In other words, the new regulations allows for corporates as well as banks to use

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[178] *Neil van Vurren, Supra note 5*

[179] *December 13, 2001*

[180] *Section 2 Legal Notice 1375 of 2001 'Designation of an activity not falling within the meaning of "the business of a bank" (securitization schemes)'*

Securitization. Van Vuuren[181] notes that by widening the definition of a Securitization transaction, the still relatively small sector is developing fast to accommodate a variety of players to a level that took the USA and countries in Europe many years to obtain.

The new regulations are aimed at facilitating the growth of the Securitization industry in South Africa in accordance with market demand, existing international Securitization principles and the draft Bank for International Settlement ("BIS") capital adequacy proposals.

Apart from these, the regulations also establish bankruptcy remoteness of SPVs and perfection of rights by debtors. South African law allows for the transfer of securitization assets and income flows without obtaining the permission from the underlying debtor that generates the cashflows in support of the securitization transaction.

The taxation framework in South Africa is considered from an Income Tax, Value Added Tax, Transfer Duty, Stamp Duty and the Uncertificated Securities Tax Act point vintage points. Income tax is governed by the Income Tax Act 58, 1962 [Tax Act]. No specific guidelines as yet do exist regarding the tax treatment of securitization assets and income flows compared to other international jurisdictions where specific amendments were introduced to existing tax laws and tax regulation together with securitization regulation

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[181] *Neil van Vurren, Supra note 5*

and/or amended securitization regulation that support the effective operation of securitization in line with securitization specific regulation.

The SPV, notwithstanding its organization form, is subject to the Income Tax Act with regard to the nature of income- and cash flows it receives in support of the securitization transaction. In addition thereto, depending on the transaction structural aspects, reinvestment income is taxable within the SPV. Limited expenses are tax deductible. The magnitude of deductibility is further a function of the overall taxation treatment of the transaction as well as the behavioural aspects of the assets and income flows regarding loss provisions and actual losses subsequent to the conduct of the transaction.

The transactional features of a securitization further affect the application of the Value Added Tax Act 89, 1991. The application thereof stem from the nature of tax treatment regarding the income flows, which support the securitization transaction. In addition thereto, the income flows also need to be looked at from its true nature.

The Stamp Duty Act 77, 1968 [Stamp Duty Act] creates the framework regarding the stamp duty payable on transfer of securitization assets and income flows other than fixed property. The Stamp Duty Act also set forth the relevant stamp duty payable, by the SPV, in respect of the issuing of asset-backed securities. The Uncertificated Securities Tax Act 31, 1998 provides for substantial cost savings available to the SPV regarding the issuing of asset-backed securities in that no stamp duty is payable by an issuer where the asset-backed securities are listed and immobilized.

Van den Berg[182] notes that existing securitization regulation in South Africa compares encouragingly to international regulatory accounting practices evident in the USA.

As opposed to many emerging markets, South Africa has a well-developed efficient and effective capital market. In fact, it is estimated that the Johannesburg Stock Exchange (JSE) accounts for about 70% of total market capitalisation in Africa[183]. Van den Berg observes that optimized development has taken place since the formation and establishment of BESA during 1996. The market has supported electronic settlement for a number of years and these developments impacted positively in substantially reducing counter party settlement risk. The listing requirements and settlement procedures for existing capital market instruments adequately supports the listing of asset-backed securities.

In order for asset-backed securities to be correctly priced, similar benchmark instruments are required. In South Africa however, given the infancy of securitization, initial transactions have to be priced against all available risk free instruments. The scope of the maturity structure of such instruments covers a broad investment horizon with the majority risk free instruments falling due within the 7-10 year maturity. From this platform, it will be possible to develop unique asset-backed security pricing principles. This is supported by recent securitization developments and a true emergence of quality corporate bond issues by large corporates. The infrastructural mechanism embodied within the South African capital market, supports adequate pricing of all risks associated with securitization. To this extent the South

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[182] *ibid*

[183] *Edward Ntalami, CEO Capital Markets Authority (Kenya) (a keynote speech delivered during the 8th Annual African Stock Exchanges Association (ASEA) Conference on 23-26 November 2004 in Nairobi).*

African capital market has the ability to facilitate both, once-off term related securitization transactions as well as conduit and multiseller programme securitization structures. The most recent development, which is an extension of earlier initiatives, is the establishment of a multi-seller collateralized-loan-obligation debt programme.

4.6 Conclusion

This chapter concluded the USA RMBS, which is the largest and most developed market is largely dependent on state support. It noted that the successes of this market are attributable to a conducive legal, regulatory and tax environment. We noted also that the UK RMBS market, the largest in Europe, is distinguished for its innovative mortgage products including the flexible mortgage which caters aptly for people with unpredictable job security. This market has evolved largely without state support and limited regulation. Of the two emerging markets studied: India and South Africa, we conclude that the latter has a more vibrant Securitization market with a strong legal and regulatory regime that has followed closely the pattern and progress in the more prosperous western RMBS markets. Although Securitization transactions are attaining currency in India, the country is yet to establish a proper legal and regulatory regime.

CHAPTER FIVE

POTENTIAL FOR SECURITIZATION IN KENYA: ASSESSING SUITABILITY OF CURRENT FRAMEWORKS FOR SECURITIZATION

5.1 Introduction

The central theme of this thesis is that the solution to Kenya's acute housing shortage can, to a large extent, be realized through Mortgage Backed Securitization. This is because the current mortgage lending initiatives have failed give more people access to housing finance thus easing housing shortage. This is because traditional mortgage lenders cannot source for cheap funds and therefore their products are expensive. One of the advantages of mortgage backed securitization is cheap finance. This chapter considers the institution of a mortgage securitization framework in Kenya by relating the legal and regulatory concerns related to the introduction of such mortgage securities market and prevailing legal rules. Informed by precursor initiatives discussed in the preceding chapter, we consider, in introducing a workable framework, the possible adjustments to land and property law, company law, banking law, bankruptcy and tax regimes and extant capital market laws and regulations.

5.2 Necessary elements for Securitization

The prerequisites for securitization, the Primary Mortgage Market, the Capital Market and a suitable legal framework, have been interrogated at Chapter Two of this thesis and the discussion hereunder draws parallel to the prerequisites as earlier discussed. In the discussion

of each of these elements of securitization, the ideal is compared with the existing Kenyan regime and suggestion on improvements given for each.

5.2.1 Primary Mortgage Market

The requisite ideal of the elements of the Primary Mortgage Markets as discussed in Chapter two and now hereunder compared with the existing scenario within the Kenyan market.

i) Mortgage origination

Under current law, MFIs[184] can lend money 'for the purpose of the acquisition, construction, improvement, development, alternation or adaptation for a particular purpose of land in Kenya'. This restriction is important because tax relief can only be claimed for a mortgage registered in favour of a duly recognized mortgage finance company. The Government of Kenya also increased infrastructure investment relief from Kenya Shillings One Hundred Thousand (Kshs.100,000/-) to Kenya Shillings One Hundred and Fifty Thousand (Kshs. 150,000/-)[185].

In reality many Savings and Credit Co-operative Societies and other NBFIs in Kenya give to their members or customers mortgage loans. These Mortgages do not however qualify for infrastructure investment relief under the Kenyan law. It would therefore be difficult to securitize the receivable in such a case. A redefinition of a mortgage finance company is needed to open up the field for more players in mortgage origination in order to achieve large

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[184] *S 15 Banking Act Chapter 488 of the Laws of Kenya*
[185] *Budget Speech for the financial year 2005/2006. Daily Nation, Thursday 9th June 2005 at 1*

quantities of securitizable mortgages; in other words, securitizable receivables. The net effect is therefore is that the number of mortgages originated and that achieve the benchmarks for Mortgage Securitization is severely constrained.

ii) The Primary Mortgage Providers

Mortgage Backed Securitization is an economical venture only if it can be sustained by high mortgage volumes. Kenya lacks a vibrant and thriving Primary Mortgage Market because banks are reluctant to make mortgage loans because of the attendant risks. Jaffe and Renaud in a 1997 World Bank study on mortgage markets in transitional economies[186], concluded that banks in transition economies are reluctant to make mortgage loans because of the risks in mortgage lending; credit, interest rate, and liquidity risks.

The primary mortgage market, though currently injected with energies derived from private sector participation still rate low mortgage volumes as mortgages tend to be tailored for high-end income earners. Serious thought should be given to diversifying mortgage products to target varied economic groups. For example, among the lower income earners, the flexible mortgage (variable rate mortgage) should be considered. This mortgage product is very popular with borrowers in the United Kingdom because of its adjustability to earning fluctuations of home seekers in an unstable employment market and harsh economic conditions. This will not only ensure forward development of the mortgage market but will also increase the quantities of mortgages requisite for anchoring stable securitization.

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[186] *Dwight M. Jaffee & Bertrand Renaud, "Securitization in European Mortgage Markets", World Bank Paper prepared for First International Real Estate Conference Stockholm, June 28 to July 1, 1995 508- <http://faculty.haas.berkeley.edu/jaffee/Papers/SecureEurope>509 last accessed on 10th August, 2006*

Although government interference in a liberalized economy should be limited, it is accepted that a housing finance system is unlikely to spring up without government support. In fact we assert that Kenya, as a transition economy faces the additional major hurdle that it must first create an economic and legal infrastructure that can support the long-term and complex market relationships and contracts that constitute a housing financial system.

iii) Land Law

The issue of security of title to land is a major concern in Kenya. The multiplicity of laws governing land, combined with the politics of property in the country has failed to inject certainty in this sector, especially with respect to security of title[187]. The Njonjo Report which generally urges reform in the land sector identified the chaos currently existing in a multiple system of land holding in Kenya as undermining security of tenure and transferability of title thereby staggering economic development[188].

Since security interest is a major concern of investors, we noted that the legal-regulatory framework must ensure the enforceability of the various claims in the securitization transaction. As we observed earlier clarity of land title, the ability to establish the priority of liens on the collateral, which requires an effective title and lien registration system, and the ability to enforce foreclosure and repossession within a reasonable time period must be core considerations.

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[187] *The Report of the Commission of Inquiry into the Land Law System in Kenya, November 2002 (Njonjo Report) para 53 noting that beyond economic factors, land issues in Kenya are deeply entrenched and this for political and socio-cultural reasons*

[188] *ibid, paras 199-206*

Comprehensive land and real estate reforms must be undertaken by government. Ahmed Galal and Omar Razzaz[189] in a study undertaken on behalf of the World Bank argue that land and real estate reforms, to be successful, must be 'comprehensive in design, even if implementation is phased in over time' and that such reforms must include institutional reforms that better define property rights, reduce information asymmetry, and improve contract performance.

In spite of this apparent flux in the processes that ensure security of title in land due to, among other factors, corruption, the two statutes that govern substantive rights in land; Registered Land Act (RLA)[190] and the Indian Transfer of Property Act (ITPA)[191] both confer a sacrosanct title in land. A lot needs to be done to return certainty into issues of title to real estate in order to improve investor confidence, which is necessary to attract long term foreign and domestic capital. Consideration should be given to expediting possesses for the conferment of such title. An effective registry of title should be assured. Automation should be considered, not only to ensure accuracy in recording, but also to improve access to information by parties to securitization transactions.

iv) Mortgage standardisation

There are currently more than one substantive land law regimes[192]. This contributes to the lack of standardisation criteria for mortgage documentation. This is primarily because each

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[189] *Galal, Ahmed and Razzaz, Omar, "Reforming Land and Real Estate Markets", (November 1999). World Bank Policy Research Working Paper No. 2616. < http://ssrn.com/abstract> last assessed on 4th October, 2006*

[190] *Chapter 300 Laws of Kenya*

[191] *The Transfer of Property Act, 1882*

[192] *RLA and ITPA*

land law regime has its own requirements for mortgage drafting, completion and registration. Further there is also lack of open informational systems amongst mortgage providers and each service provider generally works in isolation from the other with different provisions for mortgage drafting and registration.

5.2.2 The Capital Markets

Capital Markets are important for securitization. They provide the medium through which the securities of the SPV may be bought and sold. In Kenya, the Nairobi Stock Market (NSE) is the only stock market in Kenya on which companies sell shares to raise equity capital, although there are informal over-the-counter markets for unlisted shares.

The tenor of sections 33C (2) and 33C (3) of the Capital Markets Authority Act[193] is that a person may issue or list or cause to be issued or listed Asset Backed Securities (ABS) with the prior written approval of the Capital Market Authority[194] (CMA) which is required to consult with the Minister in arriving at such decision. The Act defines ABS as securities that are issued as part of a securitization transaction in which assets are transferred to a third party that issues the securities [possibly an SPV]. In terms of the Act, such securities are primarily serviced, with respect to both return of investment and return on investment, by the cash flow from the ABS[195].

[193] *Chapter 485A of the Laws of Kenya*
[194] *Established under s.5(1) of the CMA Act*
[195] *Section 33C (1) (a) and (b)*

The above provisions do not however provide satisfactorily for a workable framework. The CMA is nevertheless invested with authority in terms of its general regulatory functions under section 12 of the Act, to regulate ABS, including the issuing and listing of such securities in terms of general guidelines[196]. This general template requires that the rules, regulations and guidelines made by the CMA pursuant to this mandate provide, as a minimum that: the issuer of ABS be a company or trust set up only for the purpose of implementing and operation of the securitization transaction in question; that the issuer shall have the technical capacity to implement and operate the securitization transaction; that the issuer shall have the capacity to meet its obligations to the holders of the ABS; and that the issuer shall adequately protect the rights of the holders of the ABS[197].

In order to assess NSE's capacity to support a secondary mortgage market envisaged in the Capital Markets Authority Act[198], the following criteria need to be considered:-

i) Capital Market Liquidity.

Liquidity of a capital market is perhaps the most important consideration in assessing its capability of sustaining a secondary mortgage market because the liquidity of a market is an indicator of how much finance is available for investment in a country's infrastructure. Despite its upward growth over the years, commentators observe that the NSE, like most exchanges in on the continent suffers from liquidity problems. Mbaru[199] notes that in Kenya,

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[196] *Section 33C (4)*
[197] *Section 33C (5)*
[198] *ibid*
[199] *Jimnah Mbaru, "Transforming Africa: new Pathways to Development: Selected Papers on Financial Reforms and Development", Pg 42*

and indeed in other emerging markets are still small and relatively illiquid and that to be competitive in the global economy, they must improve their liquidity. Ntalami[200] has recently reiterated this disturbing reality noting that:

> Most capital markets in Africa are tiny, fledging and illiquid, and lack the capacity to meet the enormous development financing needs of the continent. The number of corporates listed and listing are few and far between. The tradable products are limited to government paper, a few conventional equities and even fewer corporate bonds.

This view holds true of the NSE in which capitalization is still low. Given the size of African economies, a number of commentators urge that regionalization of the capital markets is considered seriously to ensure liquidity and improve prospects of viability of these markets[201].

Like many emerging capital markets around the globe, the NSE currently faces severe constraints that limit its ability to play its full role in mobilizing domestic and foreign capital. Efficiency in its functions is largely hampered by lack of the critical mass of securities, investors and funds[202]. Although there are efforts by government to invigorate the economy[203], long years of an unfavorable macro-economic environment means that the

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[200] *Ntalami, Supra note 183*

[201] *See for instance the views of Ntalami, Supra note 179 and Mbaru, supra note 195*

[202] *Ntalami, Supra note 183 making this observation with regard to Africa's stock and capital markets.*

[203] *See the Economic Recovery Strategy for Wealth & Employment Creation, Supra note 38 for general and capital market-focussed reform measures*

development of the capital market and its capacity to mobilize significant resources is severely inhibited[204].

Given that foreign investment in the economy is important in nurturing a strong economy, top among priorities is to create an enabling political environment by dealing with issues that scare such investors away: instability in government; partial judicial processes and breakable contractual arrangements and an unstable system of title to property, in this case, real estate. Incentives should be created to encourage long term, as opposed to short term investment to properly sustain securitization. Lessons can be learnt from South Africa, which, rather than impose quotas foreign on ownership of companies, has permitted 100% ownership that has greatly increased capitalisation in vital sectors, including securitization.

ii) Capital Market Bench-Mark Yields

A developed bond market is an essential factor in securitization. The dominance of governments bonds in the debt markets on the African Capital Markets, which are generally underdeveloped, has been decried by one commentator thus:

> Debt markets in Africa are underdeveloped and dominated by government bonds. To support the development of private sector bond market, governments should take deliberate action to desist from excessive domestic borrowing as this has the effect of crowding out the private

[204] *Ntalami, Supra note 183 notes that maintenance of macro-economic equilibrium and sustainable increase in per capita real income is a real issue in Africa and that although the macroeconomic environment in the region has improved significantly in recent years, Africa's savings and investment ratios remain dismal at around 13%. Other macroeconomic issues that need to be addressed include reducing fiscal deficits, narrowing the resource gap, stabilizing the exchange rates, and revisiting the role of governments in the economy*

sector. Needless to say, investors invariably prefer sovereign bonds to corporate debt instruments due to the "faith and credit" of the government.[205]

Whereas the existence of a thriving government bond market spells a good sign in terms of capital market (NSE) performance and thus, a foundational capacity to support securities, efforts need to be invested in encouraging private or corporate bonds, if only to invigorate the markets to securitization[206]. There are currently five private companies which have floated their bonds at the NSE. These are the PTA Bank, Athi River Mining, Faulu Kenya, Sheltter Afrique and Mabati Rolling Mills Limited.

Additionally, despite the existence of a government bond market, an important element directive of possible securitization which infers long-term arrangements is missing: maturity and pricing yardstick. Since the maturity profile of government bonds is predominantly short, mostly six to nine months, there is lack of a possible pricing targets for corporate bonds and ABS (when these are introduced). Lengthening of the maturity profile of government domestic debt from short-term instruments to longer-dated securities in order to provide a reliable benchmark for pricing of long-dated corporate bonds [and RMBS] as well as facilitate the development of the capital market[207] should be pursued. Kenya has scored well in this regard. There is currently a fifteen year bond issued by the Central Bank of Kenya, the longest term bond in the market.

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[205] *ibid*

[206] *A.J. Odera, Supra note 40. In this regard, plans were at an advanced stage at the National Housing Corporation (NHC) to float a housing bond on the NSE. This initiative did not succeed*

[207] *Ntalami, Supra note 183*

iii) The Capital Markets Authority (CMA)

The function of regulation and maintenance of fiscal sanity in the capital markets is currently assured in Kenya. The CMA, the body vested with the mandate of regulating the capital and stock markets was established by law in 1989[208]. In terms of the CMA Act, the general function of the CMA is understood as the promotion and facilitation of the development of an orderly, fair and efficient capital market in Kenya. More specifically[209], the CMA is charged with the development of all aspects of the capital markets with particular emphasis on the removal of impediments to and the creation of incentives for longer term investments in productive enterprise. It is additionally invested with the power to facilitate the existence and functioning of nationwide stock brokerage services, which inevitably involves licencing. More importantly perhaps for our purposes, it is donated with the power to ensure the creation, maintenance and regulation of a market in which securities can be issued and traded in an orderly, fair and efficient manner through implementation of a system in which the market participants are self-regulatory to the maximum practicable extent.

The CMA's contribution to the functions of the NSE has been lauded. Noting that the NSE has performed remarkably well since the establishment of the CMA, Mbaru[210] states that this has been an important factor of growth at the NSE, which, hitherto did not even have proper premises for its operations floundered in disorder, indiscipline and limited scope. Admittedly, the CMA has played an important role of regulating the capital market, creating an investor compensation fund and licencing brokers and dealers. It is observed that perhaps one of the

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[208] *Capital Markets Authority Act, Chapter 485A Laws of Kenya, section 5*
[209] *Section 11 CMA Act*
[210] *Jimnah Mbaru, Supra note 199, 42*

CMA's major contributions to the bourse has been increasing investor confidence by ensuring the NSE operations are properly regulated. This, as was noted earlier, is an important factor in securitization, a complex and sophisticated instrument.

iv) Rating Agencies

In a perfect market place the interest rate on a loan would reflect the risk profile of the borrower such that a good borrower would obtain loans at a low interest rate. In the same way the risk profile of a security would determine it prices and return. This is however, not always the case because of lack of information sharing amongst the stakeholders. This usually termed asymmetrical information. Credit Rating Agencies are the clearing houses where information may be shared by market participants.

The problem of asymmetrical information need to be cured before Mortgage Securitisation can take off in Kenya. The NSE, like many markets in Africa do not require issuers of corporate debt instruments to be guaranteed or to have mandatory credit rating. It has been observed that 'this is a serious flaw in the regulatory framework as it leaves investors unduly exposed in the event of failure of the issuer to meet its obligations',[211] and that 'considering that private corporate securities are unsecured debt instruments which constitute borrowing from relatively gullible and unsophisticated members of the public, there is a strong case for making both guarantee and credit rating mandatory requirements for issuers of private debt instruments'[212]. This aptly applies to MBS, in which case investors should be assured that

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[211] *Ntalami, Supra note 183*
[212] *ibid*

they will not lose money on their investment. The importance of Rating Agencies as added assurance to investors can not be gainsaid given that the Investor Compensation Fund[213] established under CMA Act is of limited scope and is not sufficient[214].

It is noteworthy that the CMA has formulated rules and regulation with regard to Rating Agencies. This was via the Rating Agency Guidelines, 2001. In August 2000 CMA accredited Duff and Phelps of South Africa, an international credit rating agency to offer rating services within the East African Community region. Since then two other American credit rating agencies have entered the market. These are Thompson BankWatch and Dun and Bradstreet. This is a positive development in the market and will go a long way in supporting Mortgage Securitization in Kenya.

5.2.3 Legal and regulatory infrastructure supporting securitization

A cursory scrutiny of the above provisions reveals the inadequacy of the established Primary Mortgage Market and the Capital Markets as currently constituted towards the introduction of Mortgage Securitization. The thesis now turns to look at the status of legal-regulatory issues that any proposed framework for the introduction of Mortgage Securitization must address.

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[213] *The fund grants compensation to investors who suffer pecuniary loss resulting from failure of a licensed broker or dealer to meet his contractual obligations only.*
[214] *Section 18 CMA Act*

i) Assignment of receivables

Section 3[215] of the Indian Transfer of Properties Act, 1882 (ITPA) defines actionable claim to exclude a debt secured by a mortgage of immovable property and such a debt may therefore be regarded as immovable property which can only be assigned by way of a registered instrument[216]. In Mortgage Backed Securitization the receivables are therefore not actionable claims. Section 130 of the ITPA requires that transfer of an actionable claim be effected in writing, signed by the transferor and is effective whether notice of the transfer is given to the debtor or not. As indicated above where the receivables are based on immovable property, notice is a necessary requirement.

Notification is important because it perfects the transfer and also establishes priority over any subsequent assignee. An imperfect transfer results in an equitable assignment this has its attendant legal difficulties. An equitable assignment does not infuse the assignee with a right of action against the debtor. Any right of action contemplated by the assignee must be in conjunction with the assignor. This creates unnecessary dependence on the originator. Equitable assignments expose the transferee to priority problems in case of enforcement of security.

The requirement for notice also creates an unnecessary fetter in the completion of a securitization transaction as it is logistically difficult why the mortgages are in big volumes.

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[215] *Section 3 "Actionable claim means a claim to any debt other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property or to any beneficial interest in movable property, not in possession, whether such a debt or beneficial interest be existent, accruing, conditional or contingent.*

[216] *In Bank of Upper India v. Fanny Skinner (1929) AIR 51 It was held that mortgage is an immovable property and cannot be transferred otherwise than by a registered instrument*

The ability to trade a receivable without permission of the obligor is the foundation for USA Securitization market[217].

Such unnecessary fetters in securitization should be done away with. An exception similar to that provided by s.9(3)(c)of the Banking Act[218] where there is amalgamation or transfer of business between one financial institution and the other. This recognition is usually availed by all concerned offices, for example, registrars of lands and companies, once the approval of the transfer of business is gazetted by the Minister. In a securitization transaction, the transfer of receivables between the Originator (bank) and the Special Purpose Vehicle would be gazetted and this would be sufficient notice for all.

iii) The Special Purpose Vehicle (SPV)

S. 33(c) of the CMA Act provides that the SPV should be in the nature of a company or a trust. Incorporation by way of a limited liability company presents the easiest and most efficient manner to set up an SPV. The Companies Act[219] provides for the constitution, incorporation, management and liquidation of companies.

Under the Companies Act, limited companies may be liquidated for a number of reasons, especially when they become insolvent or even at the instigation of shareholders or creditors. This dispensation is not conducive for securitization in which issuers are usually incorporated

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[217] *Frederick Feldkamp, Supra note 118*

[218] *Section 9(3)(c) provides that "all agreements, appointments, transactions and documents entered into, made, drawn up or executed...in favour of the amalgamating institutions. shall remain full force and effect and shall be construed for all purposes as if they had been entered into, made, drawn up or executed with, by or in favour of the amalgamated institution.*

[219] *Chapter 486 of the Laws of Kenya*

as insolvency-remote entities. As the company law currently stands, to guard against any possible liquidation of an SPV by creditors, all contracts by the SPV with creditors should provide, for instance that all parties to contracts with the SPV enjoin themselves not to petition for the winding up or insolvency of the SPV and that the SPV shall not initiate voluntary liquidation.

By virtue of its corporate constitution, the issuer (SPV) may not engage in any transactions other than those necessary to effect the securitization. As a consequence of the 'limited purpose-concept', the SPV should not be allowed to issue any additional debt or to enter into mergers or similar transactions. This requirement has thankfully been provided for with the current regime[220].

The implementation of the SPV's object includes the receiving of the mortgage repayment instalments and the recovery of due from the obligors. This may fall within the definition of MFIs[221] within the Banking Act. MFIs require special licence to carry on their business. South Africa has specially exempted SPV from the regulation of the banking laws by expressly providing that securitization does not refer to banking business.

One of the objectives of securitization is to assure investors that the creditors of the originator that has sold assets to the SPV would not have a claim against the SPV in the event

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[220] *Section 33(c)(5)(a) of the CMA Act which provides "that the issuer of the asset-backed securities shall be a company or trust that has no other purpose other than the implementation and operation of the securitization transaction in respect of which the securities are issued*

[221] *Section 15 of the Banking Act Chapter 488 of the Laws of Kenya*

of the originator's bankruptcy[222]. This study at chapter 2 detailed how an SPV may be bankruptcy-proofed.

Telpner & Traurig[223] list a number of conditions the SPV must meet to assure that its assets are isolated from the bankruptcy risk of the originator. If adopted these may provide some measure of bankruptcy proofing the SPV. These include the requirement that:-

i) the SPV's business activities must be strictly limited to those necessary to carry out the securitization;

ii) the SPV must have its own board with independent directors,

iii) the SPV's organisational documents must restrict its ability to place itself into bankruptcy without approval by a requisite number of independent directors;

iv) the SPV must maintain separate assets, bank accounts and recording keeping;

v) the SPV must pay its own expenses out of its own funds;

vi) the originator must disclose to its creditors that the assets of the SPV are separate and not available to satisfy their claims; and

vii) there should not be inter-company guarantees, and all other dealings between the originator and the SPV should be conducted on an arms' length basis.

These recommendations need to be incorporated in any mechanism put in place to regulate a securitization transaction.

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[222] *Joel Telpner & Greenberg Traurig, supra note 47 at 5*
[223] *ibid*

The CMA regulations requirement that and SPV must have a track record, puts many willing investors with no prior record in an awkward position. Whilst this regulation may be important for purposes of protection of the investors from unscrupulous or unqualified persons and companies operating in the market, its effect may be detrimental in a market such us ours which is only at its inception. Further any company which may be have the requisite qualification and track record as an SPV may have as its objects, other financial objects other that the operation of an SPV, a fact which may disqualify it from operating as an SPV.

iii) Stamp duty

In Kenya, stamp duty is a tax levied on the execution of documents which are required by law to bear a stamp for legal validity. As an *ad valorem* tax, the rate payable on given documents depends on the value of the document in question. The documents on which stamp duty is payable are contained in the schedules of the Stamp Duty Act, which governs stamp duty[224]. Some of the documents on which stamp duty is charged include mortgages, charges, leases, trust deeds, company registration documents and documents containing certain agreements of serious substantive nature.

Mortgage Backed Securitization entails taxation at several points; at the origination of the underlying mortgage transaction, at the time of assignment of receivables by the originator to the SPV, and at the time of sale of securities amongst the investors inter se. This together with attendant registration fees add up to a large sum of money which is not good for the

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[224] *Chapter 480 Laws of Kenya*

securitization business. The current stamp duty regime does not permit the isolation (sale) of assets in a tax-efficient manner[225]. It is clear that under this Act, double taxation is a reality.

The Stamp Duty Act does not envisage a transaction done within the framework of e-commerce. This is because an e-securitization transaction is paperless. The Stamping of Mortgage Backed Securitization therefore needs proper regulatory provision.

5.3 Recent Developments

The CMA has in the recent past[226] published regulations on ABS. This is a major step towards the introduction of ABSs in the market. The regulations are quite exhaustive as they cover most of the aspects of a securitization transaction. The CMA requires that the offer, issue and listing of ABS, to handled by a lead adviser, who is a duly licensed investment bank[227]. This is a sound policy and is important as investments banks are licensed and regulated by the CMA. The CMA is therefore assured that the investment bank is on sound financial position and staffed by professionals and has the institutional capacity and memory to carry through the due diligence required for a securitization transaction. In this manner the CMA saves on vetting the persons who want to set up a securitization transaction.

The lead adviser is also required to file, together with the application for the offer, an Information Memorandum on the subject securitization transaction. The Information

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[225] *For example, currently under the Stamp Duty Act, a mortgage transaction attract stamp duty at the rate of 0.2% of the loan amount while in a case of transfer of mortgage between lenders the rate is 0.1% of the original loan amount.*
[226] *The Capital Market (Asset Backed Securities) Regulations, 2006.The regulations are still awaiting ministerial approval to be gazetted.*
[227] *Rule 4*

Memorandum is comprehensive and captures the information requirements for the investing public. For example, the Information Memorandum is required to contain various resolutions by the originator and the Issuer (SPV). It also identifies the directors of the originator and the SPV, the professional advisers (legal advisers, bankers, auditors and accountants), and experts' opinions on the subject transaction. Various financial disclosures are also required on the subject transaction. These include; the amount to be raised through the issue, tenure of the debt, the nature and numbering of debt instruments, subscription procedure and allotment policy.

The Information Memorandum is accompanied by the incorporation documents for both the Originator and the Issuer (SPV). Of paramount importance is that the Information Memorandum together with the other disclosures are required to be availed for inspection by interested parties at the registered offices of the Issuer.

The regulations also provide that the receivables[228] should be such that can provide a true and identifiable revenue stream for the life of the ABS. The regulations further provide that the transfer of assets from the Originator to the SPV does not constitute an event of default under any security agreement on the underlying transaction. This is important for quick, efficient and least costly transfer process.

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[228] *Part II Rule 14*

The SPV otherwise referred to as the Issuer in the regulations is a company incorporated under the Companies Act[229] but where the Originator is the Government or a GSE, a Trust established under the Trustees Act[230]. The regulations also require that the SPV be a newly created legal entity with no pre-existing contracts. This requirement is restrictive since it may hamper the creation of revolving ABS. The process of creating an SPV for each transaction may also prove too costly and cumbersome in the future. Whilst the SPV is required to notify the CMA of the occurrence or threats to its existence, more reporting requirements and disclosures need to be provided by the SPV to the CMA. An express provision for the regulation of the SPVs by the CMA, much in the manner of listed companies can enhance transparency in the SPV.

A major drawback of the regulations is that the final arbiter in the offer and listing of the ABS does not lie in the full compliance of the rules but on the decision of the CMA and the Minister for the time being of matters relating to finance[231]. Such executive fiat and interference may prove counterproductive to the growth of the ABS market.

While it is commendable that the regulations provide that ABSs are listed in the Fixed Income Segment of the Market, such restriction may suppress the growth of all manner of ABS in the Kenyan market. As noted in chapter 2 of this thesis ABS may be in the form of both debt and equity securities.

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[229] *Chapter 486 of the Laws of Kenya*
[230] *Chapter 167 of the Laws of Kenya*
[231] *Rule 2(1)*

5.4 Conclusion

The following conclusions may be drawn from this thesis:-

i) Housing is important for not only sustainability of human life but also for improvement of human lives.

ii) Housing involves huge capital outlay not necessarily affordable to all. Hence to bridge the gap between access and affordability both suppliers of housing (developers) and consumers (buyers) resort to housing finance in the form of Mortgages.

iii) Mortgages are availed by MFIs which rely on shortterm households deposits to advance longterm mortgage loans. This mismatch reduces the amounts available for onward lending. Mortgage Backed Securitization is a function of connecting the mortgage and the capital markets, especially the long term market.

iv) Mortgages are contractual arrangements of between less than one year and upto twenty years. The long period contractual period makes mortgages liable to inflation and changed circumstances with the lender and borrower especially in a developing economy like that of Kenya. Consequently MFIs are neither willing to lend to all applicants nor lend for a longer periods. This therefore makes housing finance unaffordable to many.

v) Mortgage Backed Securitization is a way in which many of these problems facing MFIs may be overcame. Securitization is can be used to organized the MFIs balance sheet so that the finance advanced to borrowers in mortgage loans by MFIs is recouped by them almost immediately whilst long-term investors such as pension funds via the capital markets fund the housing finance.

vi) Mortgage Backed Securitization is a complex arrangement involving convergence of the mortgage industry, real estate and land laws and financial regulation in a way which must be specifically enabled within Kenya.

vi) Whilst working on getting mortgages off MFIs' balance sheets, that is securitization, may be a good idea, it is getting the pre-securitization matters right that is sine qua non of developing good mortgage markets. It is important to have proper registration, foreclosure and eviction procedures in place.

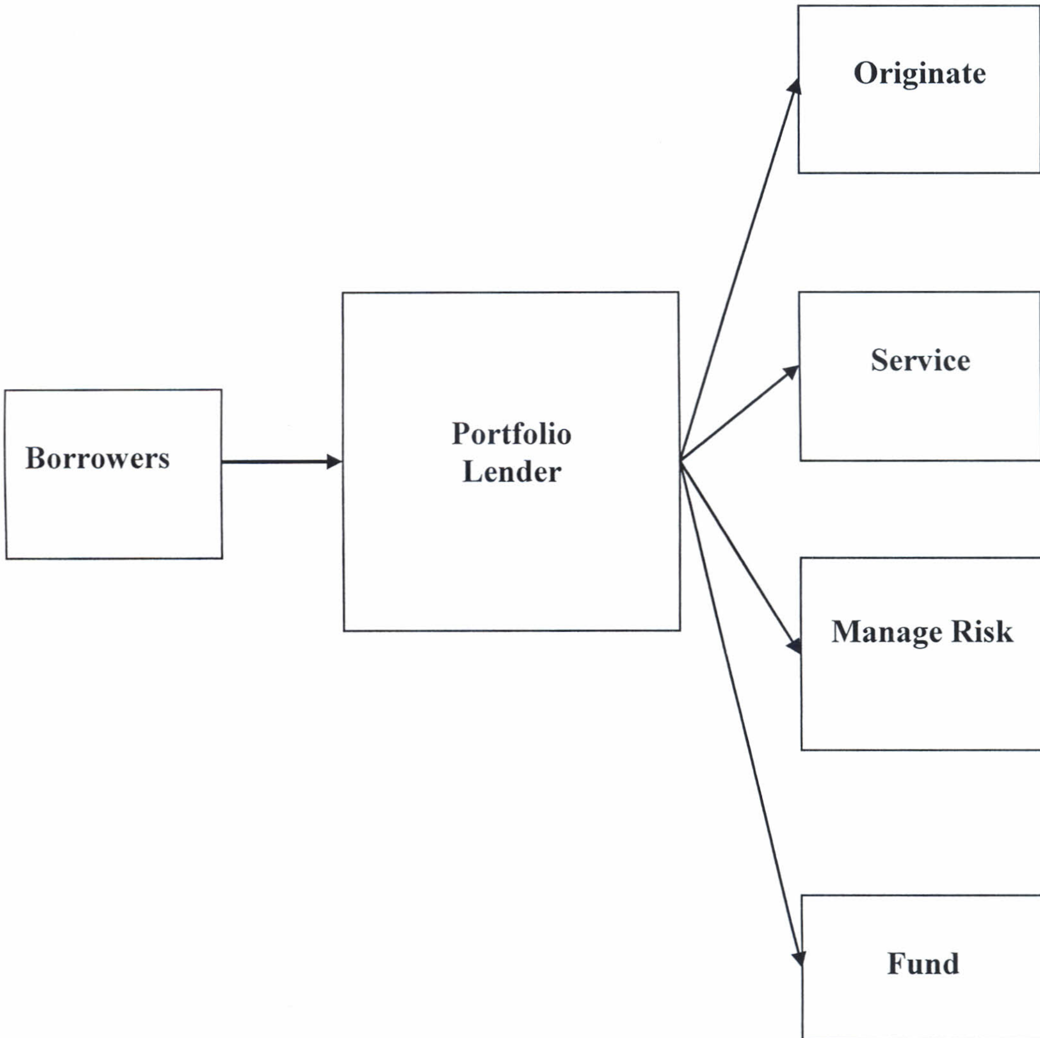
vii) The initialization of the process of Mortgage Backed Securitization requires a huge capital outlay which MFIs may not want to incur. In these two ways the government input into the process of Mortgage Backed Securitization is necessary. To initialize the process of securitization some form of government guarantee might be useful. This might require creating a Government Sponsored Entity (GSE) in the nature of Fannie or Freddie Mae.

vii) Legal issues in Mortgaged Backed Securitization affect real estate laws, banking laws, capital market laws, company laws and even stamp duty laws. In Kenya securitization is envisaged by the CMA but the provisions thereof are far from sufficient. Piecemeal amendments to other affected pieces of legislation may not be of much value either. The Kenya. Government would therefore have to enact a *sui generies* piece of legislation which would make adequate provisions for al the legal and regulatory issues that affect Mortgage Backed Securitization and the MBS.

Appendix

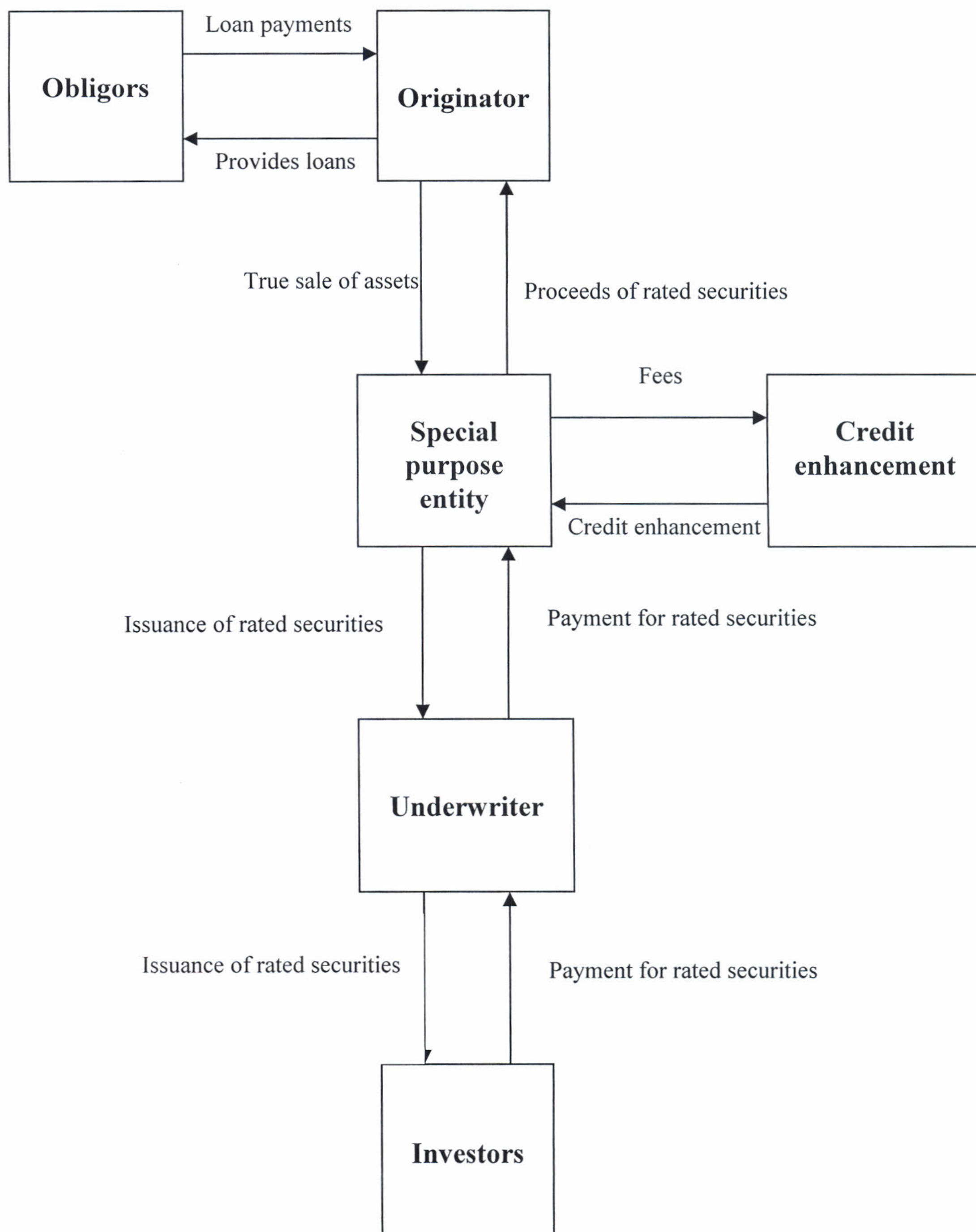
1. Annexture One

Traditional Mortgage Model



2. Annexture Two

Basic Securitization transaction model



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