



The Kenyan collateral process

Constraints and solutions

ABOUT FSD KENYA

Established in early 2005, FSD Kenya aims to support the development of inclusive financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry our goal is to significantly expand access to services among lower income households and smaller scale enterprises. FSD operates as an independent Trust under the supervision of professional trustees, with policy guidance from its programme investment committee. Finance is provided by a number of development partners including the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation together with the Government of Kenya.

Material in this briefing note has been extracted from the *Costs of collateral in Kenya: Opportunities for reform* report. This can be downloaded from the publications section of our website, www.fsdkenya.org.



The collateral process: Constraints and solutions

Creation

The creation of a security interest - agreement to transfer interest in property from a borrower to a lender in exchange for a loan.

Perfection

The perfection of a security interest - informing third parties by registering the security interest usually with the government.

Enforcement

The enforcement of a security interest - recovering the balance of loan by realising value in the collateral through its sale.

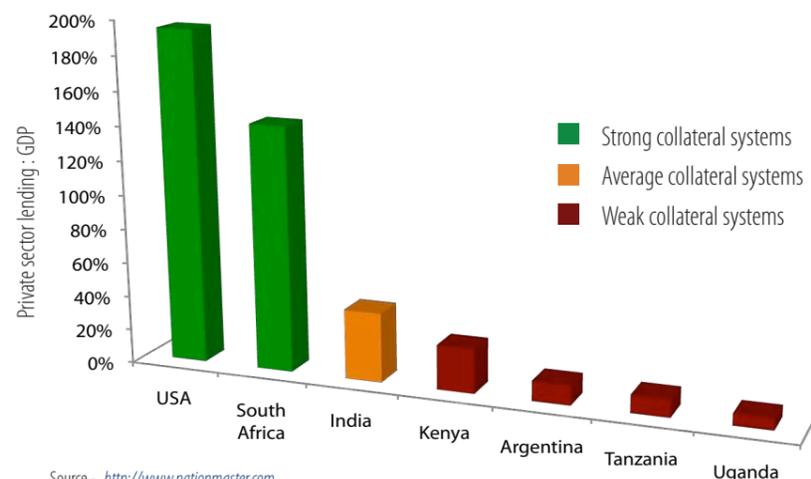
Without perfection, the beneficiary of a security interest will find it very difficult to enforce should the need to recover arise.

CREATING, PERFECTING AND ENFORCING SECURITY INTERESTS IN KENYA

	Cost	Time
Creating and perfecting	Between 2% and 6% of loan value. For a KShs 1m loan, collateral costs are between KShs 20,000 and 60,000.	To perfect a security interest in collateral takes between 30 and 60 days.
Enforcing	To enforce a security interest in collateral costs between KShs 300,000 and 700,000.	To enforce a security interest in collateral takes between 6 months and 10 years.

THE EFFECT OF COLLATERAL ON CREDIT PROVISION

In countries with well functioning collateral systems, total loans exceed GDP. By contrast with poor collateral systems, total loans are a fraction of GDP and many economic sectors are excluded from credit. The combination of high real (cash) and opportunity (time) costs force many lenders to keep the cost of borrowing high. Indeed in Kenya, the cost of collateral is at least partially to blame for credit interest rates not responding to government efforts to bring them down.



CONSTRAINTS TO EFFICIENT OPERATION OF THE COLLATERAL SYSTEM IN KENYA

1. Legal framework

More than 20 principal statutes relate to or impact upon the creation or perfection of securities and there is no uniform code for the regulation of these interests due to this multiplicity of laws. The result is a cumbersome, expensive and complex process.

2. Registry system

To be valid, security interests must be registered. Kenya has a multiplicity of registries that do not share information, do not have standardised information requirements, and do not facilitate searches by asset, lender or borrower to ascertain the status of encumbrances and cannot ensure priority of claims. Additionally most registries are manual slowing or stalling the search process.

3. Collateral enforcement mechanisms

For lenders to enforce their rights in collateral they must overcome a slow and expensive process. To sell property, lenders must obtain consent of public officials who may be compromised. In a contentious case, recovery is hampered by the costly and slow judicial system.

4. The all asset debenture (fixed and floating)

Kenyan lenders prefer a charge over all present and future assets of the borrower. This instrument restricts access to credit and results in winding down of productive businesses in cases of default resulting in loss of employment and economic contraction. Lenders require these all asset debentures because of the collateral system which cannot in its present state offer the level of protection the lender needs.

5. Banking prudential regulations

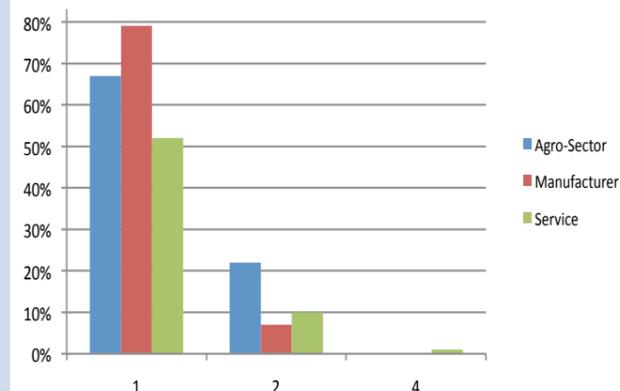
Although prudential regulations for commercial banks do not require taking of collateral to secure loans, they encourage it by prescribing higher risk weighting for unsecured lending for capital adequacy purposes. Additionally, where security is taken, regulation specifies that they should be perfected in all respects thus increasing the cost of credit.

IMPACT OF COLLATERAL PROCESS ON SME ACCESS TO FINANCE IN KENYA

- There are actually few substantial restrictions on credit and companies could have access to many sources including trade finance if the collateral system improves.
- Banks accept a wide variety of assets as collateral and are not fixated on real estate alone (common in other emerging markets), but perfection remains a constraint.
- Collateral is expensive to create and perfect in Kenya but those costs in both time and money are already factored into the decision making process by companies and few abandon the process due to these costs.
- As a result of the imperfections in the collateral system, it is the over-reliance on the all asset debenture by lenders that has the most impact on SME access to credit.
- The main impact of the all asset debenture is to reduce competition for borrowers.
- Borrowers are stuck in long term relationships with only one bank and so the benefits of collateral (lower interest rates and gradually lower collateral requirement) are not evident in Kenya.

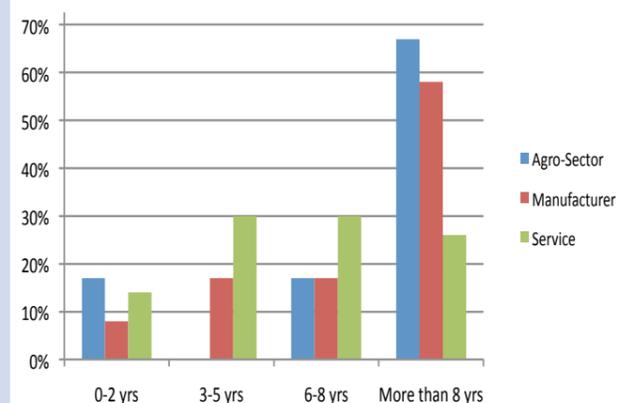
HIGH TRANSACTION COSTS RESTRICT COMPETITION IN THE BANKING SYSTEM

Figure 1: How many banks does your business have a loan with?



Source: Synovate survey, author's compilation.

Figure 2: Number of years relationship held with bank



Source: Synovate survey, author's compilation.

WHAT CAN BE DONE?

- Consolidate laws of collateral.** There are currently over twenty separate statutes related to the transfer of assets with 5 statutes dealing with land. A unified code would allow more moveable and unmoveable assets to be recognised as collateral and in the case of land should allow both rural and urban holdings to be pledged.
- Allow floating charges equal priority with fixed.** The priority of a fixed charge over a floating charge does not lend itself to the use of crops and other export commodities as collateral.
- Simplify the regulation of encumbrances.** Allow for a do it yourself regulation and remove the need to involve lawyers, valuers and other professionals unless so desired by borrowers and lenders.
- Introduction of credit bureaus.** The joint Kenya Bankers Association/Central Bank of Kenya task force on implementation of credit referencing with the support of FSD Kenya has done considerable work to make this a reality.
- Combine the multiplicity of registries** into a single collateral/encumbrances register that is fully accessible to the public and searchable by asset, lender and borrower. Physical visits to the registry should be eliminated.