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# Collateralization of intangible assets making - a case for micro, small and medium enterprises in Kenya

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# COLLATERALIZATION OF INTANGIBLE ASSETS: MAKING A CASE FOR MICRO, SMALL AND MEDIUM ENTERPRISES IN KENYA

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# Declaration

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.



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**Approval**

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# Abstract

Kenya has seen regulatory reforms in the spirit of easing the cost of doing business by overhauling various statutes regulating commerce. Some of these statutes considered in this Thesis include the Companies Act, (Act No. 17 of 2015), Insolvency Act, (Act No. 18 of 2015), the Moveable Property Security Rights Act, (Act No. 13 of 2017), Banking Act, (Act No. 25 of 2016) and the Data Protection Act, (Act No. 24 of 2019). This overhaul of statutes has elevated Kenya in keeping pace with the global community, creating conducive environments for the modern credit market. The most significant reform in these statutes is the recognition of intangibles as commodities of trade.

From the preamble of the Moveable Property Security Rights Act, 2017 it is clear that the statute addresses the mistrust between Micro Small and Medium Enterprises (MSMEs) and formal financial institutions by creating a means of registering specific security rights in moveable property.

However, despite the statutes being in place, there is need for a systemic shift towards alternatives to tangible collateral just like the market driven acceptance of mobile money. The similarities being that in both cases the collateral is intangible.

A digital registry solves the dilemma of possession which makes tangible securities attractive by allowing identification, registration and publication of security rights so as to give notice to any participant in the credit market. This is the missing link which makes intangible collateral viable. In essence as secure digital registry unlocks credit flow to the starving MSMEs if embraced by the credit market.

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## List of Acronyms

| | |
|---|---|
| BRS | Business Registration Service |
| CBK | Central Bank of Kenya |
| CMA | Capital Markets Authority |
| FSD | Financial Sector Deepening |
| GEMS | Growth Enterprise Market Segment |
| IFC | International Financial Corporation |
| KBA | Kenya Bankers Association |
| KNBS | Kenya National Bureau of Statistics |
| MPSR | Moveable Property Security Right |
| MSME | Micro Small and Medium Enterprises |
| NSE | Nairobi Stock Exchange |
| ROSCAS | Rotating Savings and Credit Associations |
| SME | Small and Medium Enterprises |

## Statutes

Banking Act, (Act No. 9 of 1989)

Banking (Amendment) Act (Act No. 25 of 2016).

Business Registration Service Act, (Act No. 15 of 2015).

Companies Act, (Act No. 17 of 2015).

Constitution of Kenya

Credit Reference Bureau Regulations, 2019.

Data Protection Act (Act No. 24 of 2019).

Draft Micro Finance Bill, 2019.

Finance Bill (Bill No. 51 of 2019).

Insolvency Act, (Act No. 18 of 2015).

Micro and Small Enterprises Act, (Act No. 55 of 2012).

Moveable Security Property Rights Act, (Act No. 13 of 2017).

Personal Property Security Act, (Act No 8 of 2013) (Malawi).

Public Procurement and Disposal (Preference and Reservations) Regulations, 2011.

The Moveable Property Security Rights Act, (Act No. 13 of 2017).

## International Instruments

UNCITRAL Legislative Guide on Secured Transactions (2007).

UNGA, 'Convention on the assignment of receivables in international trade', UN A/Res/56/81, 31 January 2002

# Cases

*Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties) [2019] eKLR*

*Commercial Bank of Africa v Wardpa Holdings Limited & 7 others [2019] eKLR*

*Commissioner of Income Tax v Kencell Communications Limited (Now Airtel Kenya Limited) [2016] eKLR.*

*Gray v G-T-P Group Limited Re F2G Realisations Limited (in Liquidation) [2010] EWHC 1772 (Ch).*

*Nicholas Mahihu Muriithi v Barclays Bank Kenya Limited [2018] eKLR.*

*Private Equity Insurance Group SIA v Swedbank AS [2016] All ER (D) 116 (Dec).*
*Sheng Shuang Quarry Limited v National Industrial & Credit Bank Ltd [2019] eKLR*

*Sunil Chandulal Shah & 3 others v I & M Bank [2018] eKLR*

## Dedication

This thesis is dedicated to my mother Joyce Atieno Odwar who instigated the desire to pursue a Masters of Law degree and to my wife Ada Wenzaka who supported me through the entire journey, filling the daddy gap during my library moments and eventually proof reading the entire thesis.

# 1 Introduction to Intangible Collateral

## 1.1 Background

In Kenya, MSMEs are defined on the basis of their annual turnover as well as number of employees thus establishments with an annual turnover of less than KES 500,000 and a minimum of 9 employees are categorised as micro enterprise, establishments with an annual turnover KES 500,001 – KES 1,000,000 and employees between 10 and 50 persons, small enterprises.[1] Medium establishments on the other hand are classified as establishments with a turnover of over KES 1,000,000 and employees between 51 and 99 persons.[2]

The success of MSMEs accounts for a significant portion of growth and economic development of Kenya.[3] Despite the MSMEs sector generally experiencing growth, some have experienced stagnation, while others have experienced negative growth which eventually leads to their closure.[4] In a survey conducted by Kenya Bankers Association (KBA) in 2014, it is estimated that 80% of MSMEs close shop in their first year.[5] Of MSMEs that close shop, financial challenges is at the apex of the reasons for closure, accounting for a 29.6%.[6]

KNBS data shows that 80.6% of MSMEs source their capital from family or their owners, 5.6% from banks, 4.6% loans from family or friends, 1.4 from *chamas*[7], 0.4% Cooperatives and 0.1% government.[8] Other researchers reach similar findings on

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[1] Section 2, Micro and Small Enterprises Act, (Act No. 55 of 2012)

[2] KNBS, Basic Report on Micro, Small and Medium Establishment (MSME) Survey, Basic Report, 2016.

[3] KNBS, Basic Report on Micro, Small and Medium Establishment (MSME) Survey, Basic Report, 2016.

[4] KNBS, 'Basic Report 2016'.

[5] KBA, 'Kenya banking value shared report 2019'.

[6] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[7] A Kiswahili term equivalent to Rotating Savings and Credit Associations

[8] KNBS, Basic Report, 2016.

initial capital reporting 88.6% of MSMEs sourcing their capital from the owners or family, 7.0% loans from family or friends, 1.2% from cooperatives, 1.1% NGO's and government programs, trade credit and other lenders, banks, non-bank finance institutions, rotating savings and credit schemes all at 0.7% each.[9]

Whereas MSMEs may not have real property, they do possess some property in form of intangible assets that can be useful collateral. These intangibles include inventories, receivables, account deposits, intellectual property among others. These intangibles although promising, are yet to be embraced by the financial market in Kenya due to over reliance on tangible collateral.[10]

Mobile money lending, also known as digital lending gives a hint on how intangibles can change the lending landscape. Mobile money lending relies on behaviour determined by savings, spending and repayment patterns which has come to be accustomed by Financial Sector Deepening (FSD) as 'reputational collateral'. The behavioural data is then used to determine the borrowers credit score.[11] This reliance on data collected based on behaviour, management, organisation, sales and brand, is generally a departure from traditional intangible assets which are defined by their ability to be traded.[12] It is important therefore, to value enterprises beyond their basic book value (capital) to include, '*skills, organizational structures and processes, culture, and other factors'*.[13]

Embracing intangibles promises to give a lifeline to most failing business Enterprises whose primary source of failure is capital constraints. By expanding the scope of

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[9] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[10] Karumba M, and Wafula M, 'Collateral lending: are there alternatives for the Kenyan banking industry' KBA Centre for Research on Financial Markets and Policy, Working Paper Series number 03, 2012, <https://www.kba.co.ke/downloads/Working_Paper_WPS_03_12[2].pdf> 27 August 2019.

[11] Cook T, 'Tech-enabled lending in Africa Nairobi' FSD Kenya 2018.

[12] Brynjolfsson E. Hitt L, and Yang S. 'Intangible assets: Computers and organizational capital', 1 Brookings Paperss on Economic Activity, 2002, 137-181.

[13] Brynjolfsson E. Hitt L, and Yang S. 'Intangible assets: Computers and organizational capital'.

collateral, the collateral pool is increased beyond real property giving MSMEs a chance of tapping the resources available in the credit market. The inclusion of credit exempt into the formal financial system marks the rescue point for many struggling start-ups.

The developed economies have embraced the reality that modern enterprises possess less of tangible assets and more of intangibles making intangibles a medium of trade. For developing economies like Kenya, only established businesses have been able to use their intangible assets through floating charges and the all-asset debentures.

As far as data on credit information is concerned, financial institutions are on the receiving end for not using credit scores to determine the viability of a lending transaction.[14] There are also concerns of rising mobile money loan defaulters blacklisted for default in repaying measly sums, affecting their credit rating.[15] The two situations indicts a system where financial institutions only use credit rating when it's convenient, that is, sieve out borrowers limiting their access to debt financed capital and fail to extend the benefits of the credit score to the borrower.[16] This explains the significantly low loan uptake from banks by MSMEs primarily because of high interest rates[17] justified as equalising bad debts in the event of default[18] which has put formal credit beyond the reach of MSMEs.

[14] Ngugi Brian, 'Misuse of credit rating barring access to loans', Business Daily, 30 August 2017, <https://www.businessdailyafrica.com/markets/marketnews/Misuse-of-credit-rating-barring-access-to-loans/3815534-4077190-x7rsdez/index.html> on 16 September 2019.

[15] Mwiti L, 'Mobile loans crisis as 500,000 get blacklisted', Standard Digital, 6 June 2018, <https://www.standardmedia.co.ke/business/article/2001283051/mobile-loans-crisis-as-500-000-blacklisted> on 16 September 2019.

[16] Gubbins P, and Totolo E, 'Digital Credit in Kenya: Evidence from demand side surveys', FSD Kenya, October 2018, https://fsdkenya.org/publication/digital-credit-in-kenya-evidence-from-demand-side-surveys/ 23 February 2020.

[17] KNBS, Basic Report, 2016.

[18] FSD Kenya, 'The potential for credit scoring for SME lending in Kenya' FSD Kenya, 1 October 2008, <http://fsdkenya.org/publication/the-potential-for-credit-scoring-for-sme-lending-in-kenya/> 4 February 2019.

Research has shown that MSMEs survive on credit from the informal sector as opposed to banks which represent formal borrowing.[19] The reasons for this preferred mode of credit has been directly linked to rigid lending practices heavily reliant on 'tangible assets' as collateral (a commodity most MSMEs don't have) making formal borrowing as a source of capital untenable.[20] Amongst reasons for rigid formal lending practices requiring collateral is the mistrust between lenders and the borrowers.[21] The mistrust is not without a cause as the success or failure of a financial institution is determined by its risk management systems[22] while the fear of foreclosure informs the preference of informal lending systems.[23]

Casual discussions with peers in the financial sector have always imbued the suggestion that collateralization of intangible assets could significantly breathe life into some chocking MSMEs. However, this suggestion is fraught with the controversy on the practicality of enforcing such securities.[24] The argument usually revolves around the fact that physical properties have titles which are easy to encumber, easy to market and easy to realise. The norm of taking tangible securities has been developed over time creating comfort and safety in their trade.[25]

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[19] Adams Dale W, 'Informal finance in low income countries: A seminar report' Ohio State University ESO No.1631, 1989 https://kb.osu.edu/handle/1811/66159 26 January 2019.

[20]Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

[21] Vision 2030, 'Sector plan for financial services 2013 – 2017' <http://vision2030.go.ke/inc/uploads/2018/05/SECTOR-PLAN-FOR-FINANCIAL-SERVICES-2013-2017.pdf>.

[22] Wood P, 'The future of international banking and financial law and lawyers' Singapore Journal of Legal Studies, 2014, 355-376.

[23]Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

[24] Balkenhol B, Schütte H, 'Collateral, collateral law and collateral substitutes' International Labour Organization, Social Finance Working Paper No 26, 2001 <https://www.ilo.org/employment/Whatwedo/Publications/WCMS_117987/lang--en/index.htm> 24 January 2019.

[25] Land Act, 2013 which recognises charges on land, Companies Act which recognises debentures, and formerly Chattels Transfer Act (Cap. 28) (repealed) which provided for chattels mortgages.

As a response to the rigidity of the credit market, Kenya has updated, consolidated and revised a number of statutes in order to create a conducive legal framework that can harness the potential raising of capital through collateralising intangible assets. Among these statutes, the Movable Property Security Rights Act, 2017, seeks to solve some of the controversies militating against intangible security, by creating a centralised registry for collateralised moveable property which includes intangible assets.[26] Moveable property in the statute is defined to include tangible and intangible assets.[27] Intangibles are further defined to include receivables, choses in action, deposit accounts, electronic securities and intellectual property rights.[28]

The Companies Act, 2015 additionally recognises progression in securities by listing goodwill and intellectual property among things capable of being charged.[29] The insolvency Act, 2015 defines property to include choses in action, legal interests, equitable interests, future profits and things in action.[30] This trend appears to be the norm globally as there is a systemic shift from traditional securities founded on real property towards moveable property and intangible property which has given MSMEs a lifeline.[31]

The overhaul of commercial statutes is a clarion call to participants in the credit market to take advantage of the safety measures introduced and embrace MSMEs within their means.

In the recent times, lenders other than banks have also permeated the credit market with innovative mobile applications that mine data from potential borrowers for the purposes of creating a credit rating that is used to set the base sum a potential

[26] Section 19(2) The Moveable Property Security Rights Act, (Act No. 13 of 2017).

[27] Section 2, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[28] Section 2, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[29] Section 878(4)(i) Companies Act, (Act No. 17 of 2015).

[30] Section 2, Insolvency Act, (Act No. 18 of 2015).

[31] Winn, Jane K, 'Introduction: Symposium on globalization of secured lending' 34(4) *The International Lawyer*, 2000, 1089.

borrower qualifies for.[32] This was mainly facilitated by the Central Bank of Kenya through revised the credit reporting regulations that allowed credit reference bureaus the mandate to develop a credit score for all persons whose data has been submitted to them.[33]

Social media, mobile money usage and credit reference records[34] was among the most common data that then served as collateral in formal borrowing.[35] The use of personal data moved so fast leaving behind the legislative framework[36] raising ethical issues on collection and use of personal data.[37] The entry of other mobile lenders into the credit market resulted in a lending race raising concerns of the predatory nature of mobile lending in an under-regulated market.[38] In response to the fears of the predatory lending the CBK moved to lock out mobile money lenders from the credit reference bureau system.[39] Some authors believe that the fear of the banking sector losing out

[32] Tubei G, '7 startups in Kenya that offer quick loans with just the click of a mouse'Business insider, 13 November 2018 <https://www.pulselive.co.ke/bi/tech/startups-7-startups-in-kenya-that-offer-quick-loans-with-just-the-click-of-a-mouse/3fb3cpn> 24 January 2019.

[33] Regulation 15(1)(d) Credit Reference Bureau Regulations, 2019.

[34] Section 31(3)b Banking Act, Cap 488 and The Credit Reference Bureau Regulations, 2013.

[35] Kagendo P and Shigoli P, 'Mobile Lending has Expanded Kenya's Credit Market but Regulation is Necessary, KIPPRA, 14 December 2018, <https://kippra.or.ke/mobile-lending-has-expanded-kenyas-credit-market-but-regulation-is-necessary/> 8 April 2019.

[36] Data Protection Act, (Act No. 24 of 2019).

[37] Watima T, 'Don't imperil personal data protection', Business Daily, 4 March 2019 <https://www.businessdailyafrica.com/analysis/columnists/Do-not-imperil-personal-data-protection/4259356-5009020-l03c7sz/index.html> 5 March 2019.

[38] Ahmed F, 'CBK boss Njoroge compares mobile loan apps to shylocks' 28/03/2019 Citizen Digital, <https://citizentv.co.ke/business/cbk-boss-njoroge-compares-mobile-loan-apps-to-shylocks-238153/> 9 April 2019.

[39] Ndemo B, Is Treasury killing fintech innovations? Business Daily Newspaper, 28 May 2020, <https://www.businessdailyafrica.com/analysis/columnists/Is-Treasury-killing-fintech-innovations/4259356-5565414-15rrt59z/index.html> 18 June 2020.

to the mobile lenders was the driving factor behind CBK restricting use of credit reference bureau records, which have been very vital to mobile lending.[40]

Banks on the other hand have remained very cautious in letting in MSMEs into their lending pool for reasons mostly associated with 'high risks'.[41] However the entry of other lenders appears to have forced banks into strategic partnerships with mobile operators to tap into this ever growing market.[42] Kenya Bankers Association (KBA) for example developed the '*inuka*[43] enterprise programme' together with other stakeholders whose aim is improving the profile, business ethics and access to credit for small business through training, mentorship and creating business networks.[44]

It is now a reality that block chains are on the rise with no tangible assets just like many MSMEs progressively possessing more intangibles. There is massive financial flow from curious investors into start-ups that have no tangible assets. *Sendy* a courier service company is one example of a start-up which is barely 6 years old,[45] being able to raise 208 million Kenyan shillings for scaling up its operations.[46] The business model links drivers to customers with delivery needs through a platform that has attracted major players in the manufacturing industry in Kenya.[47] With such potential

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40 Ndemo B, Is Treasury killing fintech innovations?

41Kira Alex, 'Determinants of financing constraints in East African Countries' SMEs' 8(8) International Journal of Business and Management, 2013, 49.

42 Sunday F, 'Technology boost as mobile lending takes bulk of loans' 9 January 2019 Standard Digital, <https://www.standardmedia.co.ke/business/article/2001308763/technology-boost-as-mobile-lending-takes-bulk-of-loans> 9 April 2019.

43 Swahili word meaning raise.

44 KBA, 'Kenya banking value shared report 2019'.

45 Ogolah G, 'Sendy creates delivery opportunities for drivers', 27 August 2019 <https://www.sendyit.com/sendyblog-post/sendy-creates-delivery-opportunities-for-drivers> 11 February 2020.

46 Mumo M, 'Courier firm Sendy in Sh208m funding deal', Business Daily Newspaper, 26 November 2017, https://www.businessdailyafrica.com/corporate/companies/Courier-firm-Sendy-in-Sh208m-funding-deal/4003102-4203494-a6r3ksz/index.html 11 February 2020.

47 Mutua J, Manufacturers to cut transport costs after new deal with Sendy', Business Daily Newspaper, 4 July 2019, https://www.businessdailyafrica.com/corporate/companies/KAM-inks-deal-with-Sendy-for-big-cargo-deliveries/4003102-5183642-o12iwkz/index.html 11 February 2020.

it would be ridiculous for a financial institution to insist on lending to such an establishment on the basis of real property.

Although Kenya has made some commendable progress by overhauling the collateral legislative framework,[48] the credit market needs to embrace the new collateral system which allows collateralization of intangible assets. The global market seems to be alive to the changing times prompting International Finance Corporation (IFC) to invest $240,000 towards project number 602042 in Kenya with the objective of ensuring the delivery of a modern collateral registry system as an important part of the credit system.[49] A digitalised registry if embraced, will ease the data access and encourage more interactions in the credit market.

## 1.2 Problem Statement

The Kenyan debt finance market is riddled with heavy reliance on tangible collateral as a mitigating measure against high risks associated with MSMEs lending. This high-risk tag has persistently clipped the wings of MSMEs access to debt finance impeding their growth and survival. Most studies appreciate MSMEs lack of capital is heavily influenced by inadequate collateral that can be traded in a credit market. The limited trading on intangibles has been brought to fore by the credit markets slow acceptance of intangibles which widens the pool of collateral, to assets within MSMEs reach.

The Moveable Property Security Rights Act, 2017 sets up a collateral registry which relies on perfection of a security right by filing a notice with the registrar.[50] This is in contrast to the current credit practices which rely on physical registration of the instrument creating the security[51] whose perfection significantly increases the cost of capital. The old regime, which is still embraced in practice, lacks a means of

[48] Mugambi M, 'You can now use crops, livestock for bank loans' Business Daily Newspaper, 10 May 2016, <https://www.businessdailyafrica.com/news/You-can-now-use-crops-livestock-for-bank-loans/539546-3922072-utft3uz/index.html> 4 February 2019.

[49] IFC project information portal, 'Kenya STCR SP' 5 December 2018 <https://disclosures.ifc.org/#/projectDetail/AS/602042> 26th February 2019.

[50] Section 19(2), Moveable Property Security Rights Act, (Act No. 13 of 2017)

[51] Section 96, Companies Act, Cap 486 (Repealed).

identifying, classifying and isolating intangible assets hence the prevalence of the 'all asset debenture' and the 'floating charge'.

The text of the law on Moveable Property Security Rights Act, is at par with developed economies in creating an electronic registry which makes creating securities in intangibles a reality.[52] There is however inadequate awareness in the credit market so as to build confidence in intangible collateral. The market is still heavily reliant on restrictive practices that favour tangible collateral, a commodity that is in short supply to MSMEs.

## 1.3 Hypothesis

This Thesis envisages that embracing intangible collateral will increase credit flow to MSMEs. This hypothesis is developed from the theory that an effective collateral legal regime creates confidence in trading in intangibles opening up their unexplored potential.

When there is market confidence in a centralised electronic collateral registry, the collateral pool is broadened increasing flow of credit for MSMEs. With ease of access to information at a click of a button, information gathering costs are significantly lowered with a net effect of cheaper credit which would be attractive to MSMEs.

If access to reliable information becomes easy, there is increase in credit flow to MSMEs by their merits. This hypothesis is developed from the theory that simple access to reliable information diminishes the information asymmetry between the MSMEs and financial institutions.

[52] Regulation 3, Movable Property Security Rights (General) Regulations, 2017.

## 1.4 Research Objectives

This Thesis seeks to give ideas on how to formalise and secure financial transactions in intangible assets without exposing formal financial institutions to the fears that small businesses are risky,[53] denying them access to credit[54] .

The thesis advocates for a merit-based lending system which takes into account the special nature of MSMEs for purposes of customising solutions that befit their structure. The Thesis will follow previous studies that have revealed that most MSMEs are ineligible to debt financed capital because of lack of collateral.[55]

Using digital lending as an example, the study is intended to show that the emergence of mobile money lending has upset the norms by embracing the 'risky'. The thesis intends to challenge formal lending institutions to invent new lending business designs that are not tangible collateral based.[56] This research will explore and provide further insights into the emerging ventures with a view to expand the scope of acceptable collateral to receivables, intellectual property, goodwill, reputation and other intangibles.

The study is a continuation of the studies by the KNBS on the establishment, performance and survival of the MSMEs in Kenya. The research will test the theory



53 Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya', Helsinki: UNU-WIDER, Research Paper 2009/006 https://www.wider.unu.edu/publication/linkages-access-finance-and-performance-small-scale-enterprises-kenya, 24 January 2019.

54 Bezant M, 'The use of intellectual property as security for debt finance', 1(3) Journal of Knowledge Management, 1997, 237.

55 Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya', DP No. 026/2000 <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.199.6914&rep=rep1&type=pdf> 26 January 2019.

56 Kenya Bankers Association, 'Kenya banking value shared report 2019' 25 August 2019 <https://www.kba.co.ke/news93.php> 26 August 2019.

by FSD Kenya which concludes that lenders in Kenya have embraced reputation collateral in the new products that have taken the credit market with a storm.[57]

## 1.5 Research Questions

This study narrows the focus on collateral lending to intangibles by asking,

(i) Whether the emergence of the Moveable Property Security Rights Act unlocks the capital dilemma portending an increase in credit flow to MSMEs.

(ii) Whether the use of a centralised electronic collateral registry makes intangible assets viable collateral for MSMEs.

(iii) Whether a simple, secure and verifiable information registry can reduce the information asymmetry between lenders and MSMEs.

## 1.6 Methodology

This thesis will employ desk research that has established capital constraints as a plague to the MSME sector. Primary data will be from KNBS reports on MSMEs, successful micro finance models, existing banking practices and rolled out policy shifts meant to open capital flow to MSMEs. The study will contrast existing practices and emerging practices that have shifted from physical registration of security documents to filing of notices. The study will proceed by looking at the nature of credit finance available for MSMEs towards untapped potential introduced by the Moveable Property Security Rights Act.

The thesis will employ comparative study by taking a sample of the successful financial institutions who have packaged products that have generally been acceptable to MSMEs. The success will be closely related with the afore view by researchers that formal institutions shunning the low-income population is not driven by any scientific research but by myths.[58]

The findings of the study will be measured against secondary literature including journals, articles, statues, treaties, Hansard, books, case studies from jurisdictions that have already embraced the concept of collateralization of intangible assets. The thesis

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[57] FSD Kenya, 'The potential for credit scoring for SME Lending in Kenya'.

[58] Adams Dale W, 'Informal finance in low income countries: A seminar report' Ohio State Universitym ESO No.1631, 1989.

will query current formal lending practice from local normative perspectives against modern practices in developed economies.

## 1.7 Limitations

This thesis will be limited to exploring intangible assets as collateral complement or substitute. It will be based on the expanded scope of collateral as delineated by the Moveable Property Security Rights Act to the extent that it introduces the potential of trading on intangible securities.

The study will be confined to the legal environment that would make it possible to trade in intangible securities but will not extend to justification or determining the quality and suitability of a particular form of asset. Issues of probabilities of default by MSMEs are beyond the scope of this study since there are already other mechanisms like credit scoring which play this role.

The research will also be limited to local MSMEs as known in Kenya and therefore will not dwell into conflict of law issues that may arise with cross border trade on intangible assets.

## 1.8 Chapter Breakdown

This thesis is broken down in six chapters. Chapter one will bring to fore the background of the problem, the hypothesis, research objectives, research questions, the methodology and the limitations. The literature is be focused broadly on highlighting the capital constraints by MSMEs and exploring intangible assets as a risk mitigating factor.

Chapter two present the literature review and the theoretical framework. This chapter explores literature on intangible assets and provides the guide through which the research was conducted. It interrogates the mistrust reality that has become an embodiment of the formal credit system against MSMEs from time immemorial. The chapter concludes by ushering in modern concepts of property that have opened up the credit world to intangibles.

Chapter three analyses the financial framework of MSMEs identifying their source of funds, the structure of informal and formal lending from known financial traditions developed in Kenya. It primarily gives a report on the situation as is, with a view of exposing the shortcomings of the credit system as enabled by settled practices.

Chapter four analyses the current legal framework and the reforms it brings to the credit industry. The chapter is centred around the Moveable Property Security Right Act, 2017. The chapter explores the legal solutions proffered by the Moveable Property Security Rights Act and interrogate their adequacy.

Chapter five reports on the findings and results of a potential alternative to tangible collateral. This chapter analyses the entry of mobile lending and how it has revolutionised the lending market with a targeted focus on business lending. This chapter tests the validity of secondary data on the approaches in the developed countries and borrows heavily from the successes in debt finance for MSMEs. This chapter concludes by analysing the legal framework currently in place and its response to the evolving market shifts to intangible assets.

Chapter six is a summary of the findings of the study and gives the recommendations on the way forward.

# 2 Analysis of Intangible Collateral

## 2.1 Introduction

This chapter presents the theoretical framework through which the research will be undertaken as well as the literature review guiding the study. It draws from the limitation of tangible collateral to invite a discussion into the expanded moveable collateral which is inclusive of intangibles. The Thesis accepts that there are other viable forms of collateral such as accounts receivables, intellectual property, goodwill among others which offer security that can substitute or complement tangible collateral.

This chapter interrogates the literature by scholars who have researched on issues that make it difficult for MSMEs to access debt finance. Among the issues is a security market that is heavily dependent on tangible collateral which is rare to come by in the MSME sector. The section proceeds by interrogating the concept of collateral with a view of making recommendations on viability of intangible collateral.

The chapter aims to demystify the myth that suggests that MSMEs are risky ventures and instead show that the financial practice is deliberately skewed against MSMEs. The laws of commerce world over have changed with legal systems paving way for new ideas that have radically transformed the traditional approaches to collateral.

## 2.2 Theoretical Framework

This thesis is focused on unlocking the capital dilemma that impedes entrepreneurship in the MSMEs sector. It is based on the mistrust theory as visualised by Atieno and Kira among other researchers doubt the rationale embraced by formal financial institutions to avoid MSMEs financing. The mistrust theory demystifies the 'risky' tag that makes MSMEs untrustworthy from the lenders perspective.

It is perceived that if there is increase of flows of capital towards MSMEs, then the capital constraint dilemma becomes a thing of the past. The solutions proffered are conceptualised from the idea that broadening secured lending beyond the traditional forms of security makes debt financing a source of capital for MSMEs a reality.[59] By solving MSMEs capital dilemma, mutual benefits accrue to the players making growth

[59] Schwarcz L, 'Helping microfinance become commercially sustainable', 46(2) Gonzaga Law Review, 2010, 495-502.

inevitable. Taking cue from the growth of K-REP bank (from a community-based aid program into a microfinance and then finally to Sidian Bank), it is particularly important that institutions that seek growth must embrace MSMEs in their numbers. However, appreciating that formal financial solutions are based on collateral, the choice of collateral must be that which is available to the MSMEs.

Enforcement of a security being at the core of credit trading, the thesis examines the myths that tend to undervalue the probity of intangible assets not being any lesser in value. The thesis will be guided by the theory that an effective collateral registry as epitomised by Love, Martinez, Maria and Sandeep who find evidence that where modernised collateral registries have been introduced, there has been increased lending to MSMEs. The study interrogates the rationale behind moving towards a uniform collateral system where notice and priority is central. In line with the base set by Blakenhol and Schütte, this thesis will draw upon research by other scholars who have identified various issues that affect use of intangible assets including banking practices and traditions and quite importantly the legal frameworks that support an embrace of intangibles.

As Adams, correctly finds, even in instances where there is adequate legislative framework, it is still costly to provide formal financial services to start-ups.[60] From this angle, it is quite clear that he theorises that informal lending thrives because of trust which replaces the need for tangible collateral giving credence to the 'mistrust theory' by Atieno. The study is a fortification of the findings that efficient data collection is a very important bridge to formal credit market, knowing their clients and feeling safe to transact.

This thesis comes at a time when digital lending is on the rise, the key feature being that the lending is secured through a credit score based on human behaviour as identified by FSD Kenya researchers. It will show that the success in digital lending is premised on the theory that use of personal data has built confidence in the mobile money market players. This theory can be attested to by credit market players who are competing to outdo each other with new products. A transaction matrix base which unlocks credit limit based on repayment of what is borrowed, and information shared by other lending institutions, highlights the potential of collateral registry as it

[60] Adams D, 'Informal finance in low income countries; a seminar report'.

would serve an important purpose of determining notice and priority. The heavy reliance of personal data to substitute tangible collateral is useful in diminishing the information asymmetry that has existed between formal financial institutions and MSMEs, chocking capital flow.

## 2.3 Literature Review

Property at law is one of the fluid concepts that by definition is descriptive using characteristics such as a bundle of rights such as possession, transferability which come into being through circumscription of positive laws in favour of one and against all or on the Lockean theory of ownership grounded on the fruits of ones labour.[61] The easier bit of defining property relates to its physical nature of what can be seen.[62] The Lockean theory of determining private property on the basis of ones sweat opens up the definition of property to ideas and value addition which then espouses intangible property, a departure from real property.[63]

The world legal order is expanding the traditional scope of financial services by embracing the modernity of our times which is more inclined towards intangible property.[64] The emergence of smart contracts and block chains signifies the paradigm shift from physical assets like land and buildings to intangible assets like intellectual property which are gaining general acceptance due to their high value. The desire of belonging in a community has caused a raft of changes into trade practices that show a world legal order that is geared towards a uniform system.[65] It is now a reality that the bracket of intangibles has expanded to things like information, skills,



[61] Lipton J, 'A Revised 'Property' Concept for the New Millennium?', Int J Law Info Tech (1999) 7 (2): 171

[62] Kameri-Mbote P, 'Monsanto vs. Schmeiser: Implications for Land Rights of Farmers in Kenya', in Wekesa M, and Sihanya B, 'Intellectual property rights in Kenya' Konrad Adenauer Stiftung, Nairobi, 2009, 112.

[63] Wekesa M, and Sihanya B, 'Intellectual property rights in Kenya' Konrad Adenauer Stiftung, Nairobi, 2009, 2.

[64] UNGA, 'Convention on the assignment of receivables in international trade', UN A/Res/56/81, 31 January 2002.

[65] Castellano G, 'Reforming Non-Possessory Secured Transactions Laws: A New Strategy?' 78(4) Modern Law Review, 2015, 611.

entrepreneurship, and other forms of human capital which have a value capable of being traded.[66]

The embrace of intangibles is however not a smooth road as they are always fraught with problematic identification and classification like in the case of 'spectrum licence'[67] or even resistance. Kameri-Mbote criticises the preference for intangibles when there are competing rights with real property rights as laid out in *Monsanto Canada Inc. v Schmeiser* [2001] F.C.T.D. 256.[68] The importance of the *Mosanto Canada Inc. v Schmeiser* in this discussion presents a universal legal regime that is quick to embrace the peculiarities of intangibles giving them an edge over traditional rights that have been entrenched over time and therefore underpinning juridical transformation in property law.

Practically, when a financial institution is approached with a security that is only valid on the basis of the performance of some obligations to a third party by the borrower, the risk of non-performance of those obligations may make the security unacceptable. Similarly when the security being offered is in the hands of a third party who may have interest in the security like bank deposits, a creditor has to be very wary of a potential loss and will therefore only trade if it can be guaranteed that there is a way for securing its security rights. Technology has made the acceptance of intangible collateral more



[66] Lipton J, 'A Revised 'Property' Concept for the New Millennium?'.

[67] Justice Tuiyott in **Commissioner Of Income Tax v Kencell Communications Limited (Now Airtel Kenya Limited) [2016] eKLR,** "Whilst still on clause 11, it assumes that the Licence can be used as a collateral and can be encumbered. Kencell is of a different view. The Court was told that an encumbrance is defined '**as a claim or liability that is attached to property or some other right that may lessen its value, such as a lien or mortgage**' (Blacks Law Dictionary). It was then argued that, in the light that the Licence can be revoked, it is unsuitable to be used as collateral. That may be so but as this Court has pointed out earlier revocation can only happen at the behest of the licensee or upon it committing certain breaches. It is not a call to be made whimsically or capriciously."

[68] Kameri-Mbote P, 'Monsanto vs. Schmeiser: Implications for Land Rights of Farmers in Kenya', in Wekesa M, and Sihanya B, 'Intellectual property rights in Kenya' Konrad Adenauer Stiftung, Nairobi, 2009, 112.

real with inventions like credit scoring and unified digital registries making it possible for information to substitute tangible collateral.[69]

The reliance on tangible collateral can be traced back to the common law doctrine of a lien, which was defined through retention of possession.[70] In this system if possession was lost, the security also became unenforceable. Although charges and mortgages are non-possessory, the encumbrance created by registration prevents further dealings in property making it a preferred choice for formal financial institutions. Where there are moveable assets, the trend has been to create all asset debentures which puts the entire life and survival of an MSME always at risk of foreclosure.[71] It is for this reason that common law developed the practice of defining enforceability of a charge on an intangible like deposits by expecting some form of control.[72]

This quality of collateral supports the data by KNBS and by Kimuyu and Omiti who identify two broad categories of lending: formal lending which heavily depends on physical collateral and informal lending where the risk is mitigated through close interactions and guarantees. This thesis closely relates what Besley identifies as lending based on close interactions common with 'non market institutions' where borrowing is based on 'knowing each other well' a value that reduces risks[73] (an intangible asset capable of substituting tangible collateral in formal lending).

Atieno confirms that smaller firms tend to embrace homogeneous and cohesive networks which support informal credit and risk sharing arrangements.[74] It is an



[69] Davies I, 'Secured financing of intellectual property assets and the reform of English personal property security law', 26(3) Oxford Journal of Legal Studies, 2006, 559.

[70] Financial Collateral Arrangements: A Lighter Shade of Gray', 6(2) Corporate Rescue and Insolvency Journal, 2013, 53.

[71] FSD Kenya, 'The Kenyan collateral process: constraints and solutions', FSD Kenya, 2010.

[72] Parsons R, Dening M, 'Financial Collateral - An Opportunity Missed', 5 Law and Financial Markets Review, 2011, 164.

[73] Besley T, 'Nonmarket Institutions for credit and risk sharing in low-income countries' 9(3) Journal of Economic Perspectives, 1995, 115.

[74]Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya', 2009.

accepted norm that formal lenders shun lending to MSMEs or lend at high interest rates because of challenges in assessing MSMEs repayment potential cost effectively.[75] Alper *et. al* note that high interest rates have always been a conundrum for policy makers as there is uncontroverted evidence that it slows down economic growth, results in financial exclusion and discourages investments.[76] Formal lending institutions are known to justify the high interest levied on credit facilities to MSMEs as a counter to high risk exposure by potential default in repayment of the facility.[77] This risk tag has made MSMEs adopt other ways of funding where risk is spread from one entity to a pool of entities.[78]

Attempts by the policy makers to curb the interest rates charged on loans have not been successful with unintended consequences of banks shifting their focus from MSMEs to large corporates' and government.[79] Researchers using Kenya as a study come to the conclusion that radical imposition of interest rate capping had the effect of achieving unintended consequences of worsening the position of MSMEs as banks shifted to less risky lending and avoid the 'risky' MSMEs.[80] This position is confirmed by the Central Bank of Kenya which was at the forefront in leading policy makers to abandon the interest rate caps, finally achieved in September 2019.[81]

[75]FSD Kenya, 'The potential for credit scoring for SME lending in Kenya'.

[76] Alper C, Clements B, Hobdari N, and Porcel R, 'Do Interest Rate Controls Work? Evidence from Kenya', IMF Working Paper (WP/19/119).

[77] Karumba M, Wafula M, 'Collateral Lending: Are there Alternatives for the Kenyan Banking Industry?, Kenya Bankers Association Working Paper Series no. 3 of 2012 (WPS /03/12).

[78] Atieno argues that small firms have discovered new sources of capital, "… where micro enterprises join together to guarantee loans for each other."

[79] CBK, 'The Impact of Interest Rate Capping on the Kenyan Economy', March 2018, <https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps_-March-2018final.pdf> 2 February 2020.

[80] Alper E, Clements B, Hobdari N and Porcel R, 'Do Interest Rate Controls Work? Evidence from Kenya', IMF, Working Paper No. 19/119, 31 May 2019.

[81] CBK, 'The Impact of Interest Rate Capping on the Kenyan Economy', March 2018.

Balkenhol and Schütte argue that the 'risk' narrative is just a facade that masks their real fiscal policies whose result is costly loans beyond the reach of MSMEs.[82] This preference has negative outcomes as the non-market institutions cannot sustain the entire MSME sector to offer a viable alternative while the formal financial institutions limit their revenue making processes by shunning MSMEs. In the end nobody wins as MSMEs are choked of the capital they need while the formal financial sector loses out on the potential of broadening their revenues through engaging MSMEs.

Stilgitz questions the high default perception and notes that banks are sensationalising the issue and deliberately classifying some borrowers as high risk without any legitimate data backup.[83] Balkenhol & Schütte on their part suggest that financial institutions simply have limited information heightening the reluctance of venturing in alternative collateral in secured transactions.[84] These views are fortified by the lessons learnt from the Indonesian project of linking banks and self-help groups which shifted to independent assessment of creditworthiness away from tangible collateral and thereby raising the value of intangible assets to the same pedestal as the traditional securities.[85]

Dale W. Adams proposes that financial institutions need to study and learn the key elements of informal lending that make it a much preferred source of capital for MSMEs in order to broaden their revenues.[86] The proposed study underscores the importance of financial institutions engaging MSMEs for relative gains.[87] Anyieni



[82] Balkenhol B, and Schütte H, 'Collateral, collateral law and collateral substitutes' International Labour Organization'.

[83] Stiglitz J, 'Peer monitoring and credit markets (English)' 4(3) The World Bank economic review, 1990, 351.

[84] Balkenhol B, and Schütte H, 'Collateral, collateral law and collateral substitutes' International Labour Organization'.

[85] Balkenhol B, and Schütte H, 'Collateral, collateral law and collateral substitutes' International Labour Organization'.

[86] Adams D, 'Informal finance in low income countries: a seminar report'.

[87] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

agrees with this view through his sample data that confirms viability of formal lending to MSMEs.[88] Embracing MSMEs by formal institutions means a shift to include intangible collateral as an alternative or even supplementary collateral since it is what would be easily available. The heavy reliance on tangible collateral is driven by the ability to liquidate the security in the event of default.[89] Once an asset is incapable of being realised without court assistance, the incentive to use it as collateral diminishes.[90] This is because a security is only appealing if enforceability is practical in terms of time and costs. Loumioti disproves the academic literature that favours tangible collateral, observing that *'intangibles are not worse quality than other secured loans'*.[91] This finding mitigates the insecurities that have been hypothesised on account of increase in acceptability of intangible assets in developed markets to the extent that some lenders are taking the lead in making offers to borrowers seeking a pledge on their assets.[92]

Locke classifies other variables that affect collateralization of intangible assets in three broad categories; 'separability, valuation and limited market transactions'.[93] She observes that the variables pose a significant challenge towards acceptance of intangible assets as collateral in formal lending.[94] Davies on his part identifies the absence of a common market for intangible property in contrast to tangible property

[88]Anyieni A, 'SME's Access to Credit, A Case of Kisii County-Kenya' 3(1) International Journal of Engineering, Science and Mathematics, 2014 < http://www.ijmra.us> 26 January 2019.

[89]Wood P, 'The future of international banking and financial law and lawyers' Singapore Journal of Legal Studies, 2014, 355.

[90] Balkenhol B, and Schütte H, 'Collateral, collateral law and collateral substitutes' International Labour Organization'.

[91] Loumioti M, 'The use of intangible assets as loan collateral' SSRN Electronic Journal, 30 January 2013 <http://ssrn.com/abstract=1748675> 26 January 2019.

[92] Loumioti M, 'The use of intangible assets as loan collateral' 2013.

[93]Locke N, 'The use of intellectual property as security for corporate debt'.

[94] Locke N, 'The use of intellectual property as security for corporate debt'.

a factor which undermines their acceptance as collateral.[95] These factors negatively affect the value of intangible assets and as Bezant notes, where intangible assets are utilised as collateral, they are only given a supplemental role to tangible collateral.[96] Bezant identifies business life cycles which he finds has significant contribution towards acceptability of the intangible assets as security as the more the business becomes profitable, the more acceptable its intangible assets become.[97] He particularly notes that before a business matures there is very little demand for debt financing supply because the risk is greater at this point.[98]

In Kenya, there has been use of 'reputational collateral'[99] particularly with credit card facilities with the only safeguard available being credit information shared.[100] This practice justifies Becker's theory that factors other than physical resources play a large role in economic growth hence the focus on intangible resources.[101] Reputational collateral gets its identity from the habits which crystallise to an intangible asset influencing the determination of risk by financial institutions.[102] That is to say that if a person consistently kept a positive credit report, some trust develops between the person and the lenders making it easier for the person to access further credit facilitates. Similarly, if financial institutions sampled the data on MSMEs, then it is

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95 Davis I, 'Secured financing of intellectual property assets and the reform of English personal property security law', 2006.

96 Bezant M, 'The use of intellectual property as security for debt finance', 1(3) Journal of Knowledge Management, 1997, 237.

97 Bezant M, 'The use of intellectual property as security for debt finance'.

98 Bezant M, 'The use of intellectual property as security for debt finance'.

99FSD Kenya, 'The potential for credit scoring for SME lending in Kenya'.

100 Mazer R, 'Emerging data sharing models to promote financial service innovation: Global trends and their implications for emerging markets' FSD Kenya, 1 June 2018 <http://fsdkenya.org/publication/emerging-data-sharing-models-to-promote-financial-service-innovation-global-trends-and-their-implications-for-emerging-markets/> 2 February 2019.

101 Becker G, 'Investment in human capital: a theoretical analysis', 70(5) Journal of Political Economy, 1962, 9.

102 FSD Kenya, 'The potential for credit scoring for SME lending in Kenya' FSD Kenya, 1 June 2018.

possible to avail credit relying on their credit score. The credit score however is not determined based on the quantity of the assets but the repayment character. This assessment is the difficult part because an opinion on character can only be formed with sufficient data.

With the advancement of technology, it is becoming a reality that mobile money lending is based on codes that monitor expenditure to identify a credit target and repayment to assess credit worthiness, unlocking ones potential to higher credit on the basis of the repayment behaviour.[103] It has become very common to see institutions sending unsolicited messages to their customers informing them that they are eligible to borrow money to a certain limit. This practice where the financial institution makes the first move as opposed to the borrower is not new as in developed countries it is not uncommon to see the bank identifying the intangible asset and approaching a potential borrower with an offer based on the intangibles.[104]

Kimuyu and Omiti identify the norms informed by the legal system which favours tangible security as a contributing to the low uptake of credit by MSMEs.[105] This norms have continued to bedevil MSMEs even in other financial markets like the security markets where there are certain customised products targeting the small and medium enterprises. Researchers note that the securities markets are still beyond the reach of MSMEs which factor limits their ability to raise capital publicly because of reliance on asset backed securities.[106] The policy makers have however responded to suggestions of liberalising the capital markets by setting up a favourable environment that can offer a viable option for raising long term capital.[107] The Growth Enterprise Market

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[103] Oriedo T, 'Big Data analytics at heart of Fuliza, M-Pesa's success' Business Daily Newspaper, 23 January 2019 <https://www.businessdailyafrica.com/corporate/tech/Big-Data-analytics-at-heart-of-Fuliza-M-Pesa-success/4258474-4948176-ytejap/index.html > 5 February 2019.

[104] Locke N, 'The use of intellectual property as security for corporate debt'.

[105] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[106] Capital Markets Authority, 'Capital Raising opportunities for SME's; The development of Micro-cap securities markets in Kenya.

[107] Mela M, Patel A, Turner S, and Wells S, 'Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya's capital market by small and medium enterprises (MSMEs)' 2015, FSD Kenya.

Segment (GEMS) is one such financial market that small and medium enterprises are encouraged to participate in, however the information asymmetry that is prevalent in the securities market is a long way from making the GEMS market an alternative to short term finance by banks.[108]

The developing nations have taken cue as there is a deliberate attempt to liberalise the market to accept intangible collateral.[109] These attempts are however overshadowed by absence of well-functioning intangible collateral registry[110] plagued by unreliable data. The developed nations on the other hand have long accepted the 'use of intangible assets as security' which is grounded on a reliable collateral registry.[111] Davies notes that when accurate information is available, borrowing costs reduce making debt financing attractive.[112] Appreciating the importance of priority and notice in secured transactions, a well-functioning registry evens the trading field and reduces lenders exposure.[113] A secured creditor is protected against third parties provided that notice of his security is registered.[114] Authors who have waded into the legal frameworks that support use of intangibles as collateral advocate for a shift from the American collateral framework which entails perfection of securities by either registration or control to the other models in which perfection is determined by

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108 CMA, 'Capital Raising opportunities for SME's; The development of Micro-cap securities markets in Kenya.

109 Marek D and Cyprian K, 'Using the UNCITRAL Legislative Guide as a Tool for a Secured Transactions Reform in Sub-Saharan Africa: The Case of Malawi' 30 Arizona Journal of International and Comparative Law, 2013, 163.

110 Love I, Martinez P, Maria S, and Sandeep S, 'Collateral registries for moveable assets: does their introduction spur firms 'access to ban finance' The World Bank, Policy Research Working Paper 6477, 2013 < http://documents.worldbank.org/curated/en/731881468314344960/Collateral-registries-for-movable-assets-does-their-introduction-spur-firms-access-to-bank-finance> on 3 February 2019.

111 Loumioti M, 'The use of intangible assets as loan collateral', 2013.

112 Davis I, 'Secured financing of intellectual property assets and the reform of English personal property security law'.

113 Davis I, 'Secured financing of intellectual property assets and the reform of English personal property security law'.

114 Section 38, Moveable Security Property Rights Act, (Act No. 13 of 2017).

registration.[115] Kenya indeed is amongst the countries that have adopted the modification of the American collateral framework by limiting perfection to registration.[116]

## 2.4 Chapter Summary

The literature explored in this chapter shows the unjustified capital constrains by MSMEs is unreasoned. The heavy reliance on tangible assets undermines the potential that is in intangibles. Times are changing and intangibles are gaining the momentum of acceptance in many collateral markets. There are now ways of reducing information asymmetry through the embrace of technology and this underscores the importance of tapping into the underutilised potential of MSMEs.

It is however clear from many researchers' perspectives that the acceptance of intangible collateral is first determined by the legal framework that is in place, then followed by the support structure that is either market developed, or policy driven. As highlighted in this chapter, traditional banking that is epitomised by heavy reliance on real property has no place in the modern world where enterprises possess more intangibles than tangibles.

The next chapter looks into the data peculiar to the Kenyan MSME market segment interrogating the current market practices. The chapter will present data obtained by researchers identifying the most common ways of raising funds by MSMEs and highlighting their shortages. The chapter will outlay data captured by the KNBS as the base for this study on MSMEs and their financial constraints.



[115] Schwarcz L, 'Helping microfinance become commercially sustainable'.

[116] Section 15, Moveable Security Property Rights Act, (Act No 13 of 2017).

# 3 Existing Credit Market for MSMEs in Kenya

## 3.1 Introduction

This chapter investigates the nature of MSMEs in Kenya and how they source their capital. The chapter interrogates the traditional forms of raising capital which includes informal lenders, ROSCAS, family and friends; formal credit institutions available being banks, micro finance institution and the securities market.

The chapter is arranged in terms of the growth cycle of a business modelled along debt finance starting with informal micro enterprise, to small enterprise and finally medium enterprise. At the formative stages of a business, informal finance is most suitable. However, as the business grows its financial needs increase beyond the reach of informal finance hence the call for alternatives.

The chapter will detail the most immediate alternative to informal finance being the micro finance credit which then is succeeded by bank credit. At maturity, the enterprise will most probably have exceeded the bank finance ceiling, or it will have engaged in long term planning making bank finance inappropriate. At this stage, if successful, the securities market becomes the solution to capital constraints.

## 3.2 The Classification of MSMEs

MSMEs in Kenya and world over are identified by their size in terms of turnover and workforce.[117] Under the Kenyan classification, micro enterprises make up 92% of MSME, small enterprises 7.1% and medium enterprises 0.7%. The KNBS data shows that 98% of business enterprises in Kenya fall within this category contributing to around 38% of the GDP.

In the KNBS basic report, 2016 MSMEs are discussed in two categories; licenced and unlicenced. Licencing is determined by registration with the National Government and the County government where they are issued with a trade licence to supply goods or services that they are engaged in. The segregation in terms of licencing reflects the growth stages of a business with most businesses transitioning from the unlicenced category into the licenced category once some traction is established in terms of profits and capacity. All of the unlicenced MSMEs fall into the micro enterprise category

[117] KNBS, 'Basic Report on Micro, Small and Medium Establishment (MSME) Survey, September, 2016.

while small and medium enterprises are made up of licenced Enterprises. 71.9% of licenced MSMEs source their funds from the proprietors' savings while 80.6% of unlicenced MSMEs sourced funds from their proprietors. In both categories, bank financing makes up a measly 5.6% for licenced MSMEs, and 0.8% for unlicenced MSMEs. This data is in tandem with researchers whose data confirms that about 6% of MSMEs sourced their capital from formal finance institutions while for the remainder, the sources are relatively undocumented.[118]

What the above data shows is that licencing introduces some level of enlightened governance in terms of how the enterprise is managed. This enlightened governance will include record keeping, skilled labour, formal workplace information which enhances chances of raising capital through debt. For formal financing there must be some level of governance that is acceptable to the banks. This would mean a registered business entity, a clear business plan and proper record keeping which determines the credit worthiness. For purposes of this thesis, the analysis will be limited to MSMEs generally without a further scrutiny between the licenced and the unlicenced.

The data established by KNBS shows that most MSMEs are constrained by lack of capital and expensive loans from formal financial institutions. This state of affairs is created by rigid lending practices that is experienced in the formal financial market and limited resources available in the informal financial markets. Studies taken on sources of capital indicates that small and micro enterprises prefer borrowing from banks because of the quantity of available credit, in preference for micro finance institutions and other informal lenders.[119] Only 48.8% of the MSMEs that apply for formal loans, were successful, while 61.8% of the unlicenced businesses that sought credit facilities from micro finance institutions were successful.[120] This data shows a significant half of MSMEs are unable to access credit from financial institutions and therefore equally risk closure for lack of capital. A deeper analysis of the data exhibits

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118 Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

119 Akoten J, Sawada Y, and Otsuka K, 'The Determinants of Credit Access and Its Impacts on Micro and Small Enterprises: The Case of Garment Producers in Kenya', 54(4) Economic Development and Cultural Change, July 2006, 927-944.

120 KNBS, 'Basic Report on Micro, Small and Medium Establishment (MSME) Survey, September, 2016.

MSMEs ignorance of the credit market as an impediment to participating in the credit market. KNBS reports that a significant 62% of MSMEs reported that they did not need credit, 16% reported that they did not know any lender and 12.3% reported that the cost of credit was too high. This data ties in with the reality that most researchers have found which revolves around mistrust between the would-be borrowers and the would-be lenders.[121]

The Chapter therefore proceeds from this quagmire into looking at the current sources of capital with a bias toward credit facilities. The chapter will analyse data prior to reforms in the commercial laws that may have created a platform for more opportunities to the MSMEs.

## 3.3 Sources of Borrowed Capital for MSMEs

### 3.3.1 Informal Finance of MSMEs

From the data by the KNBS, the MSMEs that benefit from formal finance accounts for a significantly low percentage.[122] This limited availability of debt capital from formal finance has a close link with the massive business failure related to unavailability of capital as reported by the KNBS. While formal finance is scarce, the void left by formal institutions is often filled by informal financing. The informal financing includes loans from family and friends, ROSCAS, informal lenders, informal business associations and other informal arrangements.[123]

The resort to the informal market is often a measure of last resort filling the gap that formal financial institutions create by unfavourable business practices that work against MSMEs.[124] Unlike the formal lending, the informal lending thrives on relationships and trust built through close interactions and knowing each other well which is prepacked as an alternative to collateral.[125]

It is particularly observed that informal finance is not hindered by the myriad challenges in form of poor record keeping, lack of tangible collateral and stringent

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[121] Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

[122] KNBS, 'Basic Report on Micro, Small and Medium Establishment (MSME) Survey, September, 2016.

[123] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[124]Adams D, 'Informal Finance in Low Income Countries: A Seminar Report'.

[125] Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

borrower profiling which is known to make formal finance a mirage. In their very nature, informal finance does not require stringent screening measures because participants already know each other. There are no transaction costs, there are no tangible collateral requirements and sanctions upon default are social rather than forceful deprivation of property.[126]

However, it must be appreciated that as much as informal lending is less bureaucratic, the lending capacity is usually subject to availability of funds making it an unsuitable source of capital.[127] The availability of funds is determined by the environment in which the parties are operating or the cumulative worth of the social network which makes informal finance unsuitable for long term growth of MSME's.[128] Since the availability of borrowed capital is dependent on the wealth of the lender, and with the data showing that majority of the MSMEs carry out their operations under the category of KES 50,000/- and below as working capital, it means the available funds are significantly low impeding sustainable growth. This indictment can be predicted from the understanding that the availability of capital is dependent on the company that the borrower keeps, if the borrower is engaging in a high end network, it is fair to assume that the informal market available to the borrower will significantly raise high amounts of capital.[129] Similarly, if the borrower is from a low end network, which most often is the case, then the reality is that the amount of capital available from the informal market will be significantly low. Data by the KNBS indeed reflects these unfortunate circumstances as 94% of unlicenced MSMEs and 57.2 licenced MSMEs can only afford KES 50,000/= as their working capital.

### 3.3.2 Microfinance Finance Institutions

Micro Finance Institutions (MFI) are established under the Micro Finance Act, 2006 which by definition are designed to carter for the MSMEs and low income households

[126] Schreiner M, 'Informal finance and the design of microfinance', 11(5) Development in Practice, November 2001.

[127] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[128] Kimuyu P, and Omiti J, 'Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya'.

[129] Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

that have no access to formal lenders like banks.[130] MFIs in Kenya are divided into two, deposit taking and non-deposit taking.[131] Deposit taking institutions are subject to more stringent regulations which are aimed at protecting the depositors to deter risky engagements under the supervision of the Central Bank of Kenya.[132] Non deposit taking institutions enjoy a more relaxed supervision however they only trade with their own monies and are supervised by the Ministry of Finance. Deposit taking MFIs are generally prohibited from trading in non-core banking activities like wholesale and retail trade, land sale, insurance business, sale of securities among others.[133]

Micro finance in Kenya is made up of institutions that are often community based, geographically centred and in some cases backed up by donor funding.[134] This attribute means that they are designed to alleviate certain ailments like poverty and therefore profit is never their primary concern. This eventuality then makes them less stringent in terms of lending, but their risks are reduced through lending matrices that are dependent on a member's savings.[135]

Most microfinance institutions develop their funding models through building capacities for the MSMEs with the aim of improving governance structures, business acumen and building an attractive business profile that is attractive to other lenders. Researchers link firms that receive credit to improved corporate governance structures and feasible business models which then unlocks greater potential for growth as their credit capital pool increases.[136] These qualities, if developed then become an attractive package for formal finance since risks are reduced and may allow for transitioning into the bank market where the resources available are on a larger scale. It is for these reasons that products have to be developed with close monitoring and supervision so that the culture of no records, lack of expertise, poor business ethics are mitigated.

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[130] Ali A, 'The Regulatory and Supervision Framework of Microfinance in Kenya', 3(5) International Journal of Social Science Studies, 2015.

[131] Section 3, Micro Finance Act, 2006.

[132] Section 8, Micro Finance Act, 2006.

[133] Section 14, Micro Finance Act, 2006.

[134] Ali A, 'The Regulatory and Supervision Framework of Microfinance in Kenya'.

[135] Akoten J, Sawada Y, and Otsuka K, 'The Determinants of Credit Access and Its Impacts on Micro and Small Enterprises: The Case of Garment Producers in Kenya'.

[136] Atieno R, 'Linkages, access to finance and the performance of small-scale enterprises in Kenya'.

A key feature of microfinance lending most often is that tangible collateral is replaced with a credit guarantee scheme where members of a cluster guarantee each other.[137] This system is based on the success of Grameen Bank in Bangladesh.[138] The CBK reports that there are currently 13 licenced Micro Finance Banks (MFBs) namely *Faulu* Kenya MFB, Kenya Women MFB, SMEP MFB, REMU MFB, Rafiki MFB, Century MFB, SUMAC MFB, Caritas MFB, Maisha MFB, *Uwezo* MFB, U&I MFB *Daraja* MFB and Choice MFB.[139]

There have been projects that have targeted the MSMEs sector to some considerable success. Kenya Rural Enterprise Program (K-REP) is one model that was successful in substituting tangible collateral with a collective collateral where the participants in the program a guaranteed each other. It was built upon deliberate incubation of the business through assistance in developing the business idea, working out on viable models, drawing up proposals that were vetted by the lender, and habitual repayment increased the borrowers credit threshold.[140]

Sidian Bank (formerly K-REP) is recognized as a growing bank that entered into the financial arena in 1984 as a nongovernmental organization with the objective of supporting MSMEs which move helped break even the difficulties of MSMEs accessing capital from formal financial institutions.[141] The K-REP micro finance model involved deploying highly trained individuals to MSMEs with the mandate of orienting their proprietors on how to package their businesses in a manner that is sustainable and attractive to lenders.[142] The project was started as '*Juhudi* Credit Scheme' in Kibera and Eldoret with vetting, training and then lending.[143] The loans would be secured by

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[137] Schreiner M, 'Informal finance and the design of microfinance'.

[138] Schreiner M, 'Informal finance and the design of microfinance'.

[139] CBK, 'Consultative Paper on the Review of the Microfinance Legislations, 2018', https://www.centralbank.go.ke/wp-content/uploads/2018/02/CONCEPT-PAPER-ON-REVIEW-OF-THE-MICROFINANCE-LEGISLATION-1.pdf 2 February 2020.

[140] World Bank, 'Scaling Up Poverty Reduction Analytical Case Study'.

[141] Oiko Credit, Sidian Bank Limited; More support for micro-, small and medium enterprises in Kenya https://www.oikocredit.coop/what-we-do/partners/partner-detail/10493/sidian-bank-limited 28 January 2020.

[142]World Bank, 'Scaling Up Poverty Reduction Analytical Case Study' http://web.worldbank.org/archive/website00819C/WEB/PDF/CASE_-45.PDF

[143] Humle D and Mosley P, 'Finance against poverty, Vol 1, Routledge, 1996.

the group collectively which then gave the participants the incentive to make sure that no one defaults which is similar to a formal credit guarantee system.[144] The participants would be charged some membership fee, loan application fee, insurance fund fee and a pass book fee which would then sieve out busy bodies. The model also had a savings platform which encouraged a savings culture sweetened by the incentive of increasing the available credit depending on amounts saved.

K-REP was able to transition into an NGO in the 1990's and later on into a Microfinance and eventually into Sidian Bank which is ranked by Central Bank as a tier III bank.[145] This transition was only viable because the product offered by K-REP was tailormade along the peculiar characteristics of the MSMEs. This allowed the substitution of tangible collaterals with behaviour being packaged into a guarantee that could be traded. This approach seems to be the approach that mobile lending platform are based since that data on repayment of the loans determines whether to unlock higher potential which acts as an incentive to repay the loan hence a tangible collateral substitute.

The K-Rep Bank story is similar to the *SaveSafe* in Bangladesh which encourages its members to save by collateralizing their savings for loans, allowing the clients to borrow up-to one and a half times the savings.[146] The loans granted have no shelf life provided the monthly interest is repaid.[147]

The government in appreciating the potential that micro finance has in solving the capital constraint experienced by MSMEs has set out policy frameworks that seek to create a thriving environment for micro finance institutions.[148] The CBK has proposed a revision of the legal and regulatory frameworks so as to unlock the full potential of the MFIs.[149] The taking of deposits is in line with micro finance model of lending based on savings which not only funds MSMEs but entrenches a savings culture.

[144] Atieno R, Linkages, Access to Finance and the Performance of Small-Scale Enterprises in Kenya'.

[145] Sidian Bank, 'Our History' <https://www.sidianbank.co.ke/about-us/#our-history> 28 January 2020.

[146] Schreiner M, 'Informal finance and the design of microfinance'.

[147] Schreiner M, 'Informal finance and the design of microfinance'.

[148] Micro Finance Act, (Act No. 19 of 2006).

[149] Draft Micro Finance Bill, 2019 <https://www.centralbank.go.ke/wp-content/uploads/2019/05/Draft-Microfinance-Bill-2019.pdf> 2 February 2020.

Although micro finance presents viable business models, their structures too have limitations that have prevented them from solving the capital constraint issues in the MSMEs market. There MFIs have also experienced turbulent times which has resulted in decline from 73.6 billion to 69 billion in assets by December 2017 attributed to reduction in financial income.[150] Pegging loan disbursement on savings means that a good proportion of MSMEs are locked out of the credit market and they have to find alternative sources until they are able to save a significant portion of what they intend to borrow.[151] They have limited resources because of the heavy reliance on deposits also means that the amount of lending is limited to what is available as core capital.[152] By their design and operations, MFIs are unable to replace the banking industry which makes them supplements as opposed to MSMEs core source of capital.[153]

### 3.3.3 Bank Finance

Bank finance in Kenya carries the greatest potential to capital constraints that MSMEs experience, however, as researchers contend, banks shun lending to MSMEs because of the inherent risk of default. The risk of default or non-repayment is what financial experts refer to as credit risk which drives the necessity of lending on the basis of collateral.[154] The collateral is further limited to mostly land based assets which further segregates start-ups and makes the reality of bank finance a mirage. For the few who can manage to string land based collateral, the cost of perfecting the security revolves at around 5.7% of the amount of loan to be disbursed, and the costs are directly passed on to the borrower.[155] 5.7% of the value of the facility is such a significant amount that it effectively reduces the available or working capital if the loan is disbursed to the borrower, and coupled with equally high security enforcement costs, banks will always levy interest at very high rates to protect themselves from onerous transactions.

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[150] CBK, 'Consultative Paper on the Review of the Microfinance Legislations, 2018'.

[151] Akoten J, Sawada Y, and Otsuka K, 'The Determinants of Credit Access and Its Impacts on Micro and Small Enterprises: The Case of Garment Producers in Kenya'.

[152] Section 17, Micro Finance Act, (Act No. 2006).

[153] Ali A, 'The Regulatory and Supervision Framework of Microfinance in Kenya', 3(5)International Journal of Social Science Studies, 2015.

[154] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?, Kenya Bankers Association Working Paper Series no. 3 of 2012 (WPS /03/12).

[155] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?.

Collateral is a vital factor for lending transactions and has been identified as a major impediment to bank finance as a source of capital for MSMEs.[156] Researchers agree that there is over reliance on tangible collateral which limits debt trading resulting in a loss for all participants.[157]

Researchers who have studied small and medium enterprises report that based on the current banking products, only 40% of the banks understood the small and medium enterprise market and attempted to tailor make some products targeting this market.[158] This conclusion was made after sampling the products that were on offer, and the banks understanding of SMEs which supports the reality that SME market and its potential are unknown to a majority of the banks. FSD researchers particularly note the disconnect between advertised products and the ignorance by bank employees who are meant to be selling the product. In their research they return a sorry verdict indicting banks for preaching what they don't drink. This research tells of the lip service that banks give while marketing with colourful websites, detailed brochures, huge marketing portfolio but very little research on the MSMEs market segment and fairly no differentiated products designed to exploit the peculiar nature of MSMEs.

The information asymmetry goes two ways as banks have very little information on their potential customers, while the customers equally have very little information on the bank products.[159] Lenders mitigate this information asymmetry through high interest rates while for the borrower the risk is mitigated by overcollateralizing their assets.[160]



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[156] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?.

[157] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?.

[158] FSD Kenya, 'Testing SME banking in Kenya – a mystery shopping exercise. Nairobi, Kenya' FSD Kenya,(2016) <https://s3-eu-central-1.amazonaws.com/fsd-circle/wp-content/uploads/2016/11/30092330/16-11-24-Testing-SME-banking-in-Kenya-a-mystery-shopping-exercise.pdf> 2 February 2020.

[159] KNBS, 'Basic Report on Micro, Small and Medium Establishment (MSME) Survey, September, 2016.

[160] Anyieni A, 'SME's access to credit, a case of Kisii county –Kenya'.

KBA has made tremendous efforts in trying to bridge the gap between MSMEs lack of capital and availability of capital. There are deliberate efforts to make the field even for purposes of giving MSMEs a chance to survive through the *Inuka* Enterprise Program which was launched in 2018.[161] The program takes a different approach from traditional banking and involves setting up hubs where the MSMEs capacity building is enhanced through training, coaching and networking. The *Inuka* program is a joint effort made up of stakeholders from different sectors of the economy through their associations (Kenya Institute of Management, Kenya National Chamber of Commerce and Industry and the Kenya Association of Manufacturers). The training includes how to effectively increase their production and market their products. KBA uses City Bank's 'City Foundation' and TechnoServe 'Smart *Dukas'* program and Kenya Commercial Bank's *2jiajiri* which are all aimed at building the capacity for MSMEs.[162] Kenya Commercial Bank's '*2jiajiri'* program targets youths through an upskilling program where they are given scholarships to boost their technical skills; while for already existing micro entrepreneurs business skills, the program uses discounted credit products and linkages to market and industry.[163] City Foundation and TechnoServe 'smart *dukas*' targets small retail shops emulating similar efforts in the Latin Americas.[164]

The move by banks is in line with the realisation that the market involves different structured borrowers with different abilities hence one size fits all locks out a significant portion of credit worthy MSMEs.[165] This programs tend to mimic the microfinance model where the Banks try to establish some prudentially sound patterns that guarantee that the money lent is used to fund the business and that there are actual returns with the project. Some banks are known to offer non-financial services

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[161] Karumba M, and Wafula M, 'Collateral Lending: Are there Alternatives for the Kenyan Banking Industry?'.

[162] Karumba M, and Wafula M, 'Collateral Lending: Are there Alternatives for the Kenyan Banking Industry?'.

[163] Kenya Commercial Bank Foundation, '2jiajiri overview' <https://kcbgroup.com/foundation/programs/2jiajiri/?program=2jiajiri >1 February 2020.

[164] TechnoServe, 'Smart Duka: Empowering Shopkeepers in Nairobi' <https://www.technoserve.org/our-work/projects/smart-duka-empowering-shopkeepers-in-nairobi/> 1 February 2020.

[165] Kimuyu and Omiti, 'DP No. 026/2000'.

to the customers which include marketing opportunities for their clients through their business hubs, advisory services through dedicated business relationship managers, some even offer training services that are designed to build the capacity of the MSMEs.[166]

These prudentially sound business practices are an improvement from the microfinance model since it involves some level of proper book and record keeping practices, viable proposals that are approved by the bank, regular supervision and monitoring, lending based on savings. As a starting point, when exercising the 'know your client' practices, it is a standard in the banking industry that they will require the certificate of incorporation, Kenya Revenue Authority personal identification number, identification documents for the proprietors, documents of incorporation (CR 1, CR 2 and CR8 for companies, BN2 for sole proprietors, partnership deeds for partnerships etc), passport photographs for the proprietors, telephone contacts, email addresses, postal addresses, place of doing business, trade licences amongst others depending on the industry the business is involved in.

While the banking industry appeared to have embraced the MSMEs, there have been challenges that have been blamed on state policies in the banking industry.[167] The most significant one has been the interest rate capping introduced in 2016 through Banking (Amendment) Act to introduce section 33B into the Banking Act which effectively limited the lending interest to 4% above the base lending rate set by the Central Bank of Kenya.[168] The interest rate cap was a reaction by Parliament to high interest rates that MSMEs were exposed to which at the time was thought to be a positive legislative measure to save MSMEs from high interest rates that has always

[166] FSD Kenya, "Testing SME banking in Kenya – a mystery shopping exercise. Nairobi, Kenya' FSD Kenya, (2016)'.

[167] Safavian M, Zia B, 'The Impact of Interest Rate Caps on the Financial Sector: Evidence from Commercial Banks in Kenya', Policy Research Working Paper 8393, April 2018. http://documents.worldbank.org/curated/en/681501522684167817/pdf/WPS8393.pdf 2 February 2020.

[168] Banking (Amendment) Act (Act No. 25 of 2016).

been a hindrance to their growth. The introduction of interest rate capping became such a controversial topic that litigation on the same ensued.[169]

In a survey done by KBA, it was reported that the interest capping introduced by government in September 2016 and lifted in 2019 severely affected lending to MSMEs.[170] The data collected from 32 banks with a financial market footprint of 80% showed a steady decline in lending to MSMEs during the first year after the interest rate cap by about 10%.[171] Prior to the interest rate cap, bankers had estimated an annual increase of the MSME portfolio by 14%, which was effectively reduced to 6% after the interest rate cap translating to a reduction in bank lending to MSMEs by 5.7%. Banks during that period refocused their market and took advantage of governments appetite for loans further exposing the MSME sector to capital starvation.

### 3.3.4 Stock Market Finance

MSMEs that are able to meet the banking requirements for a loan, the securities market offers an opportunity for long term financing through products specifically designed for the small and medium enterprises.[172] The Capital Markets Authority (CMA) derides its products on shortcomings of bank finance which have been reproduced above but summarised as restrictive lending, over-reliance on collateral, high costs of credit, information asymmetry and risk averseness. In the life cycle of a business, accessing the stock market shows the growth of the business from a micro enterprise with poor corporate governance to maturity into a medium sized business enterprise with sophisticated governance that is attractive to participants of a sophisticated market.[173] Micro enterprises are not considered in this section because

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[169] Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties) [2019] eKLR

[170] Kenya Bankers Association, 'Kenya banking value shared report 2019' 25 August 2019 <https://www.kba.co.ke/downloads/The%20Kenya%20Banking%20Industry%20Shared%20Value%20Report%202019.pdf > 26 August 2019.

[171] Alper C, Clements B, Hobdari N, and Porcel R, 'Do Interest Rate Controls Work? Evidence from Kenya'.

[172] Capital Markets Authority, 'Capital Raising opportunities for SME's; The development of Micro-cap securities markets in Kenya.

[173] Mela M, Patel A, Turner S, and Wells S, 'Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya's capital market by small and medium enterprises (MSMEs)' 2015, FSD Kenya.

of the sophistication of the securities market which has requirements such as setting the minimum number of shareholders for the Growth Enterprise Market Segment to 15.

The view by CMA is in consonance with researchers who appreciated that bank finance where available does not offer the appropriate solutions and that the securities market could bridge the financing gap particularly for long term capital solutions.[174] Most emerging security markets have thus attempted to create products that are favourable for small enterprises as a way of raising capital.[175] As CMA observes, at a certain point an enterprise exhausts its debt book limits and therefore becomes risky to the banking industry hence the necessity of equity capital of which the securities market is the answer.

The Government of Kenya has set up policies that seek to open up the securities market as a source of capital to supplement other forms of formal finance. The CMA has set up the Growth Enterprise Market Segment (GEMS) in response to opening the securities market for small and medium enterprises.[176]

GEMS is an addition to the already existing bond market and Over The Counter (OTC) trading market are not so popular with small and medium enterprises seeking to raise capital because of the limited knowledge and information on the same and the asset backed securities in some segments which don't have.[177] As at the time of its introduction into the market in 2011, there were 13 medium sized enterprises that had taken advantage of this opportunity.[178]



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[174] The East African Newspaper, 'Kenya launches trading floor for small businesses' 22 January 2013 https://www.theeastafrican.co.ke/business/Kenya-launches-trading-floor-for-small-businesses/2560-1672302-123mcjn/index.html 2 February 2020.

[175] Accountants For Business, 'Connecting capital markets: the Nairobi securities exchange growth enterprise market segment' https://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-afb-nsegem.pdf 2 February 2020.

[176] Accountants for Business, 'Connecting capital markets: the Nairobi securities exchange growth enterprise market segment'.

[177] Capital Markets Authority, 'Capital Raising opportunities for SME's; The development of Micro-cap securities markets in Kenya.

[178] Gachiri J, 'Vibrant over-the-counter market lists 13 new firms', Business Daily, 26 October 2011 <https://www.businessdailyafrica.com/markets/Vibrant-over-the-counter-market-lists-13-new-firms/539552-1262376-hyn5qyz/index.html>.

Even though in Kenya there are proposals to amend the Capital Markets Act, to make it easier for MSMEs to facilitate trading in fixed income securities[179], very little is known about this market segment for MSMEs. The market remains underdeveloped and information elitist.[180]

The growth enterprise market segment however portends the greatest opportunity for small and medium enterprises raising long term capital at the securities market. The decision to create different listing boards was derived from the realisation that the onerous listing condition for the main boards was too far a reach for small and medium enterprises in the securities markets.[181] There have been steady reforms with the introduction of this market segment with the adoption of a 10 year master plan that seeks raise the Kenyan Capital Market to Emerging Market status by the year 2023.[182] The regulations requirements in the GEMS segments has been relaxed slightly compared to the main market a move that is deliberate to make compliance for MSMEs achievable.

Studies have also revealed that there are benefits that come with listing; the most significant being brand reputation which increases investors interest.[183] While the reputation of the SME improves, the Capital Market Scrutiny increases corporate governance structures which has a positive effect in the management translating business growth.[184] With increase in security market liquidity, foreign investors will

[179] Capital Markets Authority, 'policy/tax incentives granted from 1995 to date'.

[180] Mela M *et. al.,* 'Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya's capital market by small and medium enterprises (MSMEs)' 2015.

[181] African Securities Exchanges Association (ASEA), 'Capital raising opportunities for Small and Medium Enterprises (MSMEs) on stock exchanges in Africa'.

[182] Awino M, 'How NSE's growth enterprise market segment can help drive the economy' 2019, Business Daily Newspaper 26 June 2019 <https://www.businessdailyafrica.com/analysis/ideas/How-NSE-Gems-can-help-drive-the-economy/4259414-5172696-plcnsj/index.html>.

[183] ASEA, 'Capital raising opportunities for Small and Medium Enterprises (MSMEs) on stock exchanges in Africa'.

[184] Mela M *et. al.* 'Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya's capital market by small and medium enterprises (MSMEs)'.

be drawn closer increasing the growth potential of the securities market as a viable alternative or supplement to bank finance.[185]

It must be appreciated that the securities market is not an all rosy affair. For a company to be able to participate in the GEMS market, it must diversify its ownership by having at least fifteen shareholders, if it has less, then it is subject to be locked in for two years. This condition is meant to make sure that there is no abuse by directors and shareholders which may expose investors. The directors of the company must undergo training for a period of two years. This is meant to test the competency of the directors and to offer induction into the securities market. The company must also appoint nominated advisors who not only assist with listing but also in effective corporate governance monitoring since they become personally liable in the event of abuse of the market.

## 3.4 Chapter Summary

This chapter has interrogated the available sources of debt capital that can be used for the MSMEs in Kenya. In all the options interrogated, there are shortcomings that have left MSMEs still capital constrained. The chapter has been able to demonstrate that the current business practices do not favour MSMEs.

In a vibrant debt market, MSMEs should be in a position of choosing the most suitable option or even combining the various modes of finance depending with its needs at the time. A critical shortfall of micro finance, bank finance and securities market is on how to protect the participants. How to set up systems that while unlocking the credit potential for the benefit of the MSMEs does not expose the lenders.

The data outlaid above shows that collateral still serves an important aspect of credit finance, however there may be other options of increasing the collateral pool that would be beneficial to the MSMEs. The next chapter will explore the Kenyan legal framework and the changes which offer a promise of market confidence in trading in intangibles.

[185] Outa E, Waweru N, and Ozili P, 'Security market regulation: antecedents for capital market confidence in frontier markets'.

# 4 The Legal Framework for Intangible Collateral

## 4.1 Introduction

In the previous chapter, this thesis set out to analyse the factual lending environment in Kenya and concluded that amongst the reasons that MSMEs are starved of debt capital is the structure of the current lending infrastructure that is heavily dependent on tangible collateral.[186] This chapter will open the discussion with an attempt of expanding the scope of collateral by suggesting that incorporation of intangible assets will widen the scope of available security by MSMEs and increase capital flow to the sector. The chapter will focus on collateral that have not found favour with the credit market such as inventories, accounts receivables and other intangible assets and show that there is a legal framework that supports the shift.[187]

## 4.2 The Framework for Collateral in Kenya

As researchers do contend, property 20 years ago does not carry the same meaning with property today.[188] Factually the legal concept of property has been expanding from things that can be physically described to things that have no physical attributes but have generic attributes if viewed from the perspective of their ownership. It is appreciated that there is a systemic shift away from physical possession whose limitations and scarcity accounts for the limited lending to MSMEs. This systemic shift on the understanding of collateral explains why the Moveable Property Security Rights Act, takes a descriptive approach towards collateral as opposed to the definitive or static meaning attributable to real property.

Financial institutions in Kenya are reported to be over reliant on collateral with 90% of enterprises stating that availability of collateral is amongst the conditions precedent

[186] Karumba M, Wafula M, 'Collateral Lending: Are there Alternatives for the Kenyan Banking Industry?.

[187] National Law Centre for Inter-American Free trade, 'Securing credit for growth: The case for a new asset register in Kenya, FSD Kenya, 2014.

[188] Lipton J, 'A revised 'property' concept for the new millennium?', 7 (2) Int J Law Info Tech (1999) 171

to being granted a loan.[189] The two most common forms of collateral in Kenya are machinery and land heavily disadvantaging MSMEs who don't possess this type of collateral in their formative years.[190] For machinery and other moveable collateral security used to be created through a debenture, hire purchase agreement or chattels mortgage and land where security is created through a charge or a mortgage.

Charges on land are governed by the Land Act where it is defined as an interest in land that secures the repayment of money or fulfilment of any other obligation.[191] A charge on land is perfected by registration which grants the *chargee* the power of foreclosure independent of court sanction making it a suitable security for lending.[192] For an informal charge, the *chargee* can only enforce the right to foreclose through court action,[193] a characteristic that makes it unfavourable to lenders.

In terms of moveable properties prior to 2017, the conventional forms of collateral were, chattels mortgage for individuals, debenture for companies and hire purchase. These moveable securities have however been redefined under the Moveable Property Security Rights Act which has radically changed the scope of collateral with the aim of making them more appealing to the lenders.

The most comprehensive policy reform is the enactment of the Moveable Security Property Security Rights Act, 2017 which will be the subject of this chapter. The chapter will analyse the changes that are presented by the reforming of the entire business landscape through the repeals to the Chattels Transfer Act (Cap 28) and Pawn Brokers Act (Cap 529), and amendments to the Agricultural Corporation Act (Cap

[189] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?.

[190] Karumba M, Wafula M, 'Collateral Lending : Are there Alternatives for the Kenyan Banking Industry?.

[191] Section 2, Land Act, (Act No. 6 of 2012).

[192] Section 56, Land Registration Act (Act No. 3 of 2012).

[193] Section 79, Land Act, (Act No. 6 of 2012).

323), Business Registration Service Act (Act No. 15 of 2015), Companies Act (Act No. 17 of 2015) and Insolvency Act (Act No. 18 of 2015).[194]

Under the Moveable Property Security Rights collateral is defined to mean a security right in a moveable asset or a receivable capable of being transferred.[195] A security right is given a descriptive meaning as an interest in a moveable asset created expressly or impliedly to secure a repayment obligation.[196] A moveable asset is defined to be any tangible or intangible asset. From the foregoing, the intention of the drafters is to avoid any exclusive definition but adopt a descriptive approach that looks into the future. This approach captures the characteristics of property as opposed to trying to define property.

Researchers underscore that the very definition of collateral underpins the difficulties that expose MSMEs to limited credit. It is therefore proposed that the scope of collateral can be expanded to allow grantors substitute tangible collateral with other viable arrangements that act as collateral substitutes.[197]

## 4.3 Intangibles as Collateral

Kenya has been ranked second in the world for pursuing business reforms that are aimed at improving the ease of doing business.[198] The ease of doing business is not only centred on registration but it goes beyond, as statutes have been reviewed to create an environment where business thrives. It is now easier to register a business enterprise than it was 10 years ago. Establishing the Business Registration Service (BRS),[199] has reformed data collection making it easier for lenders to collect reliable data before engaging in any credit transaction.[200]

[194] Section 94, Movable Property Security Rights Act, (Act No. 13 of 2017).

[195] Section 2, Moveable Property Security Rights Act (Act No. 13 of 2017).

[196] Section 2, Moveable Property Security Rights Act (Act No. 13 of 2017).

[197] Balkenhol B, and Schütte H, 'Collateral, Collateral Law and Collateral Substitutes'.

[198] Gathuma K and Mwakio S, 'Reforms in The Ease of Doing Business in Kenya.

[199] Section 3, Business Registration Service Act, (Act No. 15 of 2015).

[200] Section 4(2)b, Business Registration Service Act, (Act No. 15 of 2015.

The BRS registry has digitalised records making it easier for enterprises to get registration as well as give interested parties room for verifying registration details and other business specific data like availability of an asset for security purposes.[201] Formal lending institutions in Kenya have a set of prerequisites that are conditions precedent to establishing a business relationship. The requirements are generally industry standard and the first port of call is registration. Sole proprietors and unlimited partnerships are registered under the Registration of Business Names Act. Partnerships with limited liability are registered under the Limited Liability Partnerships Act while companies are registered under the Companies Act, 2015.

The Moveable Property Security Rights Act anticipates the reality that most enterprises have assets in moveable properties than real property. It is for this reason that the lot of intangible assets is defined to include *receivables, choses in action, deposit accounts, electronic securities and intellectual property rights*.[202] The objective of the MPSR Act is to ease access to credit by creating security rights.

### 4.3.1 Creation of a security right over an intangible asset

A security right in an intangible asset is created through an agreement which must be in writing, identifies the parties, signed by the grantor, defines the asset with precision and describes the obligation.[203] These requirements are necessary as it determines whether the security is enforceable. If any of the conditions set out above is absent, then the creditor will have to resort to the court procedures which defeats the intention of creating a security.

Security rights over intangible assets can be attach in four ways. It may be on the whole part of the specific intangible asset, on a part of a specific intangible asset or on a portion of or the whole of the debtors assets including the intangibles.[204] The security rights can also be futuristic meaning that parties can create instruments that crystallise at the happening of an event or with a future asset in mind like a floating

[201] Gathuma K and Mwakio S, 'Reforms in The Ease of Doing Business in Kenya.

[202] Section 2, Moveable Property Security Rights Act (Act No. 13 of 2017).

[203] Section 6(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[204] Section 7(2), Moveable Property Security Rights Act, (Act No. 13 of 2017).

lien or a floating debenture or a floating charge depending on the registration model of the business.[205] A grantor could also assign rights in a transaction which it is expected to receive a benefit by having his interest in that transaction identifiable and packaged as a security right.[206] What this means is that a grantor may pledge its right to receive a premium over services rendered or goods supplied directly to a creditor and that right can be attached when the circumstances of attachment arise. This type of security right can also be viewed in the sense of granting a creditor the right to demand a debt from a grantors' creditor without having to resort to garnishee proceedings.

In the case of intellectual property and other assets which generate income then the creditor will have the right to receive premiums or royalties or profits directly out of the use and enjoyment of the asset.[207] However if the security right has been created on the proceeds and not the intellectual property or other income generating asset, the right to receive premiums or proceeds of an intellectual property will not extend to intellectual property. The lenders interest will be limited to the proceeds of the asset secured.

### 4.3.2 Perfection of a Security Right Over an Intangible Asset

In order for a security right in an intangible asset to be effective, it must meet certain prerequisites. The security right must be registered with the registrar at the collateral registry.[208] The act of registration is so important in intangibles because it serves as notice to third parties[209] and also determines the question of priority which is so central to efficacy of using an intangible asset as security.[210] This is so because intangible assets are not possessory therefore registration is the only way of giving the whole world notice of a creditors interest in the asset.

[205] Section 7(1), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[206] Section 12, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[207] Section 16, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[208] Section 16, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[209] Section 29, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[210] Section 38, Moveable Property Security Rights Act, (Act No. 13 of 2017).

The intricacy of notices is best appreciated when interrogating the concept of acquisition rights. Acquisition rights in an intangible asset is the security right that arises when a creditor supplies credit for the purpose of acquiring the asset.[211] An example of an acquisition right in action is where a grantor has been funded to develop and invention that is later pledged as security. For the initial creditor to have priority over the second creditor who comes when the asset is already existing, it must have registered its interest first before the asset was pledged to the second creditor.[212]

The notice registered has a life span of ten years, which means that the creditor and the grantor must have their security arrangements align to the ten year period lest the creditor discovers exposure after the period.[213] The notice once registered must be sent to the grantor and the person registering the notice (in most cases the creditor) because he carries the risk of loss.[214]

The registration system also allows for the right to amend the records whenever circumstances change.[215] This may come in the form of tacking where there are additional advances involving other creditors or where there is substitution or even transfer of the security right to another creditor. Amendments may also arise with regard to the time capsule marking the life of a security right with an allowance of registering an extension for a further period of ten years within the last six months of the first term.[216]

There are circumstances which call for the right to amendment of information at the registry for the protection of the grantor.[217] This situation includes change of circumstances that may have rendered the security right void. An example would be where the security transaction has fallen through or where the debtor is able to

[211] Section 2, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[212] Section 47, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[213] Section 30, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[214] Section 31, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[215] Section 32, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[216] Section 31(2), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[217] Section 33 and 57, Moveable Property Security Rights Act, (Act No. 13 of 2017).

demonstrate that the registration was without its approval.[218] The grantor may also establish that it has repaid the amount lent or that circumstances have changed such that some of the assets secured have been discharged from the security arrangements.[219] The creditor in this circumstance has to register the changes failure to which the registrar will be obligated to reflect the changes in the registry.

For orderly effectiveness of the amendments, the grantor will have to first notify the creditor of the impending change and only after the creditor declines to make the appropriate amendments within 10 days, will the grantor be entitled to move the registrar for the amendment or changes.[220] Where the registrar is moved by the grantor, the registrar has to give the creditor the chance to be heard by issuing a notice before any adverse action.[221] Once the registrar has made the amendments or refused to make the amendments, recourse to the dissatisfied party lies in a court of competent jurisdiction.[222]

### 4.3.3 Enforcement of Security Rights

The enforcement of a security right is contemplated under two circumstances, the first is by exercising the rights in the security agreement and the second is by seeking courts assistance in the enforcement.[223] Where the creditor is enforcing a security right, the process commences with a notice to the grantor specifying the nature and extent of the default, the time for repayment if the default is non-payment or the time for remedying a breach if the default is a breach of covenant or warranty, and the impending action in the event of failure to remedy the default.[224] The notice must also

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[218] Section 33(2), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[219] Section 60, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[220] Section 33(4), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[221] Section 33(5), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[222] Section 33(6), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[223] Section 66, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[224] Section 67, Moveable Property Security Rights Act, (Act No. 13 of 2017).

be sent to the borrower and other creditors if present and it must be at least five working days to the impending enforcement action.[225]

The creditor must also notify the grantor of its right to apply for reliefs in court.[226] The issue of notice and the contents of the notice is vital to the enforcement process because failure to comply with the requirements entitles the grantor to seek reliefs from the court. Even where the grantor is in default, the grantor will be entitled to injunctive reliefs until the creditor complies with the provisions that seek to protect the grantor from arbitrary and capricious exercise of enforcement rights of the creditor.[227]

Enforcement rights include but are not limited to the creditors right to sue for the payment that is due and owing, the right to administer the asset, the right to sell the asset and the right to do any other thing as provided for in the security agreement.[228] In administration of the asset, the creditor is entitled to dispose, lease or generally grant user rights to a third party depending on the nature of the intangible asset.[229] The enforcing creditor may also acquire part or whole of the security right subject to carrying out the transaction at arm's length and with the appropriate notice to the grantor, other persons with rights in the secured asset and other secured creditors in place.[230] The transaction or mode of enforcement preferred must be through a transparent process aimed at obtaining the best value of the security right either by a public auction or private treaty where there are justifications premised on the trade customs and practice of that particular asset.[231] Where the enforcement realises a surplus, the creditor must account for the surplus in the following priority; settling any reasonable costs of realising the security, settling the sums due, settling other

[225] Section 73, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[226] Section 67(2)e, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[227] Sheng Shuang Quarry Limited v National Industrial & Credit Bank Ltd [2019] eKLR

[228] Section 67(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[229] Section 72, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[230] Section 75, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[231] Section 72(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

subordinate secured claims where the holder of such a claim has made a demand for the proceeds prior to the distribution.[232] For the subordinate secured creditor, there must be proof to the satisfaction of the senior creditor and where the senior creditor is in doubt, it can deposit the surplus in court.[233] Where the enforcement results in a shortfall of the amounts that are due and owing, the creditor is entitled to pursue the grantor for the balance.[234]

The secured creditor enforcing security rights must always act in good faith and with some level of prudence putting into use its best commercial judgment. In an arm's length credit transaction, a creditor is entitled to look out for its own interest and not to be a trustee for the guarantor.[235] However, failure to act prudentially and in good faith exposes the enforcing creditor to court sanction.[236]

The grantors right of redemption subsist until the property is sold. The grantor is entitled to remedy the breach at any time prior to the disposal of the asset.[237]

## 4.4 Creation of a Collateral Registry

The success or failure of the acceptance and use of an intangible asset is dependent on the limitation of risks that the grantor in possession creates. As noted in this chapter, intangible assets are non-possessory, therefore a creditor substitutes possession with a registrable interest. An asset registry becomes more useful as it makes due diligence by the lender practical and achievable since it serves as notice to prospective creditors on the availability of an asset.



[232] Section 74, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[233] Section 74(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[234] Section 74(4), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[235] Sunil Chandulal Shah & 3 others v I & M Bank [2018] eKLR in this case a debtor sued the bank for failure to exercise its right of sale of the debtors shares at a time when prices were good. Justice Tuiyott however declined to have the debtor have his way by applying the a dawn age principle that a mortgagee is never a trustee for a mortgagor.

[236] Section 76(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[237] Section 69, Moveable Property Security Rights Act, (Act No. 13 of 2017).

In Kenya, one of the challenges that parties have had to contend with is the integrity of collateral registries.[238] There have been situations where the data obtained from the registry is not accurate which has led to massive exposure to players in the industry. The lenders have at times been caught up in suits that have rendered their security rights unenforceable against conniving debtors exposing the lenders to massive losses. [239]

There is now a well functioning digital registry under the management of the Business Registration Service with the mandate of carrying out registrations, maintaining the registers, data and records at the registry.[240] The registry is headed by a registrar who has the mandate of receiving, storing and making public notices that affect security rights.[241] The registrar is under a duty to secure the integrity of the registry with a prohibition against altering the records at the registry without being appropriately moved by an interested party.[242]

Prior to 2015, Kenya had a manual registry system housed at the office of the Attorney General which served as a collateral registry. The registry was known for great risks including loss of documents, delay in registration, difficulties in documenting time of registration which factors have been blamed for increasing the costs of credit.[243]

Currently, the registration system in Kenya is central to viability of intangible assets as collateral since the failure to register as security interest subrogates the security in favour of a later but perfected security right.[244] The aspect of registration is so important that a subsequent creditor is allowed to defeat the priority of the first creditor where registration is done with the knowledge of the existence of the

[238] Gathuma K and Mwakio S, 'Reforms in The Ease of Doing Business in Kenya.

[239] Commercial Bank of Africa v Wardpa Holdings Limited & 7 others [2019] eKLR

[240] Section 4(2)a) and b), Business Registration Service Act, (Act No.15 of 2015)

[241] Section 19, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[242] Section 20, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[243] National Law Centre for Inter-American Free trade, 'Securing credit for growth: The case for a new asset register in Kenya, FSD Kenya, 2014.

[244] Section 15, Moveable Property Security Rights Act, (Act No. 13 of 2017).

unregistered right.[245] Interested participants are allowed to carry out an online search at the registry which reveals the date and time when the search was done, the information requested and a confirmation on whether or not the asset is encumbered.[246]

The Kenyan registration system mirrors the UNICITRAL Legislative Guide on Secured Transactions which is notice based.[247] This is in line with the tested Malawi system which unlike Ghana is thought to be the first African jurisdiction with an efficient legal framework for securing security rights.[248] Having reformed their securities laws in 2013, Malawi is ahead of Kenya by 4 years in terms of legislation.[249]

The World Bank through IFC has put a lot of resources in modernising the collateral registry in Kenya.[250] It was hoped that by mid of 2020, the registry would be fully digitalised and data accessible from a desktop in an office. This has been greatly achieved with the BRS system elevating Kenya to par with other developed nations where the registries have proved to be a critical institution in the credit markets.

## 4.5 Amendments to the Companies Act, 2015

Several sections of the Companies Act and the Insolvency Act have been repealed where the word charge is substituted with security right. The objective of these repeals is to expand the scope of a limitation of charge and to allow other types of securities that do not come in the form of a charge like a lien.



245 Section 40, Moveable Property Security Rights Act, (Act No. 13 of 2017).

246 Section 34, Moveable Property Security Rights Act, (Act No. 13 of 2017).

247 National Law Centre for Inter-American Free trade, 'Securing credit for growth: The case for a new asset register in Kenya, FSD Kenya, 2014.

248 Dubovec M and Kambili C, 'Using the UNCITRAL Legislative Guide as a Tool for a Secured Transactions Reform in Sub-Saharan Africa: The Case of Malawi', 30 Ariz. J. Int'l & Comp. L. 163 (2013).

249 Personal Property Security Act, (Act No 8 of 2013).

250 IFC project information portal, 'Kenya STCR SP' 5 December 2018 <https://disclosures.ifc.org/#/projectDetail/AS/602042> 26th February 2019.

Further the amendment of part XXXII of the Companies Act signals the alignment of the corporate legislation with the Moveable Property Security Rights Act. It is a requirement that once a company receives a certificate of registration of a security right the same must be endorsed on every certificate of debenture or debenture stock.[251] This is part of disclosures that is meant to protect third parties dealing with the company by giving them notice on the burdens on the company's assets.

The amendments also require the holder of a floating charge to notify the registrar within seven days whenever they exercise rights under the charge or through court appointment to administer the company or whenever they cease to administer the company.[252] This requirement is important as it gives notice to third parties and other creditors of the administration which may be adverse to their interests.

It is also worth re-postulating that failure to register a security right with the registrar of companies renders the charge unenforceable as against a liquidator, administrator or creditor of the company.[253] This provision is particularly important in creating transparency and avoiding mischief that may amount to preferential treatment of creditors for a company that is in financial trouble.

Companies are also expected to keep all record of security rights that they have created.[254] The company further is required to maintain a register in which particulars of securities are noted. [255] The record and the register are meant to be open for inspection by creditors members and other interested parties.[256] These provisions are meant to enhance disclosures and make it easy for third parties intending to deal with companies to be put on notice of the liabilities of the company.

[251] Section 882, Companies Act, (Act No. 17 of 2015).

[252] Section 886, Companies Act, (Act No. 17 of 2015).

[253] Section 889, Companies Act, (Act No. 17 of 2015).

[254] Section 890, Companies Act, (Act No. 17 of 2015).

[255] Section 891, Companies Act, (Act No. 17 of 2015).

[256] Section 892, Companies Act, (Act No. 17 of 2015).

## 4.6 Chapter Summary

This chapter focuses on the regulatory framework in Kenya and how reforms have been made targeting the credit market with the intention of making it easier for flow of credit from formal financial institutions to MSMEs. The chapter has looked into the potential opportunities for MSMEs to offer what initially was unacceptable collateral for consideration by formal financial institutions.

The foundation having been set in the statutory framework, the next chapter compares the milestones that have been achieved in the mobile money lending market and how the same can be harnessed by formal financial institutions to other intangibles. The chapter will also interrogate the nature of intangibles in jurisdictions that they have been accepted.

# 5 Emerging Trends of the Kenyan Credit Market

## 5.1 Introduction

Chapter IV introduced the legal framework for use of intangible assets as collateral. It discussed in detail the provisions of the Moveable Property Security Rights Act and the reforms in the credit industry that are meant to increase the flow of capital from financial institutions to MSMEs.

In this chapter we shall discuss the findings of the research in making a case for intangible assets as collateral. The chapter will draw lessons from mobile lending and seek to advance the acceptability of intangibles as security.

In the United States of America, it is reported that the use of intangible assets to secure corporate loans moved from 11% in 1997 to 21% in 24% in 2005.[257] Levi Strauss is one such example of a company that was able to obtain significant amounts of credit by pledging its trademarks and inventories.[258]

The chapter will answer the research questions and make its contribution to the credit market literature by showing that an effective collateral registry is one foot in a tripod stool. The chapter will however be limited to introducing the idea of intangible collateral and thus will not discuss the quality of the collateral.

## 5.2 The Emergence of the Mobile Money Credit Market

Many researchers have concluded that formal financial institutions need to learn how the informal credit system works and replicate the same with their credit products.[259] Micro finance institutions seem to have taken the cue in their products which offer credit as well as non-financial services with the aim of entrenching prudent business practices that increase the absorption rate of credit and guarantee repayment of credit taken.[260] This whole idea is based on linkages that are established when financial institutions develop close interactions with the MSMEs. Formal lenders appear to have developed a credit solution based on trust that comes with use as opposed to

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[257] Loumioti M, 'The use of intangible assets as loan collateral'.

[258] Loumioti M, 'The use of intangible assets as loan collateral'.

[259] Adams Dale W, 'Informal finance in low income countries: A seminar report'.

[260] Ali A, 'The Regulatory and Supervision Framework of Microfinance in Kenya'.

collateral backing. In this model, the use and repayment habits become a package which is intangible yet playing the role of collateral.

The emergence of digital credit signals the use of personal data to establish patterns that then are used to determine the credit worthiness of borrowers.[261] What started with one financial product *M-Shwari* has now opened up access to the unbanked through a credit race that has changed the lending landscape. In this formal set up, there are no formalities of walking into a financial institution, filling out a loan application form, providing collateral and a proposal on the viability of the project that is sought to be financed. Instead institutions are using personal data together with data from credit reference bureaus to determine the amount to lend, and thereafter the repayment habits determine if the borrower will be advanced more credit.[262]

Four formal financial institutions have developed a product called *Stawi* which is aimed at offering loans up to KES 250,000/- to MSMEs.[263] The pilot project is supported by NCBA Bank, KCB Bank Kenya, DTB Bank and Cooperative Bank of Kenya. The operating platform for *Stawi* is provided by NCBA with all the four banks giving equal contributions towards funding. The program aims to address information asymmetry in the banking industry. The loans are provided through a mobile application which the prospective customer has to download into their mobile phone. For an applicant to qualify, the applicant must be either a registered or an unregistered business with a business permit. The program is designed to reach the banked as well as the unbanked with a business turnover of KES 30,000/- to KES 250,000/-.

The key thing about *Stawi* is that it is fully dependent on a clients credit history, where ones credit history is unavailable, there is an option of depositing business income through the *Stawi* account and this is assessed within three months to generate a credit history. The business must also have been in existence for the last six months.

[261] Gwer F, Odero J and Totolo E, 'Digital credit audit report FSD; Creating value through inclusive finance Evaluating the conduct and practice of digital lending in Kenya', FSD Kenya, November 2019.

[262] Gwer F, Odero J and Totolo E, 'Digital credit audit report FSD; Creating value through inclusive finance Evaluating the conduct and practice of digital lending in Kenya'.

[263] <https://*Stawi*.ke/frequently-asked-questions>

The only security against default is the credit reference bureau where information of defaulters is sent, which greatly diminishes a client's credit score.

## 5.3 Credit Reporting

Kenya's credit reporting system is founded on the statutory requirement for information sharing.[264] The credit reporting system is enabled through a credit reference bureau that is licenced by the CBK for purposes of collecting credit information and sharing it with eligible institutions in the course of business. The eligible institutions anticipated are banks, MFIs, Saccos, public utility companies and any other institution mandated by law to share credit information.

The Banking Act is supported by Credit Reference Regulations, 2013 which is designed for collection and dissemination of positive and negative information. Positive information is defined to describe information on performing loans or other forms of credit.[265] Negative information is defined to include non-performing loans, credit default, late repayments, dishonoured cheques, proven cases of fraud and forgeries, proven cases of cheque kiting, false declarations, receiverships, bankruptcies and liquidation, tendering false securities and misapplication of loans.[266]

There are currently three licenced credit reference bureaus in Kenya; Credit Reference Bureau Africa ltd (TransUnion), Metropol Credit Reference Bureau ltd and Creditinfo Credit Reference Bureau Kenya Ltd.[267] The three institutions receive, collate and disseminate credit information for use in the credit industry. The information collected is offered at a fee to the consumer as well as the institutions.

There is a dispute mechanism which is meant to address erroneous information that is contained in a report.[268] The information generated is packaged in a form that can

[264] Section 30(4), Banking Act, (Cap 488).

[265] Regulation 2, Credit Reference Bureau Regulations, 2013.

[266] Regulation 2, Credit Reference Bureau Regulations, 2013.

[267] <https://www.centralbank.go.ke/wp-content/uploads/2016/06/Directory-of-Licenced-Credit-Reference-Bureaus.pdf> 9 February 2020.

[268] Regulation 25, Credit Reference Bureau Regulations, 2013.

easily be uploaded into digital programs giving instant analysis in what researchers refer to as 'credit scoring'.[269]

The credit reporting system is still not perfect with data showing that credit institutions use a combination of credit scoring together with other data.[270] The exception is in digital lending where credit institutions seem to rely wholly on the credit reports with occasional instances where they use user data. From the digital finance experience so far, it is certain that credit scoring achieved through credit reporting has unlocked credit solutions as predicted by FSD Kenya.[271] The unbanked which category included MSMEs are now able to access credit solutions that were beyond their reach.

## 5.4 Towards an Efficient Credit System

An efficient credit system is one where lenders have the correct data which they can use to predict the repayment probabilities with some level of accuracy that minimises the risks. A well-functioning credit system encompasses a multifaceted approach requiring a conducive legal framework, acceptable business traditions and practices, efficient institutions and a viable market.[272] An intangible security right is worthless where there is an inefficient credit registry.[273] Prior to collateral law reforms in Kenya, Kenya had a manual registry system at the Attorney General's office that dealt with moveable assets. The system was plagued with reliance on paper work and poor record keeping which made reference to the registry a costly and time consuming affair.[274]



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[269] Microfinance Risk Management, L.L.C, 'The potential for credit scoring for SME Lending in Kenya' FSD Kenya, 2008.

[270] Berg G, Fuchs M, Ramrattan R. Totolo E, Central Bank of Kenya, 'FinAccess Business – Supply: Banks Financing of SMEs in Kenya', FSD Kenya, 2015.

[271] Microfinance Risk Management, L.L.C, 'The potential for credit scoring for SME Lending in Kenya' FSD Kenya, 2008.

[272] Ballell T, 'A technological transformation of secured transactions law: Visibility, monitoring, and enforcement' 22(4) Uniform Law Review, 2017.

[273] Love I, Pería M and Singh S, 'Collateral Registries for Movable Assets: Does Their Introduction Spur Firms' Access to Bank Finance?'.

[274] FSD Kenya, 'The Kenyan collateral process: constraints and solutions', FSD Kenya, 2010.

This state of affairs made it risky to trade in movable tangible assets and even riskier, intangibles assets leading to the overreliance on the all assets debentures.[275] The system did not allow for search based on lender, borrower or asset type[276] making it a minefield for creditors who had to develop ingenious ways of securing their collateral through multiple registration systems like in the case of a registered chattels mortgage at the companies registry backed by joint registration with the registrar of motor vehicles for the case of machinery.

Research on secured transactions on intangibles outlines perfection of the security right as the determinant on the acceptability of the security.[277] It is for this reason that scholars advised the transplanting of Article 9 of the Uniform Commercial Code to other jurisdictions with a wanting legal framework by carefully crafting modifications that suit their circumstances for an efficient secured transactions system.[278]

The United Nations General Assembly adopted a general guide on secured transactions on 11th December 2008 known as UNCITRAL Legislative Guide on Secured Transactions.[279] The objective of the legislative guide on secured transactions was to reduce the cost of credit by modernising security laws to reflect the emerging trends which have expanded the scope of security to all moveable assets particularly the intangibles which never had a specific legal framework and was best secured using floating charges or liens. The most important feature of the model law is that security rights are determined by registration which serves as notice to third parties as well as settles issues of priorities.[280]

Some legal systems have embraced the call by UNICITRAL by reforming the regulatory framework on secured transactions to make the credit market safe. Australia, Belgium, Canada and New Zealand are in the forefront of countries that

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[275] FSD Kenya, 'The Kenyan collateral process: constraints and solutions', FSD Kenya, 2010.

[276] FSD Kenya, 'The Kenyan collateral process: constraints and solutions', FSD Kenya, 2010.

[277] Schwarcz L, 'Helping microfinance become commercially sustainable', 46(2) Gonzaga Law Review, 2010, 495-502.

[278] Schwarcz L, 'Helping microfinance become commercially sustainable'.

[279] UNCITRAL Legislative Guide on Secured Transactions (2007).

[280] Castellano G, 'Reforming Non-Possessory Secured Transactions Laws: A New Strategy?' 78(4) Modern Law Review, 2015, 611.

have expanded the scope of collateral to include intangible that are secured through registration.[281] Malawi which beat Kenya to reforming their securities law adopted their legal framework from New Zealand. These legislative reforms are thought to have been an improvement of the amendment of Article 9 of the American Uniform Commercial Code.[282] The improvement is in terms of making the legislation registration based as opposed to having perfection of a security right to be either by registration or possession.[283]

From the digital lending discussed in this chapter, the curious structure that makes mobile money lending thrive is the confidence in the market. Studies show that despite mobile lending being very expensive, at least six million Kenyans have at one point borrowed through mobile money for various reasons including financing their businesses.[284] A keen look at the digital lending, reveals a high demand for mobile loans signifying there is a ready market. It has become the norm in Kenya that the mobile lending services are offered through mobile applications virtually with no physical forms or visits to lending institutions. This paradigm shift has successfully changed the business traditions and practices towards digital environment that is market driven where risk is determined through credit scoring which is hinged on credit reporting requirements.[285] There is no other express legal framework that regulates mobile lending other than somewhat efficient institutions as evidenced by the numbers of monies transacted and the profits therefrom.

It is by no surprise that mobile lending has been the greatest success of Commercial Bank of Africa, now NCBA Bank, granting it market dominance with commensurate growth. NCBA Bank commands 46.16% deposits and loans accounts with a market

[281] Castellano G, 'Reforming Non-Possessory Secured Transactions Laws: A New Strategy?'.

[282] Castellano G, 'Reforming Non-Possessory Secured Transactions Laws: A New Strategy?.

[283] Dubovec M and Kambili C, 'Using the UNCITRAL Legislative Guide as a Tool for a Secured Transactions Reform in Sub-Saharan Africa: The Case of Malawi'.

[284] Gwer F, Odero J and Totolo E, 'Digital credit audit report FSD; Creating value through inclusive finance Evaluating the conduct and practice of digital lending in Kenya'.

[285] Hajat M, Ketley R, Miano M, and Njeru T, 'Towards positive selection in the Kenyan credit market: An assessment of the current and prospective future effectiveness of credit information sharing in the Kenyan market', FSD Kenya, 2016.

share of 54.8%.[286] It is therefore not by coincidence that NCBA bank provides the operational platform for *Stawi*. Digital finance in numbers shows that KCB, CBA Bank (now NCBA Bank) and Safaricom have disbursed approximately KES 87 billion which translates into a very huge portion in their books in just six months ending with June 2019.[287] This figure individually means that during the six months ending in June NCBA Bank and KCB Bank were able to make KES 484 million .

Costs associated with keeping guard against default have been decried to result in high costs of credit.[288] As discussed in this thesis, financial institutions still rely on loan officers who perform the investigative role by visiting the Enterprises they intend to lend to or they have lent to.[289] With working and reliable registries, the cost of obtaining information greatly reduces making a credit transaction affordable.[290] In the long term it is expected that with the perfection of the security, the cost of credit will significantly reduce.

## 5.5 Lessons from the Digital Lending

Researchers discussed in this thesis agree that relationships determine the risk narrative that formal commercial institutions run to deny MSMEs credit. While there have been attempts to reduce information asymmetry through linkages that come from non-banking products offered by financial institutions, the arm's length approach taken by lenders through credit reporting has significantly opened the digital finance market.

It is generally accepted that financial institutions wary of failure substitute the probability of failure of the borrowing entity with collateral which gives guarantees

[286] Gwer F, Odero J and Totolo E, 'Digital credit audit report FSD; Creating value through inclusive finance Evaluating the conduct and practice of digital lending in Kenya'.

[287] Standard Investment Bank, 'FULIZA – Dissecting the Numbers'27 August 2019, <https://www.sib.co.ke/fuliza-dissecting-the-numbers/> 9 February 2020.

[288] FSD Kenya, 'Testing SME banking in Kenya – a mystery shopping exercise', FSD Kenya, 2016.

[289] Hajat M, Ketley R, Miano M, and Njeru T, 'Towards positive selection in the Kenyan credit market: An assessment of the current and prospective future effectiveness of credit information sharing in the Kenyan market', FSD Kenya, 2016.

[290] Love I, Pería M and Singh S, 'Collateral Registries for Movable Assets: Does Their Introduction Spur Firms' Access to Bank Finance?'.

that should the business not work, there will be assets to mitigate the losses.[291] From the way personal data on borrowers repayment habits are packaged into some form of collateral underscores the untapped potential of intangible assets that could equally serve the same purpose.

Kenya is experiencing a credit age where formal financial institutions do not wait for the borrowers to approach the lender for credit. It is now common to receive unsolicited messages advising a potential borrower of a credit facility to which the borrower qualifies for. The only way this is possible is through internal surveys within the institution that carry out background checks on their customers and make an offer to the customer before even the customer seeks the facility. This we can positively conclude has been enabled by easy flow of information that has been increased by credit scoring.

Researchers have also reported that the fear of a negative credit report drives the desire to repay the facility.[292] For the part of the market that appreciate the consequences of a negative credit report, there is extra effort in repaying the facilities which is returning a lower default rate. The fact that credit reporting stimulates repayment attests to the effectiveness of the credit registry system.

The digital age particularly has seen companies with limited physical presence create platforms that trading unimaginable wealth over the internet.[293] The same way that credit reference registries provide data on credit use, a collateral registry serves a similar purposes in that it allows for an asset to be noted in the register and therefore that becomes the means of attaching the asset by giving notice to the whole world of

[291] Ballell T, 'A technological transformation of secured transactions law: Visibility, monitoring, and enforcement' 22(4) Uniform Law Review, 2017.

[292] Microfinance Risk Management, L.L.C, 'The potential for credit scoring for SME Lending in Kenya' FSD Kenya, 2008.

[293] Locke N, 'The Use of Intellectual Property as Security for Corporate Debt'.

the creditors interest.[294] Registration is important in the trade of intangibles as it signifies possession and control.[295]

## 5.6 Lessons from Other Jurisdictions

In the United States intangible security perfection system is dependent on either registration of the security right or control of the asset.[296] What this means is a creditor who controls the intangible asset like in the case of a deposit account could exercise a contractual right to set off the deposit account against a non-performing loan account. Control in this sense amounts to security even where the lender allows the grantor to use the monies in the deposit account. This approach has however been criticised as being misguided because perfection by control denies third parties notice before dealing which is essential in securing intangible assets collateral.[297]

In the European Union, matters were settled in terms of possession and control until the Financial Collateral Arrangements Directive (2002/47/EC as amended by Directive 2009/44/EC) which included intangibles like deposits.[298] The UK responded to the directive by enacting Financial Collateral Arrangements (No. 2) Regulations 2003. Common law differentiates possession and control using the analogy of a fixed charge and a floating charge, where a fixed charge signifies control while a floating charge signifies lack of control.[299] Some authors have argued that for possession to have its way, there must be some element of control.[300] This interpretation flows from *Gray v G-T-P Group Limited Re F2G Realisations Limited (in Liquidation)*[301] where

[294] Locke N, 'The Use of Intellectual Property as Security for Corporate Debt'.

[295] Parsons R, Dening M, 'Financial Collateral - An Opportunity Missed', 5 Law and Financial Markets Review, 2011, 164.

[296] Article 9-312(b)(1) and 9-314(a) Uniform Commercial Code.

[297] Schwarcz L, 'Helping microfinance become commercially sustainable'.

[298] Parsons R, Dening M, 'Financial Collateral - An Opportunity Missed.

[299] Keijser T, 'Financial collateral arrangements in the European Union: current state and the way forward', 22(1) Uniform Law Review, 2017, 258.

[300] Keijser T, 'Financial collateral arrangements in the European Union: current state and the way forward'.

[301] [2010] EWHC 1772 (Ch).

the English court interpreted a contractual trust right over deposits in an account to be equivalent to an unregistered floating charge and therefore not effective as against a liquidator. The decision was made on the backdrop of well-established common law precedents on possession and control. The precedents do not anticipate allowing the grantor to draw funds in a deposit account that is being held as security through contractual arrangements or a floating charge. The failure to define control has been viewed to entrench uncertainties in the securities framework which is undesirable for an effective collateral system.[302] It may however be argued that the controversy has now been settled by the European Court in *Private Equity Insurance Group SIA v Swedbank AS*.[303] The European Court of Justice resolved the dispute by noting that perfection by possession and control can only be effective if the creditor exercises some control by not allowing the grantor to have access and dispose the monies in the account. For the UK we may have to await the effects of Brexit since the Financial Collateral Arrangements (No 2) Regulations 2003 still has not defined control.

In Kenya, however, the principle of 'possession' and 'control' has no place in perfection of a security right over intangibles.[304] If a bank enters into a contractual arrangement where it creates a set off rights over a grantor's deposits, the same is valid for as long as there are no competing claims to the deposit which is perfected by registration.[305] This position has been brought to fore by the enactment of the Moveable Property Security Rights Act which modifies the mercantile practice which entrenched a banker's right of set off as has been known in common law jurisdictions.[306] A bankers right to set off arises where the grantor has an account (deposit account or trust account) in credit and another account (current account or loan account) in debit; if the contractual documents provide for the banks right apply any credit balance belonging to the grantor to settle the grantors account in debit, then the bank will have

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[302] Perkins J, 'Registration of charges over intangible assets', 4(4) Law and Financial Markets Review, 2010, 360.

[303] [2016] All ER (D) 116 (Dec).

[304] Section 11, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[305] Section 11(5), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[306] Section 40, Moveable Property Security Rights Act, (Act No. 13 of 2017).

an enforceable set off right.[307] Therefore if the bank does not perfect its contractual right to set off or even its right to deposits or a trust account, then the same will be deemed as an unregistered floating charge or lien, which will be defeated in terms of priority by a secured creditor who has obtained registration.[308]

The priority of secured rights extends to acquisition rights as well.[309] The failure to notify a secured creditor of the acquisition right would then expose the lender to a creditor with a perfected security right in terms of priority.[310] A good example of this predicament would arise where there is a floating charge or lien which has been perfected by creditor A encumbering all present and future assets. Once creditor B agrees to advance credit to the grantor, creditor B must put creditor A on notice prior to the advances for its acquisition right to have priority over the secured right of creditor A. Failure to put creditor A on notice would mean that creditor B would lose the right to priority over its acquisition right.

## 5.7 Some Considerations for Intangible Collateral

Most researchers on capital constraints have been able to identify lack of collateral as a significant credit impediment to MSMEs since they do not possess the assets that traditionally are favourite to lending institutions. There are however some other types of assets that MSMEs possess that are worthy of consideration. It is appreciated that most MSMEs can afford movable assets which can be useful in substituting fixed assets like land.[311] Particularly with the governments affirmative action by setting aside 30% of tenders for women, youth and persons with disabilities, micro enterprises and small enterprises.[312]



[307] Nicholas Mahihu Muriithi v Barclays Bank Kenya Limited [2018] eKLR.

[308] Section 40, Moveable Property Security Rights Act, (Act No. 13 of 2017).

[309] Section 49(2), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[310] Section 49(3), Moveable Property Security Rights Act, (Act No. 13 of 2017).

[311] Love I, Pería M and Singh S, 'Collateral Registries for Movable Assets: Does Their Introduction Spur Firms' Access to Bank Finance?'.

[312] Public Procurement and Disposal (Preference and Reservations) Regulations, 2011.

In practice most formal institutions who have dared to secure themselves using intangibles have used the all asset debenture secured by a floating charge or personal guarantees. As noted earlier in this study floating charges are rarely embraced with open arms because of the fear of foreclosure. Indeed, the failure of MSMEs business in most cases means loss of personal assets.[313] With this in mind, financial institutions should move towards asset specific charges or security rights.

Receivables are one such kind of security that is asset specific and capable of being pledged as security. Invoice discounting fits in this category as it allows the creditor to supply credit to an enterprise and then recoup the amounts financed when the invoice is settled.[314] The beauty of trading in receivable is that risk is transferred from the MSME to the institution with the duty to pay the receivable. Enterprises have been able to present invoices to financial institutions and they have been able to finance their businesses by being allowed to draw a portion of the expected payment.[315]

Although some financial institutions in the recent times may have burnt their fingers with invoice discounting due to the failure by state corporations to settle the invoices in time, there is some hope that things may change in future if the government honours its promise to pay.[316]

## 5.8 Chapter summary

This chapter has dwelt on the importance or registries through the prism of the credit reporting system that is touted as the backbone of digital lending. The chapter using mobile lending has shown the potential of intangibles being effective collateral just like the tangibles which are now being matched as viable security.

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313 UNICITRAL Working Group 1, 'Reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs)', October 2017.

314 Irungu J, Kibuine M, and Muhoho J, 'Receivables factoring and performance of private finance companies in Kenya: A case of private finance companies in Nairobi City County', 3(3), International Academic Journal of Economics and Finance, 2019, 356.

315 FSD Kenya, 'Testing SME banking in Kenya – a mystery shopping exercise', FSD Kenya, 2016.

316 Igadwah L, 'County contractors, suppliers to receive Sh51.2bn payments', Business Daily', 29 July 2019.

The insight given by mobile money lending underscores the importance of bridging the information asymmetry that stands in between borrowers and lenders. An efficient collateral registry system serves this purpose. It settles issues of notice as well as priorities which are important to lenders and build confidence in security rights.

This chapter has been able to answer the research questions that were raised in chapter one. It is now certain that increase of flow of funds to MSMEs unlocks the unrealised potential as digital lending has been able to bring the unbanked into the financial system. It has shown that where the intangible collateral system is efficient, there is confidence in the credit market which unlocks more credit to enterprises.

It is also certain the development of products like *Stawi* signifies the potential that the MSMEs market has to warrant specific attention of tier one banks in Kenya. The profits in numbers is evidence of the value of the MSMEs when financial inclusion is achieved.

The final chapter of this thesis will present the recommendations taken from the best practices that have been outstanding in the previous parts to fill the gaps that have been displayed with our current credit market system.

# 6 Conclusion and Recommendations

## 6.1 Conclusion

This study set out to establish the reasons that limit the availability of debt capital to MSMEs in Kenya. The study found that shunning MSMEs is without a valid basis since the practice in the Kenyan credit market is grounded on tangible assets presupposing that they offer a better value than intangible assets. The scarcity of tangible collateral has therefore spelt doom to the prospects of debt financing for MSMEs.

Researchers all over the world have demystified the myth that favours tangible collateral by showing that intangibles are just as good. The move towards intangible securities has been market driven with instances of proposals being originated by financial institutions. These developments are however yet to take root in the Kenyan credit system, which is still cold to alternative forms of collateral, putting MSMEs in a race where they have no realistic chance of succeeding.

Such justification is what prompted the overhaul of the Kenyan legal framework under the mantra of easing the doing of business. The legislative overhaul came through the enactment of various progressive business-related statutes with the centre of this papers' focus being on the Moveable Security Property Rights Act, 2017. However as discussed in this paper, the business-related statutory overhaul is just but a step towards embracing modern credit practices.

This Thesis has shown that the legal framework is only a part of the solution to the capital constraint dilemma. Kenya now has a robust legal system which is dynamic to the changing marketplace. What it lacks is the general acceptance of intangibles in largely due to information asymmetry.

The Thesis has looked at the shortcomings of tangible collateral and it proposes the expansion of traditional collateral to include intangibles. The research draws its findings on the potential of the intangible security market through the success of digital finance. This potential is likened to the western credit practices where the financial institutions identify the potential in intangible and then they make the first move by giving offers to the potential borrower.

Throughout this Thesis, linkages that create trust have been underscored as a vital pillar to any credit system. The trust which is often missing if achieved can give

MSMES a lifeline for their survival. The risk of failure just as has been from ancient times can be lessened through collateral lending. The risk of default as proposed by this study can be reduced through perfecting the collateral registry. With a well-functioning collateral registry, there is confidence in trading in intangibles which increases the capital flow to MSMEs.

Mobile money lending is one example of a shift from tangibles since there is no collateral that is pledged other than the reputation of the borrower. The practice has mostly been market oriented with lenders setting the terms often seen as predatory but nevertheless an unchartered credit territory that has embraced the unbanked. The volumes of credit traded in the mobile money market is visibly evidence of the untapped potential that intangible collateral can open.

This research has established that a digital registry is the ultimate equalizer in a solid intangible credit system, that if embraced secures the interests of the players. The registration of a security interest in an easily accessible register solves the information asymmetry that constantly prejudices MSMEs. The digital registry as discussed in this Thesis helps in determining important aspects of intangible securities being notice and priority which then builds the confidence of the players to trade.

Notice enables interested parties to know the availability of an asset and solves the weakness in the Kenyan tangible securities registry that has exposed some financial institutions to useless securities whittled down by fraudulent multiple registration.

Priority on the other hand determines who comes first in terms whenever there are competing security rights. The person whose interest is noted first in the register not withstanding there being another unregistered interest but first in time carries the day.

Further, the findings of this research show that intangibles are not any lesser in terms of collateral. With a market with changing products, adoption and acceptance of intangibles signifies growth of the credit market in tandem with the emerging realities. Mobile money market cannot now be ignored by any financial institution because of the growth potential that it presents. Similarly, intangible collateral should be embraced as a part of the solution to credit constraints for MSMEs. It is therefore evident that embracing intangibles would allow MSMEs trade in what is within their reach and the trade would then allow formal credit to trickle down making debt finance viable.

## 6.2 Recommendations

This study has been able to demonstrate that there is an untapped potential in intangibles that if embraced would unlock the flow of capital to the MSMEs. It is important that there be an environment that builds the confidence of market participants to trade in intangibles. Legal reforms are just but one of the facets that makes inclusion of intangibles into collateral lending a reality.

As noted by some researchers, lending in Kenya is rarely based on anticipated risks. It is for this reason that even prior to interest rate capping, interest rates were significantly within the same bracket for formal financial institutions. A combination of credit scoring and efficient collateral registry should be able to create confidence in lending based on actual risk as opposed to what others charge.

It is therefore recommended that financial institutions need to shift their culture which relies on tangible collateral and embrace the more available intangible collateral whose potential is limitless. Market realities are showing a shift towards intangibles and there is no reason why the financial sector should not migrate their trade practices as well. There has been the emergence of block chains that have transcended international boundaries and yet they possess minimal or no tangible collateral.

Similarly, we have seen the advent of technology-based companies that whose business models revolves around intangible assets. Internationally, the likes of Facebook, and Amazon are revolutionising the laws of property by the virtual nature of their assets. In Kenya, *Sendy* is one such example of a business that operates on intangible assets valued highly enough to allow them raise heavy capital from curious investors.

It is therefore recommended that all intangible security rights should be registered in a centralised collateral registry which is provided for under the Moveable Security Property Rights Act. The perfection by registration is an orderly way of giving notice to third parties as well as determining priority rights of competing interests. Appreciating that financial institutions have products that are based on securitising deposits, receivables and other similar intangibles, such facilities if secured by other arrangements should be perfected by registration. The doctrine of possession or control has no place in the modern security environment and should not be used to defeat security rights perfected by registration.

With a modern legal intangible security framework, and with the shift form floating charges and liens, financial institutions should rely on individual security rights to reduce the risk on MSMEs that may discourage borrowing for fear of foreclosure on the entire business assets. Indeed, the practice of an all-asset debenture secured by a floating charge has lost favour with modern insolvency legislations which are aimed at saving corporations rather than liquidating them, and where liquidation is necessary creating some fair level playing field for other creditors by limiting the traditional power of a floating charge.

The digitalisation of the collateral registry being work in progress, there should be a deliberate marketing to create public awareness of the benefits of a digitalised registry in guaranteeing security rights. Efforts should be made to orient financial institutions to accept the new registry as the way of doing business. Financial products should be tailored around the new registry so that there is market confidence in trading in intangibles. Market confidence would then unlock the untapped potential in intangible collateral bringing in the MSMEs into the debt financed capital segment.

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# 8 APPENDICES

## 8.1 Appendix A – Turn it in originality report

COLLATERALIZATION OF INTANGIBLE ASSETS MAKING A CASE FOR MICRO, SMALL AND MEDIUM ENTERPRISES IN KENYA

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