FEASIBILITY STUDY OF ASSET-BACKED SECURITIES IN KENYA
(A Case of Nairobi Securities Exchange)

BY

WAMBUI, CHARLES MBUGUA

UNITED STATES INTERNATIONAL UNIVERSITY

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A Project Report Submitted to the School of Business in Partial Fulfillment of the Requirement for the Degree of Masters in Business Administration (MBA)

UNITED STATES INTERNATIONAL UNIVERSITY

SUMMER 2014
STUDENT’S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University in Nairobi for academic credit.

Signed: _______________________________   Date: _______________________________
Wambui, Charles Mbugua (ID 622841)

This project has been presented for examination with my approval as the appointed supervisor.

Signed: _______________________________   Date: _______________________________
Dr. Amos Njuguna

Signed: _______________________________   Date: _______________________________
Dean Chandaria School of Business
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ABSTRACT

The purpose of this study was to investigate the feasibility of Asset-Backed Securities in Kenya. The study answered the following research questions: What are the benefits of Asset-Backed Securities in the financial market? What are the challenges facing Asset-Backed Securities market? What are the possible solutions to overcome the challenge facing Asset-Backed Securities market?

To effectively respond to these questions, the researcher adopted an exploratory research design. The target population was the senior staff working with the registered member firms of the Nairobi Securities Exchange. A convenient sample of 40 respondents was adopted. The data collection tool used was a questionnaire that was distributed by way of email and collected in the same manner using telephone follow-up. The qualitative data was coded and analyzed using content analysis while the quantitative data was validated using validation checks, edited and coded then analyzed using both descriptive and inferential statistics. Both Microsoft Excel and Statistical Product and Services Solutions (SPSS) software were used for this analysis. This information was presented both in tabular and graphical formats.

The study findings are that the market for Asset-Backed Securities in Kenya is feasible. The main benefits would be increasing liquidity in the market, lowering the cost of credit, risk dispersion, encouraging market growth and promoting FDI. Further benefits would include provide a better way to manage regulatory capital while at the same time creating revenue and managing profitability. Additionally, it would promote market and operational efficiency.

There are challenges though in terms of infrastructure due to lack of optimal regulation, un-updated legal structure on company law, taxation and accounting laws as well as credit rating firms’ challenges. In addition there are issuance and pricing challenges as well as the problem of adverse selection and risk shifting. Lack of tested credit rating agencies in the Kenyan market is another challenge as well as the issues relating to separation of the originator and owner.

These challenges may be overcome by implementing raft of laws and measures to address them including reviewing the laws and establishing an optimal regulatory framework.
Credit enhancements would be part of the solution and also a close oversight on regulatory capital. Further it would be key to manage investors’ risk appetite.

From this study the recommendations are for the Government and the regulating authority to take stock and consider marshalling the ship to securitization forward. This may be the solution to the agitation for lower credit costs and the liquidity trap that the country seems to be bottled in. Other recommendations are for further studies to be conducted on other securitized products with a view to comparing them and establishing the best starting point for Kenya.
ACKNOWLEDGEMENT

I wish to acknowledge the people who have truly contributed to the completion of this project. First of all I would like to acknowledge my Supervisor Dr. Amos Njuguna for his ever ready guidance even at night after classes. It is his dedication to see that I complete the project in time that has given me impetus to move on. Second I would like to acknowledge are my peers who have had me on my toes into completing the project, without them, this could not have been. I also want to acknowledge the USIU library staff for their readiness to assist in sourcing for the necessary resources which were scarce but they made it possible. Lastly I acknowledge the support of my dear wife and children for their understanding and support always.
DEDICATION

To my late father who passed on just one week before I completed this project. I would have loved to see him celebrate with us.
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<tr>
<td>ABS</td>
<td>Asset Backed Securities</td>
</tr>
<tr>
<td>AHG</td>
<td>Affordable Housing Goals</td>
</tr>
<tr>
<td>AIG</td>
<td>American Insurance Group</td>
</tr>
<tr>
<td>RMBS</td>
<td>Residential Mortgage-Backed Securities</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
<tr>
<td>SPE</td>
<td>Special Purpose Entity</td>
</tr>
<tr>
<td>MSA</td>
<td>Metropolitan Statistical Areas</td>
</tr>
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<td>CDO</td>
<td>Collateralized Debt Obligations</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
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<tr>
<td>CRA</td>
<td>Credit Rating Agencies</td>
</tr>
<tr>
<td>UKFSA</td>
<td>United Kingdom Financial Services Authority</td>
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<tr>
<td>CMA</td>
<td>Capital Markets Authority</td>
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<tr>
<td>NSE</td>
<td>Nairobi Securities Exchange</td>
</tr>
<tr>
<td>BCFP</td>
<td>Bureau of Consumer Financial Protection</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offer</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities Exchange Commission</td>
</tr>
<tr>
<td>FINRA</td>
<td>Financial Industry Regulatory Authority</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>SPSS</td>
<td>Statistical Product Service Software</td>
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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Problem

According to Drake and Fabozzi (2010), the financial system of an economy is comprised of three components namely: financial markets, financial intermediaries and, financial regulators. They further argue that this area of financial system is referred to as financial markets and institutions (Drake & Fabozzi, 2010). The international financial markets have experienced phenomenal growth for the last twenty years up until the financial crisis of 2007 (Balling & Gnan, 2013). The financial markets in the Sub-Saharan Africa are growing rapidly and playing a progressively more important role in providing capital for both the public and the private sector (Nkontchou, 2010). The presence of robust and efficient securities markets facilitate entrepreneurs to access financial resources required to commercialize innovation, increase production of goods and services, invest in capital improvement and new technologies and increase employment (Gakeri, 2011).

The development of new financial instruments and markets is driven by competition among financial institutions (Fabozzi & Modigliani, 2009). This is what is referred to as financial innovation and in certain circumstances, financial innovations are split into two types being the product and the process variants. The products are usually in the form of new derivatives contracts, new corporate securities or new collective investment products, and the process innovations are typically in form of new channels of distributing the securities, processing transactions or pricing transactions. This differentiation however, is not clearly observable in actual operations since both the instrument and process innovations is more often than not, linked together. Majority of the financial innovations are an evolutionary adaptation of prior instruments thus making both invention and diffusion of new instruments related (Lerner & Tufano, 2011). Further, Fabozzi and Modigliani (2009) argue that regulations that hinder the free flow of capital and competition among financial institutions stimulate the development of financial instruments.

The greatest period of financial innovations of all times was experienced from 1960 to 1980 (Miller M. H., 1986). This statement candidly underpins what had been stated six
decades ago that the most important thrust behind historical growth of capitalism is innovation (Schumpeter, 1939). Financial innovations as noted earlier are categorized and one approach that they are classified in terms of the functions of the innovation in the market. This is the classification adopted by the Economic council of Canada which identifies three broad categories: market-broadening instruments, risk-management instruments, and arbitraging instruments and process (Fabozzi & Modigliani, 2009). Schumpeter (1939) argues that financial innovations can as well be classified in a similar way to any innovation in an economy. In addition, there is a suggestion of two classes of financial innovation: (1) new financial products (financial assets and derivatives) that better suits the circumstances of the time and the markets which they trade; and (2) the strategies that use these instruments (Ross S. A., 1989).

Securitization has been identified as a very important process of financial innovation and in the field of finance, two meanings have emerged (Fabozzi & Modigliani, 2009). One way is to look at it from the widest perspective such that securitization is the process whereby a financial relationship is converted into a financial transaction (Cooper I., 1986). In this case it is important to explain a financial transaction as the case of coming together of two or more entities and relationship as the entities staying together. A good example would be if a company takes a loan from the bank; a relationship exists and if this loan is later converted into a tradable debt security, then there is a financial transaction. Examples in this dimension are the stocks and the corporate bonds being forms of securitization (Fabozzi & Modigliani, 2009).

Overtime, the meaning of securitization has evolved and specifically involves the transformation of nontrade financial instruments into a traded security. Such securities are backed up by the underlying assets (Ritter, Silber, & Udell, 1996). The process of securitization is the pooling of a group of loans into a trust and then selling securities issued against the trust. A prerequisite for securitization is the ability to standardize the asset (Ritter, Silber, & Udell, 1996). Within this meaning we have two types of securitized assets namely: (1) the mortgage backed securities (MBS), and (2) the asset backed securities (ABS). The mortgage backed securities are further divided into commercial mortgage-backed securities (CMBS) and retail mortgaged-backed securities (RMBS) (Bodie, Kane, & Marcus, 2001). Common ABS include those derived from
automobile loans, credit cards receivables loans, and home equity loans (Fabozzi, Ferri, & Mann, 2005)

According to Bodie, et al (2001), Asset-Backed securities can be traced way back in 1970 when the Government National Mortgage Association (GNMA) of the US introduced what is known as mortgage pass-through securities. This was done by making homogeneous pools from individual home mortgages. The GNMA pass-through security was backed by a pool. Holders of this security would receive payments on sale of the security as well as on interest from the said security. Following this was the collateralized mortgage obligations (CMOs), which was as a result of allowing the mortgage-backed securities to have different maturity periods by way of tranching. Later in the mid 1980s came the asset-backed commercial paper. The commercial papers were secured by almost all debt instruments across the board (Subido, 2003).

The mid 1980s saw the actual birthing of the asset-backed securities by way of extending securitization and at the close of 90s, the industry was valued at over US $400B in the US alone. The growth spread to Europe and Asia with great impact in Japan and limited impact in other Asian states (Leixner, 1999). Much of the securitizations were on car loans and credit card receivables. It has now grown in leaps and bounds into a highly diversified $1.2 trillion market with a wide range of collaterals (Guggenheim Partners LLC, 2013).

Securitization offers local institutions with additional flexibility in managing credit, liquidity and other risks coupled in originating and funding assets. Securitization has guaranteed that the market will remain liquid and that the risks are spread. This has helped in the robustness of the financial markets attracting many investors and giving confidence to the borrowers (Nkontchou, 2010). In Africa it is startling to note that only South Africa has an active asset-backed securities market. The market was opened in 1989 with an issue of R250m of MBS. The securitization market in South Africa continues to grow in both size and innovation. It has been widely observed that securitization offers tremendous opportunities and potential benefits to issuers and investors. Securitization also provides companies with access to a different source of financing from the long-established financing methods available in South Africa.
The issuers are given a vehicle that they can use to convert non-liquid financial assets into tradable capital market instruments. This provides debt equity financing at lower processing and execution costs as well as efficient and highly diversified instruments. Through securitization, the company has a way of striking-off assets from their balance sheets and invest the proceeds from this process into other assets that with better returns.

In Kenya Securitization has not taken root yet. The recent developments in this direction started with the enactment of the Asset-Backed Securities Act of CMA in 2007 (Capital Markets Authority, 2007). This was followed by the plans announced by KenGen of its intention to raise Ksh. 30B by issuing Kenya’s first asset backed bond that would trade at the Nairobi Securities Exchange (NSE). The bond is to finance expansion of geothermal power generation capacity to a volume of 3,000MW by 2018 in support of Kenya’s Vision 2030. This will be a 20 year bond and will be collateralized by the steam already drilled and the repayments will be serviced through the cash-flows from the sale of geothermal power (Mwaniki, 2013). This plan however is still in the pipeline.

1.2 Problem Statement

The international financial markets have expanded access to liquidity by way of financial innovation. In particular securitization has played a key role in this as observed by Nkintchou, 2010. In Africa however, securitization has been almost inexistent with only a slow market in South Africa. It is argued that the probable reason for this reluctance is that the Africa bankers unlike other bankers are not convinced that the benefits derived from securitization outweigh the costs (Tensfeldt, Firer, & Bendixen, 1993). This begs the question as to whether there is something that the western world knows and Africa doesn’t know. The intention of this research is to address this gap with a view to enabling a rapid initialization of Asset-Backed Securities market in Kenya.

Securitization is an area that has received minimal attention by Researchers and scholars at large in Kenya. There researcher could not find any literature on empirical studies of asset-backed securities in Kenya. Most of the empirical studies found have been conducted in the US and Europe. This fact is the force behind the desire to carry out a study of this nature to determine the perceived importance of introducing asset-backed securities at the NSE. Because of the importance particularly with regards to the
perceived benefits and challenges, it is critical that we study the perceived benefits, perceived challenges and possible solutions to unlock this great financial innovation (Waithaka & Ngugi, 2013). It would be really valuable to study it from a wider perspective looking at various aspects. This study aims at examining the feasibility of asset-backed securities at the Nairobi Securities Exchange.

1.3 Purpose of Study

The purpose of the study was to examine the feasibility of asset-backed securities in Kenya.

1.4 Research Questions

This study was guided by the following research questions:

1.4.1 What are the benefits of Asset-Backed Securities in the financial market?

1.4.2 What are the challenges facing Asset-Backed Securities market?

1.4.3 What are the possible solutions to overcome the challenge facing Asset-Backed Securities market?

1.5 Importance of the Study

The results and findings of this research study with regards to the information obtained are anticipated to be beneficial and valuable to the following entities among others:

1.5.1 The Government and Financial Market Regulators

For years, the government has shelved this so important innovation that has led to realization of phenomenal financial markets growth all over the world. Noting that Kenya is a developing country requiring huge financial capacity to, meet the financial requirements for vision 2030 and the already emerging mining and drilling industry. The results of this research may trigger the need to fast-track the establishment of a vibrant asset backed securities market since it reveals that ABS market is key to attracting foreign direct investments (FDI). In addition ABS is the driving force behind active mortgage market and the Government has been pushing and advocating home ownership for its
citizens. Such information emanating from this research will be of use by the Government in meeting its obligations to the citizens. The research will as well enlighten the financial market regulatory authorities to the framework and procedures that would be necessary to make the ABS market active. Further, the perceptions of the market will be vital to the Government and regulators in appreciating the investor appetite for the asset backed securities.

1.5.2 Individual and Corporate Investors

The current financial market in Kenya is largely limited and constrained in terms of the financial instruments available for investment. This research examined an instrument that is yet to take root in the Kenyan financial market. The research provides new information on this instrument thereby adding to the potential investor(s) an array of investment opportunities whether on long-term fixed income investment or on speculation. ABS offers the investor a range of benefits due to its attractive yields, reduced risk, predictable cash-flows, diversified investment that is of high credit quality.

1.5.3 Financial and Non-Financial Institutions

The financial institutions desire to see unlocking of liquidity crunch that they face as a result of having their funds tied up through long term loans and mortgages. The other aspect is on the ability to distribute risk associated with lending business. This research will benefit the financial institutions by providing critical information on the role that the financial institution would play in facilitating and supporting the establishment of asset backed securities market in Kenya.

Non-financial institutions such as insurance companies find themselves constrained and limited as far as investment avenues are concerned. With ABS market providing diversified instruments, this research would be of use to such institutions by giving information on the investor appetite for ABS. They may find ABS is going to give them better and stable returns.
1.5.4 Researchers and Academicians

This research is an important addition to the existing repository of knowledge and tends to expand that which is already known with a view to adding new knowledge. Academicians and researchers endeavoring to further the study on feasibility of asset backed securities in the Kenya financial securities markets will find this study to be an important tool in the course of their research.

1.5.5 The General Public

The general public may find this research quite interesting to study and by so doing expand their knowledge in asset backed securities and feasibility of these instruments to the Kenyan market.

1.6 Scope of Study

This research is conducted within the Nairobi region and the researcher specifically targeted direct and active participants at the Nairobi Securities Exchange. These participants are all the registered investment banks and brokers in good standing situated within the city of Nairobi. The current number of investment banks and securities brokerage firms at the NSE is 22 with the recent launching of KCB capital Investments Company. Out of the 22 investments banks and securities brokerage firms, two are under statutory management and were exempted from this research as well as KCB on virtue of being a new entrant leaving 19 firms for the study. In addition the researcher included the Capital Markets Authority (CMA) as the financial market regulator. The research was undertaken between April and May 2014.

The researcher made every effort and used all resources at his disposal in an effort to collect data from all targeted participants. The researcher expected that the participants would accord the required level of cooperation. It is probable that there might have been some level of non-cooperation and that some data was falsified by the respondents. Equally it would be good to note that there may be occasions where the data required was unavailable and in some instances there might have been language barriers. To mitigate on these perceived data collection issues, the researcher generalized the findings to represent the entire possible participants view in terms of the asset backed securities.
financial market. Further, the researcher targeted expert respondents who are the main players at the NSE and as such issues of language barrier and inaccurate data are expected were minimal. Finally the researcher provided a disclaimer that the data gathered will be specifically for academic research used in strict confidence and would not be used for any other purposes.

1.7 Definition of Terms

1.7.1 Securitization

This is the process where loans, receivables and other assets are pooled effectively and the related cash-flows and economic values are used to support related securities that are created from the pooled assets (Fabozzi, 2004).

1.7.2 Asset Backed Security

The securities issued through the process of securitization that is: securities created from a portfolio of loans, bonds, credit card receivables, auto loans, mortgages, aircraft leases or other financial assets, are referred to as asset backed securities (ABS) (Hull, 2009).

1.7.3 Retail Mortgage Backed Security (RMBS)

This is a financial instrument whose cash-flows are dependent on the cash-flows of an underlying pool of mortgages. Mainly, these securities are categorized into three types, that is: (1) collateralized mortgage obligations; (2) mortgage pass-through securities; and (3) stripped mortgage-backed securities (Fabozzi, Ferri, & Mann, Overview of the Types and the Features of Fixed Income Securities, 2005).

1.7.4 Special Purpose Vehicle/Entity (SPV/SPE)

This is also known as a conduit and it is a financial firm that is in the business of buying loans and/or other financial assets from the originators/sellers with the aim of making profit by pooling these assets and repackaging them as securities. These securities then are offered in the financial market either public or by private placement (Elmer, 1999).
1.7.5 Originator/Seller

The originator also referred to as the seller is the firm whose assets in terms of receivables and other assets are removed from the balanced sheet and sold off to another entity; the SPV (Fabozzi & Modigliani, 2009).

1.7.6 Financial Innovation

Financial innovation is defined in terms of creating and then marketing new financial instruments, technologies, institutions and markets. This includes both the products and the process variants (Fabozzi & Modigliani, 2009).

1.8 Chapter Summary

In this chapter the researcher has introduced the topic under research that is “Feasibility of Asset-Backed Securities in Kenya”. Further the research questions have been outlined as: the benefits of Asset-Backed Securities; the challenges facing implementation of asset-backed securities market; and the solution to overcome these challenges. The researcher also noted the possible entities that are likely to gain from this study being: the Government; investors; financial and non-financial institutions; academicians; and the general public. In addition, the researcher defines the scope of the study in terms of geographical, population and the time within which the research will be carried out. At the tail end of the chapter the researcher defines the terms that will be mostly used in this study.

In the next chapter the researcher will carry out a literature review analyzing the available literature on the research topic. The research will appreciate the studies conducted in this area, their relevance and application to the Kenyan Market as well as the gaps that might have been left out. Comparisons of the available research and a critique of the same will be carried out with a view to depicting the differences between the earlier researches and this particular research.

Chapter three of this study discusses the research methodology, explaining the research design, the population, the sampling design, the sample size, the sampling frame
techniques, as well as data collection methods, research procedures and data analysis methods. Chapter four the researcher presents the results and findings in both tabular and graphical formats. Finally, chapter five of this study provides summary, discussions, conclusions and recommendations.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter discusses empirical and theoretical studies on Asset-Backed Securities. The literature review will seek to evaluate the relevant studies done and the researcher will provide a critique of these studies with a view to underpinning the critical importance of the topic under research. The researcher will discuss literature on the benefits of Asset-Backed Securities in Kenya; the challenges impeding implementation of this securities market; and the solutions that are necessary to overcome these challenges.

2.2 Benefits of Asset Backed Securities

2.2.1 Enhancement of Market Liquidity

Literature shows that asset securitization creates value by increasing liquidity, reducing or reallocating credit or interest rate risk, improving leverage ratios, and allowing recognition of accounting gains. Above that, many of these securities give the raw material for synthetic securities traded in derivatives markets, expanding the market for the underlying asset. Through this, financial re-engineering can create entirely new cash flow patterns designed to meet various clientele needs. The investors are attracted to the spread over government security rates on asset-backed securities and trade-off liquidity, interest rate, call, and credit risk for the higher yields available in the asset-backed market. Securitization increases liquidity for the originator. In the agency-swap program, the originator receives a liquid asset in the form of a mortgage-backed security while under the cash program, the lender has cash proceeds to reinvest, either in additional mortgage lending or in alternative liquid instruments, such as Treasury securities (Ambrose, LaCour-Little, & Sanders, 2005).

The rationale is that the lenders are able to convert their illiquid assets for liquidity thereby increasing the market liquidity through securitization (Fabozzi, 2001). This argument is further extended and confirmed by Loutskina (2005) and emphasized by additional works of Loutskina and Strahan (2009).
The research works of Ambrose and Thibodeau (2004) to evaluate the affordable Housing Goals (AHG) on the rising mortgage credit availability for particular Metropolitan Statistical Areas (MSAs) showed that there was positive relationship between total mortgage originations and the percentage of undeserved borrowers within the MSA in 1998. They also found out that the more the Government Sponsored Entity bought the mortgage loans the more new mortgages were taken. Further, has been shown that for banks that securitized using collateralized Loan Obligation and hence removed these loans off their balance sheet, observed permanent increase in the loan levels by 50% spread over many years (Goderis, Marsh, Castello, & Wagner, 2007).

It is noted that ABSs could be liquid at some point but may suffer significant valuation uncertainty at other points in time. Further, market liquidity conditions may be different across issuing and secondary markets, and this difference may be subject to changes over time as well. For certain assets, secondary markets may even not exist, despite strong issuance. Prior to the financial market turmoil of 2007, CDOs had been liquid in primary issuing markets, yet secondary market trading remained limited, notably for bespoke operations (Praet & Herzberg, 2008).

### 2.2.2 Risk Dispersion

Available literature has shown that banks securitize their assets because pooling and tranching may result in risk diversification and effective risk sharing among many investors (Jiangli, Pritsker, & Raupach, 2007). The critical issue to note though is that the empirical literature analyzing the effectiveness of securitization in dispersing risk is limited. A number of studies that quantitatively look at the impact of securitization have only been published recently discussing the risk profile on issuing banks (Sabry & Okongwu, 2009).

A study done by Dionne and Harchaoui (2003) analyzes the impact of securitization on capital ratios and then on bank risk. Further, an examination of the relationship between securitization and risk-adjusted capital ratios is carried out. This is done using data from Statistics Canada’s Securitization Survey (1988 – 1998) and the findings are that increased securitization reduces risk-adjusted capital ratios. In addition the researchers question whether securitization increases the riskiness of banks as measured by its change
in credit risk. Their suggestion is that Basel I regulatory requirements do not provide the most efficient framework for banks to assess the riskiness of assets (Dionne & Harchaoui, 2003).

It is observed that the overall risk of an issuing bank is dependent on how it decides to reinvest the proceeds from securitization. Further it is noted that a bank that reinvests in risk-free assets is expected to have less overall risk, compared with a bank that expands its loan originations and thus increases its risk exposure (Franke & Krahnen, 2007). In another research Hansel and Krahnen (2007), construct several models to measure the change in beta after a securitization announcement and the findings are that the estimated change in beta due to a securitization announcement is positive and statistically significant. On performing a regression, the estimated change in beta on a number of firm-specific factors so as to determine the source of the change in systematic risk, it is found out that the change in beta is higher following a securitization announcement for banks that have a lower return on equity and a lower equity ratio. This proves that banks that are financially weak experience a higher increase in their systematic risk relative to banks that are financially sound following securitization (Hänsel & Krahnen, 2007).

Securitization is also seen as a method of hedging interest rate risk with available literature indicating that securitization permits banks to react to changes in the interest rate environment in numerous ways. The banks have more choices on how to hedge their assets. One way to do this is by changing the duration of assets through pooling and tranching loans into securities, buying investment-grade tranches of a deal, or retaining the residual tranche (Hess & Smith, 1988). In addition, securitization offers larger access to capital. This is in line with the empirical study conducted by Loutskina (2005) that indicates that banks that are able to securitize more easily are more liquid and therefore less sensitive to shocks that arise from changes in monetary policy.

Further research would be on the impact of retaining the first loss piece in a securitization transaction. Issuing banks often hold on to the residual tranche of a securitization because of potential moral hazard and adverse selection problem. Banks lower their tail risk (the risk of extreme unexpected losses) by selling the senior tranches to investors (Franke & Krahnen, 2007). This combined effect can effectively reduce a bank’s exposure to extreme losses (Jiangli, Pritsker, & Raupach, 2007).
Before the global financial crisis of 2007 the common view emphasized the positive role played by securitization in dispersing credit risk thereby enhancing the resilience of the financial system (Shin, 2009). This view was prevalent even in the policy as argued by Greenspan (2005) that the use of credit risk transfer instruments, such as securitization, facilitated the largest and most sophisticated banks to divest from credit risk by passing it on to institutions with far less leverage. Whether the total risk remained within the banking sector, securitization was meant to enable banks to lower their overall risk profile due to diversification and more tradability of assets (Duffie, 2008). In line with these observations there is empirical evidence that indicates that securitization lowers banks’ risks levels and banks which are more active in the securitization market were found to have lower solvency risk and higher profitability (Cebenoyan & Strahan, 2004).

Another empirical research carried out by Loutskina (2005) examines the relationship between securitization and liquid assets among commercial banks. The ability to securitize existing assets lets banks to convert less liquid receivables into cash, which gives extra sources of funding that can be used to originate more loans. This extra source of funding might help lessen the effect of an interest rate shock. In the event of a sudden interest rate hike, banks that securitize can dig into the cheaper, internal source of funding instead of borrowing at a high cost in order to maintain their lending activities. In follow-up of this theory, the research by Loutskina (2005) reveals that banks with more loans that are “securitizable” are more liquid and therefore less sensitive to fund shocks that arise from changes in monetary policy.

Numerous studies have examined the relationship between securitization and banks’ capital ratios. According to Dionne and Harchaoui (2003) there is a negative relationship between securitization and tier 1 capital, as well as total capital, for the Canadian financial sector over the 1988 to 1998 period. Equally, Uzun and Webb (2006) found that securitization is negatively related to the bank’s capital ratio, a measure of banks’ risk, for US banks, even though their result is primarily motivated by the securitization of credit card receivables. All these results are in agreement with the findings of Greenbaum and Thakor (1987) that securitization aids in reducing banks’ risk since assets are removed struck off the banks’ balance sheet. Far from this view, studies done by Cantor and Rouyer (2000) argue that, banks may assume higher risk assets on their balance sheet depending on the assets being securitized.


2.2.3 Reduction of Cost of Credit

Securitization is said to reduce the cost of credit by the fact that the lenders will have supply of liquidity and thus the law of demand and supply applies where the increased supply reduces the cost (Batchvarov, Collins, & Davies, 2004). Evidence shows that there is a negative correlation between the growth of securitization and the interest rates spread thus indicating that securitization reduces the cost of credit (Passmore, Sparks, & Ingpen, 2002). A further study was conducted later and equally concluded that the interest rate spread and the growth in securitization are negatively correlated (Passmore, Sherlund, & Burgess, 2005). This similar trend was shown in the research conducted by Blinder, Flannery, and Lockhart (2006). Further research has shown that securitization allows securitized assets lending firms to pass on both the benefits and losses emanating from fluctuation of interest rates faster than other form of lenders (Amelia, 2008).

It has been suggested that securitization stimulates credit growth by contributing to lowering banks’ credit standards (Shin, 2009). This extension of credit allows individuals to finance various items like housing and automobiles, and any items purchased using a revolving credit line (e.g., credit cards). Historically, individuals relied on securing the financing for big ticket items from a single lender like a regional bank. Since the supply of credit was localized, there was less competition between lenders to provide financing at low interest rates. In the growth of securitization, the number of lenders has significantly increased and become global in its reach. In Theory, the bundling of individual loans to one aggregate loan should give the economies of scale necessary for larger investors to participate in the consumer credit markets. Data collection automation brought about by advances in computing technology has enabled investors to track the performance of the underlying collateral. Standardization of these bundles of loans into tradable securities should bring market efficiencies into personal finance by allowing diverse sets of investors bidding for the rights to lend individuals money. This leads to an increase in the percentage of loans that have been securitized to lower the cost of credit to individual borrowers (Sabry & Okongwu, 2009).

Growth of Financial Markets

Over the years, there have been a lot of financial innovations that have improved the liquidity of assets, firms, and markets, better opportunities for diversification, and higher
competition between suppliers of credit. Due to this, firms have better opportunities to manage risk while the cost of capital to the non-financial institutions has reduced (Kroszner & Strahan, 2011). It has been observed that economies with better developed financial systems tend to grow faster than other economies and further indicators are that this relationship is causal (Ross L., 2005).

Through securitization banks were able to actively manage their credit, funding, and liquidity risk, and leverage up their lending role, since they were no longer required to retain the credit risk until maturity. Further, there was increase in demand for more tailored financial instruments (International Monetary Fund, 2009). In addition through securitization institutions are allowed to transfer their assets to a SPV, which issues bonds that have credit ratings dependent only on the performance of the underlying pool of loans and any additional credit enhancement used (Fabozzi & Kothari, 2007). Research has shown that the global growth of securitized products rose in most mature markets by 2007 before declining quickly due to a lack of liquidity in secondary markets and a decline in primary issuance. On the other hand securitization grew in the emerging markets due to desire for safer assets coupled with introduction of some prudential standards (Bank for International Settlements, 2011).

The economic theory indicates that securitization creates value by reducing intermediation costs and increasing opportunities for risk sharing and risk diversification (Hoffmann & Nitschka, 2009). The efficient market theory emerged as a result of perfectly competitive market as applied to financial markets, and in particular the securities market (Fama, 1970).

2.2.4 Foreign Direct Investment

It is argued that availability of creative assets and physical infrastructure is one of the motivators of foreign direct investment (FDI) (Dunning, 1993). Securitization attracts foreign currency inflows since the creation of structured finance instruments is well developed in the developed countries and as such investors from these countries would be interested in new instruments. This brings with it the foreign currency volatility (Fitch Ratings Inc., 2013).
It is further argued that financialization which lend to financial innovation and creation of synthetic financial instruments such as asset-backed securities became the source of funding after the Bretton Woods Agreement broke down in 1971 (Giron & Chapoy, 2013). This is also observed in the research conducted at the wake of financial crisis in 2007 where it was noted that there was an outward shift in the supply of mortgage credit driven by rise in securitization (Mian & Amir, 2008).

Structured finance business offers enormous payoffs in the short-run, by instantly turning illiquid assets into liquid ones (Coval, Jurek, & Stafford, 2009). The Kenyan financial system is insulated from foreign finance and relies on domestic deposits and lending. There are no derivatives or asset-backed securities being traded and within the portfolios (Mwega, 2009). A further argument is that asset securitization can, not only broaden the local financial market but can as well be a vehicle for accessing long-term funds from the international markets (Alles, 2001).

### 2.2.5 Management of Regulatory Capital

Securitization offers the banks an avenue to reduce the level of regulatory capital required as favored by the regulatory capital rules (Ambrose, LaCour-Little, & Sanders, 2005). Further information asymmetries can encourage securitization on the assumption that the lender has better information on the credit quality of the borrower (DeMarzo, 2005). It is also argued that the current standards on regulatory capital are too high and this creates an incentive to securitize the least risky products (Calem & LaCour-Little, 2004). It is further shown that, as the capital requirements increase, the incentive to securitize loans reduces (Passmore, Sparks, & Ingpen, 2002). Securitization provides an avenue to transfer credit risks to third parties enable banks to reduce their regulatory capital requirements. This releases tied-up funds that can be used for new business opportunities (Oesterreichische National Bank, 2004).

Though most originators interviewed in a research conducted by the Bank for International Settlements (BIS) rejected the view that relaxed regulatory capital requirements was a major incentive to securitization, most supervisors are not convinced. Most supervisors cite some of the re-securitization of US private label known as Re-REMICS that happened in the residential Mortgage-Backed Securities (RMBS) market
after the financial crisis in the United States and argue that the drive was to obtain regulatory capital relief and/or to reduce adverse classification totals (Bank for International Settlements, 2011). Changes in the regulatory framework are expected to reduce appetite for securitization (Bank for International Settlements, 2011).

### 2.2.6 Generating Fee Income and Managing Profits

Through securitization the originators are able to recognize income fees upfront and this motivates the originate-to-distribute models for ABS. The fees are usually generated from underlying assets, underwriting and structuring the transaction, and providing credit and liquidity enhancements for certain structures. Further, the issuers also make arbitrage income from the differences in the spread between short-term dated liabilities issued to finance the purchase and long term dated assets (Bank for International Settlements, 2011). In addition, originators are able to generate fee income that is less capital intensive by converting an on-balance-sheet lending business into an off-balance-sheet fee income line (Office of the Comptroller of Currency, 1997).

The originators not only receive income fee paid by the borrowers but also gain from the difference between the values of the originated and the sold loans (Ashcraft & Schuermann, 2008). Through securitization banks are permitted to recognize accounting gains, when the market values of loans exceed their book values, and overvaluation of the retained interest that is carried at fair market value in the case of securitizations (DeMarzo, 2005).

### 2.2.7 Informational Efficiency

Two sides of the coin are evident from the literature available. The first argument is that securitization allows tranching to create more and also less information-sensitive products and to sell the more liquid information-insensitive products. The second argument is that securitization has an information destruction effect because it prohibits the seller to sell asset cash flows separately and by so doing optimize asset specific sales (DeMarzo, 2005). Securitization is said to focus on financial assets rather than seeking to understand and analyse the risks tied to the originator’s business thus helps to reduce information asymmetry between the originator, on the one part, and investors and third-party credit enhancers, on the other part. A caution is offered though, that the real reduction of
information asymmetry would occur by way of investors and third-party credit enhancers paying careful attention to understanding and valuing the financial assets (Schwarcz, 2009).

On the other hand it is argued that securitization presents a problem of asymmetric information due to the fact that the originators would ordinarily have more information than the underwriters (arrangers) and further, the arrangers could have more information than the asset managers (SPVs) on the quality of the assets being securitized (Paligorova, 2009).

2.2.8 Allocation and Operational Efficiency

Securitization offers a way of provide efficient allocation of capital by moving securitized loans out of the books and improves the adequacy of capital since the new funds from securitization can be used to issue more loans (Office of the Comptroller of Currency, 1997). Further operational efficiency is achieved by originators by the fact that securitization allows them to obtain optimum returns from the available capital. In addition, the weak or small companies obtain cost-competitive funding thereby eliminating particular industry entry barrier based on financial strength. It is thus argued that securitization gives operational efficiency by facilitating growth as it provides greater funding availability than the unsecured capital markets (Moody's Investors Service, 2003).

Securitization also provides risk reallocation and thereby enhances allocation efficiency by way of shifting the credit risk associated with securitized assets from the financial institutions to the investors (Gaschler, 2008).

2.3 Challenges Facing Asset-Backed Securities Market

2.3.1 The Legal Framework

Legal factors present various challenges such as: The absence of clearly defined legal framework defining the transfer of receivables to Special Purpose Vehicles; and the presence of legal frameworks restricting the transfer of receivables from one legal entity to the other (Bhattacharya & Fabozzi, 1996). The Kenya Companies Act Cap 486 gives very little mention of corporate bonds as a capital generating tool and this stands in equal
measure to securitized assets. The Act views corporate bonds as just debentures that would typically be issued to specific persons, namely banks as opposed to the public (Gakeri, 2011). There also emerges issues on the best way to protect the investors of an SPV whereby even though it is argued that the best way is to require the SPV to completely waive the right to file a bankruptcy petition; this is legally unenforceable because it is against the public policy (Klee & Butler, 2002).

It is alternatively argued that, legal issues are addressed through bankruptcy remoteness which is done by making sure that the originator makes a ‘true sale’ to the SPV and by making sure the SPV does not engage in any other business so that it does not incur debts to affect the creditors (Gorton & Souleles, 2007).

2.3.2 The Taxation Framework

The taxation framework must consider how SPVs are to be taxed and the general rule is that the SPVs are tax neutral such that their profits are not taxed because not structuring them as such would result to double taxation (Gorton & Souleles, 2007). The second part of taxation framework that is necessary is to address the implications of the SPV’s debt of the originating/sponsoring firm (Gorton & Souleles, 2007).

Other critical issues that can be a challenge in securitization are cited as: the ability of the SPV to make external payments and receive income without withholding tax, elimination of local tax liability on foreign note holders, and having a favorable VAT position for the SPV (Price Waterhouse Coopers, 2006). In Kenya the investment income from an SPV is not taxable (Capital Markets Authority, 2005).

2.3.3 Accounting Framework

One of the core issues in accounting for securitization transactions relates to whether an actual sale (true sale) has taken place thus allowing the originator to remove the assets from their balance sheet. To do this the SPV must be a qualifying SPV and second the originator must surrender total control over the securitized assets (Gorton & Souleles, 2007).

The accounting framework is noted as a complex area where you find that the local and international accounting rules differ in relation to de-recognition of assets and consolidation of SPVs. In particular many institutions are yet to evaluate and consider the
implications of the potential local adoption of IAS 39 and SIC 12 specifically, on accounting for SPVs (Price Waterhouse Coopers, 2006).

2.3.4 Regulatory Framework

Regulation is a mechanism to insist that public purposes be respected by businesses and other nongovernmental institutions in their operations (Lehne, 2013). Two basic theories dominate the role of regulation in the relationship between government and private institutions these are: the public interest theory and, the private interest theory (Mitnick, 1982). Public interest theory shows that the purpose for regulation is to protect and thereby benefit the public at large or a large part of the public. Most analysis based on this view present regulation as a response to market failure by, for example, seeking to achieve the benefits of market place competition for consumers and society in situations in which competition does not occur (Stephen, 2004). Any financial institution that is subject to systemic risk, not only banks but also other interconnected financial players, like mono-line insurers, insurance companies (like AIG which turn out to be large-scale sellers of credit default-swaps), should be covered by regulation (Brunnermeier, Crocket, Goodhart, Persaud, & Shin, 2009).

Critics of regulation have argued that regulations interfere with the efficiency of the market while the proponents argue that with well designed regulations there would be both efficient markets as well as more equitable outcomes (Stiglitz, 2009). In asset backed securities the actors are the originators, the issuers, the investors, the regulators, the credit rating agencies, enhancers and special purpose entities (Office of the Comptroller of Currency, 1997).

There are two basic approaches to financial regulation: the micro-prudential approach is targeted at preventing the costly failure of individual financial institutions and is partial equilibrium in its conception while the macro-prudential approach aims at safeguarding the financial system as a whole since it recognizes the importance of general equilibrium effects (Hanson, Kashyap, & Stein, 2011). The key question in regulation is whether some forms of regulation may be more effective than others in dealing with the adverse effects of capital flow volatility on the currently shallow domestic market (The Initiative for Policy Dialogue, 2008).
For example Chile as an emerging market they started with legal reforms that helped create the necessary infrastructure and institutions for capital markets to thrive. They first developed domestic securities and exchange commissions, regulatory and supervisory framework, and established basic environment for market operations (Torre & Schmukler, 2007). This was followed by creation of new laws and regulations intended to protect the rights of investors and these enhanced the basic infrastructure (Capaul, 2003).

Monitoring of regulations is done to evaluate whether there is consistent and total adherence to the manner and form they are meant to. A core purpose of financial regulation is to assist in reduction of information asymmetry, moral hazard and adverse selection by introducing rules relating to contracts, monitoring and so on, so that the incentives for parties to behave against the interest of others and information asymmetries are minimized (Molyneux & Goacher, 2005). The capital markets have shown willingness to regulate themselves (Hull, 2009).

All over the world the securities markets are usually regulated by several bodies that operated at different levels (Coffee, 2007). There are those that operate from within the players where they practice self regulation by adopting rules to govern listing and trading. Secondly, there are those that practice industry wide self regulation by adopting rules on a consensual and requiring compliance with them as a condition of eligibility for professionals to trade in these markets (Miller S. S., 1985).

There is a diverse range of organizational forms of regulatory systems all over the world. In the US we find multiple regulators both at federal and state level that regulate the banks, insurance firms and securities firms separately. In the UK, the UK Financial Services Authority (UK FSA) has almost a single regulatory power while in Australia and Netherlands; there are two large regulating authorities. Other countries exhibit a diverse system of regulatory system organization (Pan, 2011). Kenyan legal and regulatory framework on securities markets consists of numerous Acts of Parliament, delegated legislation, where Guidelines and rules promulgated by the legislature, Capital Markets Authority (CMA), Nairobi Securities Exchange (NSE) and the Central Depository and Settlement Corporation. This is similar to United Kingdom and South East Asia especially Malaysia, Singapore and Hong Kong (Gakeri, 2011).
The early originators of ABS were depositing taking financial institutions. In the US the originators were initially regulated by the office of the comptroller of currency as the administrator of all national banks (Office of the Comptroller of Currency, 1997). This has however been overtaken by current developments with the implementation of the ABS Act in 2004 and the subsequent enactment of the Frank-Dodd Act which set up the Bureau of Consumer Financial Protection (BCFP) as an independent bureau within the Federal Reserve System consolidating the consumer financial laws (Cohen-Cole, 2010). In particular the bill empowers static pool as part of the disclosures in protecting the investor (Price Waterhouse Coopers, 2005). The new developments have evolved as a response to the financial crisis experienced globally emanating from the US Sub-prime mortgage market (Schmudde, 2009).

The Kenyan scenario is such that ABS regulation Act was only enacted in 2007 and since then there has not been further developments (Capital Markets Authority, 2007). The market players find it difficult to operate since there is no agreement on the conduciveness of licensing requirements to the ease of entry and exit of market players. The regulatory system and market structure does not sustain the correct pricing of securities. There’s no standard model for pricing IPO’s and secondary market securities. Investors in Kenya are protected by use of formal investment limits and the financial service regulators are active to this end leading to reduction in financial crimes (Akama & Jagongo, 2013). These have been further enhanced by enactment of anti-money laundering Act as well as enhancing the banking regulations. It is however noteworthy that there is still lacking the adherence to international standards and the insider dealing and market abuse issues are yet to be regulated comprehensively (Okioga, 2013). The Kenyan Government needs to concentrate on enacting new policies to remove the institutional and market barriers to competition and this would growth the effectiveness of financial intermediation (Gichuhi, 2013).

2.3.5 Absence of Tested and Experienced Credit Rating Agencies in the Kenyan Financial Market

It is generally accepted that credit rating is defined as an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations and not recommendations to purchase, sell or hold any security (Langohr & Langohr, 2008). It is argued that having few credit rating agencies creates an
oligopoly meaning that there is little or no competition especially when the market is large (Garcia & Ruiz, 2012).

The critical role played by credit rating agencies is that they offer highly independent, qualitative and quantitative evaluation of the risk profile assessment of issuers of financial instruments. They reduce information asymmetry by creating awareness of the issuer’s creditworthiness thereby giving confidence to the investor. Kenya has only one registered credit rating agency. The structure is that a credit rating agency registered in Kenya has to have reputable International shareholding and cannot be engaged in a conflicting business (Gakeri, 2011).

2.3.6 Adverse Selection and Risk Shifting Challenge

Institutions would ordinarily prefer the less costly route to securitization and thus tend to securitize lower risk assets since they have reduced credit enhancements and lower due diligence costs. On the other hand, institution may select high quality loans thereby “cherry pick” their portfolios for securitization, leaving the existing debtors with low quality assets. Furthermore, the institution could hand pick a mix of both low and high quality loans using “cookie cutter” techniques to generate securitizable loans by following secondary market in determining standards (Bhattacharya & Fabozzi, 1996).

Since securitization offers the benefit of shifting the risk from the lender to the investors, there might be temptation to sell only the weakest assets through securitized structures indicating that investors may find themselves loaded with “lemons” (Bhattacharya & Fabozzi, 1996). In their research work Benmemlech, Dlugosz and Ivashina (2012), argue that adverse selection is not an inevitable consequence of securitization and that within a good interplay between the originator and the investor mix these concerns could be addressed. They also note that the issue of one-size-fits all cannot be applied in securitization as there are critical differences in each process as well as different motivations across structure asset classes (Benmelech, Dlugosz, & Ivashina, 2012).

2.3.7 Issuance and Pricing of ABS

Issuance based on asymmetric information between originators and investors can be beneficial with the originators signaling high quality assets by retaining part of the issue through equity tranche (DeMarzo, 2005). It is however noted that four factors namely: default risk, liquidity risk, optionality and convenience will affect the ABS pricing. The
securities are priced with a risk premium factor based on the default risk. The larger markets take preference over the smaller markets owing to the mere fact that investors prefer securities that can be sold easily and at a reasonable price. Securities with limited markets must bear a liquidity premium to attract investors. The option given to the underlying assets for early repayment intimates that such a security must have wider spread (Furletti, 2002).

2.3.8 Breaking the Link between the Originator and the Owner of the Securitized Loan Presents a Challenge

It is noted that securitization separates the originator or the lender of the loan and the owner of the loan since the originator sells the loans to an independent entity the SPV who appoints the servicer for the loans (Levitin, 2013). This breaking of the link between, on the one part, the originator of the loan and the party responsible for monitoring the loan over its life-time, and, on the other part, the principal in the investing relationship – the owner of the securitized loan; reduces the motivation for collecting information and misplaces whatever information is collected: the information is not jointly transferred with the loans when they are sold for securitization by the originator (Keys, Mukherjee, Seru, & Vig, 2010). This observation is further accentuated when it is noted as the result for issuance of low quality securities resulting from information asymmetry (Purnanandam, 2011).

2.3.9 Involvement of Credit Rating Agencies in Other Commercial Activities

It is noted that the credit rating agencies are not able to foresee an oncoming default rather, they only tell after the disastrous default catastrophe has occurred (Langohr & Langohr, 2008). This failure has been the ambit of the growing agitation for regulation of credit rating agencies (Papaikonomou, 2010).

The investors rely on credit ratings for securitizations and other structured credit products. Credit rating agencies play a key role in these markets and the challenge is for these agencies to tighten governance and better their transparency as well as disclosure standards (International Monetary Fund, 2009). The agencies are relied upon not only by the investors but also the borrowers, issuers and governments in today's financial markets (Manaigo-Vekil, 2012). The CRAs started playing their role as a service to the investors but later shifted the same services to issuers (IOSCO, 2008). In addition to this shift they
became the agents for the financial regulators whereby they provided the services of requiring financial institutions to use the specific bond creditworthiness information that was provided by the major rating agencies (White, 2010). This brings to the fore the fact that there are questions of competition and conflicts that arise from the shift to issuer-pays business model which the regulators must address effectively (Bunjevac, 2009).

2.3.10 Liquid Markets for ABS Reduce Incentives to Issue Good Quality Loans.

Securitization is argued to have been the reason behind the banks’ reduced incentives and their laxity in screening the borrowers due to the fact that it allows them to remove the loans from the balance sheets and transfer borrowers’ default issues to be a direct problem of the investor. This loophole allowed a high percentage of bad-quality loans to enter the market particularly at the onset of the global financial crisis (Paligorova, 2009). During this period the greater motivations were: increased demand for more tailored instruments and, the need for securitizers to sell the lower-rated “leftovers,” (International Monetary Fund, 2009).

Contrary arguments are that the banks may desire to securitize the high quality loans and use the proceeds therefore to sell/lend to riskier borrowers to increase expected returns without changing capital requirements thus provide a perfect fit for both economic and regulated capital (Greenbaum & Thakor, 1987).

2.4 Ways to Overcome Challenges of ABS

2.4.1 Establishing Optimal Regulation

There are four basic characteristics that a regulatory system must have for it to be termed as optimal, these are: efficiency, competency, accountability, and legitimacy. These define the effectiveness of a regulatory system in meeting its objectives. The regulatory system should be designed such that there are no redundancies or even overlaps which is the weakness with the US regulatory system (Baily, 2009). The overlapping roles with no single regulatory body carrying out the entire and distinct part of the regulation have been criticized especially in the wake of financial crisis (Enrich & Paletta, 2008). In furthering accountability, the regulatory system needs to have a linkage point with international regulatory bodies, which is what was lacking in the European Union market (Pan, 2003).
The regulatory system should also be designed in such a way that it encourages competency and one of the elements of competency is expertise (Bratspies, 2009). One way to enhance expertise involvement is by assigning regulatory authority to the best positioned body. This is the core principle in advocating for self regulation and delegation of regulatory authority to self-regulatory organizations (SROs) (Jordan & Hughes, 2007).

The other element of competency is experience in that the regulators should regulate matters in which they have vast experience. Experience is enshrined in the cultural context and as such a body like SEC has had very long experience in regulating the US Financial Market (Seligman, 2012). In addition, a regulatory system should be legitimate in that its regulations are recognized and accepted by the market participants. The regulatory authorities though having legal authority can wield more power when their actions and decisions are viewed as largely being correct (Pan, 2011). The regulators lose this power particularly when the players sense a Government hand in the regulations as it happened in Japan when Government interfered with the regulatory authority response to the financial problems of the 1990s (Davies & Green, 2008).

Furthermore, it is important that the regulators be open and transparent in developing and enforcing their rules and regulations. This can be achieved by interacting with the participants by way of consulting with them, holding public meetings and even providing notice and comments on new rules and regulations (Pan, 2011). Central banks have been known not to be transparent and this is a point of concern on their role as financial regulators (Dincer & Eichengreen, 2007).

Regulators are faced with the most challenging task of striking a fitting balance between the twin objectives of ensuring the safety and soundness of the financial system, as well as improving the attractiveness of the market to foster growth and development of the financial markets (Butler & Macey, 1988). To find the proper balance of regulation, three basic strategies: regulatory competition, regulatory cooperation, and self-regulation can be employed. Competition means that the regulatory authorities are established as options to one another (Pan, 2011). This gives the institutions and persons subject to regulation an array of regulatory choices in which customers and investors will get involved in the options that have sufficient regulatory protection. On the other hand, the service providers
and issuers will only get involved in the markets where the regulatory compliance burden is reasonable (Cox, 1999).

For various reasons competition regulatory regime may not be appropriate and one of the alternatives would be regulatory cooperation. This works where regulators from different regimes meet and harmonize their regulations, thereby having different authorities ideally having similar standards (Schaffer, 2002). Regulatory cooperation is faced with the challenge of the process in which cooperation operates. This was exhibited when the European Commission tried to impose a common set of regulatory standards on individual member states using a chain of orders. These directives failed initially because some of the member states resisted and refused to implement comprehensively as required (Pan, 2011).

The third strategy is by way of self-regulation which is often considered less costly (especially to the Government) than the other strategies of regulation. It is less costly because the industry pays for its own regulatory machinery (Pan, 2011). Both Financial Industry Regulatory Authority (FINRA) and its predecessor National Association of Securities Dealers (NASD) in the US are good examples of self regulation (Ferran, 2003). FINRA is funded by its individual members and derives authority from the SEC where SEC only intervenes if the SRO is not fulfilling its regulatory mandate as required (Seligman, 2004).

Regulation roles can be combined into what is referred to an integrated approach where, one regulator has oversight on all types of financial institutions and undertakes prudential regulation as well as conduct-of-business (otherwise referred to as consumer protection) regulation. This approach is intended to get rid of regulatory arbitrage, encourage better communication and information-sharing among regulators of a given institution, and combine rule-making and application (Fresh & Baily, 2009).

2.4.2 Separating the role of credit rating agencies, competent bidding, and issuer-pays situation

Conflicts exist at two levels namely: the individual analyst level and at the rating agency level. At the individual analyst level the issues surrounding the conflict would be the individual having: ownership in the rated company, directorship in a rated company,
personal relation in a rated company, gifts from a rated company, and compensation based on the rated company rating fees. At the rating agency level the issues are likely to be: affiliated underwriter or issuer, ancillary services to rated firms, large subscriber influence, and issuer-pays model (Bai, 2010). The rating agencies have argued that their reputation is what keeps them in business and as such the issuer-pay model does not present a conflict since being biased in their ratings would mean losing their reputation and their very reason for existence. However, from the financial crisis of the 90s it has been noted that there were clear agency conflicts that led to the crisis (Coffee, 2004).

Rafts of measures among them regulations have been undertaken both in the US and in Europe to reduce the instances of conflicts. At the individual level ownership of shares in the rated firm by the credit analyst is prohibited, further directorship in a rated firm and also rating a company which the analyst received gifts from is prohibited. In addition relationship with a rated company that go beyond ordinary business must be disclosed. Notably gaps remain on the area of compensation that is wholly or partly derived from fees paid by the rated firm (Bai, 2010).

At the agency level there are measures to prohibit relationship with the issuer and the underwriter of a rated firm, also where the agency has been offering other services they are prohibited from rating such a firm. In addition, there must be set rules and procedures of engagement for large subscribers. On the issuer pays there are restrictions that not more than ten percent of the rating agencies revenue should be sourced from a single rated firm. Though this is welcome, the fact that CRAs are few means that they handle very many firms and as such revenue from each of the rated firms is minimal in terms of percentage (Bai, 2010). Above this, there are various internal regulations for the CRAs and recommendations by world finance bodies (IOSCO, 2008)

It is intimated that the desire for CRAs to self-regulate does not amount to anything much since the very issues that they seek to regulate are of their own creation among them being: separating credit rating activity from other services, modifying methodology, and improving transparency. The remarkable credit rating downgrades of 2007 and the phenomenal ratings downgrades particularly hitting structured finance instruments during the crisis, goes far to show the over-optimism that CRAs had in performing their own monitoring (Papaikonomou, 2010).
2.4.3 Credit Enhancement

The credit worthiness of the asset-backed security can be enhanced by way of internal and external credit enhancement. The internal enhancement is provided by way of collateralization while external enhancement is given by way of guarantee by a third party (Bhattacharya & Fabozzi, 1996). The first matter is to split credit risk in tranches and place them with parties that are willing or best able to absorb it. These are known as junior, mezzanine and senior tranches. Enhancement is one of the biggest costs of securitization. Internal enhancement is structural or cash flow driven while the external enhancement is third-party or seller’s guarantee. The third party may be done through letter of credit, recourse to seller, or surety bond (Office of the Comptroller of Currency, 1997).

The rating of the securitized asset is dependent on the level of credit enhancements provided for that security. This is suggestive that there is a negative relationship between the level of enhancements on a deal and the performance of securitized assets. In this scenario, enhancements serve as a buffer against observable risk (Ashcraft & Schuermann, 2008).

Studies show that the buffer role played by enhancement is the favored role as there is little or no evidence to support the signaling role which would help to solve part of the asymmetric information problems that may plague the securitization process (Mandel, Morgan, & Wei, 2012).

2.4.4 Managing the Risk Appetite of Investors and Curbing Origination of More Risky ABS

The growth of ABS market leads to increased investor appetite and pushes the originator to create more risky ABS. This was the observation made in a study post the financial crisis of 2008 where the originators had created too sophisticated products and the investors kept on going for more (Sabry & Okongwu, 2009). This challenge can be overcome by managing the risk appetite of investors. It is equally observed that the lenders’ appetite for risk grew during this period especially owing to the short term returns (Higgins & Mason, 2004).

It is similarly observed that on one hand securitization reduces the credit risk for the banks thus giving a positive association between securitization and credit risk (Dionne &
This is emphasized by Cebenoyan and Strahan (2004) when they state that securitization reduces banks’ credit risk. The challenge is noted by Purnanandam (2011) where he says that banks go for new risk. It is argued that the issuer’s credit position improves if the riskiness of the securities sold to investors is higher than that of the issuer prior to securitization, lest the transaction would exacerbate the issuer’s assets to default risk exposure (Cantor & Rouyer, 2000).

It is argued that the investors are attracted to securitized assets because of high credit quality inherent in the product since it is highly rated, with relative safety requirement being a product of remote bankruptcy where the instrument is separate from the SPE and the credit enhancement on the product. Secondly, provides a form of portfolio diversification being assets with low correlation with the other portfolios. Thirdly, the yields are attractive (Bank for International Settlements, 2011).

### 2.4.5 Strengthening Prudential Oversight of Capital Management

Reduction of regulatory capital has been highlighted as one of the key drivers to securitization structures that actually led to the global financial crisis. The regulatory framework further encouraged complex structures in that the greater the divergence between the required amount of regulatory capital for an asset and the estimate of necessary economic capital, the greater the incentive to securitize the asset (Bank for International Settlements, 2011).

Basel I framework provided opportunities for regulatory arbitrage and, these were seen as the drivers of securitization. These gaps were however addressed in Basel II but, the financial crisis would put cracks in Basel II in areas of enforcement, regulation and disclosure. Though Basel II anticipated and hived off: credit, liquidity and counterparty risks in its framing, this did not fully cater for the complexity of structure instruments and the interconnectedness of risks that emerged. The removal of securitized products from the balance sheet exposed the originators to both implicit and explicit continuing contingent credit and funding risks which were not disclosed to neither regulators, nor the investors (Kiff, Jobst, Kisser, & Scarlata, 2009).

### 2.4.6 Improving the Accounting Framework

Key findings after the 2008 global financial crisis show that there we critical issues emanating from uncertainties and complexities in securitization accounting. For example
the consolidation rules on balance sheet, financial statement disclosure, the complexity in valuation of securitization products played a key role in the financial market collapse by creating doubts about counterparties’ creditworthiness. The accounting rules also risk exposures to be hidden from the investors and further, the products held for trading Uncertainties regarding accounting rules for trading purposes (for sale before maturity) were subject to fair market valuation but as markets became illiquid valuations were difficult and had to use non-transparent models that were viewed with suspicion (Kiff, Jobst, Kisser, & Scarlata, 2009).

The two accounting issues that were critical in securitization are: de-recognition of assets and consolidation of SPVs. These issues have been addressed but loopholes still exist in the GAAP where an originator could share control with non-controlling interest in the SPVs thereby having no party with the assets in their balance sheet. Further, though both standards provide similar treatment for consolidation, there might be loophole for regulatory arbitrage and adverse incentives for recognition (Kiff, Jobst, Kisser, & Scarlata, 2009).

2.4.7 Changing the Taxation and Tax Laws

There are various forms of securitization and each of this is affected by a myriad of laws related to taxation. There are issues relate to dealing with separate entity and thus offering tax neutrality to the SPV as well as issues of consolidation that complicates taxation of SPV (Peaslee & Nirenberg, 2010).

It is critical that a high degree of certainty as to the tax position of the issuer is obtained. This is very important as the investors will require high level of assurance that there will be no tax surprises on the part of the issuer. At times it may be even valuable for the issuer to get an indemnity from the originator in case of any unforeseen taxes that may arise (International Finance Corporation, 2004).

In Kenya though the minister for finance issued a waiver of tax on investment in SPVs, it is unclear as to the tax status of the SPV itself. Further the waiver was given in 2005 and to date has not been incorporated in the main Act (Capital Markets Authority, 2005). There are no further mentions on the taxation status for profits of SPVs and this may result in double taxation. The income tax Act cap 470 is silent and expresses sources of incomes in general as taxable (Gakeri, 2011).
2.4.8 Harmonization of Legal Framework

In securitization it is usually the rule of the thumb to determine the legal status of the SPV at the onset and this is usually based on whether the transfer of the assets is going to be a true sale or not (Schwarz, 1994). This means that the transfer cannot be voided, challenged or reversed if the originator became insolvent or otherwise. It is imperative to perform as legal analysis as to whether the transaction constitutes a true sale (International Finance Corporation, 2004). It is notable that even though the CMA ABS Act 2007 states that the SPV shall be a separate entity with no relation whatsoever with the originator and that the transfer shall constitute a true sale, there is no clarity as to issues relating to information asymmetry emanating from this arrangement (Capital Markets Authority, 2007).

2.5 Chapter Summary

In chapter two the researcher has looked at the literature available on the research topic. The literature review arduously looked into the benefits of securitization and in particular the asset-backed securities. In the same breath, an in-depth look into available literature on the challenges facing implementation of a securities market for asset-backed securities was conducted. Further literature review that the researcher carried was on the solutions to overcome the challenges impeding the implementation of an asset-backed securities market in Kenya. The researcher however did not find any study on the asset-backed securities in Kenya. The only literature found on asset backed securities in Kenyan was the CMA Act on Asset-Backed Securities. The literature review also did not find any empirical evidence on the feasibility of Asset-Backed Securities in the Kenyan financial market. Further, there was no literature on credit rating Agencies other than what is in the Act on the regulations and guidelines from CMA. Even though the Act exists, there was no evidence of a company in Kenya that has securitized its assets. The only attempt was done by Kengen and there have not been any implementation this far. It is these knowledge and policy gaps that have led the researcher to embark on this research. In the next chapter the researcher discusses the research methodology, indicating the research design, the population, the sampling design and sample size, sampling frame and sampling techniques as well as data collection method and research procedures including data analysis methods.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides the detailed research methods used to study the feasibility of Asset-Backed Securities in Kenya was conducted. The chapter explicitly focuses on the research design, the population and sampling design, the data collection methods, research procedures and the data analysis methods to be implemented.

3.2 Research Design

It is noted that research design is the strategy and structure of conceived plan in a bid to acquire solutions to research problems; it is also defined as a blueprint for collection, measurement and data analysis (Cooper & Schindler, 2008). The research design that will be employed in this study is the descriptive research design which according to (Saunders, Lewis, & Thornhill, 2003), is a design meant to demonstrate a preference for commencement with and utility of theory in qualitative research. Descriptive design in addition sanctions researchers to gather, present and interpret information for purposes of clarification (Mugenda & Mugenda, 2003).

Descriptive study is meant to aid in the explanation of phenomena or characteristics associated with a subject population, it seeks to answer questions such as who, what, when, where and how of any provided topic in its wake, (Cooper and Schindler, 2008). The research design is best suited for the study as it seeks to investigate the feasibility of ABS in Kenya, thus answering the questions, what are the benefits, challenges and possible solutions to implement ABS market in Kenya? Under the descriptive research design, a survey will be conducted to identify the various benefits, challenges and possible solutions that embroil the feasibility of ABS in Kenya.

3.3 Population and Population Design

3.3.1 Population

A population is the complete set of cases or group members (Saunders, Lewis, & Thornhill, 2003); Coopers and Schindler (2008) further states that population is the total collection of elements about which one would intend to make certain inferences. The
population in this case intended for study would be the 21 member firms as listed by the NSE through their website; however two being under statutory management only 19 made the population size. Structured Finance being inexistent in Kenya, would mean that there is little emphasis on this area. For this reason the investment banks do not have a department on securitized finance as such rather, they maintain key staff who handle both debt and equity market issues. The number of senior staffs that possess valuable knowledge in this area was approximated 3 per investment advisor making the population to be 57 being the product of 3 for 19 firms. Equally, the researcher also included staff in the Capital Markets Authority; the rationale behind their inclusion is that the CMA is the regulatory body having regulatory oversight over the Asset-Backed Securities Market once established. The number of targeted respondents from CMA was approximated at 3 in line with the investment banks. The population in the study was selected as such for its convenience in data collection.

3.3.2 Sampling Design

3.3.2.1 Sampling Frame

According to Cooper and Schindler, (2008), sampling frame represents a list of elements from which a sample is actually drawn. Further, they would clearly state that the basic idea behind sampling, is primarily to draw out certain characteristics representative of the entire population, therefore the choice of the sample is extremely fundamental. For the given population, the number would not warrant a sampling technique that excluded any informant thus all the investment advisors/brokers and the CMA in the population were chosen for the study, the sampling frame is the member firms of the NSE, this sampling frame is to be drawn from the brokerage firms licensed by the CMA and listed by the NSE website, (list attached in the appendix), in addition the CMA staff will be part of the respondents for the study for their critical role in regulation of the equity derivatives in the market.

3.3.2.2 Sampling Technique

According to both Cooper and Schindler, (2008) and Saunders et al, (2003) sampling technique is a scientific or rather statistical method of selecting the sampling units that would offer the requisite estimates with their related margins of uncertainty; this would
come from the probe of only part (sample) and not the whole population. In the researcher’s case, Stratified Random Sampling was used as the researcher stratified the respondents into two, this being the CMA staff and the NSE member firms, later on Simple random sampling will be used to pick the respondents in individual categories and firms, simple random sampling is a technique under the probability sampling design which describes the whole population, it is highly representative if all subjects within the frame are to participate, thus it is most ideal for the study since all NSE listed brokerage firms were to be chosen except for the two firms under statutory management as noted. Since the selected population is rather homogeneous except for the rule enforcers, the strata will be in two, i.e. the CMA and the NSE listed firms.

3.3.2.3 Sample Size

The sample size is the actual number of respondents that would be representative of the population under research, further, the size must be large and should bear some proportional relationship to the size of population from which it is drawn (Cooper & Schindler, 2008). The sample size is determined by a three based measure, this being level of precision, the level of confidence, and finally the degree of variability in the attributes being measured. The sample size formula is provided by Yamane’s formula (Israel, 2007) as follows:

\[ n = \frac{N}{1+N(e)^2} \]
\[ n = \frac{60}{1+60(0.1)^2} \]
\[ Thus \ n = 37.5 \]

Where N is the population = 60; e is the precision level = 10%; and n is the simple size

This figure was rounded off to make the sample size 40. 40 Questionnaires were distributed. In this case, the distribution of questionnaires in the NSE member firms would be two per firm and 2 questionnaires for the CMA.

The distribution was as shown in Table 3.1 below
Table 3.1: Questionnaire Distribution

<table>
<thead>
<tr>
<th>Group</th>
<th>Number (No.)</th>
<th>Percentage (%)</th>
<th>Sample selected</th>
<th>size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Firms/NSE member firms</td>
<td>57</td>
<td>95%</td>
<td>38</td>
<td></td>
</tr>
<tr>
<td>CMA staff</td>
<td>3</td>
<td>5%</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100%</td>
<td>40</td>
<td></td>
</tr>
</tbody>
</table>

3.4 Data Collection Methods

There are a number of data collection tools available to researchers; this depends on the type of data that would be collected namely whether primary or secondary data (Denscombe, 2010). This research used primary data; the sources of primary data are interviews, questionnaires, case studies, observation, ethnography or a mix of them. Primary data was chosen to answer the objective questions; the data is to be collected using semi-structured questionnaires containing both open and close-tab questions which are to be developed from the objectives of the study and consequently from the literature reviewed concerning the title on ABS. A semi-structured questionnaire was best suited to collect the primary data as this provided some lee-way for the respondents to give additional information where required in a bid to complement their preferences. The developed questionnaire was sent to each of the selected 19 member firms of the NSE, and to the CMA staff attached with a letter of introduction. The questionnaires were distributed to all the respondents to fill-in their responses, after which they were returned via email and through telephone follow-up.

For attaining the relevant information for the different elements from the respondents of this research project the survey schedule (Appendix I) was structured as below in relation to the research questions: question 1-6 - general information data; question 7 - perceived benefits of ABS market in Kenya; question 8 - perceived challenges facing implementation of an ABS market in Kenya; and question 9 – perceived ways to overcome the challenges in implementing an ABS market in Kenya.

3.5 Research Procedure

The researcher has employed a research procedure that involves conducting a pilot study or a pre-test, this according to Cooper and Schindler (2008) would best be suited in order to analyze the questions and determine that the questions are well framed and they are not
vague, a pre-test is important as it evaluates the respondents interest. It is further stated that pilot studies are critical for analyzing the time it takes to answer the questions as well as assessing validity of the questions. The pilot study tested on 5 peers and 5 investment advisors. The purpose of the pilot study was to establish the validity and reliability of the tool being used. Having administered the pilot study, the questionnaire was amended as advised by the respondents.

The questionnaire was distributed by email with the researcher making a phone contact and paying a physical visit to the firms and then sending the questionnaire. The questionnaires were then collected electronically by way of email through telephone follow-up.

3.6 Data Analysis Methods

The various data collected was both qualitative and quantitative in nature. The qualitative data will be coded using a code book and analyzed using content analysis. The content analysis is used to interpret meaning from the context of the text data and thus adhere to naturalist paradigm (Hsieh & Shannon, 2007). The quantitative data collected was validated using validation checks, edited and coded and then analyzed using both descriptive and inferential statistics. The data presentation methods used is both tabular and graphical presentations. Quantitative data was used by the researcher to obtain detailed information which has consequently facilitated establishment of substantive conclusions and recommendations on the feasibility of Asset-Backed Securities in Kenya. The data was analyzed using the statistical product and service solutions (SPSS) software.

3.7 Chapter Summary

This chapter analyzed the research methodology used in the study; it introduced the research design to be used in the study stating a descriptive study was used in the research study. The population was introduced, 60 in number, comprising of the entire investment firm base as listed by NSE as well as the CMA staff with their relevance being the rule framers of the Capital markets in Kenya, in addition, the sampling design was introduced as probability sampling technique with the frame sort from the NSE listing of member firms. For the sample size, the formula for determining the sample was shown and used to give 40 as the most suitable, the data collection methods were also introduced, with a
drop and pick method of data collection most preferred as it gave respondents enough time to go through the questions.

The questionnaire structure was also presented with a two section questionnaire with four category data which contained the two question types on quantitative and qualitative, these being both open ended and closed questions. A pilot study to determine whether or not the questionnaires were sufficient and free from errors was done. The method of data analysis was done using both Microsoft Excel and SPSS program for statistical analysis where the results are presented in the next chapter on the results and findings as either tables or figures.
4.0 RESULTS AND FINDINGS

4.1 Introduction

In this chapter the researcher intends to present the results and findings of the research study as deducted from the data collected from the respondents. The first section of this chapter presents analysis of the general information. The next three sections will present results and findings on the perceived benefits; the perceived challenges, the possible solutions to overcome the challenges of introducing Asset-Back securities in the Kenyan financial market respectively. The targeted number of respondents was 40 based on the senior management staff of the registered and operational firms at the Nairobi Securities Exchange (NSE). The number of registered firms at the time of study was 21 with two of the firms being under statutory management, hence making the target firms to be 19 and for oversight purposes the regulating body CMA (Capital Markets Authority) was added to make the number of target firms 20. To these twenty firms 40 questionnaires were distributed by way of physical visitation to the firms, emails and collected through email using telephone follow-up. From the 40 questionnaires distributed, 36 questionnaires were returned duly completed making a response rate of 90%.

4.2 General Information

This section forms a critical part of the results because it forms a fundamental foundation of the nature of the results obtained. It therefore presents some basis that would facilitate, inform and explain the basis of the results received and provide understanding of the same.

4.2.1 Respondents and Target Organization General Profile

Out of the 36 respondents, 52.78% were baccalaureates while 47.22% were post graduates. None of the respondents had a diploma as their highest level of education. This information is represented by table 4.1 below.
4.2.2 Respondents Number of Years with the Organization

The respondents’ experiences within their organization was that 52.78% had been with the organization for a period of between 0-3 years, 33.3% had been there for between 4-7 years and only a total of 13.9% had worked with the same organization for over 7 years. This information is given by table 4.2 below.

Table 4.2: Years Worked for the Organization

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-3 Years</td>
<td>19</td>
<td>52.8</td>
<td>52.8</td>
</tr>
<tr>
<td>4-7 Years</td>
<td>12</td>
<td>33.3</td>
<td>86.1</td>
</tr>
<tr>
<td>8-11 Years</td>
<td>3</td>
<td>8.3</td>
<td>94.4</td>
</tr>
<tr>
<td>Over 11 Years</td>
<td>2</td>
<td>5.6</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

4.2.3 Respondent Firms’ Business Activities

The information from the respondents profile also showed that 52.8% of the organizations deal with virtually all activities relating to shares and stocks, that is: shares and stocks brokerage, corporate finance, shares and stocks transfers, and portfolio management. This is indicated in table 4.3 below.
Table 4.3: Activities of the Organization

<table>
<thead>
<tr>
<th>Activity</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares and Stocks Brokerage</td>
<td>9</td>
<td>25.0</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Corporate</td>
<td>5</td>
<td>13.9</td>
<td>13.9</td>
<td>38.9</td>
</tr>
<tr>
<td>Shares and Stocks Brokerage, Corporate, Shares and Stocks Transfers,</td>
<td>19</td>
<td>52.8</td>
<td>52.8</td>
<td>91.7</td>
</tr>
<tr>
<td>Stocks Brokerage, Corporate Finance, Shares and Stocks Transfers, Portfolio Management</td>
<td>2</td>
<td>5.6</td>
<td>5.6</td>
<td>97.2</td>
</tr>
<tr>
<td>Shares and Stocks Brokerage, Shares and Stocks Transfers</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

4.2.4 Respondents General View on Asset-Backed Securities in Kenya

Majority of the respondents disagreed that the Government is doing the best it can in the development of Asset-Backed Securities with 55.6% being sure of their response while another 33.3% remained neutral in their opinion and only a mere 11.1% agreeing that the Government is doing the best it can. It is notable that none of the respondents strongly agreed that the Government is doing the best it can. This is shown in table 4.4 below.

Table 4.4: Government is Doing the Best it can

<table>
<thead>
<tr>
<th>Response</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Disagree</td>
<td>6</td>
<td>16.7</td>
<td>16.7</td>
<td>16.7</td>
</tr>
<tr>
<td>Disagree</td>
<td>14</td>
<td>38.9</td>
<td>38.9</td>
<td>55.6</td>
</tr>
<tr>
<td>Neutral</td>
<td>12</td>
<td>33.3</td>
<td>33.3</td>
<td>88.9</td>
</tr>
<tr>
<td>Agree</td>
<td>4</td>
<td>11.1</td>
<td>11.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

4.2.5 Perceived Drivers for Asset-Backed Securities

On the perceived drivers of Asset-Backed Securities market, 33.3% agree that the market will be driven by local corporate investors, while 30.56% see the market as being driven by foreign corporate investors. Another group making up 13.89% of the respondents
agreed that this market will be driven by a combination of local and foreign investors being a mix of corporate and individuals. A further 11.11% of the respondents agreed that the market will be driven by corporate investors only, both foreign and local. A paltry of respondents had various combinations of whom they agreed to be the drivers of this market. Their combined total percentage was 11.11% as indicated by the table 4.5 below.

**Table 4.5: Perceived Drivers of ABS Market**

<table>
<thead>
<tr>
<th>Perceived Drivers of ABS Market</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Corporate Investors</td>
<td>12</td>
<td>33.3</td>
<td>33.3</td>
<td>33.3</td>
</tr>
<tr>
<td>Foreign Corporate Investors</td>
<td>11</td>
<td>30.6</td>
<td>30.6</td>
<td>63.9</td>
</tr>
<tr>
<td>Local and Foreign: Both Corporate and Individual Investors</td>
<td>5</td>
<td>13.9</td>
<td>13.9</td>
<td>77.8</td>
</tr>
<tr>
<td>Local Corporate Investors; Foreign Individual Investors; Foreign Corporate Investors</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>80.6</td>
</tr>
<tr>
<td>Local and Foreign Individual Investors</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>83.3</td>
</tr>
<tr>
<td>Local Investors: Both corporate and individual</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>86.1</td>
</tr>
<tr>
<td>Local Corporate Investors; Foreign Individual Investors</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>88.9</td>
</tr>
<tr>
<td>Corporate Investors: Both Local and Foreign</td>
<td>4</td>
<td>11.1</td>
<td>11.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

**4.2.6 Investor Awareness of Asset-Backed Securities**

On the issue of the level of investor awareness of Asset-Backed Securities’ market, 75% of the respondents agreed that it is low with 38.89% rating it as very low and another 36.11% rating it as low. Only 25% had an opinion that the investor awareness of the Asset-Backed Securities market is moderate. It is important to note that there was no single respondent who rated this awareness as either high or very high. Table 4.6 below gives the scenario indicating that there were no respondents who rated the awareness as either high or very high.
Table 4.6: Investor Awareness of ABS Instruments

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Very Low</td>
<td>14</td>
<td>38.9</td>
<td>38.9</td>
<td>38.9</td>
</tr>
<tr>
<td>Low</td>
<td>13</td>
<td>36.1</td>
<td>36.1</td>
<td>75.0</td>
</tr>
<tr>
<td>Moderate</td>
<td>9</td>
<td>25.0</td>
<td>25.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

4.2.7 Correlations Analysis

From the general information there are some relationships that are important to test. We will test the relationship between the number of years in the organization being the independent variable and the investor awareness of ABS. Secondly we will test the relationship between level of education as the independent variable and number of years in the organization as the dependent variable.

4.2.7.1 Correlation Analysis between number of years in the Organization and the Investor Awareness of ABS

The $H_0$ is: There is a correlation between the number of years worked in the organization and the respondent's perception of the investors’ awareness of ABS products.

From the statistics the P value is 0.071 being greater than the standard value of less than 0.05. This means that there is no correlation between the number of years that one has stayed in the organization and the perception of the investor awareness of ABS instruments. Details are as shown in table 4.7 below.
Table 4.7: Correlations between number of years in the Firm and Perceived Investor Awareness of ABS Instruments

<table>
<thead>
<tr>
<th>Years worked for the Organization</th>
<th>Pearson Correlation</th>
<th>Sig. (2-tailed)</th>
<th>N</th>
<th>Investor Awareness of ABS Instruments</th>
<th>Pearson Correlation</th>
<th>Sig. (2-tailed)</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.305</td>
<td>.071</td>
<td>36</td>
<td>1</td>
<td>1</td>
<td>.305</td>
<td>36</td>
</tr>
</tbody>
</table>

4.2.7.2 Correlation Analysis between Level of Education and number of years Worked with the Firm

H_0 is: There is a relationship between the level of education and the number of years worked in the firm.

The P value is greater than 0.05 and as such there is no relationship between the level of education and number of years in the firm. The detailed results are shown in table 4.8 below.

Table 4.8: Correlations between level of education and years in the Firm

<table>
<thead>
<tr>
<th>Years worked for the Organization</th>
<th>Pearson Correlation</th>
<th>Sig. (2-tailed)</th>
<th>Sum of Squares and Cross-products Covariance</th>
<th>N</th>
<th>Highest Level of Education</th>
<th>Pearson Correlation</th>
<th>Sig. (2-tailed)</th>
<th>Sum of Squares and Cross-products Covariance</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.109</td>
<td>.526</td>
<td>26.000</td>
<td>36</td>
<td>1</td>
<td>.109</td>
<td>.526</td>
<td>1.667</td>
<td>36</td>
</tr>
</tbody>
</table>

45
4.3 Perceived Benefits of having Asset-Backed Securities in the Kenyan Market

The research had identified 11 possible benefits of having Asset-Backed Securities in the market. The results from the respondents are presented in figure 4.1 below. Analysis shows that the respondents that the implementation of Asset-Backed securities will give the enumerated benefits. Though a high number of respondents agree that Asset-Backed Securities will deliver the noted benefits, it is important to note that when it comes to both the benefit of managing profits for each period and that of enhancing information efficiency, the respondents were divided right across the middle in that a similar percentage to those who agree are those who were neutral. Further it is critical to note that though majority agree with the benefits, those that are neutral and do not know what the outcome will be come in second.

![Figure 4.1 Perceived Benefits from Asset-Backed Securities](image)

**Figure 4.1 Perceived Benefits from Asset-Backed Securities**

4.3.1 Increased Liquidity

From the data collected, 69.44% of the respondents agree that Asset-Backed Securities will contribute towards increased the liquidity in the market. Another 16.67% strongly agree that in deed Asset-Backed Securities will increase liquidity in the market. In total, 86.11% agree that this benefit will be realized by Asset-backed Securities. This is indicated in figure 4.2 below.
4.3.2 Credit Risk Dispersion

The data shows that 47.22% agree that Asset-Backed Securities will contribute to credit risk dispersion. A further 27.78% strongly agree with this observation. In total, 75% of the respondents agree that Asset-Backed Securities will enhance credit risk dispersion as shown in figure 4.3 below.
4.3.3 Lower Cost of Credit

Figure 4.4 below shows that, a total of 66.67% of the respondents agree that Asset-Backed Securities will lower the cost of credit. This result is split between those that agree and they that strongly agree by 50.00% and 16.67%.

![Figure 4.4: Lower Cost of Credit](image)

4.3.4 Financial Market Growth

On the growth of financial market 86.11% of the respondents agree that Asset-Backed Securities will facilitate the growth of financial market. This is shown in the figure 4.5 below where 72.22% agreed and another 13.89% strongly agreed with this observation.

![Figure 4.5: Financial Market Growth](image)
4.3.5 Foreign Direct Investment

When the respondents were asked whether they perceive that Asset-Backed Securities will attract foreign direct investment, 66.66% of them agreed, with 47.22% just agreeing and 19.44% strongly agreeing. This is depicted in figure 4.6 below.

![Figure 4.6: Foreign Direct Investment](image)

4.3.6 Managing Regulatory Capital

The respondents agreed that Asset-Backed Securities will be a benefit in managing the regulatory capital with 66.67% agreeing and another 5.56% strongly agreeing; making a total of 72.23% as show in figure 4.7 below.

![Figure 4.7: Managing Regulatory Capital](image)
4.3.7 Generating Income Fee

The research study results indicate that Asset-Backed Securities will generate income fee. This is shown in the figure 4.8 above where a total of 86.11% agreed that in deed Asset-Backed securities will generate fee income having 63.89% of the respondents agreeing and an additional 22.22% strongly agreeing. These results are shown in table 4.8 below.

![Figure 4.8: Generating Fee Income](image)

4.3.8 Managing Profits for Each Period

The above results (figure 4.8) show that 44.44% agree that Asset-Backed Securities will contribute to managing profits for each period. Another 44.44% are not sure whether to agree or disagree and were neutral on this particular perceived benefit. Further, the results show that 11.11% disagree that this benefit would be realized by introducing Asset-Backed Securities.
4.3.9 Enhancing Information Efficiency

The results obtained shows that the respondents agree that Asset-Backed Securities will indeed enhance information efficiency. This is confirmed by the data given in the figure 4.10 above where 41.67% agree and a further 11.11% strongly agree.

4.3.10 Allocation Efficiency

The results indicated in figure 4.11 below show that the respondents are in agreement that Asset-Backed Securities will provide allocation efficiency. Out of those that gave their
responses, a total of 72.22% agree where; 61.11% just agreed and another 11.11% had a strong agreement with this perceived benefit.

![Figure 4.11: Allocation Efficiency](image)

4.3.11 Operational Efficiency

The respondents have shown that Asset-Backed Securities will provide operational efficiency. A total of 72.22% agree with this opinion. This is shown in figure 4.12 below.

![Figure 4.12: Operational Efficiency](image)
4.4 Perceived Challenges in Implementing Securities Market for ABS

In this study, the researcher had identified ten challenges that may impede the introduction of ABS market in Kenya. These were the legal framework, the taxation framework, the accounting laws, current ABS Act, absence of tested CRAs, adverse selection, issuance and pricing, link between originator and issuer, provision of other services by CRAs and reduction in incentive for good quality loans. Questions on these variables were put forward to the respondents by way of a structured questionnaire. The responses from the returned questionnaires were that there is a clear agreement on 9 out of ten variables that they could present challenges in introducing an ABS market in Kenya. The results on reduction of incentives to issue quality loans were divided. This overall picture is shown in figure 4.13 below. The details of each result will be presented hereafter.

![Perceived Challenges on the Introduction of ABS](image)

**Figure 4.13: Perceived Challenges on the Introduction of ABS**

4.4.1 Challenges with the Current Companies Act

Data shows that 66.67% of the respondents agree that the current companies Act as it stands could present a challenge in implementing an Asset-Backed Securities market in Kenya. These results comprised of 63.89% who agree and 2.78% who strongly agree. This is shown graphically in figure 4.14 below.
Figure 4.14: Current Companies Act

4.4.2 Challenges with the Current Taxation Framework

Table 4.9 below shows the results on the perception of current taxation framework as a challenge in setting up an ABS market. From the data it is evident that 91.7% of the respondents agree that this is going to be a challenge with only 8.3% not sure and none of the respondents disagreed.

Table 4.9: Taxation Framework

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neutral</td>
<td>3</td>
<td>8.3</td>
<td>8.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Agree</td>
<td>30</td>
<td>83.3</td>
<td>83.3</td>
<td>91.7</td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>3</td>
<td>8.3</td>
<td>8.3</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

4.4.3 Challenges with Current Accounting Framework

Seventy five percent of the respondents are in agreement that the current accounting framework may be an impediment to the implementation of an ABS market in Kenya. We have 69.44% agreeing and 5.56 strongly agreeing. The remaining 25% were neutral as shown in figure 4.15 below. It is notable that there were no respondents that disagreed.
Challenge with the Current ABS Act

The results show that 86.11% of the respondents agree that the current ABS Act may present challenges while introducing the ABS market in Kenya. Another 11.11% were neutral and 2.78% disagreed. This is shown in figure 4.16 below.

Figure 4.16: Current ABS Act
4.4.5 Lack of Tested Credit Rating Agencies in Kenya

Data indicates that 86.11% of the respondents agree that lack of tested credit rating agencies in the Kenyan market may be a challenge in implementing as Asset-Backed Securities market. Within these results 50% agreed and another 36.11% strongly agreed. On the other hand we have 8.33% who disagree with this view and a further 5.56% remaining neutral. This information is presented graphically in figure 4.17 below.

![Graph showing the distribution of responses regarding lack of tested credit rating agencies.]

Figure 4.17: Lack of Tested CRAs

4.4.6 Adverse Selection and Risk Shifting

The results indicate that 72.2% of the respondents agree that adverse selection and risk shifting may be a challenge that impedes the implementation of an ABS market in Kenya. Notable is that 13.9% of the respondents were neutral and similar number of 13.9% disagrees with this perception. Details are shown in table 4.10 below.

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disagree</td>
<td>5</td>
<td>13.9</td>
<td>13.9</td>
<td>13.9</td>
</tr>
<tr>
<td>Neutral</td>
<td>5</td>
<td>13.9</td>
<td>13.9</td>
<td>27.8</td>
</tr>
<tr>
<td>Agree</td>
<td>25</td>
<td>69.4</td>
<td>69.4</td>
<td>97.2</td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Table 4.10: Adverse Selection and Risk Shifting
4.4.7 Challenge with Issuance and Pricing of ABS

Results show that 69.44% of the respondents agree that issuance and pricing may affect the introduction of an ABS market in Kenya; we have within that group, 58.33% who agree and another 11.11% who strongly agree with this opinion. It is important to point out that 16.67% of the respondents were neutral and 13.89% disagreed with this perception. Figure 4.18 below gives this information.

![Figure 4.18: Issuance and Pricing](image)

4.4.8 Link between the Originator and the Owner of the Loan

The results collected results indicate that 66.67% of the respondents agree that there would be challenges emanating from the link between the originator of the loan/receivables and the debtor. This is shown where 55.56% agree and another 11.11% strongly agree with this opinion. Those that were neutral make 22.22% of the respondents and another 11.11% disagreed. This is shown below in figure 4.19
4.4.9 Involvement of Credit Rating Agencies in Provision of other Services

Data gives clear evidence that 77.77% of the respondents are in agreement that there would be a challenge when implementing an ABS market because of CRAs’ involvement in other commercial activities. We have 69.44% agreeing and another 8.33% strongly agreeing. Neutral were 16.67% and further 5.56% disagreed. This is shown in figure 4.20 below.

4.4.10 Reduction of Incentives for Good Quality Loans

Only 33.33% of the respondents agree that ABS market may lead to reduced incentives to issue good quality loans. Another 36.11% remained neutral on this issue while a further 30.56% disagreed with this perception. This is shown in figure 4.20 above.
4.5 Ways to Overcoming ABS Implementation Challenges

We have presented results on the benefits and challenges in implementing an Asset-Backed securities market in Kenya. It is only fair that we present the research results on perceived solutions that would help in overcoming the challenges. These were noted as: having an optimal regulatory framework, separating the roles of CRAs, subjecting CRAs to competitive bidding, requiring that all ABS instruments have credit enhancements, managing the investor risk appetite, strengthening prudential oversight on regulatory capital, reviewing the accounting laws, reviewing the taxation laws and revising the legal framework. The combined response results are shown on figure 4.22 below which indicates that the respondents were in agreement with all these perceived solutions.
4.5.1 Establish an Optimal Regulatory Framework

The results show (figure 4.23 below) that an overwhelming majority of the respondents 97.22% agree that it is critical that an optimal regulatory framework be in place as ABS market gets underway. Surprisingly, majority of these 63.89% agree strongly while 33.33% agree. Only 2.78% remained neutral.

4.5.2 Separate the Roles of the Credit Rating Agencies

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Figure 4.22: Ways to Overcome the Challenges

Figure 4.23: Establish Optimal Regulatory Framework
From the data 77.78% of the respondents agree that the roles of the credit rating agencies need to be separated for a properly functioning ABS market. Of these 52.78% agree and another 25% strongly agree. This is what is shown in figure 4.24 below.

**Figure 4.24: Separate CRAs' Roles**

4.5.3 Subject the Credit Rating Agencies to Competitive Bidding

The results (figure 4.25) give 72.22% of the respondents agreeing that the CRAs’ should be subjected to competitive bidding. From these, 13.89% are in strong agreement while another 58.33 are in agreement. There is notable dissention of 16.67% disagreeing and another 11.11% being neutral.

**Figure 4.25: Subject CRAs to Competitive Bidding**

4.5.4 Require Credit Enhancements for all ABS instruments
From the results, 86.1% of the respondents agree that the ABS products will need to have credit enhancement. The remaining 13.9% were neutral on this matter. These details are indicated in table 4.11 below.

Table 4.11: Need for Credit Enhancement

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neutral</td>
<td>5</td>
<td>13.9</td>
<td>13.9</td>
<td>13.9</td>
</tr>
<tr>
<td>Agree</td>
<td>25</td>
<td>69.4</td>
<td>69.4</td>
<td>83.3</td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>6</td>
<td>16.7</td>
<td>16.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

4.5.5 Manage the Investor Risk Appetite

From the data received, 72.22% of the respondents agree that there would be need to manage the investor risk appetite. We have 58.33% of them agreeing and another 13.89% having a strong agreement. A notable 27.78% were neutral as indicated in figure 4.26 below.

4.5.6 Strengthen Prudential Oversight on Regulatory Capital

Figure 4.26: Managing Investor Risk Appetite
From table 4.12 below, 88.9% of the respondents agree that strengthening prudential capital oversight would be a critical factor in establishing an ABS market. Of these, 27.8% are in strong agreement while a further 61.1% agree. 11.1% of the respondents were neutral and none were in disagreement.

Table 4.12: Strengthen Prudential Oversight on Regulatory Capital

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
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<tr>
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<td>4</td>
<td>11.1</td>
<td>11.1</td>
<td>11.1</td>
</tr>
<tr>
<td>Agree</td>
<td>22</td>
<td>61.1</td>
<td>61.1</td>
<td>72.2</td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>10</td>
<td>27.8</td>
<td>27.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

4.5.7 Review the Current Accounting Laws

On accounting laws, 86.11% of the respondents agree that the current accounting framework needs to be revised at the onset of implementing an ABS market. From those who agree 58.33% agree while another 27.78 strongly agree. Only 13.89% of the respondents were neutral and none of the respondents were in disagreement. These are the results shown in figure 4.27 below.

Figure 4.27: Review Current Accounting Laws

4.5.8 Review Current Taxation Laws
The data collected shows that 86.11% of the respondents agree that the current taxation framework will need to be reviewed in consideration of implementing an ABS market in Kenya. Out of this 86.11%, 33.33% are in strong agreement while a further 52.78% are in agreement. 13.89% of the respondents were neutral. Figure 4.28 below gives this information.

Figure 4.28: Review Current Taxation Laws

4.5.9 Revise the Current Legal Framework

The research results show that 77.78% of the respondents agree that the current legal framework will need to be revised in readiness for implementation of an ABS market in Kenya. Of these, 50% agree and another 27.78% strongly agree. The remaining 22.22% are spread that 19.44% are neutral and only 2.78% disagree. This information is given in figure 4.29 below.
4.6 Chapter Summary

In this chapter the researcher has presented the research results as collected. A detailed analysis of the results has been performed on the general information received from the respondents and the research objectives responses. Data has been presented in both tabular and graphical format for ease of interpretation. The research objectives were: the perceived benefits of implementing an Asset-Backed Securities market in Kenya; the perceived challenges that would impede this implementation, and possible ways of overcoming these challenges.

In the following chapter, the researcher will provide discussions, conclusion and recommendations drawn from this study. The chapter will open with a brief introduction of the chapter outline, the chapter summary before rolling over to the discussion, conclusions and recommendations.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter will have four sections consisting of: summary, discussion, conclusions and recommendations. In the summary, key elements of the research will be brought up in reference to the objectives and research methodology. The next section will discuss major findings emanating from the research and how they compare with the literature review. The third part of this chapter seeks to draw conclusions from the discussion of findings. Finally the chapter will seek to make recommendations for implementation and further works in the area of study.

5.2 Summary

The purpose of this study was to examine the feasibility of Asset-Backed Securities market in Kenya. The study was guided by the following research questions: What are the perceived benefits of having an Asset-Backed securities market in Kenya? What are the perceived challenges of implementing an Asset-Backed securities market in Kenya? And what are the ways in to overcome these challenges?

The researcher approached the study from exploratory research focusing on the registered firms at the Nairobi Securities Exchange and the Capital Markets Authority as the market regulator. The study targeted the structured instruments senior staff from the target firms. It was established that at the time of this study there were 21 registered firms at the NSE with two of them under statutory management. This left 19 firms and CMA was added to the target firms to make the total 20. A convenient sample of 40 was picked based on two members of staff working in the area of structured instruments for each firm. The collected data was analyzed using SPSS software and the results presented in tabular and graphical form.

The findings on feasibility of Asset-Backed securities in Kenya are that it is feasible and that their introduction into the market would provide various benefits to the originators, the issuer, the investors and the economy as a whole. Among the benefits it merged clearly that ABS has the potential to increase the market liquidity. It was clear that the originators would draw the benefit of dispersing the credit risk. In addition ABS will propel the wheels for market expansion and growth as well as direct foreign direct
investment to the economy. It is further noted that originators, issuer and investors will increase their revenue and have a better way of managing their profits. It was also evident that ABS will provide better means of managing regulatory capital as well as provide informational, allocation and operational efficiency.

There are however, challenges that act as a barrier to introducing these instruments into the market. The research has shown that these challenges surround regulation, credit rating, adverse selection, taxation and accounting laws as well as the company law. Notable of all was the fact that the respondents were indifferent when it came to the challenge of reducing incentive to issue good quality loans.

Furthermore the research has shown that there are ways that are available to overcome the challenges impeding implementation of an ABS market in Kenya. First among these was the need for an optimal regulatory framework. Other things that can be done from the research is to clearly separate the role of credit rating agencies with the option of subjecting them to competitive bidding; making sure that the instruments have credit enhancements; managing the risk appetite of the investors; provide strict oversight on regulatory capital and reviewing tax, accounting and legal frameworks.

5.3 Discussion

5.3.1 Benefits of Implementing an Asset-Backed Securities Market in Kenya

Asset-Backed securities have been used in the developed countries as an alternative funding for corporate. Corporate find this a cheaper and quicker way to finance their projects. Further ABS has been used by banks to manage their regulatory capital requirement. The investor has found a safe and stable reliable high yield investment product in ABS. This study is in agreement with many other studies that have been conducted in the western world. For example Loutskina and Strahan (2009) found that the banks would use ABS to create liquidity by tranching the loans and were able to disperse the risk. There is further confirmation that ABS has become financing option away from the Bretton wood institutions (Giron & Chapoy, 2013).

From the findings it is clear from majority of the respondents that an ABS market will be beneficial. This market will benefit the originators (usually the banks), the issuers (SPVs), the general investors and the general economy. Further benefits will be drawn from better
regulation due to the presence of credit regulators. In addition as foreign investors as the study has indicated growth in FDI, there will be job creation. Recently the agitation in Kenyan market has been to reduce the borrowing rates. This study has given confidence that with introduction of ABS market there will be reduced cost of credit.

5.3.2 Challenges facing Introduction of an ABS market

The research has shown that there are critical impediments to having an ABS market in Kenya. It is important to note that the ABS Act in Kenya was enacted in 2007 at the onset of the global financial crisis which was largely attributed to structured finance and in particular securitized products. This could be pointer to the delay in implementation of the ABS market. Further the entire world had to go back to the drawing board and find out what went wrong. It is in light of this that raft measures were worked on to retrace the steps to securitization. The global crisis issues that plagued securitization are the same challenges that Kenya is facing and no wonder that the results were positive on these challenges.

It is clear that credit rating agencies presented a challenge in the manner in which they operated and the respondents are in full agreement on this. The findings also show that the existing tax and accounting laws have loopholes that could augur negatively to the ABS market. Matters surrounding legal entity and ownership and transfer of property beleaguer the ABS market especially when the company law is not clear. This is in line with what was noted on clarity of what constitutes a true sale (Gorton & Souleles, 2007). Further observation is that there would be challenges on issuance and pricing. This is particularly because it is based on rating and comparison with other bonds. It was a problem during the global financial crisis since there lacked quality products to compare values (Kiff, Jobst, Kisser, & Scarlata, 2009).

Notable here is the fact that the respondents were indifferent as far as ABS reducing incentives to issue good quality loans. This indifference is replayed the world over. The arguments are that the originators would relax in screening the loan takers since they are originating and distributing (Schwarcz, 2009). The contrary opinion is that this cannot happen because the originator would like to issue new loans again and again and thus cannot risk poor rating of the loans (Papaikonomou, 2010).
5.3.3 Ways to Overcome Challenges Facing Implementation of an ABS market in Kenya

The study gives evidence and hope that there are solutions to the challenges. The respondents agree that it would be important to have an optimal regulatory framework. Regulation is the backbone of structured finance and as such going wrong here would make the entire process wrong. Since 2008 crisis there have been recommendations on regulation and others have been implemented all over the world. For instance in the US the Dodd-Frank Act came into play as a response to the financial crisis. In Europe the European Securities Markets Authority has worked on raft of regulations ranging from prudential regulation to regulation of CRAs (Garcia & Ruiz, 2012).

The research has shown that ABS would not work properly without credit enhancements. This is again in agreement with the financial markets requirements all over the world. Enhancement gives confidence to the investors that they are protected. Enhancement also gives the instrument the high yield that is attracts. This was the finding of the joint forum from Basel (Bank for International Settlements, 2011).

The respondents also agree that the entire legal framework can and must be revised. This includes the taxation, accounting and company laws. After 2008, the financial accounting standards board (FASB) had to re-look at the accounting structure on securitization (Sabry & Okongwu, 2009). Further in the US a lot of work was done to revise the taxation laws to avoid the pitfalls of 2008 (Peaslee & Nirenberg, 2010).

5.4 Conclusions

5.4.1 Benefits of Implementing an Asset-Backed Securities Market in Kenya

The study concludes that the ABS market is feasible in Kenya. Further conclusions from the study are that once implemented it is envisaged to benefit various groups in the financial market key among them the investors, the originators, issuers and the general economy. In addition the study is positive that there will be specific benefits derived from implementation of an ABS market. These benefits are: increased liquidity in the market, risk dispersion, reduction in the cost of credit, growth of the financial market, increase in FDI, and better management of regulatory capital for financial institutions,
greater avenue to generate revenue and manage profits, reduction of information asymmetry, and provide both allocation and operational efficiency.

5.4.2 Challenges facing Introduction of an ABS market

On challenges, the study appreciates that there are a myriad of challenges that beleaguers this market. It concludes that the entire legal framework is a challenge, the credit rating agencies and nature of their operation is a challenge, the knick knacks surrounding adverse selection and risk shifting would be a challenge, the issuance and pricing complexities are a challenge. On the contrary there is no conclusion on the reduction of incentive to issue good quality loans.

5.4.3 Ways to Overcome Challenges Facing Implementation of an ABS market in Kenya

The study is conclusive that the challenges can and must be overcome. In this conclusion the study agrees and concludes that optimal regulatory framework is not an option rather, is a must. The separation roles played by the rating agencies is required and further conclusion on this is that competitive bidding for these agencies is critical in their engagement. The study would additionally conclude that ABS must have credit enhancements. All the legal issues surrounding ABS must be revised, the study concludes.

5.5 Recommendations

5.5.1 Recommendations for Practice

The study has shown that an Asset-Backed Securities market in Kenya is feasible. It has noted the benefits and critical challenges as well as ways to overcome them. This then gives the basis for recommendations on what needs to be done. The Government and the financial market regulating authority (CMA) needs to explore the challenges pointed in this study with a view to kick-starting the birth of an Asset-Backed Securities market in Kenya.

5.5.2 Recommendation for Further Studies

This study only focused on Asset-Backed Securities. This is just one type of securitized instruments among many others. For this I would recommend for studies to be conducted
on other securitized products with a view to assessing which of them would be more feasible for the Kenyan market to start with. In addition, I would recommend that a study be conducted on the effect that ABS market would have on the market for other instruments such as derivatives and corporate bonds.
REFERENCES


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APPENDIX I: QUESTIONNAIRE

Instructions: Please fill-in the questionnaire provided by ticking/clicking appropriately or filling in as directed. (Check boxes provided for easy online ms-word user - you don’t have to print the document). Kindly complete all questions for this questionnaire to be valid and just tick/check one box per question.

SECTION A

1. Please indicate your highest education level completed.
   - □ College diploma
   - □ Bachelor’s degree
   - □ Post graduate

2. How long have you worked for your organization?
   - □ 0-3 Years
   - □ 4 - 7 years
   - □ 8 - 11 years
   - □ Over 11 years

3. Which trading activities of is your organization involved in?
   - □ Shares and Stocks Brokerage
   - □ Corporate Finance
   - □ Shares and Stocks Transfers
   - □ Portfolio Management
   - □ All of the above

4. In your opinion, the central government is doing the best it can in the development of Asset-Backed Securities market? (kindly indicate the extent you agree with the statement in the range 1 to 5, with 5 for strong support, 1 for Strong disagreement)
   - 1 □
   - 2 □
   - 3 □
   - 4 □
   - 5 □

5. The trading in Asset-Backed Securities market will greatly be driven by...
   [Kindly tick/check the appropriate box (s)]
   - □ Local Individual Investors
   - □ Local Corporate Investors
   - □ Foreign Individual Investors
   - □ Foreign Corporate Investors
In your opinion what is the awareness level about ABS financial instruments by investors? Please tick/check appropriately.

<table>
<thead>
<tr>
<th>Very low</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Very High</th>
</tr>
</thead>
<tbody>
<tr>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>

SECTION B

7. Kindly indicate to what extent you agree or disagree with the following statements with regard to introduction of Asset-Backed Securities (ABS)

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS market will lead to increased market liquidity</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market will provide credit risk dispersion</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market will lead to lower cost of credit</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market will propel financial market growth</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS will encourage growth of Foreign Direct Investments</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market provides a way of managing regulatory capital</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market generates fee income</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market helps in managing profits for each period</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market enhances informational efficiency</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market facilitates allocation efficiency</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>ABS market strengthens operational efficiency</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>

7. B. In your opinion what would you add as other benefits of Asset-Backed Securities?

a. ________________________________________________________________

b. ________________________________________________________________

c. ________________________________________________________________
SECTION C

8. Kindly indicate the extent to which you agree or disagree with the following statements on issues that might affect adoption of Asset-Backed Securities (ABS) in Kenya

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Companies ACT will affect the adoption of ABS market.</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>There are taxation issues that may affect the adoption of ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The current accounting laws will affect adoption of ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The current CMA ABS ACT will affect adoption of ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Absence of tested Credit Rating Agencies in the Kenyan Financial market will be a challenge</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Adverse selection and Risk shifting will be a challenge in the adoption of ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Issuance and Pricing will affect the adoption of ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The link between originator and the owner of securitized debt presents a challenge</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Involvement of credit rating agencies in other commercial activities will affect adoption of ABS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ABS market will reduce incentives to issue good quality loans</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>

8. B. What other factors in your opinion do you believe will impede the adoption of an Asset-Backed Securities market?

a. __________________________________________
b. __________________________________________
c. __________________________________________
SECTION D

9. Kindly indicate to which extent you agree or disagree with the statements below on what needs to be done to overcome the challenges of implementing an Asset-Backed Securities market in Kenya.

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>An optimal regulatory framework is required ABS market</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The roles of the Credit rating agencies needs to be separated</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The credit rating agencies need go through a competitive bidding selection process</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The ABS will require to be enhanced through credit enhancement</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The risk appetite of investors will need to be managed</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Prudential oversight on capital management will need to be strengthened</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The current accounting framework will need to be improved</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The current tax laws will need to be revised to accommodate issues</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>surrounding ABS market operation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The companies ACT will need to be revised to address legal issues</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>arising from ABS implementation</td>
<td></td>
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</tr>
</tbody>
</table>

B. In your opinion kindly suggest other issues that may need to be addressed for effective implementation of a successful Asset-Backed Securities market in Kenya.

a. ........................................................................................................

b. ........................................................................................................

c. ........................................................................................................

*******THE END*******

Thank you for your time and honest feedback