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Factoring as tool of financial inclusion in Kenya

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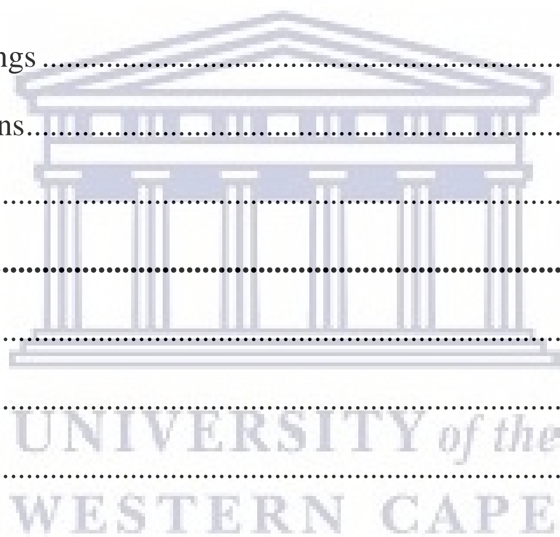
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LIST OF ACRONYMS AND ABBREVIATIONS

ABFA	Asset Based Finance Association
AfDB	African Development Bank
AFI	Alliance on Financial Inclusion
Afrexim	African Import and Export Bank
ATM	Automatic Teller Machine
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
FAPA	Fund for African Private Sector Assistance
FCA	Financial Conduct Agency
GDP	Gross Domestic Product
IFC	International Finance Corporation.
IFG	International Factors Group.
MFIs	Microfinance Institutions
MVNO	Mobile Virtual Network Operator
PRSP	Poverty Reduction Strategy Paper
ROE	Return on Equity
RBA	Retirement Benefits Authority
SACCOs	Savings and Credit Cooperative Organization
SASRA	Sacco Society Regulatory Authority
SMEs	Small and Medium Enterprises
UNCITRAL	United Nations Convention for International Trade Law.
UNDP	United Nations Development Programme
UNIDROIT	The International Institute for the Unification of Private Law

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DECLARATION

I, FIONA MOSONGO, do hereby declare that *Factoring as tool of financial inclusion in Kenya* is my original work and has not been submitted for any degree or examination in any other university or institution of higher learning. While I have relied on numerous sources and materials to develop the main argument presented in this mini thesis, all the materials and sources used have been duly and properly acknowledged.

Signed: FionaBMosongo

Date: 28/11/2019

Supervisor: Professor Riekie Wandrag

Signature… …… …………………

Date… ……4 /12/2019…………………….

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DEDICATION

This Mini-thesis is dedicated to my family whose love, support and encouragement pushed me through showing me that together we can achieve anything. To the shoulders that bolstered me to newer heights and the dedication of my loved ones. This is for you.

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DEFINITION OF TERMS

Factoring:

Factoring in simple terms has to do with negotiations in business. It also connotes a type of debtor finance where accounts receivable are sold at a reduced price or sold on credit.

Trade Facilitation: Trade facilitation is a phenomenon targeted at helping to reduce the cost of price during trading. The concept seeks to reduce the complexity of transaction process as much as it promotes efficiency, transparency, and predictability of transactions among other things.

Economic Development: This is a step by step process improving the quality of economies from emerging economies to advanced economies. This simply means that the economic standard of countries are raised and there is an all-encompassing improvement in the well-being, health, and academics of nations.

Trade Finance: Trade finance is a designed concept that helps to ensure that there is little or no risks involved in anything called or remotely close to international transaction.

Financial Regulation: Financial regulation is a concept used to ensure that financial institutions pass specific requirements and guidelines before they can be endorsed. This process is to ensure that financial systems have integrity intact all the time.

Financial Inclusion: Financial inclusion is a concept that targets individuals of all class; ensuring that irrespective of class net worth and size, all individuals have access to the financial services. With financial inclusion comes the freedom of all individuals to acquire financial services at very affordable prices without feeling excluded.

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CHAPTER ONE

INTRODUCTION

1.0 Background of the Study

A popular difficulty that all SMEs have had to face is limited access to finance. The fact that banks are not prepared to finance small businesses, has exacerbated the existing 'financing gap' in the small and medium-sized business which is already present in the SME industry. In an analysis of small and medium business are faced with a myriad of difficulties often as a result of restrictions in current collateral systems that do not offer a viable degree of risk mitigation due to ineffectual legislation, insufficient enforcement procedures, or an existing legal structure.[1] All of these have therefore made factoring a great choice as far as SMEs go in all African countries that want to have access to financial services. Factoring is the service that, in order to provide the underlying credit sales of goods or services (known as a factor), is provided by a third-party. [2]

The third party's role is to purchase accounts that can be accepted from vendors and this purchase must be done at a reduced price. This happens so that the former can provide the latter with the finances that will keep the business moving. Inadequate financial management is the biggest obstacle facing SMEs. Conventional methods of financing such as banking loans are generally inaccessible, as excessive interest rates and collateral requirements exacerbate the problem only.[3]

Factoring is already in existence in Kenya but not often practised. Cap 448, a Banking Act of the Laws of Kenya sees factoring as an instrument of finance that Central Bank controls. Although, the law is does not legislate on factoring and its entails, This paper seeks to investigate how the factoring legislation of Kenya can be improved to make Kenya 's industry globally competitive.

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[1] Mamman, A., Kanu, A. M., Alharbi, A., & Baydoun, N. (2015). Small and Medium-sized Enterprises (SMEs) and Poverty Reduction in Africa: Strategic Management Perspective. Cambridge Scholars Publishing.

[2] Summers, B., & Wilson, N. (2000). Trade credit management and the decision to use factoring: an empirical study. *Journal of Business Finance & Accounting*, *27*(1-2), 37-68.

[3] Ackah, J., & Vuvor, S. (2011). The Challenges faced by Small & Medium Enterprises (SMEs) in Obtaining Credit in Ghana.

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1.1 Problem Statement

Economic theory states all programs providing all financial groups of the population with official, open, and affordable financial services.[4] This inspires quality attention for all classes of people including the group that has been ignored for several years by important sectors of finance because they have been deemed low income earners. To state things specifically, this thesis discusses small and medium-sized enterprises' role in ensuring wide access to risk-based financial services, expanding entrepreneurship and financial integration. Consequently, financial inclusion is essential to ensure economic growth that is sustainable and inclusive.

All these have made financial inclusion very integral in the process of making economic growth and development as inclusive and maintained as possible. SMEs have over the time become very important contributors to the economic growth and development of the country. These enterprises serve as the foundation of entrepreneurial skills and artistry at its best, it is also a means to employment and the individual growth that expands towards the all-round growth of the economy of the country.

So many of the obstacles of SMEs are attached to accessibility to finances and policy makers are burdened with the regulation of financial policies to promote inclusion and embrace diversion for the enterprises. One reliable way to do this is factoring that has been established to be a transaction of finances of the business with account receivable to factor at a much reduced price. With the reason for this transaction being to promote effective, immediate payment of account receivables as it helps to improve business and encourage the influx of cash. The reason here is why factoring is a globally accepted method or tool for helping to finance SMEs. Notably, this financial transaction is still limited in most African countries.

Factoring helps to substitute the commonplace financial services and in the same vein, helps to lift the limitation of finances that serve as obstacles for small and medium sized exporters. When there is no adequate financing, there is limitation in the distribution of the goods. This is mostly

[4] Ledgerwood, J., & White, V. (2006). Transforming microfinance institutions: providing full financial services to the poor. The World Bank.

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because without finance, little or nothing can be done to in the area of production and payment. The performance risk also accelerates drastically.

The financial transaction, factoring is done most times without proper assistance which signifies that there is a credit assumed risk done for the buyer's capacity of payment, this also causes no security because the risk has only been assumed not confirmed. There is only one type of financial service that has all of the following; account receivable, book keeping, financing, collecting services and credit protection and it is what may have already been guessed; the comprehensive financial service. [5]It is also satisfactory if the uncertainty about the regulation can be ignored; as far as this goes, all the registration processes that have not been specifically asked for can as well be put on the list of things to ignore. It is important that all angles of factoring are clarified.

A typical example is ensuring that there is a regulation stated clearly about the differences between factoring and loans. A feature common with factoring in organisations are but a few. Collaboration between credit lines and bank can give credit limit and the edge of competition over any other method. An enabling regulatory framework and a supportive financial infrastructure are essential in the medium term to encourage sustainable, viable, and significant improvements in economic development through access to SME finance.[6] For factoring to be a successful financial service, there must be a supportive legal and regulatory framework, designed through effective government support mechanisms to strengthen the financial infrastructure.[7] This also makes sure there is a measure of the things that inspire inclusion of all the levels and

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5 The White Paper on Regulatory Framework for Factoring Egypt Financial Services Project Technical ReportUSAID Strauss S, Task 3 Technical Team 7 (published in28 December 2005).

6World Trade Organization (WTO) Trade finance and SMEs Bridging the Gaps in Provision (2016).

7 International Finance Corporation *G-20 SME Finance Policy Guide Report* (2011).

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group that make contributions to the economy. Kenya's financial regulatory system has been structured in such a way that there is fragmentation and this causes a dent in the free flow of things. Which inadvertently leads to a dent in the financial services offered. This is mostly because the regulatory system was borne out of a silo system. A silo system involves a three financial sectors which include banking, insurance and security. All of which have been designed with different purposes and to serve a central body; Central Bank of Kenya (CBK).

The above has been known to lead to conditions that need a lot of services rendered with diverse frameworks, as long as all of the services rendered remain under a particular framework. Therefore, other regulatory systems cause a dent in the accessibility to financial services of major capital requirements, it tend affects the financial exclusion for SMEs to a large extent.[8]

The system that helps to regulate is also popular for its inability to enable factoring as a financial service when it is to be done outside CBK. This has been known to require correction on the things governing the legislations in order for availability to be made possible. The regulatory structure has only the need to fixate attention on the functions that have nothing to do with banking. This will give room for inclusion and understanding of the model law of factoring. [9] .

[10] It will see to it that reformation of financial policies through customisation of financial services belonging to all SMEs is always encouraged

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1.2 Significance of the Problem

1.2.1 Contribution to financial regulatory system

This work focuses on expanding the understanding and inclusion of factoring into the financial regulatory system of a country like Kenya. It is an extensive paper. In that, the successes that have been achieved through using this system in other countries like South Africa are explored coupled with the hypothesis of having the system that has been used in this country operate in a

8 The White Paper on Financial Regulation in Kenya; Balancing Inclusive Growth with Financial Stability. Mwega FM 407 (2014) 19-22 (hereafter *Financial Regulation in Kenya*)

9Afreximbank model law on Factoring developed to create cross-border uniformity in transactions and for adoption by countries. Include ref to model law

10Oramah BO Foundations of Structured Trade Finance (2015) 44

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country like Kenya adopted into the Kenya. The country's system of legal aid has done tremendous things with the British Law being the fundamental support of factoring and all of these do not make them perfect.

Businesses do transactions via the use of open accounts and this usually incurs debts that last within 30-60 days. Slow payments in most cases extends these days and 75-95 days can be the expected duration. This issue here is a clear indication that factoring is a need.

There is a sustainable finance as far as trade in concerned that has been known to work for others that leads to a good standard of living and economy, maybe not right away. But, eventually.

1.2.2 Contribution to economic development

The advantage of increasing the awareness for factoring brings is nothing short of increase in expansion as far as availability of liquidity is concerned among all business. It is a great factor for pushing the expansion of the supply and demand of the people. As a result of the increased awareness, authorities that have been put in place to make things go smoothly are inspired to work on the growth of the factoring in Kenya.

Business tycoons and supporters that range between auditors, tax advisors, trainers and consultant are advised to begin to introduce factoring as a must have financial service in the industry, the result of this is not far-fetched. It will fill gaps and make people understand the beginning and end of the factoring business. Although, there is an advantage public intervention has over all these and this is not inclusive of the risks that involve market distorting and unfair wages given to financial institutions around Kenya.[11]

1.2.3 Contribution to Financial Inclusion

In contrast to a small scale awareness, a large scale awareness does more. It increases the level of availability and the use of the financial sector and inclusion by the Kenya enterprises.[12] The result of this study has the tendency to case its effect on the level of availability that can be seen

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[11] International Finance Corporation *G-20 SME Finance Policy Guide Report* (2011) 8.

12Tomusange LR (2015) Factoring as a Financing Alternative for African Small and Medium-Sized Enterprises 146

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in finances options for all SMEs. Hence, there is an encouragement of investors across the board in countries that are known for their similarities in economy.

Bank lending is rather tilted towards larger than smaller companies just as it is known for its constant openness to meet needs that are similar to cash flow availability. This study has wings and is set to make its mark in the creation of awareness for factoring which can work effectively in the stead of SME tools. The collaboration that is set as a result of putting debt finance and administration together will help to cause the production of things that are capable of under-pinning liquidity starved companies dominating the country.

The bigger and greater the awareness, the bigger the achievement that is set to fall on the sustainable developmental goals on the economic plans of Kenya as predicted by the United Nations Development Programme 2018[13].

1.3 Research Questions

- What is the historical background of Kenya's financial regulatory system when it comes to legislation?
- What is the extensive effect of factoring as a tool for financial inclusion in Kenya?
- What legislative structure is needed to make sure factoring does the inclusion of finances to SMEs in Kenya1.4 Research objectives?

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This section talks about the answers to the above questions. With different sections contributing very much to the questions that the paper is set to focus on. In-depth analysis of the legislative historical background of Kenya's financial regulatory system. This will provide a basis for why and where the factoring legislation should be included.

- Highlighting the impact of factoring in Kenya: The goal is not to be confused for any other thing than the significance of factoring in helping to make inclusive decisions and choices for SMEs. The legal and regulatory implications of the introduction of factoring:

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13 United Nations Development Programmes 'Sustainable Development' available at *https://sustainabledevelopment.un.org/memberstates/kenya* (accessed 13 September 2018).

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This is unlike the first, the focus here is o the existing financial legislation and how it can be used to the advantage of inclusive factoring.

1.4 Literature Review

Literature review has to carry very little on the factoring that is done in Kenya and Africa as a continent. This is not to say it is not in existence in most African countries, it just implies that academic recognition has not been placed on it in African counties.

As it continues to make its impact, a lot of countries around Africa continually improve in all ramifications, specifically in the accessibility and the usage of the financial services. Both of which constitute the major servicers of factoring. Recently, above sixty countries have adapted the reform methods so that there may be adequate promotion and expansion of services. Holistic approach to things seems to be in rife and it is gradually extending to factoring and used to ensure that there are more substantial changes in financial inclusions. This is to ensure that customer's satisfaction is reached.

Financial regulators emerging from countries around the world; twenty of them have made a commitment to financial inclusion under the 'Maya Declaration' to (i) raise an encouraging environment that allows access to lover financial services costs coupled with the things to be done via emerging technology; (ii) execute a structure that helps to balance the three major financial board; inclusion, integrity, and stability. iii) begin a protection and empowerment structure for financial inclusion protection and empowerment for financial inclusion; and iv) use data as a source of information and track the results. It is a proper documentation of SMEs that make a huge contribution when it comes to the industrial growth and development.[14] recently, researchers have found that little or no access to finance can cause a dent in the development of SNEs even when the per capital income in countries is impressive. Market failures, notably in financial markets fall disproportionally on SMEs, resulting in more credit rationing, higher costs of "screening" and higher interest rates from banks than larger enterprises.[15]Factoring is also

14 The AFI Network The Role Of Financial Regulators In Promoting Access To Financing For MSMES (2016).
15Beck T &Demirguc-Kunt 'A Small and Medium-Sized Enterprises: Access to Finance as Growth Constraint' (2006) Journal of Banking and Finance 25.

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useful for bridging the gap between the non –banking trade and the finances for the future of Kenya's growth.[16]

The African Development Bank (AFDB) put out a comprehensive report that showed the availability of financial inclusion in the international market. With their major focus being the availability of the information like the cooperatives, mobile finance banking, and other financial services that are non – banking. Information and data on financial capability of an SME to have express access too finance and the luxury to measure the effect that is set to come when the greater financial access is produced. According to the Alliance on Financial Inclusion (AFI),[17] policymakers in Africa have their concerns on the understanding of financial inclusion. They should therefore be fierce advocates of national data that is to be regulated and used to measure the legislative method in the grand scheme of things. The development of Factoring in so many countries over the time has helped to develop a regulatory system. There is a foundation where the all the countries/ finding themselves, it is with the Government The clarity of goals and framework will help to achieve the goal of being great Factoring has developed in a variety of legal and regulatory settings, specific to the individual country in which the factoring is provided. Factoring has a very high tendency to develop properly in areas that have been known for clarity in the definition of the Law and Policies.[18]

The demand from the end of exporters her it comes to Factoring is not limited to finance but expansive that it covers assurance of payment with a risk this is why the position of the thought will ever stand. [19] There has been a shift by many international banks to include factoring within the range of financial services.[20] This, as far we know encourages the documentation of literature to ensure that it tools different repayment programmes can be considered.[21] This would

16 The World Bank Group IFC-SME Department *Kenyan Factoring Initiative* (2002) 12.
17 AFI is an organization that was founded as a global knowledge exchange platform with an aim to expand and improve financial inclusion regulation and policy.
18 The White Paper on Regulatory Framework for Factoring Egypt Financial Services Project Technical ReportUSAIDStrauss S, Task 3 Technical Team 7 (published in28 December 2005).
19 Ruddy N, Mills S, Salinger F & Davidson N Salinger on Factoring (1996) 13.
20 Ruddy N, Mills S, Salinger F & Davidson N Salinger on Factoring (1996) 15.
21 Eric B 'Finance of International Trade: A volume in Essential Capital Markets' (2004) 144.

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provide excellent timeframes and ensure certainty within the contracts for the parties thus encouraged.[22]

Chapter Outline

Chapter two: History of financial regulation for SME's in Kenya

Kenya's financial sector is known for what it has undergone since the 1980s and all these things have pointed to one major achievement; the stability of banks and other institutions of finance when they take deposits. This stability, hopefully aids the decline of crises in the finance industry.[23] The other reason for the things they have undergone is to encourage efficient delivery of credit and financial services. All of which will help to make sure that the expenses are affordable and the services and goods are of good quality.[24]

Chapter three: Role of factoring in Financial Inclusion

This chapter will examine the effect that inclusion in the fiancé sector has on the economy of the country. The essence of having a system that includes all classes and groups of people for SMES in Kenya. The Alliance for Financial inclusion (AFI) as some SME Financial Inclusion Indicators which will be used to pass criticism to the growth that will be needed for the research. This paper will further provide a review of the things that cause barriers and their effect on SMEs. It would be done by getting an insight into transformations around financial services that have been executed so that there will be inclusion in the financial sectors. Improve their financial inclusion and the corresponding effect. The paper will examine the significance of Factoring having to do with solutions that enact inclusion.

Chapter four: Case analysis on factoring regulation in South Africa

This chapter has the focus on one goal and that is on the things that South Africa has been able to do to encourage economic development for their country. It will also focus on the achievements

22Oramah B Conceptual Foundations, Origins and Definitions'in Foundations of Structured Trade Finance (2015) 34.

23 Anne KW Efficiency in the Banking Sector: An Empirical Investigation of Commercial Banks in Kenya (unpublished PhD thesis, University of Nairobi, 2009) 25.

24Nyaoma G 'Financial Sector Reforms Including Legislative Issues' (2006) 22. Paper Presented to the Central Bank of Kenya (CBK) Monetary Policy Advisory Committee.

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that may be used also by Kenya. This is based on the similarities in the Constitution and other regulatory practices. Further the analysis examines the impact of factoring in financial inclusion that is a key pillar in financial regulation in the South African economy.

Chapter five: Regulatory Changes for Kenya

This chapter will serve as the review section where the level of the functions of the inclusion of the model Law factoring into the Kenyan silo system of financial regulation and other relevant laws. It will also focus greatly on the things that help to guide according to CBK as it helps to control lending and the depository function of both Banks and non – banks lending. This, of course has a lasting and direct effect on the Factoring as a system or framework and also the regulation. The paper will review the level assimilation of scheme that has been designed for use by UNIDROIT[25] it covers transactions like the border transaction and Afreximbank. As expected, there will be effect and the areas to feel the effect include the proposed financial regulatory restructuring of Kenya and the advantages that come with have express access. Also the inclusion of all classes and groups as they are all subject to the regulation.

Chapter six: Conclusion and Recommendation

In this section, the paper will draw conclusions effective immediately from study of the case that has been able to provide all these recommendations drawn from the research. It will expand the things to do to ensure that research remains unbiased all through as data collection and analyses ensue.

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1.5 Methodology

Achieving a thorough and well researched study is largely dependent on the methodology. For this study, the method used and employed is the qualities research method with a focus on the case analysis in South Africa. South Africa is also used as reference point as much as it is used to find parallels that would be needed for the relevance of the Kenya research. Largely, this will be coined from the result of the legislative space, relevance of the law and financial inclusivity. The

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25 UNIDROIT Convention on international factoring (Ottawa, 28 May 1988)

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analysis will be of both primary and secondary documentary sources to ensure that the literature review is unbiased and sustainable. The study will be clear and precise, drawing analytical comparisons for the South Africa that will offer significance in drawing qualitative conclusions to the impact the study.

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CHAPTER TWO

HISTORY OF FINANCIAL REGULATION FOR SME'S IN KENYA

2.1: Introduction

There are currently many jurisdictions focusing on the concept of financial regulation and supervision and leading to an enormous transformation of the financial services sector in recent years.[26] The industry has moved to a more integrated service range, from institutions offering various services, including banking, security and insurance, where conglomerates currently offer many financial products worldwide. Also, conventional products are markedly misleading because they continue in their efforts to maximise profit through business expansion and innovation in finance.[27]

In the financial services industry, globalisation has increased massively, which has led to a virtually unlimited market.[28] In financial regulatory models, some of them have not been restructured to reflect new business realities; this sector has shown weaknesses[29]. To reflect this, various jurisdictions have reformed their regulatory frameworks.[30]

However, international regulatory frameworks are not uniform, and in some countries, sectors are deregulated or controlled by the government. In many countries, specialised agencies continue to organise financial regulations and supervisory bodies with individual tasks for each

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26Jordan C & Majnoni G 'Financial Regulatory Harmonization and Globalization in Finance (2002) 15.
27 Mwega, F. M. (2016). Financial regulation in Kenya: Balancing inclusive growth with financial stability. In *Achieving Financial Stability and Growth in Africa* (pp. 99-122). Routledge..
28 PwC Financial Services Technology 2020 and beyond: Embracing Disruption (2016) 5.
29Ward, K. (2006). 'Policies in motion', urban management and state restructuring: the trans-local expansion of business improvement districts. *International Journal of Urban and Regional Research*, *30*(1), 54-75. 1.
30 Mwega, F. M. (2016). Financial regulation in Kenya: Balancing inclusive growth with financial stability. In *Achieving Financial Stability and Growth in Africa* (pp. 99-122). Routledge.
30 Allen F & Gale D 'Competition and Financial Stability' (2004) Journal of Money, Credit and Banking (vol 36)(3) (II) 455

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sector. This trend, however, is progressing towards a standard regulatory body. The aim of regulating the financial sector is to ensure a stable financial system.[31]

The financial sector under which each regulatory framework operates is always distinct, although it may be that the regulatory model is similar. This means that when designing a framework, account must be taken of the domestic conditions. There is no exception to the discussions in Kenya on the united regulatory framework.[32] Consequently, the proposals for a unified regulator must be taken into account based on local conditions that are unique to the industry and the latest developments in the industry.[33]

This chapter discusses the rationale and models for regulating financial services. The report also discusses broad financial regulatory objectives such as protecting investors, equity, protecting against misconduct and safeguarding consumer trust. This chapter analyses each regulatory model's advantages and disadvantages. To achieve Kenya's progress in this regulatory framework, it pays attention to the unified regulator and discusses its main strengths and weaknesses. This chapter should also provide a context for the regulatory framework in Kenya, with an emphasis on emerging field issues.

2.2 Definition of regulation

The Regulation defines a set of binding provisions issued by a private or public body.[34] It is also the rules applied by all regulators in the exercise of their functions.[35] Market access and

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31 Mwega, F. M. (2016). Financial regulation in Kenya: Balancing inclusive growth with financial stability. In *Achieving Financial Stability and Growth in Africa* (pp. 99-122). Routledge.

32 Demirgüç-Kunt A & Klapper L *Financial Inclusion in Africa: An Overview* Policy Research Working Paper 6088. The World Bank (2012) 75

33 Mwega, F. M. (2016). Financial regulation in Kenya: Balancing inclusive growth with financial stability. In *Achieving Financial Stability and Growth in Africa* (pp. 99-122). Routledge.

34 Fawcett, A. C. (2001). Examining the objectives of financial regulation–will the new regime succeed? A practitioner's view. *Regulating Financial Services and Markets in the 21st Century, eds.*14

35 Scott, C. (2004). Regulation in the age of governance: The rise of the post-regulatory state. *The politics of regulation: Institutions and regulatory reforms for the age of governance*, *145*, 148.

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financial activity risk control, corporate governance and internal control systems, as well as corporate rules and monitoring methods, are covered in the Financial Regulation.36

Regulation can be viewed as a public agency's ongoing and focused monitoring of publicly valued financial-sector activities.37 It aims to prevent the development of dubious reputational entities that are unable to implement the industry's intended activities effectively.38

Based on either principle or rule, a regulatory framework may be developed. A principle-based system in which regulators merely lay down a set of principles which regulated undertakings should follow.39 Principal regulations in most jurisdictions are generally referred to as soft law. The main regulatory element of the voluntary code is the approach of soft law.40

In contrast, regulatory bodies must impose and supplement regulatory principles by detailed rules that regulated companies must comply with.41 These rules, such as the Sarbanes Oxley Act 72 and the Dodd-Frank Act, are included in the law. 42Although the majority of researchers agree on the fundamental reasons for the regulation, there is the inevitable discussion of the precise nature of the intervention. In this discussion, we usually take account of the specific circumstances of a sector. 43 If a country, therefore, decides to use a specific regulatory framework, it must achieve the specific goals it seeks.44

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36 Allen F, Demirguc-Kunt A, Klapper L & Peria MS(2012). The Foundations of Financial Inclusion - Understanding Ownership and Use of Formal Accounts: Policy Research Working Paper
37 Madise S 'Rationale of Regulating the Financial Services, Models of Regulation and Need for Regulatory Independence' available at *http://dx.doi.org/10.2139/ssrn.2538437* (accessed December 2018).
38Demirgüç-Kunt A & Klapper L *Financial Inclusion in Africa: An Overview - Policy Research Working Paper* 6088. Washington: The World Bank (2012) 75
39Mwenda, K. K. (2003). Legal Aspects of Unified Financial Services Supervision in Germany. German Law Journal, 4(10), 1009-1031.
40Quintyn M, Michael W & Taylor 'Should Financial Sector Regulators be Independent?' IMF Economic Issues available at http://www.imf.org/external/pubs/ft/issues/issues32/#1 (accessed 28 February 2017)
41 Financial Services Deepening Kenya, Central Bank of Kenya Financial Inclusion in Kenya: Survey Results and Analysisfrom FinAccess (2009) 6.
42ALI, H. S. (2016). Financial Inclusion, Financial Stability And Economic Growth In Developing Countries.
43 Government of the Republic of Kenya *Finance Act*. Nairobi: Government Printer.
44Anyango, L. A. (2014). Financial Services Regulation In Kenya A Critical Analysis Of The Proposed Unified Financial Services Regulator (Doctoral dissertation, University Of Nairobi).

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2.3 Financial services

Any business service or financial product provided by the financial industry refers to a financial service.[45] Financial services are also used to describe organisations in money management. Financial services generally include insurance, estate, trust services, agencies, securities, acquisition of deposits, credit and investment services and all types of financial or market intermediation not restricted to distributions of financial products.[46]

To facilitate the transfer of funds between investors in the financial services industry. It also monitors resources allocation through several corporate governance arrangements. Consequently, for economic performance, the financial sector is crucial. Therefore, in designing financial regulation, it is essential to be aware of its impact on the broader economy.[47] The collapse of large financial sectors may, for example, lead to poor economic policies. The financial sector is divided into many different operations and can be divided into various subsectors. Different countries have different financial services systems, consisting of different market sectors, that supply different types of service to various products and services.[48]

As a consequence, financial services may be governed by a public entity exercising the regulatory or supervisory power delegated by law.[49] There are still unprecedented changes in the industry, which are driven by different factors including consolidation, technological advances and market regulation. Traditionally, financial services have been structurally and functionally distinct. These differences among banks, insurance firms, securities and courier companies have fallen. It is not happening any more.[50]

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45 Groenewald, T. (2004). A phenomenological research design illustrated. *International journal of qualitative methods*, *3*(1), 42-55.

46Mwenda, K. K. (2003). Legal Aspects of Unified Financial Services Supervision in Germany. German Law Journal, 4(10), 1009-1031.)

47 Anthony I Ogus, (1985) Regulation: *Legal Form and Economic Theory*, vol 152 (Clarendon Press Oxford 1994) 4

48 Ruddy N, Mills S, Salinger F & Davidson N *Salinger on Factoring* (2006) 34

49Quintyn, M., & Taylor, M. (2004). *Should financial sector regulators be independent?* (Vol. 32). International Monetary Fund 2-7 *http://www.imf.org/external/pubs/ft/issues/issues32/#*(accessed 28 February 2015)

50Bankable Frontier Associates 'Promoting Financial Inclusion Through Social Transfer Schemes' (2008).

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Many jurisdictions have now asked for a consolidated or unified financial framework to take into account the developments mentioned above.[51] In many countries, the development of the Financial Services Regulation has generally followed a historical pattern.[52] All elements that influence the pattern are the national policies, structure of the existing legal framework, impact of best practices at international level on different aspects of financial regulation, movements towards regional integration,[53] governmental response to financial scandals, pressure on the international community and market pressures for reform in general.[54]

2.4 History of financial services sector regulation in Kenya

There have been different paces in the various subsectors of the financial sector regulations, discussed below.

2.4.1 Banking industry

The UK introduced the formal banking system in Kenya. After independence, western imperialism and globalisation continue to have an impact on the banking sector. Kenya has been influenced directly by the introduction of the monetary system. Business banks with headquarters in the UK started their businesses in Kenya in the 1890s. Most banks have no relationship with Kenya's native people, so they are focused on the immigrant-colonising community when they entered deposit banks. The then political and financial system served colonial interests. After independence, it has been stressed the need for proper control of the financial and monetary system in order that economic, social and political goals may be achieved.[55]

In order to control monetary and fiscal policies in Kenya, the Independence Government undertook to correct this by creating a central bank, by introducing money from Kenya, by

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51Anyango, L. A. (2014). Financial Services Regulation In Kenya A Critical Analysis Of The Proposed Unified Financial Services Regulator (Doctoral dissertation, University Of Nairobi).
52Ogus, A. I. (1994). Regulation: legal form and economic theory. 45-49
53Grant, W., & Wilson, G. K. (Eds.). (2012). The consequences of the global financial crisis: The rhetoric of reform and regulation. 25
54Mwenda, K. K. (2003). Legal Aspects of Unified Financial Services Supervision in Germany. German Law Journal, 4(10), 1009-1031.
55Groenewald, T. (2004). A phenomenological research design illustrated. *International journal of qualitative methods*, *3*(1), 42-55.

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joining the banking community with the Community's state-owned banks, or by purchasing stocks from existing banks and by creating banking legislation in Kenya.56 The Governments steps in rectifying this situation ensured all banking systems are subject to the Banking Act at present.57 The law was passed in 1989, and the banking law of 1969 was repealed and replaced. Banking had been subject to banking rules in Kenya before.58

The banking order was a colonial law at the time of independence, inherited from the new government.59 The Act 2015 (cap488) has given the finance ministers of licensing banks, non-financial institutions and the central bank of Kenya responsibility for inspections of all financial institutions.60 The Act, however, has several legal weaknesses. The objective was to reinforce the sector's institutional framework once adopted. However, this goal was not met, as shown by the significant crises that collapsed in many banks in the 1980s and 1990s. Capitalism, high failure to perform loans and corporate governance were the key reasons for the banking crisis.

In conclusion, the financial sector became financially fragile, and there was a loss of public trust. The 1985 Banking Act (amendment) rectified these shortcomings.61 It first examined the Act to give more legal powers to the regulatory body and to extend obligations and exposures of companies, such as micro-financial institutions.62 Secondly, the licensing has now been routed through the Kenya Central Bank with the Minister's permission.

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The change also resulted in the creation of the Deposit Protection Fund in 1986.63 Thirdly, to promote internal controls, capital appropriation, risk classification of assets and the overall risk

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56 International Finance Corporation *G-20 SME Finance Policy Guide Report* (2011)
57 Banking Act Chapter 488 Laws of Kenya
58Nyasha, S., & Odhiambo, N. M. (2014). The dynamics of stock market development in Kenya. *Journal of Applied Business Research (JABR)*, *30*(1), 73-82.
59 Brownbridge, M. (1996). Government policies and the development of banking in Kenya.Working Paper Series, 29
60Factors Chain International (2013) *'Ireland' World Factoring Yearbook* (2013)
60Banking Act Chapter 488 Laws of Kenya
61Brownbridge, M. (1996). *Government policies and the development of banking in Kenya*.Working Paper Series, 29. Brighton: IDS.
62Nyasha, S., & Odhiambo, N. M. (2014). The dynamics of stock market development in Kenya. *Journal of Applied Business Research (JABR)*, *30*(1), 73-82.
63 Deposit Protection Fund 1986

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management of the banking sector, prudential rules were reviewed to avoid a repetition of defects. The above reforms were no longer viable, along with current global trends in the banking industry. In 2003 the Kenyan Central Bank also pointed out that the banking sector was still struggling with the goals of the recovery strategy and thereby undermining the achievement of the goals.64

These included a comparatively large share of a non-performing bank loan; insufficient competition in the bank sector; wide interest rates spreading to high loan costs; low loan amounts and inadequate quality loan assessment; lack of strong long-term financial institutions; weak legal structures that create long-term delays.65 These problems included relatively high loans. Even if the inefficiencies of banks remain, they are still due to new trending around the world even after the Act is amended, and some of these shortfalls also affect other financial service institutions.66

2.4.2 Insurance sub-sector

There was no specific insurance law in Kenya before 1960 when the Insurance Ordinance was promulgated. The law aimed to control the establishment, operations and finances of insurance companies. 67 Assurance companies had to comply only before the Ordinance with the Companies Act.68

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After 1963, Kenya and other emerging economies in Africa, following independence, realised that insurance legislation was required to guide growth in the industry and to make it relevant for the domestic economy. Nevertheless, insurance providers generally remain free-hand in most of

64Mitullah, W. (2003, December). Street trade in Kenya: The contribution of research in policy dialogue and response. In *Urban Research Symposium on Urban Development for Economic Growth and Poverty Reduction* (pp. 15-17). World Bank.
65Mwega, F. M. (2016). Financial regulation in Kenya: Balancing inclusive growth with financial stability. In *Achieving Financial Stability and Growth in Africa* (pp. 99-122).
66 Financial *Sector Reforms including Legislative Issues*. Paper Presented to the Central Bank of Kenya (CBK)
67 William Olotch (2006) 'The Kenya Insurance Market' *The African Reinsurer* available at *www.africare.com/areport/eng_a/4a.pdf* (accessed 31 August 2016).
68Companies Act Laws of Kenya (Repealed by Companies Act No 17 of 2015) Chapter 486 William Olotch (2006) 'The Kenya Insurance Market' *The African Reinsurer* available at *www.africare.com/areport/eng_a/4a.pdf* (accessed 31 August 2015).

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the activities.[69] This scenario created an environment of problems that is still alive today. Among the challenges faced by the insurance sector were the growth of broad-based cartels from the industrial sectors, the erratic judiciary, low technology use, fraudulent insurance companies and the poor mobilisation of investment capital.[70]

The Insurance Act[71] was enacted in 1986 and implemented on 1 January 1987. It was aimed at streamline the insurance sector by providing supervisory services for insurance companies and supporting fair, safe and stable maintenance in the insurance sector.[72] This Act established a Commissariat for Insurance with the mandate of licensing, monitoring and regulating actors in the sector.[73]

The Act also established a Consultative Committee to supervise the Commissioner's mandate. The insurance industry still faced some challenges as this Act was introduced; in particular, the liability system for third parties designed to offset the victim of accidents.[74]Several insurance companies have collapsed, among other factors that contributed to the deterioration of the sector.[75] In addition to the numerous industrial challenges, the fall of several insurance companies in the region in the 1990s required modifications to their relevant legislation. In 2003, the Act was first significantly amended. The 2003 amendments were intended, among other things, to address corporate governance problems with the increased number of boards, expertise and financial transparency.[76] In 2004 the Act was amended to create the Policy Holders Compensation Fund to partly alleviate the plight of insurance policyholders as insurance

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69World Bank.Kenya Economic Update *Reinvigorating Growth with a Dynamic Banking Sector*. (2013) No. 9 ed. 9 37

70 Ledgerwood J Microfinance Handbook *An Institutional and Financial Perspective* (2013) 256

71 Insurance Act Kenya CAP 487(revised 2012)2010

72 Yohana Gadaffi '*Reforming the Insurance Regulatory Framework in Kenya: An Analysis'* vol 20 (6) Journal of Research in Humanities and Social Science

73 Central Bank of Kenya (2016) '*Bank Supervision Annual Report'*

74Kiragu, S. M. (2014). Assessment of challenges facing insurance companies in building competitive advantage in Kenya: A survey of insurance firms. *International journal of social sciences and entrepreneurship*, *1*(11), 467-490.

75 Chibba M (2009) Financial Inclusion, Poverty Reduction and the Millennium Development Goals European. Journal of Development Research, 213-230.

76Okeahalam, C. C., & Akinboade, O. A. (2003, June). A review of corporate governance in Africa: Literature, issues and challenges. In *global corporate governance forum* (Vol. 15, No. 1, pp. 1-34).

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undertakings break down and increase consumer confidence.77 In 2006, the Act was amended to establish the Insurance Governing Body, which took the responsibility of the Commissioner of Insurance.78

The Commissioner thus became the CEO of the agency while management authority was then transferred to the Management Board. The Act also establishes an insurance tribunal which has the mandate to hear and solve market player disputes.79 These amendments were aimed not only at limiting fraud but also at encouraging acceptable management practices in insurers.

In 2010 the Act was further amended to extend regulatory and supervisory powers of the financial regulatory agency. The changes also strengthened the supervisory role of the authority and tried to clarify the tasks of the compensation fund board of the Strategy Holders. Any risk profile of an insurer was one of the core tasks set out in the amendment.80

In 2011 and 2013 the law was further amended to reinforce the mandate of the Insurance Regulatory Authority and to establish a more uniform document covering many previous amendments. The insurance legislation has been amended several times since 1963 and has been aligned with developments and current challenges facing the industry by the first act passed in 1984. The new law has remained the same. While the amendments establish a regulatory policy framework that addresses, and not only Kenya's specific concerns, the industry continues to evolve, and therefore the reform is continuing to maintain international best practice in the assurance industry.

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2.4.3 Savings and Credit Cooperative Societies (Saccos)

For Saccos, Kenya has had a long time a separate legal and supervisory framework.81 All Saccos were governed by the Cooperative Societies Act 190. Due to a lack of regulatory oversight, risk exposure, exceptional disclosure standards and no reserves of liquidity are not

77Musyimi, ZN (2014) Effectiveness of Policyholders' Compensation Fund in Kenya's Insurance Sector 56.
78 Insurance Amendment Act 2003 s 27 A (a)
79 Insurance Amendment Act 2003 s 31 (h)
80 Musyimi, ZN (2014) Effectiveness of Policyholders' Compensation Fund in Kenya's Insurance Sector 56.
81 Legal Notice No 105 of 2004

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limited by prudential guidance or rules. This lead to the maladministration of the funds and certain Saccos collapsed.[82]

The fast growth of the sub-sector Sacco has emphasised special legislation, which is why Sacco Society Act 192 has been implemented to precisely monitor and control its operations. This law established the licensing, regulation, monitoring and promotion of Sacco companies. Sacco companies. It has also set up the Sacco Regulatory Authority (SASRA). The Authority was tasked with the license and regulation of Saccos and guidance on the protection of members' deposits.[83] The Act aimed to enhance Sacco's management transparency, accountability and corporate governance practices.[84] The Act has not been amended to date.

2.4.4 Retirement/pension schemes

Before legislation governing and regulating pension systems was enacted, the interests of pension schemers and their recipients were not sufficiently safeguarded. There was a concern about the poor management, financial viability and investment in the scheme funds. The risk of mismanagement and total misappropriation were, in most cases, insufficient controls and surveillance.[85] Moreover, disclosure and responsibilities were not available. Also, management concerns regarding its investments and benefit payments have continued to concern the National Social Security Fund (NSSF).[86] The stakeholders generally have minimal trust in the subsector. In 1997, the Retirement Benefits Act, and the National Social Security Fund, was adopted to improve pension governance, administration and efficiency.[87]The Act resulted in the creation of the pension authority in 2000. This marked the beginning of a regulated, organised and responsible pension sector in Kenya.

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82 Insurance (Policy Holders Compensation Fund) Regulations 2004
83Njeule, M. A. (2013). The effects of central bank of Kenya prudential Regulations on financial performance of commercial Banks in Kenya (Doctoral dissertation, University of Nairobi).
84Kamau, A. W. (2009). Efficiency in the banking sector: An empirical investigation of commercial banks in Kenya (Doctoral dissertation).
85Kusewa, L. M. (2007). The impact of regulation of the retirement benefits sector on the financial performance of occupational pension schemes in Kenya (Doctoral dissertation).
86Mutua, N. N. (2003). A survey of the extent of compliance with the retirement benefits act by retirement benefits schemes in Kenya (Doctoral dissertation).
87Retirement Benefits Act CAP 107 Laws of Kenya (revised 2012)

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Furthermore, despite the adoption of legislation addressing historical challenges, there is no concerted effort to address regulation complexities that have evolved throughout the different subsectoral fields. Many independent regulators responsible for overseeing their specific subsectors are part of the existing framework for financial services in Kenya.[88] There were free thinkers, legislative overlaps, multiple regulators, regulatory incompatibilities and operational standard divergences in this regulative structure.

Besides, reforms, even with the industry's regulatory modernisation, were progressively underway. Moreover, the desire to replicate developments in other jurisdictions has mostly meant the need for a Kenya financial services sector regulatory reform.[89]

2.4.5: Microfinance Institutions (MFIs)

Under the supervision of the central bank, the microfinance Act governed the implementation, licensing and supervision of large microfinance institutions. In December 2006, the Microfinance Act was enacted.[90] The Act thus aimed at creating a conducive environment to encourage microfinance deposit-takers to operate and maintain themselves whilst at the same time protecting depositors' interests. By mid-2009, the Central Bank authorised two leading microfinance institutions to become depositories, which extended their mandates solely through microcredit and allowed them to mobilise their money domestically.[91]

Microfinance amounts are measured in Kenya by the number of MFIs operating formally as well as informally in the country. The number of research projects undertaken by themselves or in close cooperation with other institutions, organisations or countries, to develop framework measures aimed at increasing microfinance in Kenya, compared to other African states, remained

88Anyango, L. A. (2014). Financial Services Regulation In Kenya A Critical Analysis Of The Proposed Unified Financial Services Regulator (Doctoral dissertation, University Of Nairobi).
89Central Bank of Kenya 'Bank Supervision Annual Report' (2014)
90 Mureithi C Effects of Financial Regulation on Financial Performance of Deposit Taking Microfinance in Kenya (unpublished MBA thesis, University of Nairobi).
91 Ochanda R 'Factors Influencing the Establishment of Micro-finance Schemes in Kenya' available at http://ssrn.com/abstract=2064178

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a significant player among those countries that are genuinely trying to improve their micro-finance practice.92

A statistical study of the pre-installation of the Poverty Reduction Strategy Paper will help identify micro-finance practices performance and their impact on the population and comparing the statistics of current economic conditions for low- and poor-income workers, who are the objectives of MFi and micro-finance practices in Kenya.93 The poverty rate in this country has increased from 43.8% in 2016, to 52.3% in 2017, as in 2017. This has been reflected in the rural development trend that has increased by 46.8% to 52.9%. It shows that over the two years, urban poverty has grown considerably from just 29 percent to over 49 percent and that traditional views have changed that poverty is mostly rural. 94

2.5 Current financial sector regulation in Kenya

In the present financial sector regulatory framework, in Kenya, several independent regulators exert jurisdiction in different subsectors.95 A fragmented model is adopted in the Regulatory Framework for Kenya, in which each regulator has responsibility for a particular subsection.96 It is also a mixture of functional and institutional models of regulation.97 Several government agencies regulate specific subsectors of financial services. The Finance Department currently supervises these agencies.98

a) The Kenyan Central Bank regulates all commercial, non-bank financial, mortgage and forex offices, building and microfinance entities.

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92Kadet, (2005). *Integrating financial services into poverty reduction strategies: institutional experience of Kenya*. Paper presented at the Southern Africa Sub Regional Workshop, Maseru, Lesotho. [Online]. Available: www.afraca.org/ accessed sepember 2018)
93 Kwagara, M. P. (2006). An Assessment of credit risk management techniques adopted by micro-Finance institutions in Kenya (Doctoral dissertation, University of Nairobi.).
94 Dondo, Aleke, (2003). *An overview of the Microfinance Industry in Kenya*, A paper presented at the Kenya. Institute of Bankers' conference, Nairobi.
95 Central Bank of Kenya ‘Bank Supervision Annual Report’ (2016).
96 Banking Act Chapter 488 Laws of Kenya
97 Central Bank of Kenya Act Chapter 491 Laws of Kenya
98Nyaoma, Gerald (2006), *Financial Sector Reforms including Legislative Issues*. Paper Presented to the Central Bank of Kenya (CBK) Monetary Policy Advisory.

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b) REBA is regulating pension schemes, pooled schemes, National Social Safety Fund managers and managers for the fund, and is the regulator for the pension industry.

c) The Insurance Regulatory Authority is governed by all insurance companies, brokers, insurers and loss adjustors or health management enterprises.

d) A securities market, fund manager, central stock exchange, supervisor, custodian, investor's banking system,central depository systems, custodians, investment banks, collective investment schemes and a publication and advertiser shall be administered by the Capital Markets Authority.99

e) Sacco Societies Regulatory Authority shall regulate all savings and credit cooperative societies.

2.5.1 Banking Sector

The Banking Act,100 the Kenya Central Bank Act101 and the various prudence guidelines issued by the Central Bank of Kenya shall govern a subsector of the banking sector. It is the responsibility of the Kenyan Central Bank to devise and implement monetary policy and to promote liquidity, solvency and the proper operation of the financial systems.102 Banking operators are authorised by and regulated under banking law by the Central Bank of Kenya

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2.5.1.1 Banking Act

The Act governs the banking sector. In the supervisory and control functions of banks, the Central Bank of Kenya has extensive powers.103 These include the power to lay down guidelines for institutions to guarantee a stable and efficient financial and banking system.

99Gakeri, J. K. (2012). Regulating Kenya's securities markets an assessment of the capital markets authority's enforcement jurisprudence.5-10

100Banking Act Chapter 488 Laws of Kenya

101 The definition of banking business as per the Act means: a. The accepting from members of the public of money on deposits repayable on demand or at the expiry of a fixed period or after notice.

102 Kamaan, C. K., & Nyamongo, E. M. (2014). *The effect of monetary policy on economic growth in Kenya.* International Journal of Business and Commerce, *3*(8), 11-24.

103 Task 3 Technical Team (2005) Regulatory Framework for Factoring Egypt Financial Services Project Technical Report No. 28,

http://etd.uwc.ac.za/

Prudential Guidelines were issued in this respect by the Central Bank to entities licensed according to this Act.104

The guide covers new authorisations, corporate management, equity and capital adequacy, asseter and supply risk classification, liquidity management, currency exposure limits, prohibited business, crime and cash laundering proceeds, external auditors, financial statements publication and disclosure, new business location opening, closing and changing locations.105 Concerning the proposed sector, several legislation and regulations were proposed. For example, the Banking (Amendment) Bill was published to amend the bank act to restrict the interest rate charged by banks and other financial institutions on credit or monetary advance.106 The Bill also proposes to lay down a minimum interest rate for deposits held in banks' or financial institutions' accounts. On 10 November 2011, the Bill's first reading was approved but never moved on.

The bill aimed to curb banking challenges for consumers and to strengthen robust frameworks in corporate risk management. This will help the sub-sector manage cross-border risk and allow banks to improve liquidity management, borrowing and macroeconomic shocks resilience. It also tried to reinforce, in the recent past, the majority of changes to the Act with a view to harmonisation. It is important to note, however: the banking industry is also evolving rapidly, and each amendment will not solve all the problems in financial services permanently.

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2.5.1.2 Central Bank of Kenya Act

In the context of Article 231 of the Kenyan Constitution, the Central Bank of Kenya107, as read in conjunction with the Central Bank of Kenya Act, which also governs its activities. The Central Bank's goal is to oversee and develop and implement policies to encourage banks to set up,

104M David, M., Kithinji, ., & Njeru, E. Effect of Central Bank of Kenya Prudential Guidelines On Financial Performance Of Commercial Banks. Case Study of Commercial Bank In Cbd Nairobi.45
105Nier, E. W. (2009). Financial stability frameworks and the role of central banks: lessons from the crisis. IMF Working Papers, 1-64.
106 Beck T & Fuchs M (2004).Structural Issues in the Kenyan Financial System: Improving competition and Access
107 Constitution of Kenya art 231

http://etd.uwc.ac.za/

regulate and supervise authorised traders.108 The Kenyan Central Bank is authorised under the Act to perform all types of banking functions required by the Kenyan Central Bank.109

The Central Bank of Kenya110 has all the central bank's competences. It, therefore, has the authority to establish its own rules and procedures to ensure that they are properly governed and run. Accordingly, all Kenyan banking institutions are regulated by the Central Bank. Other institutions are also served as bankers by the Central Bank. It allows institutions to monitor and regulate, for instance, by requiring institutions to inform them and to carry out their tasks reasonably.111

2.5.1.3 Agency banking

The Agency Banking adopted the Prudential Guidelines in Kenya in 2010. They outline the way banks and other financial institutions can function by agencies. Prudential Guidelines define an agent as an entity which has been contracted, on behalf of that institution, to provide the services of the institution by the Central Bank of Kenya, following the procedures laid down in the Prudential Guidelines.112

To be entitled, an entity must have at least 12 months before the date of application for the eligible business a business license or a legitimate business activity permit. The institution should take account of the credit risk, the business risk, legal risk, liquidity risk, reputable hazard, and respect for anti-money laundering and terrorist financing rules when appointing a person or entity to its agents.113

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108 Central Bank of Kenya Act Chapter 491 Laws of Kenya
109Kamau, A. W. (2009). Efficiency in the banking sector: An empirical investigation of commercial banks in Kenya (Doctoral dissertation).
110 Central Bank of Kenya Act s 4
111SME FINANCE (SMEF) WorkingGroup(2016) The Role of Financial Regulators In Promoting Access To Financing For MSMEs 5
112Omino, G. (2005). Regulation and supervision of Microfinance Institutions in Kenya. Central bank of Kenya.
113 Lauer K, Dias D & Tarazi M Bank Agents: Risk Management, Mitigation, and Supervision. Focus Note (2011) 75.

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2.5.1.2 E-banking

In recent years, mobile network operators have made numerous advances in technology in the industry pioneered. Customers can open their digital accounts, send money, get credit for their mobile phone and receive payment bills. Users may also withdraw the money from the ATM, deposit and withdraw the money from the agent network, including airtime retailers and banking agents.114

The companies are not classified as deposit-receiving institutions and are therefore not authorised under the Bankengesetz (Banking Act). The Board of Deposit Protection does not protect the deposit to an electronic funds transfer account. Without going to the bank, users still cannot make fundamental banking transactions. There has been no regulation to regulate this famous and renowned global service to date.115

Although Kenya's Communications Authority governs mobile phone transfers and mobile payments, more banking and ICT services are required. There are several legal and financial risks involved in the current framework.

There is also uncertainty about banks' need for a Kenya communications agency to operate the money-transfer and mobile money payment system because they do not have the competency to regulate banking.116 As part of Kenya's recent move to implement enough consumer protection and money laundering prevention measures, the Kenyan Central Bank recently adopted a Money Remittance Regulation for supply and regulation of electronic retail transfers and e-money.117

This Regulation applies to all payment transfers by electronic payment method and all payment service providers authorised by the non-bank and financial institution. Banking and telecommunications convergence includes products like M-Shwari and M-Benki, which offer savings systems and consumer loans via mobile telephones. Crediting money is traditionally a

114 Constitution of Kenya 2010 art 231

115 Cull R, Gatere P, Beck T, Fuchs M, Randa J, Getenga J & Trandafir M(2010). *Banking Sector Stability, Efficiency, and Outreach in Kenya* 3

116 Kimenyi MS and Ndung'u NS, „(2009)Expanding the Financial Services Frontier: Lessons from Mobile Phone Banking in Kenya.5

117Jack, W., Suri, T., & Townsend, R. M. (2010). *Monetary theory and electronic money: Reflections on the kenyan experience.* FRB Richmond Economic Quarterly, 96(1), 83-122.

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banking or Saccos service. As has already been pointed out, this area is yet to be regulated; such consumers are not legal protection in the event of a crisis.118

A new trend is the MVNO license concept which allows operators to offer mobile money services without the need to construct new cellular infrastructure.119 The current regulation in Kenya focuses on operators of mobile networks governed by the Communications Authority of Kenya. There is a very unclear regulatory model for the operations of the Company.120

Digital currency is a new trend which enables immediate transactions and unlimited transfer of ownership.121 Kenya has recently seen the use of Bitcoin in its virtual market currency.122 However, the Central Bank of Kenya (CBK) stated that bitcoin and other virtual currencies are not legally accessible because they are not issued by the government or guaranteed. Also, VMTs are subject to money laundering, terrorism financing, and other offences, thereby exposing users to possible losses.123

2.5.1.3 Islamic banking

Currently, there are two full-scale Shariah banks in Kenya, and more conventional banks are divided into Islamic banking. It is now necessary to harmonise and standardise rules for the financial institutions and products that comply with Shariah rules for Kenya's Central Bank, and for other financial regulators. 124 Some of the unique challenges identified by the Islamic banking industry is First, the absence of a Shariah compliant legal framework is a large

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118Ondiege, P. E. T. E. R. (2015). Regulatory impact on mobile money and financial inclusion in African countries-Kenya, Nigeria, Tanzania and Uganda. Center for Global Development (CGD), 50.
119Lee, S., Chan-Olmsted, S. M., & Ho, H. H. (2008). The emergence of mobile virtual network operators (MVNOs): An examination of the business strategy in the global MVNO market. The International Journal on Media Management, 10(1), 10-21.
120Mutua, J., & Oyugi, L. N. (2007). Poverty reduction through enhanced rural access to financial services in Kenya. Institute for Policy Analysis and Research (IPAR).
121 Ølnes, S. (2016, September). Beyond bitcoin enabling smart government using blockchain technology. In *International conference on electronic government* (pp. 253-264). Springer, Cham.
122Raskin, M., & Yermack, D. (2018). Digital currencies, decentralized ledgers and the future of central banking. In *Research Handbook on Central Banking*.
123 Mazer, R., & Rowan, P. (2016). *Competition in mobile financial services: Lessons from Kenya and Tanzania1*. The African Journal of Information and Communication, (17), 39-59.
124 Noormohamed, S. I. (2019). *The Inadequacy of the Legal Framework Governing Islamic Banking in Kenya* (Doctoral dissertation, University of Nairobi).

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contributor to its weak penetration of the financial market.125 This is due to existing financial services legislation which was not amended to include Islamic banking in the regulatory environment. Also, no supervisory body has been established to standardise and converge Islamic banking products.126

The Central Bank also faces the challenge of monitoring a free interest and an interest system. Secondly, Islamic law also has its framework for the implementation of commercial and financial contracts and transactions.127 Disputes resulting from products from Shariah shall be settled under the same legal system as conventional courts and judges. The products of Shariah are the same system of law. Thirdly, the lack of effective prudential regulation is one of the weaknesses of shariah-compliant banking.128

The problem is that there is a group of Islamic scholars within each institution who endorse the product. In comparison, Islamic financial institutions offer the same fundamental products. Thus, the same product can have different characteristics, and different types of rules apply in these institutions. There is no proper mechanism of public disclosure and transparency in place to ensure consumer protection provided by Shariah.129 Fourth, accounting insecurity includes income implementation, accounting, accounting, assessment, revenue and matching expenditure, among others.130 The results of Islamic banking schemes, especially the profits and losses of depositors, can not, therefore, be defined appropriately. 131 Therefore. Besides, Shariah-compliant banking has no adequate credit analysis standard. Fifthly, there is an insufficient

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125Mohieldin, M., Iqbal, Z., Rostom, A., & Fu, X. (2011). The role of Islamic finance in enhancing financial inclusion in Organization of Islamic Cooperation (OIC) countries. The World Bank.
126 Oramah, BO 'From the Periphery to the Centre: Africa as the Growth Market for Factoring' (2014) 5 Contemporary Issues in African Trade and Trade Finance Volume 1 Number 1 Cairo: Afreximbank
127 Sheikh SA, „Factors That Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry" (MBA Thesis, University of Nairobi 2009)
128 Abdulatiff L (2011) 'The Emerging Trends in Commercial and Financial Law Banking Law, Capital Markets Law and Corporate Governance'
129 Alarcon RB (2014) '*International Factoring and Development: The Impact of the Factoring Model Law of 2014'* available at *https://fci.nl/about-factoring/international-factoring-rosana-bastos-sep2014.pdf*(accessed September 2017)
130 Milgrom, P. R., North, D. C., & Weingast*, B. R. (1990). The role of institutions in the revival of trade: The law merchant, private judges, and the champagne fairs. Economics & Politics, 2(1), 1-23.
131Kinyanjui, S. N. (2013). Challenges facing the development of Islamic banking. Lessons from the Kenyan experience. *European Journal of Business and Management*, *5*(22), 94-102.

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supply of Shariah-compatible banking experts. Experienced or trained banking professionals are behind the expansion of Islamic banking.132 Training needs affect not just domestic and non-Islamic banks, but foreign banks as well. Training involving aspects related to the study of financial feasibility, monitoring of companies and portfolio appraisals is widespread.133

- Real Estate Investment Trust schemes

As one of the companies that are entitled to act as trustee of the investment trust scheme for real estate, the Capital Markets Authority established Real Estate trust regulations and commercial banks. However, the Banking Act limits a bank from holding land interests unless the bank is required to hold its own company or employees, and a bank is allowed to carry on a banking activity only. The Banking Act needs modification to permit commercial banks to act as trustees of an investment trust scheme for real property.134

- Kenya Deposit Insurance Act

The Kenya Deposit Insurance Act was introduced to create a Kenya Deposit Insurance company (K Deposit Insurance Corporation) as the place of a Deposit Protection Fund board, following a banking crisis that began in 2008. The Authority is the Central Bank of Kenya's independent department. In the Law, deposit-insurance schemes are established, and deposit-taking institutions are received and liquidated. This is designed to protect depositors from losses in the event of a bankruptcy. 135

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2.5.2 Insurance

The Insurance Act was adopted to regulate the subsection. It seeks to establish the Insurance Regulatory Authority as the insurance supervisor and regulator using 2006 amendments to replace the Insurance Commissioner. The Commissioner of Insurance resorted to the Minister of

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132 Zaher, T. S., & Kabir Hassan, M. (2001). A comparative literature survey of Islamic finance and banking. *Financial Markets, Institutions & Instruments*, *10*(4), 155-199.
133 World Bank Group, IFC-SME Department *Kenyan Factoring Initiative*, (2002)
134 Tomusange L. R. Factoring as a Financing Alternative for African Small and Medium-Sized Enterprises (published Walden University 2015)
135 Capital Markets Real Estate Investments Trusts Collective Investment Schemes Regulations 2013

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Finance, but the new authority of the regulator is more autonomous. The efficiency of the subsector monitoring has been strengthened.136

Additional amendments in the Act were made in 2010 to extend the regulatory and supervisory powers of the Insurance Regulatory Authority. A bill to regulate and supervise risk-sensitive insurers currently exists that represents a shift from basics. It aims at establishing a framework to monitor and regulate Kenya's insurance industry following core principles and practices. Some of the principal feasibility of the project include that the Insurance Regulatory Authority only provides for insurers.137

The Bill offers flexibility in adapting to constant changes in the insurance industry changes in international standards and best practices. It is mandatory to issue technical and detailed guidelines/regulations with clarity of application by the Insurance Regulatory Authority. This last is not required for use; the subsector is followed up to ensure conformity.138

2.5.3 Cooperative Savings and Credits (Saccos)

The Sacco Regulatory Authority was created in 2008 by the Sacco Societies Act (SSRA)139. The Authority is responsible for licensing Sacco Societies for business deposits, regulating and overseeing deposits for Sacco Companies, managing the Deposit Guarantee Fund, following the law-designated trustees, and for advising the Minister of national policy concerning Sacco deposit in Kenya. Saccos differs because Saccos provides, over and above credit from micro-finance institutions, an intermediate range of financial services. 140

In contrast to microfinance institutions, they mobilise consensus share capital from their members to an even greater extent and are owned by equal community owners. They are

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136 Insurance (Amendment) Act 2006

137 Kihara, J. (2014). Strategies adopted by the insurance regulatory authority in enhancing compliance in the insurance industry in Kenya (Doctoral dissertation, University of Nairobi).

138 Central Bank of Kenya (CBK) Monetary Policy Advisory Committee (2006). *Financial Sector Reforms including Legislative Issues*. Paper Presented to the Central Bank of Kenya (CBK) Monetary Policy Advisory Committee on September 26 2006.

139 Sacco Societies Act No. 14 2008

140 Mwangi, M. (2014). The influence of members' income and conduct of Saccos in the relationship between characteristics and efficiency of Saccos in Kenya (Doctoral dissertation, University of Nairobi).

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different from others because of the type of services offered by the saccos. Unlike other cooperative companies, financial intermediation saccos are specialised in which prudential financial standard and oversight are required. In terms of membership, portfolio, loans and overall performance, Saccos reported recent improvements to their performance after the legislative process. This is because of several factors, including higher membership, high efficiency, high demand, quick recovery, but the regulatory framework of Sacco Societies. This is because of the factors. In order to prevent the locking of most Saccos, the regulator was complied with. The inclusion of Saccos in the official financial sector, increasing trust via effective Saccos leadership and management, promoting fair competition via the destruction of nonethical business practice, creating and shifting the company's development for Saccos and not institutional development are some of the notable advantages of the Regulation for Saccos. Over the years, Sacco will have grown to provide low-income people with a whole range of financial services.

Throughout the years, both coverage and assets of the microfinance institutions were developed. The number of borrowers, branch networks and capital markets reflects this growth. Many Kenyans are today part of the many Saccos in the country. There has been an increase in financial inclusion within the country. As a result, conventional Saccos banks have again begun to focus on micro-finance. In particular, it was focused on a share of the growing SME market, which the Kenya government also acknowledged as the growth driver for the 2030 vision.[141]

Saccos's high growth in Kenya shows that many Sacco institutions subsequently became banks and micro-finance companies. The growth of the sector has further increased the convergence of services traditionally offered by the banking sector.[142] They only provided credit, for instance, at the beginning of the Saccos development in Kenya, but now accept deposits and savings of their members and operations for all the Saccos in Kenya. Saccos is also widely used to accept

141 AFI Network (2015) The Role of Financial Regulators in Promoting Access to Financing for MSMES Lessons from the AFI Network (GN.23 of August)

142 World Trade Organization (WTO)(2016) Trade Finance and SMEs Bridging the Gaps in Provision

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deposits, provide credit facilities and save its members from mobile money services. The banks also provide these services.143

2.5.4: Microfinance Institutions

The Kenya Microfinance Industry Legal, Regulatory and Surveillary Framework is established by the Microfinance act of 2006 and by the 2008 Deposit-Taking Institutions, published below. The main aims of the Microcredit Act include the restriction of implementing, operating and operating microfinance institutions in Kenya through licensing and supervision.144 It enables microfinancing banks to promote competition, efficiency and access, mobilise general public savings and play an essential role in enhancing the markets and making the financial services and products accessible to the majority of Kenyans.145

Only credit MFI is covered by the largest microfinance companies in Kenya. The category is not regulated because the finance minister has been requested to lay down provisions for the 2006 Microfinance Act. All MFIs must publicise and submit their account, pricing, and other fees as well as their accounts and books under the Microfinance Act and the credit-only regulations proposed.146 The Consumer Protection Act of 2012 has been widely adopted. It also provides for conflict resolution and mechanisms. The Microfinance Act, as well as the credit-only provisions proposed, make this a requirement.147

Also, all financial institutions, including MFBs, must share both negative and positive customers information through licensed credit institutions under the 2013 Credit Reference Bureau Act.

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143 Ngaira, L. (2011). The impact of sacco regulatory authority guidelines on sacco operations in kenya-the case of nairobi deposit taking saccos (Doctoral dissertation).
144 Rachel Keeler & Abijah Kanene (2012) Development in Practice International Development Assistance Service (IDAS) Impact Paper (2015).
145 Mutisya, W. A. (2017). Revenue Diversification and Financial Performance of Commercial Banks in Kenya (Doctoral dissertation, University of Nairobi).
146Kago, E. W. (2014). The effect of credit reference bureau service on financial performance of deposit taking micro finance institutions in Kenya (Doctoral dissertation).
147 Microfinance Act CAP 493D 2006 Laws of Kenya

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The information is sent monthly to the CRBs. Only MFI institutions share information in the full file of the Credit Information Sharing Initiative. 20 institutions have fully endorsed this.148

2.6: Current Regulation Challenges

The current legal regime has been criticised for not being sufficient today to regulate the financial services sector effectively. One of the major challenges in this context is the diversity of regulations.149 This is the case where the companies were incorporated and regulated under either the Banking Act or the Insurance Act. For those listed on the Nairobi securities exchange, capital market legislation is further required.

Management demands of various laws and agencies often conflict in this respect, affecting decision making and efficiency. The Presidential Task Force on Parastatal Reforms' review identified many main problems and challenges in existing legislation and legislation.150 These include a lack of a single overall law, the negative impact of the various legislation that governs public organisations and a sometimes conflicting burden of compatibility with existing legislation.151 Due to its essential role in the country's monetary policies, the CBK was formed in 1966. However, over the years, other regulatory authorities have been at risk and chaotic. The insurance industry, which was more advanced than the securities market, was, for example, not under any form of supervision, before the Insurance Act became in operation in July 1987. The Commissioner for Insurance even supervised it.

Only in 2006 did the industry have a regulatory agency. The Business Administration was established in 1989, and the Pension Administration was established in 1997. Finally, the Regulatory Authority for Sacco Societies was set up until 2009, while Sparks and loan cooperatives formed an integral part of both rural and urban communities. In the various

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148 Ghosh A(2007) *Financial Inclusion through Micro Finance in India and Emerging Role of POSB*: An Analysis, a paper presented at the 60 All India Commerce Conference

149 Ezeoha, AE *Firm versus industry financing structures in Nigeria*. African Journal of Economic and Management Studies (2011) *2*, 42-55. doi:10.1108/20400701111110768

150Mohamed, A. H., & Awuondo, I. (2013). Report of the Presidential Taskforce on Parastatal Reforms. *Executive office of the President, Republic Of Kenya*.

151 Task 3 Technical Team(2005) Regulatory Framework for Factoring Egypt Financial Services Project Technical Report No. 28 December, USAID

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subsectors too, regulatory duplication occurs. For example, both the RBA and the Capital Markets Authority regulate the administration of the fund. Fund managers and guardians are necessary for financial institutions. Both the Regulatory Insurance Authority and the Central Bank of Kenya provide premium funding, while the retirement and insurance regulatory authorities are covered both by brokering and administrative authorities. The coded banks shall be regulated both by the CBK and by the Capital Markets Authority, and the Insurance and Capital Markets Authority shall regulate the coded insurers. The insurance companies are coded. The Capital Markets Authority and the Competition Authority must also approve acceptance and merger with listed companies. In the current framework, no government agency may monitor systemic financial risks adequately across the industry.152

The major change in the regulatory system involves developing prudential guidelines in the different subsectors designed to address emerging risks and ensure the industry's continued stability and integrity. 153 Moreover, regulatory changes were proposed in the sector. The fundamental question, however, is whether the above challenges are enough to lead the movement to change regulatory paradigms.

2.7 Chapter Conclusion

The section reviews concepts of financial regulation and oversight. It considered the justification and the different models of financial services regulation. It also addressed broad objectives of financial regulation such as investor protection, fairness for safeguarding abuses and preservation of consumer confidence.154 The chapter also discussed the pros and cons of each regulatory model. They took into consideration the Unified Regulatory Agency as they move on to this regulatory framework and discuss its key strengths and weaknesses. It tried in Kenya to contextualise the regulatory framework with a focus on emerging sector issues.

In the sense that bankers can find it much more accessible to historical credit companies, the factors differ from conventional lending. Also, the company does not restrict how funds are spent

152 Companies Act Chapter 486 Laws of Kenya (Repealed by Companies Act No. 17 of 2015)
153 UNIDROIT Convention on international factoring (Ottawa, 28 May 1988)
154Chiu, I. H. (2016). Fintech and disruptive business models in financial products, intermediation and markets-policy implications for financial regulators. J. Tech. L. & Pol'y, 21, 55.

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because this is not a loan. In turn, it would be beneficial to small and medium-sized enterprises because loan limitations are more regulated and access to cash is more uncomplicated.

The application process is also faster, and significantly reduced documentation is needed. The process for applying is short. Approval tends to occur faster, and funding is provided faster. While factoring may be more expensive in some cases than banking loans, immediate financing availability promotes smooth operations and potential development. Factoring offers some comparative advantages to the inaccessibility of conventional banking. [155]This trade aid tool should be fully supported as it addresses the financing problem facing small- and medium-sized enterprises in Kenya. Chapter 3 highlights the role of financial inclusion.

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155Hamanyati M Factoring as an International Trade Finance Product: Making a Case for The Enactment of a Factoring Act in Zambia (Doctoral thesis, University of Pretoria 2017).

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CHAPTER THREE

ROLE OF FACTORING IN FINANCIAL INCLUSION

3.1 Introduction

This section provides an overview of financing of Kenyan companies, the current factoring situation and the source in the weaker environments, the consideration of opportunities for financial institutes, the factoring of solutions for small and medium-sized businesses and the access to finance, differences in African financial systems, the challenges of working capital management and the action of financial institutions.156

Financial integration is now a priority for financial sector regulators and policymakers, with a growing globalized world bringing comprehensive reforms to increase access and utilization of tailored investment banking, informed by a rapidly increasing body of expertise.157

3.2 Financing Kenyan SMEs

SMEs are known worldwide as a significant driving force of economic growth and job creation, innovation, investment and services.158 SMEs dominate the state-run sector in Africa. In Kenya, the micro, small and medium-sized companies (SMEs) dominate the market, representing approximately 1.73 million people and employing almost 80% of total Kenyan workforce. They also make nearly 20% of Kenya GDP.159

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Naidu and Chand attest to MSMEs being the main drivers of economic growth, job creation and GDP. SMEs play an essential role in encouraging competitiveness, promoting economic growth

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156 International Factoring Group, Country Data Reports. Available at http://www.ifgroup.com/research/country-data/ (accessed 31 May 2016).
157Prasad, E. S. (2010). *Financial sector regulation and reforms in emerging markets: An overview* (No. w16428). National Bureau of Economic Research.
158Singh, R. K., Garg, S. K., & Deshmukh, S. G. (2008). *Strategy development by SMEs for competitiveness: a review*. Benchmarking: An International Journal.
159Burkart, M., Ellingsen, T., & Giannetti, M. (2005). *What You Sell is what You Lend?: Explaining Trade Credit Contracts*. Centre for Economic Policy Research.

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and innovation.[160]Small and medium-sized enterprises could play a crucial role in maintaining a country's jobs creation, economic dynamic, and improving opportunities, security and inclusiveness of impoverished people.[161]

Access to funding is the key to the challenges facing African SMEs.[162] Only 2% of new SMEs have access to loans in South Africa. Kounouwewa and Chao analysed the data of several firms from 16 African countries and found that the size and ownership of the company influence funding barriers; with smaller and domestic companies reporting more significant barriers, but foreign firms reporting fewer access to financing barriers.[163] Showing that financial and institutional obstacles of SMEs in developing countries are more restricted than large enterprises.

SMEs operating in relatively new or unknown sectors, such as energy products and services, are being confronted with high barriers to accessing affordable financing.[164] Young SMEs have minimal access to sustainable funding from Serrasqueiro, and Nunes added. SMEs' access to finance is not just endemic to African businesses and developing countries.[165] In the South-Pacific area, Naidu and Chand have identified 19 financial hurdles affecting MSMEs following a survey of 200 MSMEs in Fiji and Tonga.[166] Daskalakisetal's observed micro and small firms in Greece wanted to make more use of debt, in particular long-term debt, but the access to long-

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160Beck, T., & Feyen, E. (2013). Benchmarking financial systems: introducing the financial possibility frontier. The World Bank. 45

161Kumari, R. L. (2012). Enhancing SMEs access to green finance. *International Journal of Marketing, Financial Services & Management Research*, *1*(7), 22-35.),

162Quartey, P., Turkson, E., Abor, J. Y., & Iddrisu, A. M. (2017*). Financing the growth of SMEs in Africa: What are the contraints to SME financing within ECOWAS?*. Review of development finance, *7*(1), 18-28.

163Kounouwewa, J., & Chao, D. (2011). Financing constraints determinants in African countries. *The International Journal of Applied Economics and Finance*, *5*(1), 30-45., .https://doi:10.8928fijaef.2011.80.45.

164Ezeoha, A. E. (2011). Firm versus industry financing structures in Nigeria. *African Journal of Economic and Management Studies*., 42-55. doi:10.1108/20400701111110768

165 Serrasqueiro, Zélia Maria & Nunes Paulo Maçãs(2012.) *Is Age a Determinant of SMEs' Financing Decisions? Empirical Evidence Using Panel Data Models* (2012) (Entrepreneurship Theory and Practice, Vol. 36, Issue 4, pp. 627-654,

166 Naidu E & Laeven L *Political Connections and Preferential Access to Finance*: The role of campaign contributions. Journal of Financial Economics (2008) 88(3), 554-580

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term debt finance was limited.167 It has led to the continuing restrictions on access to credit for small and medium enterprises in the UK.168

Small-scale enterprises must be supported in the management of their financing challenges in order to achieve minimal efficiency and positively affect economic growth.169 Policymakers must focus on SMEs, in particular young SMEs,' short- and long-term financing requirements. Banks and other financial intermediary institutions must take account of the financing needs of SMEs rather than rationing mobilised savings for the benefit of large companies.170

3.2.1 Bank lending to SMEs

Banks dominate some developing countries' financial systems.171 Banks reluctantly extend credit to SMEs on several grounds, including a lack of record of performance, a lack of collateral to raise debt financing and the failure to implement consistently sound risk assessment procedures. The high demands of banks for paperwork and high interest rates are preventing SMEs from seeking funds from banks.172

Banks have difficulty managing small and medium-sized enterprises risk and experience high transaction costs to help them. There is irregular information about the loan from the borrower (SME) and smaller financial institutions are not necessarily better placed to meet small and medium-sized enterprises' needs for funding. The regulatory policies and framework for loans for the SME sector are not supportive. The strategic focus of banks (toward SMEs) with banking

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167 Daskalakisetal R *Law and firms' access to finance.* American Law and Economics Review (2005) 7(1), 211-252
168Armstrong, A., Davis, E. P., Liadze, I., & Rienzo, C. (2013). *An assessment of bank lending to UK SMEs in the wake of the crisis.* National Institute Economic Review, *225*(1), R39-R51.
169Soufani K, Poutziouris, P & Michaelas N *Trade Credits: The Case of Small–Medium Sized Enterprises.* Global Business and Economics Review (2013) *15*, 163-180. doi:10.1504/GBER.2013.053067
170Cull, R., Davis, L. E., Lamoreaux, N. R., & Rosenthal, J. L. (2006). Historical financing of small-and medium-size enterprises. *Journal of Banking & Finance*, *30*(11), 3017-3042.
171Malhotra, M., Chen, Y., Criscuolo, A., Fan, Q., Hamel, I. I., & Savchenko, Y. (2007). *Expanding access to finance: Good practices and policies for micro, small, and medium enterprises*. The World Bank.
172 Harhoff, D., & Körting, T. (1998). Lending relationships in Germany–Empirical evidence from survey data. *Journal of Banking & Finance*, *22*(10-11), 1317-1353.

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acting freely, resulting in the credit rationing of small and medium-edge companies, is not regulatory required.173

Given the perceived risk of SME lending, banks should shy away from the SME sector. However, some bank managers see the SME sector as a strategic opportunity for business. The notion that large banks do not want to serve the small businesses was has been abandone.d174 The large banks by taking advantage of new technologies and structures of risk management to finance the SME sector.175 The banks (foreign, domestic and government) employ a variety of technologies and organisational facilities to lend to SMEs.176

Financial costs may be the main obstacle to external financing for SMEs. Compared with large businesses, SMEs encounter higher borrowing costs on an ongoing basis. Price competitiveness in Ghana was a determinant of the selection of SME banks.177 The size, type and pricing of bank loans to SMEs across the developing and developed countries were significantly different.178 The different institutional and legal contexts were authored have advised that banks would distinguish between borrowers who are highly susceptible to success, when they offer real estate collateral, to borrow at a low level of interest rates.179

3.2.2 The African financial sector

The African financial sector is dominated by state-owned or a few big foreign banks. While the recent regulatory and economic reforms have led to improvements in the capitalisation and trade activities, Africa's financial sector is being hit with liquidity and profound challenges. Beck and Cull claimed they were stable, even if African banking systems were shallow. They further

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173 Kwenda F (2014). *Trade Credit in Zimbabwe's Economic Recovery.* Mediterranean Journal of Social Sciences, 5, https://doi:10.5901/mjss.2014.v5n2p431

174De la Torre, A., Soledad Martinez Peria, M., & Schmukler, S. L. (2008). *Bank involvement with SMEs: Beyond relationship lending*. The World Bank.

175Ali, D. A., & Deininger, K. (2014). Causes and implications of credit rationing in rural Ethiopia: The importance of zonal variation. *Journal of African Economies*, *23*(4), 493-527.

176Beck, T., Demirguc-Kunt, A., & Martinez Peria, M. S. (2008). Bank financing for SMEs around the world: Drivers, obstacles, business models, and lending practices. The World Bank.

177 Narteh, B. (2013), *"SME bank selection and patronage behaviour in the Ghanaian banking industry*", Management Research Review, Vol. 36 No. 11, pp. 1061-1080

178 Ibid172

179 Comeig, I., B. Del Brio, E., & O. Fernandez-Blanco, M. *(2014). Financing successful small business projects.* Management Decision, 52(2), 365-377.

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added that the African banks are well-equipped and liquid, but lend less to the private sector than other banks.180 African stock markets are emerging and are thin and illiquid. SMEs must be supported to overcome the financing challenges to achieve the least cost and to have a positive effect on economic growth.

Regulators must be focused on SMEs, in particular young SMEs, in short-term and long-term financing needs. Financial institutions involved in financial intermediation must be careful not to reduce mobilised savings for big business but to meet the financing needs of small businesses.181

3.3 The origin and current state of factoring

The history of factoring has been well described by authors such as Bakker et al. They claim that it is one of the oldest forms of commercial finance that went up four thousand years ago to the Hammurabi in Babylon. It is also reported to be widely used in the Roman Kingdom.182 Factoring in Europe evolved to address the difficulties of vast areas between customers and the business in the English wool industry throughout the 14th century. Factor sales and credit advice were also involved during these times. Factoring still consists of a bundle of services: financing and debt collection.183 Worldwide, factoring sales have increased tremendously in the last few decades in the past 30 years, the factoring industry grew four times more quickly than the global economy. This study examines the use of this study to solve the problem of limited access to financing (work capital) for SMEs.184

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180Beck, T., & Cull, R. (2013). *Banking in Africa*. The World Bank.
181 Senbet, L.W. and Otchere, I., 2006, January. Financial sector reforms in Africa: perspectives on issues and policies. In Annual world bank conference on development economics 2006: Growth and integration (pp. 81-120).
182Lachmann, R. (2000). Capitalists in spite of themselves: Elite conflict and economic transitions in early modern Europe.
182Klapper, L., Laeven, L., &Rajan, R. *Trade credit contracts.* Review of FinancialStudies, (2012), (25), 3 pg 838-867
182 Wright, M., Westhead, P., & Ucbasaran, D. (2007). *Internationalization of small and medium-sized enterprises (SMEs) and international entrepreneurship*: A critique and policy implications. Regional Studies, 41(7), 1013-1030.
183 Bakker, M. H., Klapper, L., & Udell, G. F. (2004). Financing small and medium-size enterprises with factoring: Global growth and its potential in Eastern Europe. Warsaw: World Bank.
184 International Factoring Group Country Data Reports. (2017), Available: http://www.ifgroup.com/research/country-data/. Last accessed 31st December 2017.

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3.4 Factoring as a solution in weak environments

Under the circumstances described above, factoring seems to have an advantage over bank loans. Factoring less depends on an advanced financial infrastructure.185 Firstly, the SME sells its accounts debts: no collateral is needed instead of a loan. Secondly, credit risk is transferred from the sale to the underlying asset by the SME. The capability to loan of the asset depends ultimately on the buyer, the obligor.186

The quality of accounts receivable, and ultimately the client, is thus less important to the credit details of the SME itself. This makes it especially attractive when the buyer is a transparent company of high quality that offers more reliable information. SMEs cannot be able to fund their cash flow through traditional bank credit through weak legal and informational infrastructure. However, these environments can be used to factor. Theoretically, factoring is claimed to be a solution for SMEs in weak circles in which access to financing is a problem. This is why stakeholders called for more research in on the effectiveness of factoring systems, their suppliers and their role in increasing SME access to finance.187

There are several types of factoring. There are two main types: factoring with and without recourse. In the event of a default in the accounts receivable, it is implicit that a recourse factor should be taken into account. The default risk is totally transferred to the factor when factoring on a non-recourse basis. 188Another fascinating factor for small and medium-sized enterprises operating in weak circumstances is the reverse factor: many suppliers buy debts, but only a couple of top sellers. Only information about the buyer should be collected.189

185Beck, T., & Demirguc-Kunt, A. (2006). Small and medium-size enterprises: Access to finance as a growth constraint. *Journal of Banking & finance*, *30*(11), 2931-2943.
186Klapper, L. 2006) *The role of factoring for financing small and medium enterprises*. Journal of Banking & Finance, (30(11), 3111-3130
187Massara, M. A., & Mialou, A. (2014). *Assessing countries' financial inclusion standing-A new composite index* (No. 14-36). International Monetary Fund.
Ruddy N, Mills S, Salinger F. Davidson N *Salinger on Factoring* (2006) London; Sweet & Maxwell 45
188 Schiffer, M., & Weder, B. (2001). *Firm size and the business environment: Worldwide survey results* (Vol. 43). World Bank Publications
189 Beck, Thorsten; de la Torre, Augusto. (2006). *The basic analytics of access to financial services (English). Policy*, Research working paper; no. WPS 4026. Washington, DC: World Bank.

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Factoring services could be offered to SMEs by financial institutions. Because of their global reach, international factoring providers can enable international trade for SMEs. This allows you to gather information about foreign debtors. 190You can also capable to collect receivables abroad with consideration that banks would be highly profitable in this SME segment. 191 However, due to the problems overcome by the asymmetric information described above, banks are underexposed to this segment. Therefore, factoring also offers financial institutions a chance. 192

3.5 Factoring and SMEs access to finance

Berger &Udell review finance in the United States for small companies. 193 These authors focus on size and age, arguing that companies need different financing approaches and capital structures at various stages in the so-called 'growth cycle.' They state that the degree of opacity in information is crucial in determining the range of finance options available for small businesses. 194 To address these information problems, financial intermedia have to screen, agreement and monitor borrowers. Schiffer and Weder research firms around the world and their business environments using unique data collected by the world bank from cross-country surveys. 195 Regression results with different company characteristics and for company size of a small-scale bias in terms of access to finance: smaller companies report more funding challenges than their larger rivals. 196.

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190 Kano, M., Uchida, H., Udell, G. F., & Watanabe, W. (2006). Information verifiability, bank organization, bank competition and bank-borrower relationships. Discussion papers, 6003.
191 Michalski, G. (2008). Factoring and the firm value. *FACTA UNIVERSITATIS Series: Economics and Organization*, *5*(1), 31-38.
192Beck, T. (2007, April). Financing constraints of SMEs in developing countries: Evidence, determinants and solutions. In *KDI 36th Anniversary International Conference* (pp. 26-27).
193 Berger, A. N., & F Udell, G. (1998). The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle. Journal of Banking & Finance, 22(6), 613-673..
194 Bushman, R. M., & Smith, A. J. (2003). Transparency, financial accounting information, and corporate governance. *Financial accounting information, and corporate governance. Economic Policy Review*, *9*(1).
195Lin, W. L., Cheah, J. H., Azali, M., Ho, J. A., & Yip, N. (2019). Does firm size matter? Evidence on the impact of the green innovation strategy on corporate financial performance in the automotive sector. *Journal of Cleaner Production*, *229*, 974-988.
196 Schiffer, M., & Weder, B. (2001). *Firm size and the business environment: Worldwide survey results* (Vol. 43). World Bank Publications.

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Smaller companies are using less external funding. In countries with better systemic, economic and political ecosystems, that effect is much more prevalent. Beck et al. found that testing, outsourcing and tracking cost vastly greater in those ecosystems, which lead to limited funding. Access to finances is identified as the most prominent cell wall for SMEs in developing countries.[197] This research focuses on various corporate environments and institutions. To address the issue, the authors claim that institutional development is the best solution. However, they maintain that the use of innovative lending (such as factoring) technologies in the absence of effective institutions should be able to improve SME access to financing. In weak institutional environments, Beck &Demirgüç-Kunt investigates the drivers of limits in SME access to finances. They claim that the availability of credit ultimately depends on a country's financial infrastructure; the so-called legal and information environment for the two elements that this includes.[198]

The former examines the influence of a country's legal origin on the way its financial system operates. Investigations direct that when the legal systems are more efficacious and adaptable (casual legislation and equity principles are more commonly accepted as the foundations of legal decisions) firms are less likely to report financing obstacles using panel regressions on company survey data. The data studies funding barriers and their effect on strong economic growth. These authors find that, when the judicial framework is better developed, the effects of funding obstacles are smaller for small businesses.[199] Factoring less depends on loans, loans and collateral legislation, and is, therefore, a solution to enhance access to finance for small businesses in weak legal environments.

Salinger is one of the first authors to dedicate a book to the promotion precisely. He argues that factoring should have a significant role in countries with weak creditor rights in comparison to

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197Ayyagari, M., Beck, T., & Demirguc-Kunt, A. (2007). Small and medium enterprises across the globe. *Small business economics*, *29*(4), 415-434.
198Wehinger, G. (2014). SMEs and the credit crunch: Current financing difficulties, policy measures and a review of literature. *OECD Journal: Financial Market Trends*, *2013*(2), 115-148.
199Beck, T., & Demirgüç-Kunt, A. (2008). Access to finance: An unfinished agenda. *The world bank economic review*, *22*(3), 383-396.

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ordinary bank loans as it is less affected. 200 It is argued similarly in Eastern Europe's investigation of factoring: weaker procedural rules could affect all loaning products but could have a lesser influence on factoring since factoring is a sales and acquisition of goods in trade law and not a guaranteed loan. They assert that factoring can be an essential element in banking markets where legal practice, competition policy and insolvency structures are feeble as risk can be passed on to a better lendable counterparty.201

After an indepth examination of the beginning of figuring universally, it is obvious that the higher GDP bank credit is related to indeed more variables that are characterized as factoring volume to GDP.202 This implies that factoring is not a replacement for bank lending, but rather an additional improvement. A replacement product would have an adverse effect. The factoring, be that as it may, might still handle SMEs confronting managing an account credit boundaries. In nations with weaker legal systems, the impact of the factors on SMEs' access to finance is expected to be more significant. Be that as it may, in nations with weaker legitimate frameworks, the affect of the components of the SMEs' is variable distint. The response has also been empirically shown to be decisive for credit availability. The use of private credit offices and public credit records appears that sharing credit data can viably diminish unfavorable choices that lead to expanded bank credit and lower credit hazard. It is directly associate the presence of these organisations with the financing constraints that companies use corporate data and bank lending observed in a country. 203

They find that cash sharing is linked to higher bank lending and reduced funding barriers through particular private credit bureaus. In nations where the financial data environment is not very well developed, factoring may play a significant role. Small and medium-sized companies not covered by information because no public credit registry or private credit office will find it

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200 Salinger, F. R. (2006). Salinger on factoring. Sweet & Maxwell.57
201 Gray, S., Chailloux, A., & McCaughrin, R. (2008). Central bank collateral frameworks: Principles and policies. *IMF Working Papers*, 1-67.
202 Klapper, L., Laeven, L., &Rajan, R. *Trade credit contracts.* Review of FinancialStudies, (2012), (25), 3 pg 838-867
203 Love, I., & Mylenko, N. (2003). *Credit reporting and financing constraints* (Vol. 3142). World Bank, Development Research Group, Finance.

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difficult to obtain bank loans.[204] Factoring does not depend on the credibility of a small and medium-sized enterprise, but the credibility and transparency of its receivables or ultimately its buyers' accounts.[205]

The facilitation of funding for SMEs in the poorly informed countries would be anticipated to be far more efficient. Klapper sees the opposite in terms of indicators of factoring throughout nations. In countries with an enhanced credit information system, the author shows that factoring / GDP is higher. However, the effect on access to finance, in this case, is not also included in this author's analysis. Factoring can also help SMEs become involved in international trade by directly finance export capital and collecting cash flows abroad via a global organisation of factors.

The explicit examination of the reverse factoring as well which is explicitly successful in poor environments, as the factor assumes an extensive credit risk – the risk of buyers not being able to pay – under normal conditions (especially without recourse). This risk is greater in developing countries due to a lack of financial data and possible fraud.[206]

Reverse factors, also known as supply chain finance, provides adequate reprieve where the cash flow of high quality, low-risk buyer is obtained in this sort of accounting. This buyer may be a large corporation that operate internationally. The credit risk is equal to that of this purchaser's default risk. This effectively makes it possible to factor risky SMEs without resort. Also, further an example of a bank that uses technology to reverse factors, establishing chains of smaller (risky and opaque) buyers and large (high-quality, transparent) buyers, thus enabling small businesses to finance their operating capital in a fragile, informational setting.[207]

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204 Abe, M., Troilo, M., & Batsaikhan, O. (2015). Financing small and medium enterprises in Asia and the Pacific. *Journal of Entrepreneurship and Public Policy*.
205 Udell, G. F., Bakker, M. R., & Klapper, L. (2004). Financing small and medium-size enterprises with factoring: Global growth and its potential in Eastern Europe. The World Bank.
206 Klapper, L. (2005). The role of factoring for financing small and medium enterprises. The World Bank.
207 Factors Chain International (2017), *Factoring in International Trade*. Available: http://www.fci.nl/about-factoring/factoring-in-international-trade. Last accessed 6th December 2017.

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Even though encouraging, reverse factors still represent a small number of factors worldwide, and unfortunately, little data is available.[208] Reference to governance quality in one country, opined pragmatic observation by the author argues that the root of information dissonance is weak governance showing poor management, and therefore more risk is linked to higher factoring levels. [209]

3.6 Factoring as an opportunity for financial institutions

Relationship lending is the traditional approach of SMEs catering for financial institutions. The "conventional wisdom" approach to addressing information opacity in finance indicates relationship lending. This claim is confirmed in earlier literature.[210] State relationship loans from Berger & Udell[211] is a useful approach in conditions where creditors' information is problematic. They define partner lending as a long-term agreement wherein the lender gathers information softly by observing the performance of the borrower in credit agreements or other services. The authors examine credit lines and lending relationships for small businesses. They see evidence that the prolonged link reduces the asymmetries of information between the lender and borrower; small and medium-sized enterprises with a more in-depth relationship spend lower rates and are less likely to commit collateral.

In a review the relationship between the bank borrower in Japan and revealed that companies without an audited account profit the most from the relationship credits. [212] Further review of the role of loan agents in banking relations it is notable that the activity of loan officers involves soft information on small and medium-sized businesses and those financial institutions provide softer

[208] Love, I., & Mylenko, N. (2003). *Credit reporting and financing constraints* (Vol. 3142). World Bank, Development Research Group, Finance. 5

[209] Klapper, L. (2006). *The role of factoring for financing small and medium enterprises*. Journal of Banking & Finance, 30(11), 3111-3130.

[210] De la Torre, A., Martínez Pería, M. S., & Schmukler, S. L. (2010). *Bank involvement with SMEs: beyond relationship lending.* Journal of Banking & Finance, 34(9), 2280-2293.

[211] Demirgüç-Kunt, T. B. A., & Levine, R. (2005). *Law and firms' access to finance*. American Law and Economics Review, 7(1), 211-252.

[212] Kano, M., Uchida, H., Udell, G. F., & Watanabe, W. (2006). Information verifiability, bank organization, bank competition and bank-borrower relationships. Discussion papers, 6003.

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information. [213] Soft information refers to "unmeasured and consists of information collected over time by contacting the company, the company management/contractor, the company's suppliers, clients and other local sources."

Beck et al.[214] find proof that the SME section is seen as highly profitable using bank polling data. The authors show, however, that banks are still underexposed. This implies that lending relationships do not address SMEs' problem with access to financial services satisfactorily. The authors are providing proof of Berger & Udell's [215] new paradigm. The most important institutions for overcoming information asymmetry problem depending on specific knowledge and network were small and local banks. Nevertheless, large and foreign institutions have an advantage in serving small and medium-sized enterprises through so-called lending technologies for transactions. These techniques are based on real data and/or related to the asset value.[216]

The prime basis of the prerogative choices is lending technologies. This foundation is 'hard' information in so-called lending transactions: the decision of lenders to provide funding is based on quantitative information gathered and processed.[217] The writers first target individual lending technologies for transactions and discuss how these technologies can effectively address SME access to funding, in contrast to conventional wisdom. It is explicitly discussed how the problem of opacity is addressed by focusing in particular on the reliability of the promisee instead of the 'borrower' or vendor. This means that international providers are benefiting from financing internationally traded small and medium-sized enterprises because of their global exposure in gathering (credit) data about bonds.[218]

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[213] Uchida, H., Udell, G. F., & Yamori, N. (2012). *Loan officers and relationship lending to SMEs.* Journal of Financial Intermediation, 21(1), 97-122.
[214] Beck, T., Demirgüç-Kunt, A., & Peria, M. S. M. (2008b). *Banking services for everyone? Barriers to bank access and use around the world.* The World Bank Economic Review, 22(3), 397-430.
[215] Buch, C. M. (2003). Information or regulation: what drives the international activities of commercial banks? Journal of Money, Credit and Banking, 851-869.
[216] Hallberg, K. (1999). Small and medium scale enterprises: A framework for intervention. The World Bank.
[217] Salinger, F. R. (2006). Salinger on factoring. Sweet & Maxwell. (23,45)
[218] Sleuwaegen, L., & Goedhuys, M. (2002). *Growth of firms in developing countries, evidence from Cote d'Ivoire*. Journal of Development Economics, 68(1), 117-135.

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De la Torre et al.[219] provide empirical proofs on formal institutions using transaction technologies in dealing with SMEs. By using an unknown world bank survey report and IFC, they identify various devices across banks in various developing countries. The original information obtained by these writers will be useful for this study due to its unique specific information on the uses by financial institutions of emerging systems (including factoring), across countries. The writers requested this database. Unfortunately, because it was collected from financial banks under a secrecy contract, the author keeps the actual data confidential.

Berger et al.[220] study the relationship between the structure of the banking market and the small business loan. In terms of opacity, the study found little difference between small and large banks borrowing from SMEs. This supports the idea that while small financial institutions can overcome the information gap by lending relationships, large companies can use Transaction Technologies.

Berger & Udell[221] show little empirical proof that comparative benefits by size are available when using specific loan technologies (e.g. factoring). However, because of scale savings, they expect big organisations to benefit from problematic information processing. The empirical study on the country-wide banking firms and their impact on access to finance is conducted by Beck et al.[222] They find that while the lower use of financial services dominates banks, small-scale investment firms and specialised lenders promote access to finance. Small companies in developing countries are relieved of their financing constraints, especially large-scale specialised lenders.

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[219] Jappelli, T., & Pagano, M. (2002). Information sharing, lending and defaults: Cross-country evidence. Journal of Banking;& Finance, 26(10), 2017-2045.
[220] Berger, A. N., Rosen, R. J., & Udell, G. F. (2007). *Does market size structure affect competition? The case of small business lending*. Journal of Banking & Finance, 31(1), 11-33.
[221] Berger, A. N., & Udell, G. F. (2006). *A more complete conceptual framework for SME finance*. Journal of Banking & Finance, 30(11), 2945-2966.
[222] Beck, T., Demirgüç-Kunt, A., & Maksimovic, V. (2008a). *Financing patterns around the world: Are small firms different?* Journal of Financial Economics, 89(3), 467-487.

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Research demonstrates that a major institution is increasingly involved in serving small and medium-sized companies using intuitive technology. [223] This body of research shows that larger banks benefit from factoring to small- and medium-sized enterprises due to their benefits and risk reporting. [224] Furthermore, bigger banks have more global partners that are particularly useful when it comes to offering factoring to internationally trading SMEs. International service allows for the collection of information (such as bonds) and collection of receivables across nations.[225]

3.7 Variations exist in Africa's financial systems

Countries such in the South of Africa have fairly advanced bank systems and capital markets, while countries such as Central Africa to eastern Africa have low-cost banking systems with a limited supply of financial ingress.[226] There are four factors that make banking more difficult in Africa than in other regions, namely: small economies with populations scattered, implying scope savings, demand for financial access, a lower profit-generating population; informal business models leading to enhanced costs and risk; [227]

The emergence of the African banking markets leads to credit rationing and reduced opportunities for SMEs to access external finance. It is crucial to understand the cash requirements and management strategies of businesses to meet their short-term duties known as work capital management to understand the funding challenges facing African companies. It is crucial to understand how companies seek to boost sales by offering commercial credit, which leads to accumulation of receivables holding the necessary cash.[228]

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[223]Beck, T., & Feyen, E. (2013). *Benchmarking financial systems: introducing the financial possibility frontier*. The World Bank.Washington, DC: World Bank. 23

[224] Beck, T., Demirgüç-Kunt, A. and Singer, D. (2013). *"Is small beautiful? Financial structure, size and access to finance"*, World Development, 52, pp. 19–33

[225] Kaster, T. (2014,). *Does factoring improve SME access to finance? Finance & Investments.* Retrieved from http://hdl.handle.net/2105/23532 (123--125)

[226] Kameni, E. (2014) *Regulatory reforms in Africa*. In M. Bickers (Ed.), World factoring *yearbook 2014* (pp. 6-12). Kent, United Kingdom: BCR Publishing Ltd.

[227]Beck, Thorsten; Feyen, Erik. 2013. *Benchmarking financial systems:Introducing the financial possibility frontier (English)*. Policy Research working paper ; no. WPS 6615. Washington, DC: World Bank. 23

[228] Dyckman, B. , (2011). Supply chain finance: *Risk mitigation and revenue growth*. Journal of Corporate Treasury Management4, 168-173. Retrieved from http://henrystewart.metapress.com/link.asp/

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3.8 The working capital management challenge

Working capital is a crucial element for a company's survival. Efficient working capital management is a prerequisite to a company's success. Working equity is vital for the profitability of SMEs[229] as a form of short-term financing, which enables organisations to develop their short-term financing responsibilities. Some businesses have been led to often sell their products or services to their clients through the negotiating power of individual purchasers and industry practice.[230] Some purchasers demand 30-90 days to pay after goods and services are delivered. Companies record credit sales as short-term assets known to as accountable receivables on their balance sheet until cash is collected. Because of the amount of cash held in the accounts due, SMEs can find it hard to finance their cycle times.[231]

A link has been created between accounts billing cycle and cash flow worldwide and in Africa. In a study carried out in 2005–2009,[232] a significant negative relationship in both profit margins (total net revenue) and cash conversion cycles was found among manufacturing companies in Egypt, Kenya, Nigeria and South Africa. Ukaegbu deduced that a boost in the conversion cycle of cash results in a decrease in company profitability.[233] It supported the importance of good cash management. Managers must ensure an optimal cash flow to avoid a negative impact on the economy.

While Paul and Boden[234] were warning of the dangers of collecting debts, companies are still selling credits because of demand by customers and the need to achieve strategic advantages. Kwenda[235] has found that the use of trade loans is in conjunction with company size and current

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[229] Ruddy N, Mills S, Salinger F. Davidson N (2006) *Salinger on Factoring London*; Sweet & Maxwell 45
[230] Mwega F. M (2012) Financial regulation in Kenya; balancing inclusive growth with financial stability working paper 407 18
[231] Lee, N., Sameen, H., & Cowling, M. (2015). Access to finance for innovative SMEs since the financial crisis. *Research policy*, *44*(2), 370-380.
[232] Ukaegbu B. , (2014) "*The significance of working capital management in determining firm profitability*: evidence from developing economies in Africa" Res. Int. businessfinance 315
[233] Baños-Caballero S, García-Teruel J, and Martínez-Solano P (2014) *Working capital management, corporate performance and financial constraints* Journal of business Research 67 (3),334.
[234] Paul Y. S and Boden R. (2011) *Size matters: The Late payment problem*, Journal of small business and enterprise development vol 18 issue 4 page 740 Emerald group publishing limited.
[235] Kwenda, F. (2014).*Trade credit in Zimbabwe's economic recovery*. Mediterranean Journal of Social Sciences, 5, 431-439. doi:10.5901/mjss.2014.v5n2p431

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asset investment. In the absence of any loan, Kwenda[236] concluded; companies use commercial credit. There is still a correlation between income revenues and commercial loans. Companies use commercial credit to discriminate prices and to finance the internal markets. There is proof that bigger, more profitable firms that generate internal funding and have access to financial institutions' credit lines tend to receive commercial credit.[237] The nature of the goods transacted also determines the credit given to companies in differentiated services as compared to companies dealing with common goods; they are more susceptible to the collection of cash flow.[238]

The amount of goods transactions is also decisive for the granting of business loans, with companies buying longer-term credits for goods and services in higher volumes.[239] Despite the benefits of boosting sales, commercial loans may lead, as a result of increasing agency costs and the risks of losing control of the company, to liquidity problems which insolvent profitability for enterprises.[240] Yazdanfar and Ohman[241] alerted trade loans to adverse effects on the company's performance. Bastos and Pindado have warned of credit contact in the value chain if companies with credit restrictions use the postponement of suppliers' payments.[242] Corporate managers should consider both the local and global partners in their supply chain decisions about their cash management.[243]

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[236] Kwenda, F. (2014). *Trade credit in Zimbabwe's economic recovery.* Mediterranean Journal of Social Sciences, 5, https://doi:10.5901/mjss.2014.v5n2p431
[237] Tomusange L. R. (2015Factoring as a Financing Alternative for African Small and Medium-Sized Enterprises),published Walden University
[238] Oramah B.O, Dzene R. Kameni(2014) E. *Contemporary Issues in African Trade and Trade Finance* (CIAT) (vol 1) (no. 1) Afreximbank, Cairo
[239] Paul Y. S and Boden R. (2011) *Size maters ;The Late payment problem*, Journal of small business and enterprise development vol 18 issue 4 740 Emerald group publishing limited.
[240] Mwega F. M (2012) Financial regulation in Kenya; balancing inclusive growth with financial stability working paper 55
[241] Yazdanfar D and Öhman P (2015)"*Debt financing and firm performance: An empirical study based on Swedish data*" The Journal of Risk finance Vol1.pp 102-118. https://doi.org/10.1108/JRF-06-2014-0085
[242] Bastos R and Pindado J(2004) Trade credit policy: Theory and Empirical evidence 6 SSRN-id 16681.
[243] Stiglitz, J. E., & Weiss, A. (1981).*Credit rationing in markets with imperfect information*. The American Economic Review, 71, 393-410. doi:10.2307/1802787

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By looking outside of one company, managers of companies can strengthen their working capital positions.[244] Stakeholders throughout the entire supply chain must cooperate and coordinate to maximise cash flows. More and Basu[245] highlighted problems in the supply chain: the lack of a shared vision of participants in the supply chain, delays in financial transactions that lead to unpredictable cash flow, the lack of payment process automation and the lack of knowledge on payments instruments. Enterprises may reduce the payment cycle time through cooperation across the supply chain and promote better economic security.[246] Supply chain financing can transform the management of working capital by allowing early payment of participating companies.[247] Supply chain funding, also referred to as supplier financing, is a series of solutions that optimise cash flows by allowing companies to extend their payment terms to their suppliers whilst offering their large and small business suppliers the chance of early payment. This means that the buyer and the supplier are in a win-win situation.[248] The purchaser optimises working capital and generates a further cashflow throughout the supply chain, minimising risks.

Silvestro and Lustrato[249] argued that banks could play a part in helping supplier and buyer optimise work capital by enhancing integration within the supply chain. Companies in the supply chain can optimise net cash positions by collaborative work in two main areas: pre-payment financing and pre-payment payment.

Profitability and production can have an impact on access to value chain products financing.[250] There are cases of trade credit provision and aggressive management of accounts receivable.[251]

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[244] Tessier, S. (2012*). From field notes, to transcripts, to tape recordings: Evolution or combination?* International Journal of Qualitative Methods, 11, 446-460. Retrieved from http://ejournals.library.ualberta.ca/index.php/IJQM/
[245] Mbatha, M. T. (2011). Risks and rewards of providing "reverse factoring" as a financing technology for small and medium-sized enterprises in South Africa (MasterThesis). Available from http://upetd.up.ac.za/thesis/available/etd-05262012-201508/unrestricted/dissertation.pdf
[246] Leech, N. L., &Onwuegbuzie, A. J. (2011). *Beyond constant comparison qualitative data analysis: Using NVivo*. School Psychology Quarterly, 26(1), 70-84. doi:10.1037/a0022711
[247] Kwenda, F. (2014).*Trade credit in Zimbabwe's economic recovery*. Mediterranean Journal of Social Sciences, 5, 431-439. doi:10.5901/mjss.2014.v5n2p431
[248] Beck, T., & Cull, E. (2013). Benchmarking financial systems: introducing the financial possibility frontier.
[249] Silvestro, R., & Lustrato, P. (2014). *Integrating financial and physical supply chains: the role of banks in enabling supply chain integration*. International journal of operations & production management, 34(3), 298-324.
[250] Kounouwewa, J., & Chao, D. (2011*) Financing constraints determinants in African countries*. International Journal of Applied Economics and Finance, 5, 30-45. doi:10.8928fijaef.2011.80.45.

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Smaller companies which are more vulnerable cannot compete without offering commercial credit, and if they do, they may face challenges of working capital. Credit policies are implemented, credit management functions are created for specialised individuals, the risk categorisation is customer categorised, credit control and payment methods improved, credit management techniques are implemented, and credit insurance is carried out.[252] This advice may be noble, but they challenge SME managers to implement.

Detailed credit control procedures are required for effort and management systems and distract small and medium-sized companies from their core business functions. Credit insurance will also probably be a financial investment for small and medium-sized companies. SMEs ought to seek alternatives to working capital funding because of the extension of payment terms by trade lenders.[253] Companies should shift their concerns towards low costs and efficient means that do not hinder flexibility and agility by making cash management decisions.[254] The purpose is to investigate in return for immediate cash, a factoring concept that transfers the management of the accounts of the companies' receivables risk to a third party.[255]

3.9 Action framework for Financial Inclusion

A comprehensive approach towards financial inclusion must cover at least three aspects: access to financial services and products; the use of financial services and products and the quality of financial and product services, as defined by consumers' ability in new financial services and products.[256] Customers are willing to bring new financial services and products from formal institutions through increased access.

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[251] Mwega F. M (2012) Financial regulation in Kenya; balancing inclusive growth with financial stability working paper 407 (15)

[252] Haselip, J., Desgain, D., & Mackenzie, G. (2014) *Financing energy SMEs in Ghana and Senegal: Outcomes, barriers and prospects*. Energy Policy, 65, 369-376.

[253] Groenewald, T. (2008). A phenomenological research design illustrated. International Journal of Qualitative Methods, 3, 42-55.

[254]Giorgi, A. (1997). The theory, practice, and evaluation of the phenomenological method as a qualitative research procedure. *Journal of phenomenological psychology*, *28*(2), 235-260.

[255]Hallberg, K. (2000). A market-oriented strategy for small and medium scale enterprises. The World Bank.

[256] Madise, S,(2014). *Rationale of Regulating the Financial Services, Models of Regulation and Need for Regulatory Independence*http://dx.doi.org/10.2139/ssrn.2538437 (Accessed on December 2018)

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Actions to gr+ow financial access can first identify potential barriers to lower-income and undervalued customers by institutions and then catalyse or take action to address them. The first aspect is the use of financial services and products regularly and the frequency of adoption. In addition to promoting financial products, a comprehensive strategy promotes the ability of customers to benefit fully from them. The third issue is the extent the financial services are available to consumers.[257]

In order to boost financial services' upgrades, lower the risks of increased access to funding and help customers enjoy financial services, financial capability and consumer protection must be priorities alongside financial inclusion.[258] The financially competent consumers can choose and use financial services according to their needs, with the know-how, skills and opportunities. Financial integration strategies may be defined as action maps agreed and established at the national or sub-national level that stakeholders pursue in order to achieve the objectives of financial integration.[259] Practical approaches organise attempts with the key players, define responsibilities and establish precise resource planning, for example, by setting priorities.

3.10: Chapter Conclusion

The reviewed literature shows that an empirical analysis of factoring and the access of SMEs to financing is required. Recent academic documents indicate that the availability of credit to SMEs depends on financial infrastructure: legal and informational conditions. The limited research pool that explicitly investigates the factoring expected to be less dependent on these environments than traditional forms of funding. The use of factoring is therefore expected to increase access to financing for small and medium-sized companies operating in poor financial infrastructure. SME finance has traditionally been focused on small, local banks lending relationships. Innovative transactions such as factoring, however, allow large banks to access finance for SMEs because they have enormous advantages, advanced systems of risk management and an international

[257] Berger, A. N., & Udell, G. F. (1995). *Relationship lending and lines of credit in small firm finance*. Journal of Business, 68(3), 351.

[258] Jappelli, T., & Pagano, M. (2002). *Information sharing, lending and defaults: Cross-country evidence*. Journal of Banking & Finance, 26(10), 2017-2045.

[259] Love, I., & Martínez Peria, M. S. (2012). How bank competition affects firms' access to financehe World Bank Economic Review,(7)

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network. Factoring is thus expected to improve access to financing by large financial institutions. From the empirical review, factors are a useful tool for financial inclusion, so a legislative framework on factoring must be developed. A case analysis of factor regulation in South Africa is provided in this chapter.

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CHAPTER FOUR

CASE ANALYSIS ON FACTORING REGULATION IN SOUTH AFRICA

4.1 Introduction

South Africa was considered one of the case studies countries as the factoring and lease services to SMEs were successfully implemented. Approximately 60% of SMEs in 2005 contributed to jobs, with half contributing to GDP.[260] SMEs can therefore play a significant role in local development and are mainly represented in the four main areas of the industry: agriculture, wholesale, manufacturing and local services. [261]This section brings to fore a case study of the South African Factoring Regulations. The study looks at the institutional factoring framework in South Africa, factoring and leasing costs and factoring success factors.[262]

4.2: A brief history of South Africa's Rise to Prominence

South Africa's banking system, banking rules or policies on financial integration have minimal insight into the south most country of Africa.[263] The only recognised system is the famed apartheid policy which has been legitimated discrimination. It is recognised. This consisted of a legalised 'separation on macro and micro-social levels: on the macro-level it was created, adopted and enforced by legislative documents to create and subsequently separate different

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[260] Factors Chain International, 'Ireland' World factoring yearbook 2013, United Kingdom: (2013)

[261] Oramah B.O, Dzene R. Kameni E. *Contemporary Issues in African Trade and Trade Finance* (CIAT) (vol 1) (no. 1) Afreximbank, Cairo (2014).

[262]Giannetti, M., Burkart, M., &Ellingsen, T. *What you sell is what you lend? Explaining trade credit contracts.* Review of Financial Studies, (2011),(24), doi:10.1093/rfs/hhn096

[263] Louis, L., & Chartier, F. (2017). Financial Inclusion in South Africa: An Integrated Framework for Financial Inclusion of Vulnerable Communities in South Africa's Regulatory System Reform. *Journal of Comparative Urban Law and Policy*, *1*(1), 13.

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racial and ethnic identities; those identities had been consolidated through routines of personal documents and public signs.[264]

The per capita GDP of South Africa doubled in buying power equity and in 2016 it was the continent's highest. Unfortunately, this is not the positive aspect of recent data.[265] Louis and Chartier praised the economic and financial measures of South Africa in 2017 "excellent for the developing countries of the G20, especially as the G20 countries focused primarily on austerity policies and sustainability in the financial crisis." The growth and increased exports promised at that time were regrettably not realised, and the current economic outlook is dire. The IMF "joined a chorus of voices in recent statements that put pressure on the government of President Cyril Ramaphosa to accelerate moves towards boosting economic growth .." The organisation urged the President to carry out reforms proposed by Finance Minister Tito Mboweni.[266]

The World Bank has highlighted the importance, in the developing countries as far back as 2013, of financial inclusion as 'a key social and economic goal.[267] This remains valid today, in particular in the current economic climate, as well as expanding access to financial services to vulnerable communities in South Africa' which could help in reducing poverty and improve job creation. [268]

While convinced that this is possible also in South Africa but only when the financial services industry, in particular, is 'paradigm shifted to seek greater cohesion between vulnerable, marginalised groups and the formal economy of South Africa rather than seeking greater profit.[269]

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[264]Burkart, M., Ellingsen, T., & Giannetti, M. (2005). *What You Sell is what You Lend?: Explaining Trade Credit Contracts*. Centre for Economic Policy Research.
[265]Sy, A. N. (2016). Foresight Africa: Top priorities for the continent in 2016.
[266]Qobo, M., & Soko, M. (2015). The rise of emerging powers in the global development finance architecture: The case of the BRICS and the New Development Bank. *South African Journal of International Affairs*, *22*(3), 277-288.
[267]World Bank Group. (2013). *Global financial development report 2014: Financial inclusion* (Vol. 2). World Bank Publications.
[268]World Bank Group. (2013). *Global financial development report 2014: Financial inclusion* (Vol. 2). World Bank Publications.
[269]Williams, T. (2007). Empowerment of whom and for what? Financial literacy education and the new regulation of consumer financial services. *Law & Policy*, *29*(2), 226-256.

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Growth and diversification of the banking sector in South Africa have led to expansion across different sectors, leading in turn to a higher demand for better financial regulation in order to cater for the expansion of the financial services industry such as insurance and credit.[270]

4.3: Institutional framework of factoring in South Africa

In South Africa, the majority of debt factorings are performed by specialist departments of banks and subsidiarity firms. There are also some independent businesses specialising in various markets. [271]These companies offer a wide range of debtor financing, including full factoring, discounting / finance of invoices, factoring imports and factoring exports. Leasing occurs, on the other hand, in both South Africa's car and goods sectors.[272]

Financing is either provided by South African ownership interests or banking agencies. Less than 2% of the receivables were estimated for SMEs, though not separately monitored. [273]The types of equipment leases from the Federal Engine Carrier Safety Administration (FMSA) dealerships are light commercial vehicles, tractors and equipment.[274]

4.4 Terms and conditions of contracts

Debt over 90 days is not funded, and discount paper days are not over 90 days. They also do not take foreign debt, consignment stock debt, debt to be sold or returned, debt to be repaid, debt to

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[270]Karlan, D., & Morduch, J. (2010). Access to finance. In *Handbook of development economics* (Vol. 5, pp. 4703-4784). Elsevier.

[271]Ezeoha, A., & Botha, F. (2012). Firm age, collateral value, and access to debt financing in an emerging economy: evidence from South Africa. *South African Journal of Economic and Management Sciences*, *15*(1), 55-71.

[272]Louis, L., & Chartier, F. (2017). Financial Inclusion in South Africa: An Integrated Framework for Financial Inclusion of Vulnerable Communities in South Africa's Regulatory System Reform. *Journal of Comparative Urban Law and Policy*, *1*(1), 13.

[273] F Unal 'Turkey' *World Factoring Yearbook 2017 Edition* (2017) 138. (Available at www.ebglaw.com/content/uploads/2017/06/Tatge-World-Factoring-Yearbook-2017-eBook.pdf (Last Accessed 27 September 2017)

[274]Fatoki, O. O., &Smit, A. V. Constraints to credit access by new SMEs in South Africa: A supply-side analysis. *African Journal of Business Management*, *5*, (2011). https://doi:10.5897/AJBM10.1335.

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be disputed.[275] The terms attached to factoring agreements are, in addition to the collateral required of shareholders, a sale and purchase agreements in respect of claims.[276]

The lease contracts last 24 months. The conditions attached to these agreements include the use of equipment, compliance with maintenance conditions, damage to equipment and repair conditions and the conditions upon return of equipment.[277]

4.5 Costs of factoring and leasing services

Factoring services costs are linked to a primary rate of two percent and fourpercent, even though they are rarely higher. The factoring companies are also providing full debtor administration services, which charge a factoring fee of the gross invoice value sold and impose a minimum fee.[278] The factoring agreement costs are set up at an early stage, and both interest and service charges are negotiated at the time that the agreement is signed. Increasing reimbursement and taking account of equipment expenses and customer risk and usage and related residual risk equipment will be leased at a viable rate for commercial and equity return (ROE).[279]

4.6 SMEs Lending Rates in South Africa

In South Africa, default rates for factoring and leasing are below 10 percent.[280] The default of SMEs is that the debt available for factoring cannot be sufficiently funded to collect the exposure. Factoring enterprises undertook continuous assessments of debtor books and

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[275]Rogerson, C. M. (2008, March). Tracking SMME development in South Africa: Issues of finance, training and the regulatory environment. In *Urban forum* (Vol. 19, No. 1, pp. 61-81). Springer Netherlands

[276] F Unal 'Turkey' World Factoring Yearbook 2017 Edition (2017) 138. (Available at www.ebglaw.com/content/uploads/2017/06/Tatge-World-Factoring-Yearbook-2017-eBook.pdf (Last Accessed 10 September 2018)

[277] Dalal, A., Debock O., Gelade, W. and Matul, M. (2013) Why People Do Not Buy Micro -Insurance and What Can We Do About It. Micro insurance Innovation Facility, International Labour Organisation (ILO), Capetown South Africa.

[278]Udell, G. F., Bakker, M. R., & Klapper, L. (2004). Financing small and medium-size enterprises with factoring: Global growth and its potential in Eastern Europe. The World Bank.

[279]The Role of Financial Regulators in Promoting Access to Financing for MSMES Lessons from the AFI Network (GN.23 of August 2016)

[280]Florette, N., Gerson, K., & Postrick, M. (2008). Enhancing the role of factoring and leasing companies in providing working capital to Small and Medium Enterprises (SMEs) in Namibia.

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confirmed that these debtors permit this to reduce such defaults.[281] Companies which factor also conduct customer audits and therefore also assess the financial performance of SMEs.[282]

Furthermore, guarantee letters and indebtedness are also taken as mitigation measures for defaults. The rental companies ensure compliance with the law, assurances, customer risk assessment, account surveillance and inspection, collection policies, debt reimbursement restructuring and equipment disposal.[283]

4.7 Success factors in South Africa

In 2012, the total factoring volume of the industry in South Africa stood at EUR 21,000 million (7.21% of GDP) and was increased by EUR 15,000 million in 2011. The business finance industry in South Africa achieved incremental progress in 2012, at 1.3 million euro with 1616 customers, 79.742 debtors and 306 jobs.[284] Discounts are the dominant products in South Africa, with over 80 percent of business finances. The awareness and acceptance of factoring in South Africa is medium, and the demand is buoyant.[285]

In South African companies, the critical success factors include the state of the economy, as well as the abolition of factoring stigma that is labelled as ultimate finance, the efficient legislative environment, good corporate management, and the freedom of markets process. Including good IT, experienced and capable staff, separation of the credit and market functions, and right procedure and controls are factors that improve the operation of a successful factoring company. The Debtor Financing Committee also carries out an ongoing monitoring process with its

[281]Spasić, I., Bejatović, M., & Dukić-Mijatović, M. (2012). Factoring-Instrument of financing in business practice– Some important legal aspects. *Economic research-Ekonomska istraživanja*, *25*(1), 157-173.
[282]Watkins, J. A. (2012). A literature review of small and medium enterprises (SME) risk management practices in South Africa. *African journal of business management*, *6*(21), 6324-6330.
[283] J Brehcist 'Global Industry Report for 2016' FCI Annual Review (2017) 32 https://www.fci.nl .
[284]International Factors Group (IFG). (2013). Global Industry Activity Report (GIAR) 2012. Brussels, Belgium: International Factors Group. Retrieved from http://www.ifgroup.com/wp-content/uploads/2013/07/GIAR-2012-Public-1.pdf
[285] Mbatha, M. T. (2011). Risks and rewards of providing "reverse factoring" as a financing technology for small and medium-sized enterprises in South Africa (Master Thesis). Available from http://upetd.up.ac.za/thesis/available/etd-05262012- 201508/unrestricted/dissertation.pdf

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customers to make sure that the right products are used by SMEs and the right reasons.[286] The doubling of the private sector credit ratio is linked to an increase of almost 2 percent in average long-term growth.[287]

In the short term, the International Factors Group (IFG) has a positive impact on growth.[288] Nevertheless, caution is required in order to achieve financial driven growth in pursuing lending expansion. Inflation, depreciation or institutional insolvency could also lead to too-rapid growth. The development of the financial system is usually linked to credit expansion. Even so, they should also work correctly and extensively in the sense of providing companies, services, intermediate amounts of funds and resources.

Three channels are provided to influence growth: mobilising savings, promoting efficient allocation and transforming risk both to reduce this through accumulation and to enable those who are more ready to carry. Finance is provided for. Finance is being shown to affect growth by increasing overall productivity instead of capital quantity or by increasing aggregate savings. Deeper financial systems nevertheless contribute to increasing opportunities for external financing for firms.[289]

However, it is claimed that the financial systems and services that it offers only benefit the wealthy and that the worsening income distribution can have adverse effects on the poor.Then the policy instrument to deal with poverty would be relegated to financial development.[290] One theoretical study assumes that agents must pay the initial set-up cost to participate and benefit from the financial sector. Since poor households are not interested in incurring this cost and

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[286]Chikomba, C. P., Dube, M., & Tsekea, S. (2013). An investigation into the effectiveness of risk management policies employed on credit finance to SMEs: A case study of SEDCO, Bindura Satellite Branch, Zimbabwe.

[287]Amidžic, G., Massara, A. and Mialou, A (2013) Assessing Countries' Financial Inclusion Standing - A New Composite Index, Working Paper No. 14/36, International Monetary Fund (IMF). Available from https://www.imf.org/external/pubs/cat/longres.aspx?sk=41385.0(Accessed on 15th May 2017)

[288] International Factors Group (IFG). (2013). *Global Industry Activity Report (GIAR) 2012.* Brussels, Belgium: International Factors Group.

[289]World Bank. Kenya Economic Update, (December 2013, No. 9): Reinvigorating Growth with a Dynamic Banking Sector. (ed.9 2013).

[290] Priest-Stephens, L. and E. Kameni 'Building a Model' Trade and Forfaiting Review 1 June 2016 http://www.tfreview.com/feature/regions/building-model.pdf (Accessed 7 March 2018).

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prefer to use their savings for other purposes, they will continue to deteriorate in the distribution of wealth.[291] The view that finance is "regressive" is thus supported.

Little empirical literature is available to examine the impact of financial development on absolute poverty. The IFG argues that the proper functioning Financial System can promote a competitive environment and undermine the power of existing companies and help poor households avoid exploitation.[292] Also, the evidence available rejects this trade-off between growth and poverty. One international study investigates inequality and shows a markedly negative relationship between the financial depth and the Gini index.[293]

Jordan and Majnoni are suggesting that credit restrictions for poor households will be relieved as the financial sector develops in South Africa, enabling them to invest. For example, if poor farmers access safe forms of finance, they can protect themselves against a bad year and put them below the poverty line. The link between funding and poverty also has indirect evidence.[294]

Other sources of external financing distinguish the factoring. Factoring offers companies an array of advantages including expedient access to finance, without additional guarantees, regardless of the company's credit rating, and access to unrestricted funds which can be invested immediately.[295]Unless there are no shareholder links between buyer and supplier, companies seeking funding will have less opportunity for refusal. Factoring enables management to concentrate on core companies rather than to be indebted.[296] Factoring provides protection against non-resource factoring invoices unpaid, export factoring foreign exchange risk

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[291] FCI 'MAC Carpet—FCI on flying carpets around the world' https://fci.nl/en/about-factoring/case-studies/ (accessed 25 April 2017).

[292]Chiu, I. H. (2016). Fintech and disruptive business models in financial products, intermediation and markets-policy implications for financial regulators. *J. Tech. L. & Pol'y*, *21*, 55.

[293] Woo, J., Bova, M. E., Kinda, M. T., & Zhang, M. Y. S. (2013). *Distributional consequences of fiscal consolidation and the role of fiscal policy: What do the data say?* (No. 13-195). International Monetary Fund.

[294] Jordan C and Majnoni G, Financial regulatory harmonization and globalization in finance, World Bank publication (2002)

[295]Goh, K. (2017). Trading places: Benefits of invoice finance for small and medium sized enterprises as opposed to bank lending. *Aberdeen Student L. Rev.*, *7*, 56.

[296]Oramah, B. O. (2012). Foundations of structured trade finance. Ark Group.

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protection, and provides a variety of export services capable of enabling SMEs to enter new and risky yet lucrative markets.[297]

4.7: Chapter Conclusion

The above-noted financing is used as a stabilizing force which reduces financial volatility. While finance can protect output growth from trade shocks, the effect of inflationary shocks can deteriorate. Depth financing can increase rather than alleviate the risk without the correct institutional and incentive characteristics. The policy requirement of this debate in South Africa is that developing countries should not attempt to engineer the expansion of credit and indebt development of financial systems.[298] They should instead create an environment that allows individuals to become involved in the market system and that the financial system effectively delivers services. The following chapter illustrates Kenya's regulation changes, the financial consumer protection laws and regulations, fair market practices and financial infrastructure on the Kenyan market.

[297] Ruddy N, Mills S, Salinger F. Davidson N *Salinger on Factoring* (2006) London; Sweet & Maxwell

[298] Prasad, E. S., Rogoff, K., Wei, S. J., & Kose, M. A. (2007). Financial globalization, growth and volatility in developing countries. In *Globalization and poverty* (pp. 457-516). University of Chicago Press.

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CHAPTER FIVE

REGULATORY CHANGES FOR KENYA: THE SIGNIFICANCE OF FACTORING LAW

5.1: Introduction

Legislators with a strategy of financial inclusion are likely to get more financial inclusion regulations passed through parliamentary process as they have access to resources to implement them in relevant laws[299] This can catalyse a reaction by the private sector to raise financial inclusion dramatically. For example, financial infrastructure reforms support the implementation of low cost and lower risk products and delivery models critical to increasing financial inclusion. This chapter provides a background to the model law of factoring and a summary of the legal framework to support financial inclusion by cementing factoring in legislation.[300]

5.2: The theory of Financial Inclusion

The duo of Triki and Faye claimed to have a seamless financial infrastructure, which allows individuals and firms to actively participate in the economic development. [301] They offered the definition of financing inclusion as 'all activities, making financial services accessible, accessible and affordable for all segments of the population.' Over 2.5 billion people are excluded globally from financial systems or under-served. [302] The significant populations that are destitute or underserved are a combination of formal or informal financial services that are not able to meet their various financial needs appropriately.[303] The World Bank Group espouses the notion that financial inclusion lies at the heart of the development process: [304]

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[299] King RG & Levine R 'Finance and Growth: Schumpeter Might be Right. (1993) Quarterly Journal of Economics.108 3

[300] Buku, M. W., & Meredith, M. W. (2012). Safaricom and M-Pesa in Kenya: financial inclusion and financial integrity. *Wash. Jl tech. & arts*, *8*, 375.

[301] Triki, T., & Faye, I. (2013). Financial inclusion in Africa. *African Development Bank*.

[302] Fadun, S. O. (2014). Financial inclusion, tool for poverty alleviation and income redistribution in developing countries: Evidences from Nigeria. *Academic Research International*, *5*(3), 137.

[303]Stephen, A. G. Effectiveness of Financial Inclusion Strategy in Nigeria.

[304] Demirguc-Kunt, A., Beck, T., & Honohan, P. (2007). *Finance for all?: Policies and pitfalls in expanding access* (No. 41792, pp. 1-268). The World Bank. Washington DC available at www.openknowledge.worldbank.org/handle/10986/6905 (accessed 10 August 2017)

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'Finance is at the core of the process of development. Built on sound empirical evidence, developing professionals are becoming increasingly confident that the best way to channel funds to the most effective uses and to allocate risks to those who can bear them is to improve opportunities, boost economic growth, and distributions of income and reduce poverty. In contrast, the benefits of financial development will likely elude many individuals and companies to the extent that there is limited access to finance and the available range of services, leaving much of the population totally in poverty.'[305]

Therefore improved access to finance is a critical imperative to promote trade. The narrative states:

'Without inclusive financial systems, poor individuals and small enterprises need to rely on their personal wealth or internal resources to invest in their education and become entrepreneurs. Financial market imperfections, such as information asymmetries and transaction costs, are likely to be especially binding on the talented poor and the micro- and small enterprises that lack collateral, credit histories, and connections, thus limiting their opportunities and leading to persistent inequality and slower growth Services that needs to be available when and where desired, and products need to be tailored to specific needs…'[306]

Kenya has also shown its renewed desire to enhance financial inclusion by participating actively from the founding in 2011 in the Alliance for Financial Inclusion (AFI).[307] The Maya Declaration was first signed in the Riviera Maya, Mexico in 2011. She was one of the first countries.

'*The Maya Declaration is an initiative to unlock the economic and social potential of the 2 billion unbanked population through greater financial inclusion. It represents the*

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[305]Andersen, T. B., & Tarp, F. (2003). Financial liberalization, financial development and economic growth in LDCs. *Journal of International Development: The Journal of the Development Studies Association*, *15*(2), 189-209.
[306]Beck, T., Demirgüç-Kunt, A., & Honohan, P. (2009). Access to financial services: Measurement, impact, and policies. *The World Bank Research Observer*, *24*(1), 119-145.
[307] Güngen, A. R. (2018). Financial inclusion and policy-making: Strategy, campaigns and microcredit a la Turca. *New Political Economy*, *23*(3), 331-347.

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world's first commitment platform which allows AFI member institutions to mainly make concrete financial inclusion targets and implement in-country policy change. A public commitment to the Maya Declaration is a means to spearhead financial inclusion.'[308]

Studies show a considerable correlation between financial inclusion and the creation of robust economies: the most innovative and dynamic are often small companies. Countries with financial barriers that stifle these potential lose their growth potential.[309] Therefore progress towards greater financial inclusion and intergration is central to overcoming the insistent problem of access to finance. Financial inclusion can strengthen macroeconomic stability from a governmental viewpoint, while increased financial inclusion equates to a broader customer base from a financial sector perspective.[310] To find solutions to the challenge, Kenya needs to adopt an inclusion strategy.

5.3: The existing legal framework governing factoring in Kenya

Kenya is a former British colony and therefore has a typical English law-based legal system. Kenya does not have a particular factoring-regulating statute similar to its colonialist. There are, however, three (3) UK bodies dedicated to regulating factoring firms: the FCA and ABFA and Her Majesty's Treasury. The Financial Conduct Agency (FCA) is also involved in regulating factoring companies in the UK.[311] It sets regulatory standards to assure fair business for the sector's parties, and it is 'an independent non-governmental body regulating the financial services industry in Great Britain'.[312] It also receives complaints and helps with the resolution of financial services disputes, including factoring.[313] ABFA was set up as a trade association for

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[308]Sakariya, S. (2013). Evaluation of financial inclusion strategy components: Reflections from India. *Journal of International Management Studies*, *13*(1), 83-92.

[309] World Bank (n 160 above)

[310]Forment, C. A. (2013). Democracy in Latin America, 1760-1900: Volume 1, Civic Selfhood and Public Life in Mexico and Peru (Vol. 1). University of Chicago Press.

[311] Elaine S 'How are Factoring Companies Regulated? Available atPickernell, D., Senyard, J. M., Jones, P., Packham, G., & Ramsey, E. This file was downloaded from: http://eprints. qut. edu. au/60721.*https://www.companeo.co.uk/factoring/guide/how-arefactoring-companies-regulated*(accessed 27 September 2017)

[312] Scott, C. (2002). Private regulation of the public sector: a neglected facet of contemporary governance. *Journal of Law and Society*, *29*(1), 56-76.

[313] Elaine (n 305above)

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manufacturing firms in the UK and Ireland forty-one years ago. It has 41 members who account for 95% of all invoice finance companies in the UK.[314]

5.3.1: Financial Services Authority Act, 2016

One of the most well-known of these is the 2001 Act on the Central Bank of Kenya (amendment). This aimed to bring interest and deposit rates into line with the 91-day Treasury Bill rate. It required the CBK to ensure that the maximum rates for bank lending were not greater as 4% above the Treasury Bill of 91 days, while deposits of deposits would not exceed 70% of the rate paid on the 91-day Treasury bills. The Donde Act was challenged and declared illegal by a court on a technicality concerning its commencement after its enactment and before implementation.[315]

When awarding the license, the Central Bank will consider, among other things, the applicant's capital adequacy requirements, the financial position and the experiences and character of the directors, the relevant shareholders, the beneficial owners of the financial service, the founders or persons who propose to be involved in the management.[316] Section 17 of the Bill 2016 of the Financial Services Authority provides that a license may be suspended or cancelled. The ramifications of cancelling or suspending are also explained in this section.

The Corporate Governance issue is Part IV of the Act. All financial institutions have to have the Board of directors responsible for ensuring the corporate management of the service provider, ensuring that the company operates in compliance with all applicable laws, as well as for managing the company. It is mandatory to disclose an interest in contracts.[317] Paragraph 39 of the Law criminalises the making of false accounts or reports. Criminalisation is also made

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[314] Hamanyati MFactoring as an International Trade Finance Product: Making a Case For The Enactment of a Factoring Act in Zambia. (2017)
[315] Central Bank of Kenya (Amendment) Act 2001
[316] Musembi, D. M. (2018). Effect Of Liquidity Risk Determinants On Financial Performance Of Commercial Banks Listed At Nairobi Securities Exchange, Kenya (Doctoral Dissertation).
[317] Section 38 Banking and Financial Services Act

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against or attempt to obstruct an authorised audit or inspection of the financial service provider.[318]

The prudential regulation and supervisory powers of the central bank shall be defined in Part VI of the Act. Article 52 gives the Central Bank of Kenya the authority to "specify the minimum paid-up capital, the minimum common equity level, the minimal primary capital and minimal requirements for regulatory capital of the providers of financial services."[319] Section 57 requires financial institutions to maintain appropriate and suitable types of liquidity, according to the Central Bank's recommendation. The Central Bank may initiate a review of the financial situation, compliance with the Act and other relevant written laws of a financial service provider. The financial service provider may also refrain from adopting or following unsafe or unsafe business practices.[320]

The central bank has a robust power in exercising its supervisory powers to impose sanctions on a financial institution that is not in complaint or under-completed. This means that corrections must be taken, or that a financial service provider is restricted, suspended or cancelled or takes possession of a financial service provider.[321] Article 75 allows a provider of financial services to challenge the Central Bank's taking-over. In this case, legal proceedings are instituted before the High Court of Kenya within 21 days. Section 76 highlights the impacts that possession has on the evolving nature of legislation in order to curb fraudulent transfers.

Part VII of the Act concerns restrictions on financial service providers' transactions. In order to minimise failure risk. Unless the Central Bank has previously granted its written consent, Section 83 prohibits a financial institution like a factoring company from engaging in any business or business for which it is not licensed. The parameters under which financial institutions operate are also set out in Sections 84 to 87.

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[318] 3 Section 63 Banking and Financial Services Act.

[319] Mwenda, K. M. (2011). Relationship between core capital and profitability of commercial banks in Kenya (Doctoral dissertation, University of University).

[320] Daumont, R., Le Gall, F., & Leroux, F. (2004). Banking in Sub-Saharan Africa: what went wrong?.

[321] Ramchander, M. (2011). The impact of the financial advisory and intermediary services act of 2002 on consumer awareness and financial service providers in South Africa (Doctoral dissertation, University of Zululand).

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The financial statements and accountability are covered in Part VIII of the Act. Section 88 requires the company's board to ensure "the maintenance of proper financial service operators books and other records.[322]" Additionally, the board must prepare financial statements, accounts, and reports every financial year which meet international accounting standards. Section 90 is a factoring element. It states that 'the annual financial statements of a financial service provider are subject to regulatory statements issued according to this Law to create or vary the reserves for bad and doubtful debts that are suitable.

The Act, Part IX, concerns the protection of consumer and anti-competitive activities. Essential for factoring is Article 104(1), which states that 'the provider of financial service must not harass, oppress or abuse a person in debt collection.' Also crucial for factoring is that Section 107 mandates a financial institution to "apply for the Central Bank's written prior approval before raising tariffs or introducing a new fee for SMEs. Unless specifically allowed under the Act, Article 108 criminalizes the imposition of penal interest.

Today, Kenya uses both institutional and operational regulatory frameworks. This is the model that regulates every intermediary in the industry by another body, organisation or agency.[323] For example, the Insurance Regulatory Authority regulates the securities markets,[324] the Central Bank of Kenya regulates the sub-sector banking, the Capital Markets Authority regulates the securities markets, and the regulatory authority regulates subsection companies.[325] Each sub-sector is regulated under this structure by a different regulatory entity. In some cases, a sub-sector may have over one regulator that supervises its activities. An example would include the fact that a company is registered and licensed to operate under the Companies Act.[326] The Insurance Regulatory Authority shall govern such a company.

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[322]Ntim, C. G., Lindop, S., & Thomas, D. A. (2013). Corporate governance and risk reporting in South Africa: A study of corporate risk disclosures in the pre-and post-2007/2008 global financial crisis periods. *International Review of Financial Analysis*, *30*, 363-383.
[323] Companies Act No 17 of 2015
[324] Gakeri, J. K. (2015). *Financial Services Regulatory Modernization in East Africa*: The Search for a new.
[325] National Consumer Council ‘Models of Self-regulation: An overview of models in Business and the Professions’ (accessed 10 November 2014)
[326] Companies Act No 17 of 2015

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Curiously, the Banking and Financial Services Act does not define what is involved. The Act neither explains how to regulate or promote factoring. This poses an obstacle for companies in need of funding because the law does not specify their rights and duties. Factoring has become a cardinal tool for trading finance used in both in intra and intercontinental transactions. In previous chapters, it was revealed that existing financial institutions also have liquidity issues. It is therefore vital to draw foreign investment into the jurisdiction in the form of factoring enterprises. Investors may lack the confidence to enter the market because of the persistent insecurity of how factoring works in Kenya. A solid legal framework which addresses its various aspects.

5.4: Role of the Afreximbank in promoting factoring

Afreximbank was instituted under the auspices of the AfDB[327] as a pan-African multilateral financial institution.[328]

As an important stakeholder, the AfDB has cordinated with Afreximbank via the Fund for African Private Sector Assistance (FAPA) for factoring companies in the continent, to further this pursuit of financial inclusion. FAPA grants will be used to promote innovative programmes, in particular supporting small and medium-sized enterprises. More importantly, funding to draft the African Model Law[329] on Factoring has been approved by the AfDB that was launched as an Africa-made Model Law on Factoring in Cape Town, South Africa.

To support the supply and growth of trade financing in Africa for small, medium-sized and large enterprises, the Afreximbank has long been intended to support factoring as a financial instrument. In most African countries; the Bank has poignantly noted that the fact that there are no factoring laws and regulations present a challenge to product growth.[330] It has thus learnt essential lessons from current model legislation and has adapted itself to the needs of states in

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[327] *https://www.afreximbank.com* (Accessed 13 January 2019).
[328] AfDB Group 'Annual Report 2016' available at https://www.afdb.org (accessed 13 January 2019).
[329] Oramah, B. O. (2012). *Foundations of structured trade finance*. Ark Group.
[330] Hamanyati, M. (2017). Factoring as an international trade finance product: making a case for the enactment of a factoring act in Zambia (Doctoral dissertation, University of Pretoria).

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Africa.[331] Therefore, it is essential to begin with a brief review of the UNIDROIT, UNCITRAL and IFG model laws, before examining the targeted legislation.

5.5: Overview of current Factoring Model Laws

The Ottawa Convention was concluded in 1988 by the Institute of Unification of Private Law (UNIDROIT). It considered International factoring in its Preamble as having an instrumental part in significant contribution to the development of international trade. To this end, it 'is important to adopt uniform rules in order to provide a legal environment which facilitates international factoring.[332] It is a legal prototype for the domestication of laws in Russia and with other several jurisdictions, including Nigeria.

The Convention on Assignment of Receivables in International Trade was finalised in 2001 by the United Nations Committee on International Trade Law (UNCITRAL). This Convention, in its format, covers a wide range of claimable products such as the forfeits, securitisation and factoring, and provides the necessary tools in order to facilitate access to cheaper credit across national borders.[333] The impact of the UN Convention is nevertheless minimal as it is not passed into law by a single jurisdiction. The most beneficial effect of this Convention is that it was the basis of the 2014 Model Law on Factoring of the International Factors Group (IFG). The Model Law of IFG 2014 aims at giving legislators a proposal for factoring legislation incorporating recognised and developed legal principles. It shares significant similarities with the philosophical foundations of the Afreximbank Model Law.

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The model legislation in more than one country is intended for adoption and should not be substantially altered. This will allow for the unification of national private law. Consequently, the interpretation of this Law shall take account of its purposes and the necessity to promote uniformity in its application and the adherence to the good faith in trade. National legislators may wish to consider implementing the rules proposed in national law with the assistance of national and international advisors. However, national legislation should be reconsidered and

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[332] https://www.unidroit.org/instruments/factoring (accessed 13 January 2019)

[333] https://www.uncitral.org/uncitral/en/uncitral_texts/security/2001Convention_receivables.html (accessed 1 September 2017).

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modernised in line with the suggestion of this Model Law, in the interests of encouraging finance and trade.[334]

5.6: Afreximbank's Model Law

The Afreximbank model law derives its basis from the IFG recognizing the fundamental additives made by the IFG legislation.[335] The model law of Afreximbank. had prepared its model legislation intending to improve factoring profiles and commercial financing for the continent and create a benchmark to enact its legislation in African countries.[336]

However, there is a stark difference in the terminologies used in the model laws that seems to lends itself to find a correctness with the usage of terms found under commonwealth legislation. This is one of the reasons that makes it very favourable for usage under the Kenyan law.

'factoring contract' means the term used instead of 'assignment contract,' and the term 'supply contract' substitutes for 'original contract.' The reason coming forth is for ease in assimilation by states that seek to harmonise their law of factoring with international standards. [337] It is prepared in a parliamentary format that reflects the commonwealth legislative drafting system this is significant as a majority of African states including Kenyan are former British Colonies.[338] The model law consists of seven (7) parts. The preamble above these parts states.

An Act to establish principles and to adopt rules relating to the assignment of receivables in order to create certainty and transparency and to promote the modernisation of the law relating to assignments whilst protecting existing assignment practices and facilitating the development of new practices and ensuring adequate protection for the interests of debtors in order to promote the availability of capital and credit and to facilitate domestic and international trade..

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[334]https://fci.nl/about-us/model-factoring-law-cv-140221.pdf (accessed 13 January 2019).

[335] Afreximbank 'Afreximbank Model Law on Factoring' available at *https://afreximbank.com/wpcontent/uploads/2016/10/Model-Law-on-Factoring.pdf* (accessed 21 May 2017).

[336] Tatge & Kameni (n 334 above)

[337] Afreximbank (n 338above).

[338] Afreximbank (n 339above).

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The preliminaries including definitions and interpretation of model law are discussed in part 1. There is a need to review some essential definitions. Definition of 'assignment' in the African Model Act is based on UNCITRAL and the broad definition of the IFG model law as follows:

Assignment means transferring entire or part interest in a debtor payable by agreement of the customer to a factor and whether or not a debtor has been advised. The establishment of rights in the claimant as debt or other obligation is considered a transfer of responsibility.[339]

. The Afreximbank model law defines the factoring contract as' contract concluded between the customer and a factor under which: [340]

a) categories of trade receivables from supply contracts between the customer, and debtors are assigned or offered to be assigned for factor; and

b) at least one of the following functions must be performed by factor:

i. the supply or provision of customer finance, including lending and advance payments that are directly linked to the value of each receivable and its perceived credit risk at or after the receivable is created;
ii. Maintaining (edging) accounts related to the assigned claims;
iii. Compilation of payables for assessment and
    A. Any collection is for its account and not as the customers' agent unless otherwise agreed;
    B. any collection of the factor made by the customer is deemed to be made by the factor;
    C. Protection from default on debtors' payment can or can not be granted only as a result of their inability to pay;
    D. The debtors could or may not be notified of the assignment of the receivable.[341]

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[339] Section 1.1 Model Law.
340 https://www.afreximbank.com (Accessed 31 August 2018)
[341] Section 1.1 Model Law.

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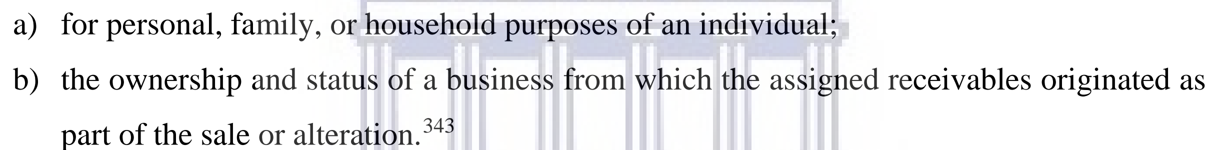
Consequently, the Model Law makes it clear that only one of the three first services described above is required for its purposes.

A future trade receivable arises after the conclusion of a factoring contract where an "international assignment," whereby the factor and the customer are placed at a time when the factoring contract was concluded, is defined as a trade receivable. A "future trade receivable" An 'assignment notice' must be decreased and communicated to the debtor as such. Also, the factor and the assigned receivable must be identified in reasonable terms stating explicitly that the receivable is assigned to a factor. The meaning of 'writing' is also explained as 'any information accessible for further reference...'

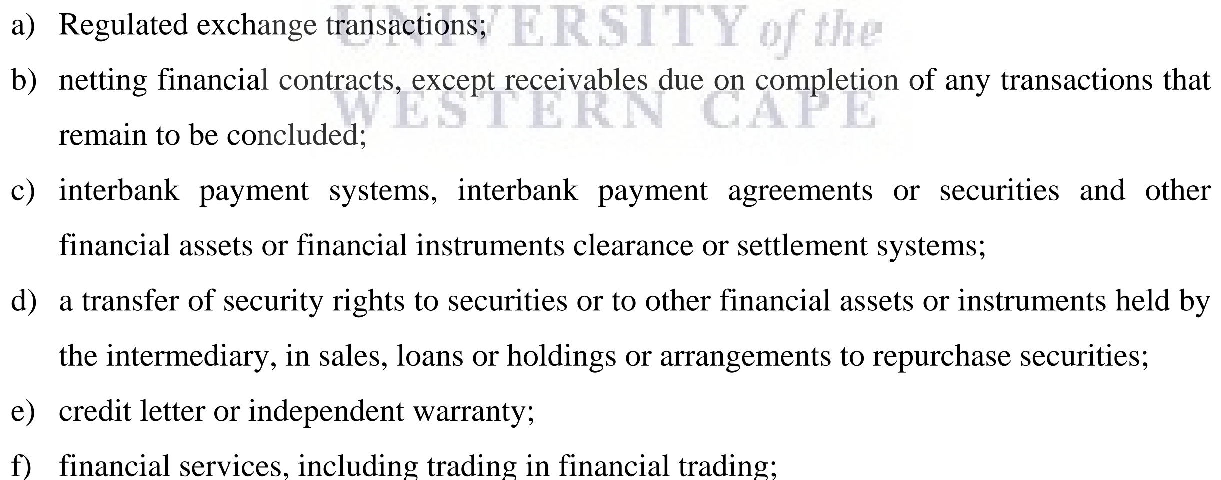
Part 2 concerns the scope and limitations of the application. The application of the Act for domestic and cross-border factoring contracts is precise in section 3.[342] However, the assignment made "does not apply:

a) for personal, family, or household purposes of an individual;



b) the ownership and status of a business from which the assigned receivables originated as part of the sale or alteration.[343]

Furthermore, the Act does not apply for 'assignments' of claims under or from: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a) Regulated exchange transactions;
b) netting financial contracts, except receivables due on completion of any transactions that remain to be concluded;
c) interbank payment systems, interbank payment agreements or securities and other financial assets or financial instruments clearance or settlement systems;
d) a transfer of security rights to securities or to other financial assets or instruments held by the intermediary, in sales, loans or holdings or arrangements to repurchase securities;
e) credit letter or independent warranty;
f) financial services, including trading in financial trading;

[342] Section 3.1 Model Law.
[343] Section 4.1 Model Law.

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g) safety interests established by other statutes;
h) the lines of the landlord except for the attachments;
i) debts arising from property selling or leasing;
j) transferring interest on or in a claim under an insurance policy;
k) transfer of wage claims or employee compensation;
l) the sale of a business;
m) set-off claims
n) Claims in court proceedings.[344]

If just a few accounts are bought, the customer may pledge the unbought accounts in the form of a security guarantee for the customer's contractual factor obligations. The bank model law, in a similar fashion to the UNCITRAL and IFG model laws, recommends that a centralised system be created for accounts security interests. This will alleviate the problem of asymmetry and fraud in the information.

Part 3 allows the factoring agreement parties freedom to derogate from or amend the Model Law provisions except as expressly provided for in the Act.[345] The effects of the assignment are provided in part 4.

The assignment remains effective as between the facteur and the client or against the obliger or a contending claimant. The right of factor can not be denied a priority as a result of assignments of more than one claimant, or future claimants or on account of the assignment of more than one receivable or the fact of the factors of the assignment.

(a) as individual claims relating to the assignment;

(b) the claims to which the assignment relates, either in the time of the assignment or, for future claims, in the time the supply contract is concluded, may be identified in other ways if the same can be said of claimables.[346]

[344] Section 4.2 Model Law.
[345] Section 5 Model Law.
[346] Section 6.2 Model Law

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The Law is sacrosanct in Section 7. A state can not claim to ban assignments. Notwithstanding a ban on the assignment, an assignment of a receivable remains valid. This means that a trading debtor is no longer in a position to prohibit the third party from being assigned debts by a supplier as a factor. Moreover, because the customer acted in contravention of such a prohibition, the debtor shall not avoid its obligations under the supply contract.[347] Neither the customer nor the factor is liable to the debtor for contravening a cession prohibition, nor can any claim for payment of an assigned debt be relied upon by the debtor as a defence or set-out.[348]

Section 7.3 states: 'We shall not, in violation of any prohibition against assignment, act either on the customer or on the assignment of a receivable.' Part 5 deals with the rights, obligations and defenses that are available to the parties.

Section 9 recognizes the autonomy that the factor and its customer have, including any rules or general conditions contained therein, to defines their mutual rights and obligations resulting from conditions enshrined in the factoring contract. In Section 10.2, the factor does not mean that the debtor is capable of payment of the debt or otherwise discharge of the debt in the absence of any agreement between the client and the factor.

Section 11 encapsulates the right to notify the client: 'Unless the customer and its factor have otherwise agreed, a notice of the assignment and a payment instruction may be forwarded to the debtor, whether by the client or by the factor or by the other means.[349] The assignment shall not affect the rights and liabilities of the debtor, including payment terms included in the supply contract, without the debtor's consent.[350] However, the opposite provisions contained in the Act could override this position.[351]

On reception, a notice of the assignment or instruction issued to the payer shall take effect in a language reasonably expected to advise the debtor of the content of the assignment or payment

[347] Section 7.1 Model Law.
[348] Section 7.2 Model Law.
[349] Section 11.1 Model Law
[350] Section 11.2 Model Law
[351] Section 13 Model Law.

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instruction. If the notice or payment instruction is available in the contractual language, it is enough.[352]

Article 15 stipulates that the debtor is entitled, by payment under the supply contract, to discharge a trade receivable. However, the debtor can only discharge the trade payable by settling the debts per the provisions of the notice when he receives a notification about the assignment.

Article 16 stipulates the debtor's defences and compensation rights. Sub-section 1 reads as follows: '16.1 In claiming all defences and set-off rights arising from the supply contract, or other contracts which were part of or closely related to the same transaction, of which the debtor could use the factor, the debtor can raise against the factor of payment of the assigned tradable receivable.

(a) arising out of the factor's fraudulent acts;

(b) Based on the inability of the debtor.

International factoring is the subject of Part 6 of the Model Act. It is concise and only contains one section. It provides that international factoring transactions are governed by the rules (if any) of an association, both of which are members, and the law agreed between them if no such rules exist. The Act laid down in Parts 1-5 of the Model Act is in default in case a contravening agreement is not reached by the influencing factors or controlled more by rules of an organisation that both factors belong.[353]

The in-force entry, application and repeal of statutes is provided for in Part 7 of the Model Law.[354]

5.7 Reasons for Legislating factoring for Kenya

There are abundant sufficient reasons for the enactment of legislation to govern Factoring in Kenya. In the first place, regulations provide the frontiers for which the services can be rendered

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[352] Section 14.1 Model Law.
[353] Section 24.1 Model Law.
[354] Section 25.4 Model Law. 70

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safely and adequately. This provides standards that contribute to the blooming of the industry's profile and inspire trust in factoring, bolstering the industry's credibility. The model law is equally essential to operate in different jurisdictions uniformly. This makes the product globally acceptable as factors in Kenya can be confident that the law governing the contract of factoring will be identical or similar in another jurisdiction hence facilitating safer cross-border transactions[355] It boosts export trade thus proffering a solution that ensures overcoming the significant challenges that SMEs face, including but not limited to decreased borrowing credibility and increased costs associated with complementary financing.[356]

Factoring can provide fundamental export-import services to small and medium-sized companies locally. In the instance of a common impediment for companies in emerging markets trying to sell into export markets there is a unwillingness for foreign customers to work on credit letters. Companies in developed countries refuse to pay companies in developing markets on delivery because they need time to determine product quality. You also know that it could be challenging for companies in countries with slow judicial systems to receive a refund on returned or harmed goods.[357]

In case of no specific factoring legislation or regulations, existing legislation is applied or interpreted to propel dispute resolution. In common law jurisdictions, this case law can establish a factoring corpus of judicial law causing dissent on the principle of separation of powers that is a cornerstone of our constitution.[358] The United Kingdom is a relevant nstance where, due to a lack of specific laws governing the factoring, the party's resort to drawing up long factoring contracts to ensure that the documents clarify and cover possible areas of dispute to prevent the need to interpret the contract legally.[359]

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[355] Priest-Stephens, L. and E. Kameni 'Building a Model' Trade and Forfaiting Review 1 June 2016 http://www.tfreview.com/feature/regions/building-model.pdf Accessed 7 March 2019

[356] Gakeri, J. K. (2015). *Financial Services Regulatory Modernization in East Africa*: The Search for a new. International Journal of Humanities and Social Science

[357] Klapper L (2005). The Role of Factoring for Financing Small and Medium Enterprises. The World Bank.

[358] Hamanyati, M. (2017). *Factoring as an international trade finance product: making a case for the enactment of a factoring act in Zambia* (Doctoral dissertation, University of Pretoria).

[359] Priest-Stephens, L. and E. Kameni 'Building a Model'(2016) *Trade and Forfaiting Review* 1 June 2016 *http://www.tfreview.com/feature/regions/building-model.pdf* (Accessed 13 January 2019).

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A parliamentary act would play a great role in establishing distinct protective measures and cement the relevant processes in factoring This would bolster the confidence of the financial community. Looking at contribution it would make to the development of jurisprudence as dispute resolution measures would take shape. The presence of a legislative act would support an excellent legal framework. Consequently, the country must position itself by applying the appropriate legal and regulatory framework to allow it to benefit from the myriad benefits of factoring.[360]

5.8: Shortcomings of Kenya's regulatory framework and implementing the model law

It is argued that this is an anomalous position for legislation to be adopted as the UK has, as has been demonstrably shown above, bodies are establishing regulations and supervising their law. Consequently, Kenya cannot claim to have recourse to English common law, which is continually evolving and interpreted to the change of policy and legislative framework in that jurisdiction that informs business and finance. The facts about the exact nature of a factoring contract in Kenya are immediately evident. It is clear. The Kenyan courts had no opportunity to rule on a factoring dispute. Furthermore, the different complications of the financial service in the current framework are not adequately covered.

Furthermore, suppose Kenya is to be an actor in the factoring area and draw foreign factoring companies into the jurisdiction. In that case, there needs to be harmonised the factoring law with generally accepted international standards. Aligning the legislation with international model legislation, as the factoring sector is predictable and stable, will certainly also facilitate international trade.

Some relevant issues, such as the Kenya proposed legislation, should address:

- Factoring processes and distinctive principle as in contract law.
- The rights and obligations of factors
- Law on receivables assignment and recovery of assets

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[360] 5 K Awani 'Africa Needs Facilitating Infrastructure to Tap 200 Billion Euros Factoring Growth' available at *www.biznisafrica.com* (accessed 10 September 2017).

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• Development of a Professional body to have oversight authority on the process in conjunction with other existing legislative systems

• International factoring contracts and the application of Private international law

• Best practise on international standards on dispute resolution

Although the Afreximbank Model Law offers numerous advantages, regulatory problems are inherently challenging. Firstly, there are cost implications for regulation. It will be necessary to finance the regulatory body to enforce the proposed law.[361] Funds may be raised by factoring companies' membership fee, which may, in turn, pay their customers an extra charge as in the UN treaty bodies. The minimal expertise in the processes of factoring is another obstacle. Regulators must have the necessary industry know-how so as to legislate effectively and ensure that the policies put in place are air-tight and relevant . The varying facets of accounts receivables and debt financing in the majority of African jurisdiction do not have sufficient jurisprudence. Training for professionals from various fields is therefore necessary in order to raise awareness.

The ban of assignments in the underlying contract is a common challenge considering that they are legal in Kenya. This puts the model law at loggerheads with existing jurisdictional procedure.[362] The validity of such prohibitions will affect the customer's right to take action against the customer, rather than the customer, is continuously nullified. In essence, this means that the debt cannot be factored.[363]

Another issue worth considering is insolvency and its effect on the factor's rights. The commencement of insolvency proceedings means under Kenya’s legal regime that no security holder can exercise the insolvent company's security interest. Nevertheless, the location of the factor is not precise. Given that the operational cash flow of the customer often passes through

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[361] Priest-Stephens L & Kameni E ‘Building a Model’ Trade and Forfaiting Review 1’ available at http://www.tfreview.com/feature/regions/building-model.pdf (accessed 13 January 2019).
[362] Istuk, I. (2015). The potential of factoring for improving SME access to finance. In *Research Handbook on Secured Financing in Commercial Transactions*. Edward Elgar Publishing.
[363] Reed, C. (2001). Managing Regulatory Jurisdiction: Cross-Border Online Financial Services and the European Union Single Market for Information Society Services. *Hous. L. Rev.*, *38*, 1003.

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accounts held or controlled by the factor, a continuation of the factoring facility may be preferable, especially if the customer enters the rescue proceedings.[364] This puts immense pressure on the could be legislators to ensure a balance in risks versus the rights accorded to a the factor to continue paying funds if such funds are not recovered.[365]

5.9: Chapter Conclusion

The establishment of the African Model Law on Factoring propels the continent into the natatorium of supply chain financing. The Model Act aims to encourage inclusive financing options as well as establishing a benchmark in order for African countries to implement modern, harmonious legislation leading to a unified approach and seamless intra African trade. The legal infrastructure cultivates previous existing regimes from UNIDROIT, UNCITRAL and IFG's corps of world-class model laws to further buttresses the pillar of to promoting international trade and business to provide access to finance to small and medium enterprises. Hence its provisions replicate those of previous models of legislation inextricably. This has led to the removal of restrictions on contracts imposed by law. These guidelines provided ensure African countries, act promptly can reinforce their private sectors and move forward slowly over decades.

Lack of access to finance is the common thread against the free potential of small and medium-sized businesses in the country. These small businesses are being incentivized by various players in the financial sector however the proper legal framework to meet their needs is still lagging behind. Regulation of policies such as factoring will bring in an aspect of professionalism, financial certainty, and a legal backbone for it to thrive and excel. It will also provide a foundation for formalizing KYC and AML processes for the SMEs'. This is because the law will

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[364] Salaberrios, I. J. (2016). *The effects of using invoice factoring to fund a small business* (Doctoral dissertation, Walden University).

[365] Priest-Stephens L & Kameni E 'Building a Model' Trade and Forfaiting Review 1' available at http://www.tfreview.com/feature/regions/building-model.pdf (accessed 13 January 2019).

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allow the regulator to keep track of the companies and will build investor confidence boosting economic development and the country's economic output[366]

Kenya's Banking and Financial Services Act of 2017 recognises that the Central Bank's final supervision is one of the financial services. The Act does not provide for factoring regulations. The Factoring Law, in its present form, is not sufficient to facilitate and promote this critical tool of trade finance.

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[366] Sarma, M., & Pais, J. (2011). Financial inclusion and development. *Journal of international development*, *23*(5), 613-628.

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CHAPTER SIX

CONCLUSION AND RECOMMENDATIONS

6.1: Introduction

That final chapter provides a conclusion to the proponents discussed as well specific recommendations to the proposed Act that can contribute to a sustainable legal framework to meet the ever-changing Kenyan financial inclusion landscape. These proposals are based primarily on best practices in previous discourse jurisdictions and adapted to the socio-economic realities in Kenya. The findings and recommendations of this paper will trigger the necessary steps to enact the proposed legislation.

SMEs contribute significantly of Kenya's GDP. The principal factor limiting their business activities, however, remains the lack of access to finance.[367] Small and medium-sized enterprises often do not get into conventional modes of access to finance because they nearly always have insufficient resources for security or other reasons such as a lack of loan history to cover banks. Moreover, in Kenya, the majority of SMEs are not registered officially, thus aggravating the problem. Innovative ways of attracting small and medium-sized enterprises to the formal sector, therefore require careful consideration and sustainable steps such as the implementation of laws keeping up with the modern trends.[368] The main topic of the paper was to propose a Factoring Act in to enable financial inclusion Kenya, which is based of the model legislation by Afreximbank.

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6.2: Summary of Chapters

The paper looked at Factoring, the origins of the Kenya's financial history that could allow for factoring and its influence on trade and financial systems in certain jurisdictions. South African statistics and case studies have illustrated that governments must improve the performance of

[367]Malhotra M, Chen Y, Criscuolo A, Fan Q & Hamel II (2007) 'Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises*(14)* available at *elibrary.worldbank.org* (accessed 15 January 2018)

[368] Hamanyati M 'Factoring as an International Trade Finance Product: Making a Case for the Enactment ofa Factoring Act in Zambia' available at *repository.up.ac.za* (accessed 13 Januay 2019)

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SMEs by adopting legislation and establishing institutions to supervise and promote the industry. It has been found that the industry accounts for 6 percent of South Africa's GDP as a correlation of a supporting and facilitating factoring framework.[369]

Chapter two provided a brief summary on Kenya's historical background and current financial legislative framework and outlined spaces for increasing economic development and financial access. Chapter two presented a legislative summary. The chapter evaluated the constellation of Kenya factoring statutes currently in place. Legislation has been dissected to assess the legal environment within which the proposed Factoring Act may have to align. Importantly, it has also been shown that existing legislation does not provide an adequate facility for regulating modern factoring intricacies. The chapter concluded that the current law in Kenya is not sufficient for regulating factoring.

Chapter three establishes that factoring is a suitable alternative facet of bank lending, highlighting the proponents crucial to financial inclusion. In particular, factoring has been found to offer numerous advantages over these traditional forms of lending and that while factoring may, on the one hand, be more costly than banking, it has the benefits of flexibility and accessibility which negate its disadvantages.[370]

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Chapter four provided a case study of South African factoring regulations. The study analyses the institutional factoring framework in South Africa, factoring and leasing costs and factoring success in South Africa. The chapter concluded that emerging economies should not attempt credit expansion and the development of the financial system. Instead, the financial system needs to create an environment that facilitates people's participation in the market system, and that provides services effectively.

Chapter five echoed the importance of financial inclusiveness with the personalised focus on efforts to tackle the terrible disparities prevailing on the continent by the AfDB and

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[369]Hamanyati, M. (2017) 'Factoring as an International Trade Finance Product: Making a Case for the Enactment of a Factoring Act in Zambia (Doctoral dissertation, University of Pretoria).

[370] Michalski G. 'Factoring and the Firm Value' (2008) FACTA UNIVERSITATIS Series: Economics and Organization, 5(1), 31-38.

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Afreximbank.[371] The chapter also draws in greater detail essential lessons from the global models on the factoring of the proposed Afreximbank Model Act.

The proposed law recognises that jurisdictions may deviate from certain provisions. However, such divergences must be evaluated carefully in order to prevent them from deviating from their core principles. This is reflected in the wording of IFG's 2014 forerunner model law.[372] The paper's recurring principle for implementing legislation anchored in the provisions of the Model Law, concluded in Chapter Five, which cited compelling reasons such as the need to harmonise law with international standards and to create a legal infrastructure to facilitate financial accessibility and economic development[373]

6.2: Chapter Conclusions

Factoring is accredited globally as an efficient banking supplement product that offers a wide range of advantages to SMEs that aren't covered by traditional forms of funding. The application of this product for private enterprise is caused by the rapid growth and development of the informal trading sector leading to redistribution of resources to all economic sectors. They are great contributors to the economic upturn and increased GDP in both developing and developed countries worldwide.[374]

Even with the great strides taken by Kenya's emerging economy, the problem of financial is still acute in the African continent. This problem has been exacerbated in this jurisdiction because factoring as a tool for financial inclusion remains unclear and unregulated[375] Besides the significant uncertainties about the product, it may also enhance the status of a piece of legislation that specifically governs factoring, as an alternative source of financing. Kenya will importantly

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[371] Oramah BO 'The Role of Afreximbank and IFG Africa Chapter in the Development of Factoring in Africa' Presentation at the First Symposium and Academy on Factoring in Africa available at *https://www.afreximbank.com* (accessed 15 July 2017)

[372] Kameni E 'An Insight into Recent Legal and Regulatory Reforms in Support of Factoring in Africa' (2014)

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serve as an exemplar of a state that has adjusted its factoring laws with international standards, thus attracting factoring businesses from abroad.

The study showed that a fragmented and dissecting financial regulatory system in Kenya, therefore, does not provide the necessary platform to offer financial service factoring.[376] Factoring outside the realm of CBK does not also allow for the regulatory framework, which, in turn, requires necessary legal modification to be made available in the regulatory legislation.[377]

The study found that the current regulatory framework was criticised as inadequate to for the financial services sector effectively today.[378] The framework includes duplication of regulation as one of the major challenges. In the case of countries with a weak information environment, it has been noted that factoring will increase access to finance for SMEs. The study showed that in countries with a more robust credit information system, factoring / GDP are higher. Factoring can also be of use in facilitating international trade for small and medium-sized enterprises, where factoring companies directly finance the working capital of exporters and collect foreign receivables from a global organisation of factors.[379]

The research concludes that factoring is not a replacement for bank loans, but rather an additional improvement. A replacement product would have a negative relation. Factoring may still address small and medium-sized businesses which face barriers to bank lending. In countries with a robust judicial system supporting creditors, factoring was seen to be more significant. In countries with less legal systems; however, the effect of factoring on SME's access to finance is projected to be greater.[380]

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The study concludes that regulators and supervisors of policies and regulations have a crucial role to play in the creation and implementation of the financial inclusion environment. Sound legal and regulatory frameworks that are effectively enacted promote market and competitive development while ensuring that financial institutions and agents are subject to sound and appropriate prudential regulation and rules of conduct to protect consumers and depositors and to ensure the stability of the market.[381]

In addition to various programs for poverty elimination and the generation of jobs, the government should also focus its attention on policy for financial inclusion to alleviate poverty from the human development index which combines health, education and revenue with GDP. It should be considered a means of alleviating poverty.

In the end, Kenya must therefore adopt a proper legal and regulatory framework so that it can take advantage of the myriad advantages that the factoring offers. SMEs are the economic lifeblood and therefore must be nurtured with sustainable mechanisms, such as supporting legislation.

6.3: Recommendations

The recommendations that support Kenya's Factoring Law based on model laws and lessons from other jurisdictions are as follows: A good piece of legislation must ensure a healthy balance between the interests of all concerned and the interests of society. Therefore, what is needed in the proposed Act is to be suggested as follows:

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Firstly, the government must encourage factoring enterprises through favourable tax treatment and additional incentives to speed up industry growth.[382] The case studies show that the favourable governmental treatment factoring businesses enjoyed is one of the elements that has

[381] Wang'oo, E. W. (2013). The relationship between financial inclusion and economic development in Kenya. *Unpublished MBA thesis, University of Nairobi*.
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intensified the factoring industry in this jurisdiction. Local, as well as foreign investors, are likely to consider making them a lucrative industry as a conducive legal environment.[383]

Secondly, the legislation must ensure that factors with affordable rates are compulsory credit insurance. In order to reduce the risk of the factoring services offered, the use of the credit insurance (CI) industry is essential. In the export industry, the risk of factoring services is exceptionally high. Across the globe, it is used in all kinds of debt-finance supported agreements to protect factoring arrangements. The law shall also allow foreign credit insurance firms in Kenya to be established and shall recognise, if prima facie authenticated and notarised, credit insurance certificates obtained from outside the jurisdiction. This will lead to trust and a willingness of factoring companies to take risks.

It is a compelling argument for and well-organized, consistent and independent dispute resolution system because the international sector has firmly secured its position on five continents. It is suggested that disputes be resolved by an arbitration tribunal comprised by three skilled, arbitrators with relevant expertise, who must be nominated in accordance to the contract concluded by the parties or in the absence of the agreement in conformity with UNCITRAL's Model Law on Arbitration rather than resolving international factoring disputes in domestic courts. This aligns itself with the arbitration practise in Kenya law.

There are several benefits of creating a professional body through legislation.[384] A professional body monitors the behaviour of its members, establishes an ethics code and offers its members an opportunity to build and maintain close business relations. Certain exercises that professional bodies usually undertake include publications, training courses and seminars and other forms of advocacy. Buy-in is likely to be made from different economic sectors if the industry is of the utmost importance.

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The Central Bank regulates all financial services in Kenya. Consequently, factoring legislation would play a complementary, specialised role in regulating its members' affairs. Empirical evidence shows that proactive factoring agencies were the centrepiece behind their countries' remarkable industry growth.[385]

It is thus advisable that the law should be enacted and that a factoring association should be created, which has the mandate to promote factoring growth in Kenya and to ensure the service meets global standards. The proposed association can also serve as a link between its international partners and the FCI.[386]

Finally, the study in answering the research questions determined that Kenya's financial regulatory system has a legislative history that is desirable and amenable. While dynamic, the introduction of factoring will improve services and will ensure inclusive access for small and medium-sized companies to finance to improve the regulatory environment.[387]

Secondly, it would foster a significant step forward in business economic development and the nation's overall socio-economic status as a means of financial inclusion. Financial regulation cannot derogate from its influence on financial inclusion, particularly in the banking sector.

To ensure the financial inclusion of Kenyan SMEs, the legislative framework is required to enact the Model Factoring Law in Kenya. In the first place, the regulation generally defines the parameters in which the factors can perform its activities and establishes a minimum standard to be respected. These standards will increase the industry's profile and inspire confidence in managing the company, improving inclusiveness in borrowing and loans. This will help to increase trust in the process and to use the factoring system, and to integrate the SME into the economy financially.

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