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RESEARCH ARTICLE

EFFECT OF PRUDENTIAL REGULATORY STANDARDS ON THE FINANCIAL PERFORMANCE OF DEPOSIT TAKING SACCOS IN KENYA

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ABSTRACT

Savings and Credit Co-operative is a financial institution that is owned and controlled by its members and operated for the purposes of promoting thrift, providing credit at low interest rates and providing other financial services to its members. Over the years the SACCOs expanded financially and even started banking like services which were called FOSA in attempt to increase efficiency in services delivery but instead led to illiquidity, capital inadequacy, poor credit management and low confidence among members. The rapid growth and such failures in the SACCO Sub-sector created the need for SACCO Specific legislation hence the enactment of the SACCO Societies Act (2008) to specifically regulate and supervise their operations. The purpose of this study is to establish the effects of Prudential Regulatory Standards on Financial Performance of Deposit taking SACCOs in Kenya. More in detail the study ought to establish the effect of liquidity management regulatory standards; loan provisioning requirements and core capital regulatory standards on Financial Performance of DTS. The relevant literature was reviewed to ascertain the knowledge gap left by earlier scholars. The target population of the study will be all 175 DTS registered and operate in Kenya which will be obtained through random sampling using Comparative research design. Secondary source of data will be used and data analysis will be done using both descriptive and inferential statistics with the aid of SPSS. The study findings indicated that Liquidity ratio as recommended by SASRA had the highest effect on financial performance of DTS in Kenya in Pre PRS era. Liquidity ratio and Loan allowance both had a high effect on financial performance of DTS in Kenya in Post PRS era. Further research should be conducted in the areas relating to risk management framework because DTS like any other financial institution are affected by risk factors and expound on other measures of performance.

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INTRODUCTION

According to Mudibo (2005), the importance of regulations is to hedge against the high risk attributed to imbalances in financial institutions balance sheets as they serve as prudential measures that mitigate the effects of economic crises on the stability of the financial institution system and subsequent accompanying macroeconomic results. Sound regulation means the institutions are able to achieve objective of giving cheap loans, as well as protecting member's savings. Basically, there are three arguments for financial regulation. The first is that regulation is needed for prudential reasons, Jackson *et al*. (1999). The other argument is that financial regulation is needed to counter moral hazard problems created by the regulator themselves (Benston and Kaufman, 1996). The final argument is that financial regulation is needed to protect small depositors (Craig and Hardee, 2007).

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SACCOs regulation and performance relate in that the regulations are meant to set specific requirements on the 6 tools used to measure performance (PEARLS) leading to a direct relationship (Financial Sector Deepening, 2009). SACCO Societies like any other financial institutions need regulations that guides them in their operation and take care of the general stake holders interests. According to Baskin *et al*. (2012), regulation is a supervision which subjects institutions to certain requirements, restrictions and guidelines with the aim of maintaining integrity of the financial system. In this case the institutions need to adhere to the guidelines and provisions that are issued from time to time from various regulators in daily conduct of their affairs. Prudential regulatory standards are standards provided to an institution to minimize risks and guarantee safety of member funds (Government of Kenya, 2008). The rapid growth of the SACCO Sub-sector created the need for SACCO Specific legislation hence the enactment of the SACCO Societies Act (2008) to specifically regulate and supervise their operations.

The enactment of the SACCO Societies Act, made provisions for licensing, regulation, supervision, promotion of SACCO Societies and establishment the SACCO Societies Regulatory Authority (SASRA). The government of Kenya established The SACCOs Societies Regulatory Authority (SASRA) under the Ministry of Cooperative Development and Marketing in an effort to reform SACCOs and ensures that there is confidence in the public towards the SACCOs sector and spurring Kenya's economic growth through the mobilization of domestic savings (Ministry of Co- operatives and Marketing, 2008). SASRA emphasizes that in accordance with vision 2030, the policy objective of establishing prudential regulation of deposit taking SACCOs societies is to enhance transparency and accountability in the SACCO subsector.

The SASRA regulatory framework spells out the minimum operational regulations and prudential regulatory standards required of a Deposit taking SACCO society. Chumo (2013) in his study on effects of regulatory compliance on financial performance of DTS pointed out that share capital a component of core capital; liquidity management systems and enhanced credit policies are the major and critical provisions that DTS need to comply with if they were to succeed under new regulation. For the purpose of the study the researcher has focused on the key considerations of the prudential regulatory standards; Liquidity desirable levels; Capital adequacy that is Core Capital and loan provisioning requirements. On liquidity desirable level Government of Kenya (2008), SACCO Societies Act advocates for 15% Liquidity ratio which is computed as total cash and cash equivalent divided by the summation of short term deposits and short term liabilities. Loan provisioning requirement was also a point of focus by the researcher.

According to SACCO societies Act no.14 of 2008 DTS should ensure that loan granting and lending confirm to the approved credit policy of the SACCO; classify in accordance with the classification criteria prescribed in the regulations. Capital adequacy requirement was also another subject the researcher was interested. Jansson (1997) defined capital adequacy as a relative measure and establishes the maximum level of leverage that a financial institution is allowed to reach on its operations. To regulate DTS in Kenya SASRA outlines the minimum requirements that DTS should have a Core capital of not less than shillings ten million**.**

Performance of Deposit taking SACCOs like any other financial firm can be measured using cash flow statements; industry set standards and financial ratios. Weston (1986) classifies ratios into six fundamental types; Liquidity ratios which measure ability to meet maturing short term obligations, Leverage ratios ,which measure the extent to which a firm has been financed by debt, Activity ratios which gauge effectiveness in use of resources, Profitability which measure management effectiveness indicated by returns on investments, growth ratios which indicate the firm's economic position in industry and valuation ratios which measure management ability to create market values in excess of investment outlay. According to Cole (2004) there are common examples financial performance including operating income, earnings before interest and taxes, and net asset value. For the purpose of this study the researcher measured financial performance of DT-SACCOs in terms of Net income before taxes and donations.

Statement of the problem

Before 2008 regulatory reforms which became operational in 2011, there were minimum conscious efforts made to regulate the SACCO subsector prudently because the organizations were not thought to pose any significant risk to the country' financial system. However, the organizations expanded financially and later exposed to illiquidity, capital inadequacy, poor credit management and low confidence among members. In lieu of these problems, in 2008 the government and the SACCO stakeholders formulated and legislated SACCO Societies Act 2008 and subsidiary deposit taking SACCO regulations of 2010 in a move to regulate and supervise DTS. According to Manyara (2003) the major problems facing SACCOs financial growth and protection of members' deposits were liquidity challenge; capital inadequacy; credit management and membership growth. Despite the critical role played by SASRA on improving management of DTS, there have been very few studies that have focused on establishing the effects of SASRA prudential regulatory standards on financial performance of deposit taking SACCOs in Kenya.Most of the previous studies have focused on credit risk management and SACCO financial performances; Gisemba (2010) undertook a study on the relationship between credit risk management practices and financial performance of SACCOs in Kenya. Gaitho (2010) carried out a study on survey of credit risk management practices adopted by SACCOs in Nairobi. From the above it is clear that there is need to determine the effects of prudential regulatory standards on financial performance of deposit taking SACCOs in Kenya, and this study will seek to address that and contribute further to the existing body of knowledge on the same subject.

Objectives of the Study

This study was guided by three objectives; (1) To determine the effect of liquidity management regulatory standards on financial performance of DTS in Kenya, (2) To examine the effect of loan provisioning requirements on financial performance of DTS in Kenya, (3) To access the influence of core capital on financial performance of DTS in Kenya.

Literature review

Theoretical literature

The agency theory was developed by Jensen and Meckling (1976) as a comprehensive theory of a firm under agency arrangements. According to Abdullah & Valentine (2009), agency theory explains the relationship between the principals, such as members and agents. In this theory, members who are the owners or principals of the Sacco, hires by electing the management board as their agent (Mitnick, 2006; Bruton *et al*., 2000). Principals delegate the running of business to the management board which in turn hire and delegate authority to the managers (Clarke, 2004). Agency theory explains how best the relationship between agents and principals can be tapped for purposes of governing a corporation to realize its goals. Since the owners of capital (principals) have neither the requisite expertise nor time to effectively run their enterprises, they hand them over to agents (managers) for control and day-to-day operations, hence, the separation of ownership from control, and the attendant agency problems.

The theory was important to this study because member, principals contribute such funds as deposits which are used by managers, agents to grant loans to the members. The managers need to adhere to loan provisioning regulatory requirement as outlined by SASRA to enable them continuously improve loan repayments hence profitability. This theory was also important to this study because share capital is part of core capital which is contributed by members of the SACCO who are now the principals and these are part of members' funds which are managed by board of directors through the hired managers, agents. This gives an agency relationship.

Empirical literature

On liquidity requirement and financial performance; Mutinda (2016) carried out a study in Kenya on the impact of prudential regulatory framework on financial performance of deposit taking SACCOs. The study used a regression model to access the relationship between the minimum liquidity requirement and financial performance of DTS and found that the liquidity requirement had the least impact in influencing financial performance of SACCOs in Kenya. A descriptive survey design found that the application of prudential regulatory requirement was even among all the SACCOs in Kenya. The study concluded out that though liquidity though was a requirement had little impact on financial performance.

Ireri (2010) carried out a study in Kenya on the effects of working capital policies on profitability of the SACCOs in Nairobi. Ireri used a multivariate regression model to explain the relationship between working capital management and profitability of a SACCO, A causal-effect research design was used and carried out on a sample of 35 SACCOs selected on systematic random sampling found that working capital management is important because of effects on firms profitability and risk and consequently its value. He concluded that firms with high liquidity working capital may have low risk then low profitability. Wanyoike (2013) carried out a study; effects of compliance to SASRA regulations on financial performance of SACCOs in Kenya. A multiple regression model was used to show the relationship of several compliance guidelines against financial performance of SACCOs and found that compliance liquidity requirement had a positive relationship with performance. Survey research design and a sample of 34 SACCOs were used.

In view of the above previous studies though the researchers used different research design and models in different environment they tend to concur that liquidity requirement is a key factor that determines the financial performance of DTS On loan provisioning requirement and financial performance; Nagash (2015) in the study conducted in Ethiopia, Non-performing Assets and Their Impact on Financial Performance of Commercial Banks in Ethiopia, found out that loan loss provision and capital adequacy ratios refleced an inverse and direct causal relationship with financial performance of commercial banks (ROA) respectively. Therefore, it is recommended that commercial banks in Ethiopia should enhance their capacity in credit analysis and loan administration while the regulatory authority should pay more attention to bank's compliance to relevant provisions of the bank and other prudential guidelines. A quantitative approach was employed for the required data collection and a sample of six commercial banks were selected for data collection on a cross sectional basis for nine years.

Ngaira (2011) did a study in Kenya on the impact of SACCO regulatory authority guidelines on SACCO operations in Kenya. The case of Nairobi deposit taking SACCOs which adopted descriptive research design and a sample of 50 SACCOs. Multivariate regression model was used look at the impact SASRA has had on SACCO performance since its inception. Based on this study, it can be concluded that, SASRA regulations has greatly impacted on the SACCOs performance in terms of outreach and sustainability. Most SACCOs reported recent improvement in their performance both in membership, portfolio and loan cycle and general efficiency. This was attributed to a number of factors ranging from increased membership, high efficiency, high demand and quick recoveries and one can easily attribute this to be as a result of SASRA regulatory framework. Metzemakers (2005), found a significantly positive impact of loan growth on provisions due to application of prudential regulations in his study carried out in Kenya. The main regulatory changes which affected provisioning were changes in loan classification standards, which were particularly intense in the late 1990s and early 2000s, when Japan tightened its guidelines on loan classification, which had come under attack for its overly slow recognition of problem loans (Packer, 2000).

Mbogo (2010) explains that the cost of running deposit-taking SACCOs is set to go up significantly due to the new regulations threatening the low interest rates regime that has for decades given the co-operative movement an edge over commercial banks in the lending market. The regulations covering 220 Deposit Taking SACCOs also known as FOSAs, with an estimated membership of five million and assets worth Shi 50 billion, demands that societies converting from the non-deposit taking to the deposit-taking platform invest in new banking halls and install sophisticated security equipment, including armed security personnel from the Administration Police and private security guards. Findings from the above previous studies carried out by different researchers who used different models tend to explain that credit management practices had a positive impact on financial performance of a firm.

On Capital requirement and financial performance; Kioko (2016) carried out a study in Kenya on effects of capital adequacy regulations of SACCOs. A descriptive research design was used and a sample of 35 SACCOs. Descriptive statistics was employed to access the impact capital adequacy regulations on SACCOs and the study concluded that SACCOs had benefited significantly from the regulations in various ways such as, managing credit risk, improved public confidence, providing a safety net for members' deposits, provision of operating capital, increased lending capacity, providing a base for future growth, and preventing insolvency. SACCOs had faced various challenges in complying with capital adequacy regulations. These were reduced pay-out on members' funds, recruitment of new members, restricted avenues for investment, and reduced lending capacity. Wanjiru (2012) did a descriptive study on the effect of financial regulation on financial performance of deposit-taking microfinance institutions in Kenya targeting the 6 deposit-taking microfinance institutions. The study found that the supportive Deposit Taking Microfinance Regulations of 2008 led to the improvement in financial performance of DTMs. The regulations contributed to increase in the value of loans outstanding, total assets of DTMs, the profitability of DTMs

and the respective shareholders' equity. The study recommends comprehensive impact analyses prior to implementation of new regulations in the financial sector particularly micro finance institutions; a long-term view when structuring regulatory framework to provide DTMs a clear view of the thresholds to attain on the path to institutional development and transformation (CBK, 2011). Meagher (2002) investigated the effects of capital adequacy requirements as the main regulatory tools for the financial institutions and found that the requirements performed two main duties. First, as a risk sharing function of buffering against losses and protecting depositors and limits the recourse to deposit insurance. Second, they limit the moral hazard issue of shareholders incentive to take on excessive risk in order to maximize share value. This positive correlation between capital and profitability has also been concurred to by Gale (2010) and Kerwer (2005) who all assert that increase in minimum capital requirements reduce the risk of bank distress which will then result in increased profitability.

Kahuthu (2016) on his study on impact of prudential regulations on financial performance of DTS in Kenya targeted a population of 124 SACCOs. He used comparative research design and linear regression to establish the impact of prudential requirements on SACCOs' financial performance and found that core capital requirement was also a strong predictor of financial performance after prudential regulations were enacted. This concurred with mutinda (2016) study that capital adequacy requirement had a positive impact on financial performance. Bouvatier, V and L Lepetit (2008) carried out a study in United states on the relationship between the return on equity and the capital asset ratio for a number of banks in the United States for the period from 1983 to1992 and his study showed that return on equity and capital asset ratio tend to be positively related. From the above previous studies it is evident that capital adequacy requirements which include core capital and institutional capital had a positive impact on financial performance.

METHODOLOGY

This study adopted a comparative research design because the study compareed performance of SACCOs in the period prior to enactment of regulations, 2008 and the period after regulations. The study population consisted of all 175 DTS registered under SACCO Societies Act in Kenya (The SASRA Annual Report, September 2017). The sampling frame in this study was a list of all 175 DTS in Kenya. The data used was of six years; financial years ending 31st December 2007 to 2009 and 2010 to 2012 (before and after SASRA regulations respectively. This study adopted a stratified random sampling method. The study made use of secondary data mainly from audited financial statements of the DTS in the sampling frame from the SASRAs' website. This was because the DTS are required to submit monthly, quarterly and yearly financial reports and there are penalties imposed on failures hence the data was considered appropriate. Data collection template as per appendix "A" was used to record and compile the data. All the collected data was cleaned, coded, and entered in to computer for fast and accurate analysis. Tabulation of data was done to summarize raw data and display the same in compact form for further analysis (Saunders, 2009). The summarized data was analyzed using descriptive and inferential statistics (Correlations and Multiple regression analysis).

To measure the relationship between the dependent and the independent variables multiple correlation analysis was used. Multiple linear regression models were applied to analyze the effect of prudential regulatory standards on the financial performance of DT SACCOs in Kenya.

RESULTS AND DISCUSSION

The researcher collected and analyzed data for six years: three years before the introduction of prudential regulatory standards (Before-PRS) in 2010 and three years after introduction of prudential regulatory standards (After-PRS): (2007-2012). The averages of the four variables for the first three years was used as Before-PRS data while the averages of the same variables for the last three years was used as After-PRS data. The data used enabled the researcher to find out the effect of Prudential Regulatory Standards on the financial performance of DTS in the study area. There was also a weak positive correlation between liquidity ratio and financial performance at r=0.361 in period before-PRS, There was a moderate positive correlation between core capital and financial performance of DTS before prudential regulatory standards (PRS) at r=0.586and finally, there was a strong positive correlation between loan allowance and financial performance of DTS in Pre-PRS era at r=0.999. The relationship between financial performance and core capital as well as loan allowance were statistically significant at P=0.001 and P=0.000 respectively. Also, There was a strong positive correlation between financial performance and liquidity ratio as well as Loan allowance at r=0.893 and r=0.998 respectively there was a moderate correlation between core capital and financial performance of DTS in Post PRS at r=0.642. The relationship between all the independent variables and financial performance of the DTS after PRS was statistically significant at P=0.000.

There was a strong relationship between all the independent variables (liquidity ratio, loan allowance and core capital) and financial performance of the DTS before the introduction of prudential regulatory standards in Kenya. From the findings in table 4.4, R represents multiple correlation and it shows a strong correlation between the variables at R=0.999 and 0.918 during before and after PRS eras while the coefficient of determination (R Square) is 0.997 and 0.844 which depict a strong relationship between the variables. The independent variables can statistically and significantly predict the dependent variable, $F(3, 29)=4.239$, $P<0.05$ in the period before PRS and $F(3, 29)=6.494$, $P<0.05$ at Post PRS which implied that the regression model is a good fit of the data.

Financial Performance= -1890191.184+6 2074.418X_1+2.3 83X_2+.040X_3+ € before PRS, the regression model obtained showed that holding all other factors constant a unit increase in Liquidity ratio results to increase in Financial Performance by 62074.418; a unit increase in Loan allowance increases Financial Performance by 2.383 while a unit increase in Core capital increases Financial Performance by .040 and Financial Performance= -154994107.864+4929440. 365X_1+1165 7198 .124X_2+ 1.896X_3+ € after PRS, the regression model obtained showed that holding all other factors constant, a unit increase in Liquidity ratio results to increase in Financial Performance by 4929440.365; a unit increase in Loan allowance increases Financial Performance by 11657198.124 while a unit increase in Core capital increases Financial Performance by 1.896 after PRS. Out of the three Independent variables, the Liquidity ratio had a statistically significant contribution to the financial

performance of the DTS before PRS while Loan allowance had a statistically significant contribution to the financial performance after PRS. The researcher sought to establish the effect of liquidity requirement on Financial Performance of DTS in Kenya. In this case the researcher used liquidity ratio to determine its effects on Net Income before Taxes and Donations. From the findings, it can be noted that there was a weak positive correlation between liquidity ratio and financial performance in Pre-PRS, (r=0.361, P=0.050). The relationship between the two variables was not statistically significant. There was a strong positive correlation between liquidity ratio and financial performance in Post-PRS era (r=0.893, p=0.000). Since P<0.05, there was a significant relationship between the two liquidity ratio and financial performance in Post-PRS era. The findings of this study were not in agreement with those of Mutinda (2016) which established that liquidity requirement had the least impact on influencing financial performance of SACCOs in Kenya.

The researcher sought to establish the effect of loan provisioning requirement on financial performance of DTS in Kenya. In this case the researcher used Loan allowance amounts to determine its effects on Net Income before Taxes and Donations. From the findings, it can be noted that there was a strong positive correlation between loan allowance and financial performance in the Pre-PRS era at (r=0.999, p=0.000). Since p<0.05 then there was a significant relationship between the two variables. The results of this study also revealed that there was a strong positive correlation Loan allowance and financial performance after PRS at (r=0.998, p=0.000). Since p<0.05 then there was a significant relationship between the two variables in post-PRS era. The findings of the study particularly on the above objective have been also supported by Nagash (2015) who found out that Loan loss provision reflected a direct casual relationship with financial performance of Commercial banks in Ethiopia.

The researcher sought to establish the influence of Capital Requirement on Financial Performance of DTS in Kenya. In this case the researcher used Core Capital to determine its influence on Net Income before Taxes and Donations. From the findings, it can be noted that there was a moderate positive correlation at r=0.586 between Core Capital and Financial Performance of DTS in Kenya in Pre PRS and a moderate positive correlation at r=0.642 between core capital and financial performance of DTS in Post-PRS. The relationship between core capital and financial performance was significant at p=0.001 in pre PRS and at p=0.0000 in post PRS. In regard to Core Capital and Financial Performance the findings of the study have also concurred with the findings of Meagher (2002) that there was a positive correlation between Capital and Profitability. This has also been attested by Gale (2010) and Kerwer (2005) who all assert that increase in minimum Capital requirement reduce the risk of bank distress which then results in increased Profitability.

Conclusion and Recommendation

According to data analyzed, the Liquidity ratio had a significant effect on financial performance of DTS in Kenya in relation to all other factors investigated by the researcher in pre-PRS era. Liquidity ratio also had a significant effect on the financial performance of the DTS in Post PRS. While the regulator provides the minimum Liquidity ratio that SACCOs should observe, the SACCOs should invest excess cash in profitable projects to derive more income rather than holding more cash and cash equivalent in the name of being liquid. However the study concludes that liquidity ratio has less effect or no effect on financial performance. From the findings of the study it is apparent that Loan allowance was a key indicator of financial performance of Deposit Taking SACCOs in Kenya. The study concludes that there exists a positive and significant association between Loan allowance and financial performance and that an increase in Loan allowance leads to an increase in financial performance due to fact that the management of SACCOs will employ stringent measures that will aid in loan recovery hence minimal default. The study concludes that Core Capital influences the financial performance of Deposit Taking SACCOs in Kenya. The study concludes that there exists a positive and significant association between Core Capital and financial performance and an increase in Core Capital leads to a positive and significant increase in financial performance of the DTS. Therefore this shows that Core Capital has an influence on financial performance. The study recommends that the Management of DTS should grow their loan portfolio while focusing on minimal loan default as this will also aid in improving financial performance.

While DTS continue to adhere to recommended Liquidity ratio to meet daily customers demand the Management of DTS should be encouraged to invest in more liquid assets. This will not only improve financial performance but it will also enable DTS meet their short term obligations as they fall due. More research and studies should be carried out to determine the effect of risk management framework on financial performance of DTS among other parameters such as quality of board, staff competence and implementation of strategic plan among others.

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