



THE BASICS OF ASSET BACKED SECURITIES

Structured finance is a financing technique that provides solutions to problems not easily addressed through conventional financing techniques. As UNCTAD defines it, structured finance is a technique whereby certain assets with predictable cash flows are isolated to mitigate risks and used to secure credit. One of the common instruments of structured finance is Asset Backed Securities (ABSs).

ABSs are notes which are backed by assets that have been securitized. Securitization of assets, on the other hand, is the process of turning economic assets into marketable securities and involves the use of complex legal and corporate structures.

Due to the underlying structure of ABSs, it is not feasible to securitize assets with no predictable cash flows. As such, some of the assets that could be securitized include bank loans, mortgage loans or trade receivables, among others.

Where the assets securitized are mortgage receivables, the resultant securities are known as Mortgage Backed Securities (MBSs). Likewise, where the underlying assets are not mortgage loans, the resultant securities are known as non-mortgage asset backed securities.

The process of securitization involves a transfer of assets to an entity, a Special Purpose Vehicle (SPV), which pools all underlying assets and issues ABSs to willing investors. The investors make their returns from the income derived directly or indirectly from the cash flows of the securitized underlying asset pool.

Due to the complexity of the structures involved in the asset backed securitization process, it is in the best interest of the issuer of ABSs to involve seasoned expertise in structuring an ABS.

ABSs in a Kenyan Context

The Capital Markets Authority (CMA) issued initial regulations for ABSs in the year 2007. However, amendment provisions to the Capital Markets Act were introduced in 2013 and these have since been inconsistent with the 2007 regulations. To address this lapse in the legal framework, the CMA is in the process of finalizing a Policy Guidance Note (PGN) to clarify and offer guidance for asset backed securitization.

Among other issues clarified in the PGN, the most important are: -

Achieving a true sale of assets – This is to ensure that assets to be securitized are owned by the SPV and as such the shareholders and creditors of the seller have no claim over any underlying assets of the ABS.

Status of the SPV – The draft PGN has proposed that the SPV can either be a common law unincorporated trust or a company. Where a company is used as an SPV, compliance with the Companies Act and the ABS regulations will be required.

Bankruptcy remoteness – The SPV should be bankruptcy remote to ensure that it is not wound up before the ABS transaction is complete. Therefore, the SPV must be structured in a way to ensure it is a bankruptcy remote entity.

Once approved, the PGN will go a long way in setting the right foundation for asset backed securitization in the country. The regulations will see the introduction of a new product in the capital markets which will attract capital flows to the country. With such initiatives, Islamic ABSs which are sharia compliant can be developed.

However, it should be noted that, regardless of all efforts by the CMA and other stakeholders in preparing the regulatory framework on asset backed securitization in Kenya, the success of the securitization process is dependent on the goodwill of the Kenya Revenue Authority (KRA) in offering tax neutrality to the SPV. Tax neutrality will ensure that more entities approach the ABS market since the tax costs of structured finance will not be significantly higher than the tax costs of conventional financing.

When all is said and done, investing in ABSs will be a viable option for pension funds, insurance companies and other investors. Likewise, banks and other financial institutions will be better equipped to manage their liquidity risk while the county and national governments will be in a position to mobilize capital for infrastructural development.



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