EFFECT OF CAPITAL ADEQUACY REGULATIONS ON SAVINGS AND CREDIT COOPERATIVE SOCIETIES IN KENYA: A STUDY OF DEPOSIT-TAKING SACCOS IN NAIROBI COUNTY

BY

ALICE MWENDE KIOKO

UNITED STATES INTERNATIONAL UNIVERSITY-AFRICA

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ALICE MWENDE KIOKO

A Research Project Report Submitted to the Chandaria School of Business in Partial Fulfillment of the Requirement for the Degree of Masters in Business Administration

UNITED STATES INTERNATIONAL UNIVERSITY-AFRICA

SPRING 2016
STUDY DECLARATION

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

Signed___________________________ Date____________________

Alice Mwende Kioko (625874)

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

Signed_________________________________ Date____________________

Dr. Amos Njuguna

Signed_________________________________ Date____________________

Dean, Chandaria School of Business
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ABSTRACT

The purpose of the study was to investigate the effect of capital adequacy regulations on savings and credit cooperative societies in Nairobi County. The study sought to answer three questions, namely: Why is it necessary for SACCOs to adhere to capital adequacy regulations? What challenges have SACCOs faced in complying with capital adequacy requirements and what strategies have SACCOs undertaken to meet the requirements for capital adequacy?

The study evaluated the requirements for commercial banks in Kenya as outlined by the Central Bank of Kenya as well as the requirements for SACCOs specified by SASRA in the prudential guidelines. An analysis of strategies that these institutions have undertaken to adhere to capital adequacy regulations, as enforced by their respective regulatory bodies, has also been described. This was done with comparison to commercial banks for strategies that are also applicable to SACCO industry. Finally the challenges that these institutions face in their efforts to comply with prudential guidelines of capital adequacy has been covered, with specific reference to SACCOs in Kenya and reviewing specific situations that have been encountered.

The design of the research was a descriptive study that sought to detail the effect of capital adequacy regulation on SACCOs. The population under study was the Front office Savings Activity, FOSA, operating SACCOs within Nairobi County whereby a census was taken of all 35 of these SACCOs operating within the county. Data collection was carried out by means of questionnaires and interviews with respondents being chosen randomly from within the SACCOs. Analysis was undertaken using SPSS software to determine any correlations and frequencies within the data.

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. The SACCOs had engaged in strategies to meet capital adequacy. Of these strategies, SACCOs found issuing new capital, increasing membership base, diversifying product base, adjusting dividend pay-out ratio, stricter
credit rating, matching share contributions to loan amounts guaranteed and reduced payment periods to be most effective.

The study recommends that managers of the SACCOs closely adhere to the requirements provided by regulation so as to continue to reap the benefits discussed in this study. Further, the study recommended a review of their lending rates via cost pricing methods to ensure that though the rates remain competitively low they yield adequate revenue to offset costs involved in provision of these products. Finally, more cooperation is required within Kenya Union of Savings and Credit Cooperatives (KUSCCO) to enable the SACCOs jointly overcome the challenges they still face.
ACKNOWLEDGEMENT

I would like to express my gratitude to my supervisor Dr. Amos Njuguna for the patient but critical guidance he gave me throughout the course of this study.

I appreciate my friends, Ojijo, Wangui, and Susan (to name but a few) for their continuous prayerful and moral support.

My greatest debt of gratitude is to my family; without whose help and enduring moral support this work could not have been written.
DEDICATION

This work is dedicated to my family, Daniel, Angelina, and Jeremiah.
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LIST OF ABBRVIATIONS

**BCBS**: Basel Committee on Banking Supervision

**BIS**: Bank for International Settlement

**BOSA**: Back office Savings Account/Activity

**CBK**: Central Bank of Kenya

**FOSA**: Front office Savings Account/Activity

**GOK**: Government of Kenya

**KUSCCO**: Kenya Union of Savings and Credit Cooperatives

**SACCO**: Savings and Credit Cooperative Society

**SASRA**: Sacco Societies Regulatory Authority

**WOCCU**: World Council of Credit Unions
CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the Problem

Credit unions are defined as “non-depository institutions mutually organized and owned by their members” (Saunders and Cornett, 2011, p. 65). Savings and Credit Co-operatives (SACCOs) are “user-owned financial institutions that offer both savings and credit services to their members” (Tache, 2006). As such, the terms, SACCO and credit union, refer to the same institutions but are used in different regions of the world. In Kenya, the common term used is SACCO.

The main purpose of these institutions is to promote the social and economic welfare of their members who could be both net savers and net borrowers. They pay an entrance fee and invest funds to purchase at least one share in the union. In addition, members are expected to deposit their savings in the credit union and these funds are only lent out to members and not the general public as is the case of commercial banks. Generally in establishing the credit union, members have a common bond, such as that of occupation or social association (Saunders and Cornett, 2011). An example of the latter could be a rural community youth group. As such SACCOs are integral to the social and economic development of the communities within which they operate.

According to Co-operative Bank of Kenya (1993), the co-operative movement in Kenya can be traced back to 1908 when the European farmers at Lumbwa, near Kericho, first established co-operative production and Marketing. Cooperative development was very slow due to discouragement by colonialists. However, it has evolved over the last 40 years into a powerful force for the social and economic transformation of the society in Kenya. The co-operative societies in Kenya cut across various sectors and activities such agriculture marketing co-operatives, teachers, tea, employee-based and community based (Co-operative Bank of Kenya, 1993).

The SACCO sub-sector is part of the larger cooperative movement in Kenya. There are two broad categories of co-operatives: Financial co-operatives (Savings & Credit Co-operative Societies- SACCOs) and Non-financial co-operatives (includes farm produce
and other commodities marketing co-operatives, housing, transport and investment co-operatives). Kenya has over 10,000 registered co-operatives and 5,000 active SACCOs representing the most developed co-operative movement in Africa (SASRA, 2012).

According to SASRA (2012), the total Sacco sub sector assets stood at Kshs. 293 billion an increase of 17.7% from Kshs. 249 billion in 2011. The total membership for the sector grew by 15% from 2.6 million members in 2011 to 3 million in December 2012. Total deposits for the sector stood at Kshs. 213 billion posting an increase of 18.4% from Kshs. 179.9 billion in 2011. Loans to members increased by 23% to stand at Kshs. 221 billion up from 179.9 billion in 2011.

Based on these statistics, it is quite apparent that in the past decade SACCOs have been growing at close to exponential rate. Due to this tremendous growth, Kenya has become a leading light in co-operative development in Africa having been rated number one in Africa and number seven in the world. The Kenyan SACCO subsector is the largest subsector in Africa with several of Kenya’s large SACCOs having capital base large enough to rival the banks. Deposit-taking Savings and Credit Cooperative Societies have dominated the SACCO sector business claiming 81 per cent of the entire industry worth (WOCCU, 2014).

SASRA (2015) reports an increase in the number of licensed Deposit-taking SACCOs at the end of the transition period granted by law to SACCOs that were conducting deposit-taking Sacco business before the regulations took effect, to build and attain the prescribed minimum licensing requirements. As at 18th June 2014, out of 80 deposit-taking SACCOs which were expected to be licensed under this window, only 49 managed to achieve the minimum licensing requirements, and were subsequently licensed. The remaining 31 SACCOs were directed to cease deposit-taking business, close down their existing deposit-taking business and revert to non-deposit taking business popularly known as Back Office Service Activity (BOSA) business. This brings the total of licensed SACCOs to 181 at the end of the year 2014.

The SACCO sub-sector recorded growth in the total asset base of the 181 deposit-taking SACCOs which grew by 17.2%. This was funded principally by members’ deposits which also grew by 12.7% and is also attributed to growth in membership from 2.6 million to 3 million representing 15.30% growth. Table 1.1 below shows this growth.
Table 1. 1 Growth in Key Performance Indicators

<table>
<thead>
<tr>
<th>Measure</th>
<th>2014</th>
<th>2013</th>
<th>% Growth</th>
</tr>
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<tbody>
<tr>
<td>Assets (Millions Kshs)</td>
<td>301,537</td>
<td>257,368</td>
<td>17.20%</td>
</tr>
<tr>
<td>Deposits (Millions Kshs)</td>
<td>205,974</td>
<td>182,683</td>
<td>12.70%</td>
</tr>
<tr>
<td>Loans and Advances (Millions Kshs)</td>
<td>228,524</td>
<td>197,409</td>
<td>15.50%</td>
</tr>
<tr>
<td>Capital Reserves (Millions Kshs)</td>
<td>43,086</td>
<td>32,991</td>
<td>30.60%</td>
</tr>
<tr>
<td>Membership</td>
<td>3,008,497</td>
<td>2,609,300</td>
<td>15.30%</td>
</tr>
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</table>

(SASRA, 2015)

It is, thus, impossible to disregard the integral role that these institutions play in provision of financial services to their members. According to Owen (2007), SACCOs are a big contributor to the Kenyan economy, and are also a major player in the financial market as providers of loans. Their primary role in the financial market is financial inclusion – the provision of loan facilities to low income earners who do not meet the credit criteria set forth by commercial banks especially with regard to collateral. As such SACCOs meet the financial needs of non-salaried and other low income earners.

Up to the mid-1990s, a key element of the Kenyan co-operative movement was its extreme dependence on direct government support, partly due to the historical evolution of these organizations in the country. As mentioned earlier, cooperative societies were molded by the colonial government to serve the interests of the white settlers who were agitating for more agricultural services from the government. The colonial government, therefore, allowed the formation of cooperatives as its instruments for providing services to the white farmers and went on to bar Africans from participating in these enterprises through strict legislation (Wanyama, 2005). At independence, the government sought to use co-operatives as instruments geared towards promoting economic development in the country, especially in the rural areas. The introduction of a legal framework for all types of cooperatives in 1966, The Co-operative Societies Act, Cap.490, facilitated state controlled promotion of cooperative development as this framework dictated strict supervision of co-operatives by the government (Wanyama, 2005).

By the end of the 1980s, co-operative development in Kenya had been, to a large extent, impeded by the state, such that the cooperatives could barely survive without government and donor support (Wanyama, 2005). Economic liberalization that followed the implementation of Structural Adjustment Programs (SAPs) during this period launched a
new economic environment by the early 1990s, which demanded government withdrawal from the co-operative sector. This led the government to make amendments to the Co-operative Act (Wanyama, 2005). The 1997 amendments to the Co-operative Act, Cap 490, enabled SACCOs to make investments without approval from the Ministry of Cooperatives. (Republic of Kenya, 1997) This eliminated, to a great extent, bureaucracy from the day-to-day operations of the societies but also increased the risk of making unsound investments.

The financial crisis of 2007-2008 was marked by acquisition, bankruptcy, receivership and government bailout for several banks in the United States and Europe. This caused a contagion with effects trickling down to other nations and not limited to banks as other deposit taking financial institutions were invariably affected (Basel Committee on Banking Supervision, 2010). The Basel Committee on Banking Supervision (BCBS) thus recognized inadequate regulations in the banking sector as pertains to capital and risk allocation for assets. The framework for Basel III was published in 2011 with an aim to strengthen the stability of the financial sector by introducing stricter capital ratios for banks.

Some SACCOs suffered in this recent bank crisis. Therefore, the timely establishment of SACCO Societies Act 2008 places the licensing, supervision and regulation of deposit taking under the SACCO Societies Regulatory Authority (SASRA). Through this new legal framework, prudential regulations have been introduced to guide SACCO’s growth and development by way of monitoring capital adequacy and liquidity amongst other key performance indicators (Mudibo, 2005).

The Ministry of Co-operative development and marketing facilitated the enactment of the Sacco Societies Act 2008. The enactment of the Sacco Act 2008 in 2010 led to the establishment of Sacco Societies Regulatory Authority (SASRA) with a mandate to license and regulates all deposits taking SACCOs. The Act also set up a depositor’s protection fund meant to reimburse depositors part of their savings in the unlikely event that a SACCO collapses (SASRA, 2012).

1.2 Statement of the Problem

Despite holding huge amounts of money, SACCOs have largely operated outside the radar of authority, unlike the banks, MFIs, capital markets or the insurance industry. The
sub-sector has been largely under the purview of the Commissioner of Cooperatives, which used the weak provisions under the cooperative Societies Act, No. 12 of 1997 and the Rules made there under to supervise their operations. This situation exposed member’s funds to a lot of governance, liquidity and capitalization risks. However, with advent of liberalization, the activities of SACCO Societies rapidly evolved to include a wide range of financial services and products such as Front Office Service Activities (FOSAs), transfer payments, insurance, and ATMs under the oversight of ill-equipped co-operative officers (Co-operative Bank of Kenya, 2008).

In the advent of the SACCO bill, the WOCCU carried out a study, Regulatory Impact Assessment, to gauge the extent to which SACCOs were ready to comply with the requirements of the proposed bill once it was passed as law. The study concluded that out of the 148 FOSA operating SACCOs surveyed, only seven would comply (WOCCU, 2005).

The study established that one of the major reasons was that many of the SACCOs were undercapitalized putting members’ funds at risk. In addition, a large percentage of their loan portfolios constituted non-performing loans. Some of these loans were not recoverable due to members over-guaranteeing each other and continued to attract interest with no provisions made. Furthermore, there were no prudential guidelines set as a benchmark of performance intrinsically and comparatively creating an unstable operating environment. Finally, the entirety of SACCOs’ capital was held by members and used to guarantee against loans as such liabilities greatly exceeded assets contributing additionally to the unstable operating environment (WOCCU, 2005).

Since the ratification of the SACCO Act in Kenya, prudential guidelines were set forth for the continuous licensing of FOSA operations. Makori, Munene and Muturi (2013) explore the challenges facing deposit-taking Savings and Credit Cooperative Societies’ regulatory compliance in the Gusii region of Kenya following the commencement of the SACCO Act. Ngaira (2014) studies the impact of SACCO regulatory authority guidelines on SACCO operations in Kenya specifically examining the level of knowledge and understanding that SACCOs have in respect to the SASRA proposed regulations and supervision and any improvement in the performance of the FOSA’s as a result of the new SASRA regulations.
Of particular interest in this study is the SACCO compliance with regard to capital adequacy requirements that were set up as prudential standards in the new regulation administered through SASRA, especially with the lapse of the four year grace period prescribed in the SACCO Act 2010.

**1.3 Purpose of the Study**

The purpose of the study was to investigate the effect of capital adequacy regulations on savings and credit cooperative societies in Kenya.

**1.4 Research Questions**

The study was undertaken with a view of answering the following questions:

1.4.1 What benefits have accrued to SACCOs as a result of adherence to capital adequacy regulations?

1.4.2 What challenges have SACCOs faced in complying with capital adequacy requirements?

1.4.3 What strategies have SACCOs undertaken to meet the requirements for capital adequacy?

**1.5 Significance of the Study**

**1.5.1 SACCO Management**

This study is an informative tool to SACCOs that are not yet in complete compliance to capital adequacy regulations on strategies they may undertake to adhere to said regulation so as to obtain licensing. It will serve to advise supervisory committees of the SACCOs of the current state of their industry with regard to the said regulation and thus enable them to make future plans for their organizations.

**1.5.2 Government**

The research carried out through this study serves to provide information to the government and relevant bodies such as SASRA on the challenges that SACCOs have faced in meeting with set guidelines. Thus the government can strategize on actions to take to provide necessary support to these financial institutions.
1.5.3 Academics, Scholars and Researchers

The study provides a knowledge base for scholars with regard to capital adequacy in SACCOs which is not as available as with other financial institutions such as commercial banks and insurance companies. It also opens the way for more extensive research with regard to specific models of capital adequacy that may be most appropriate for SACCOs in Kenya.

1.6 Scope of the Study

The study sought to investigate the effect of regulation on SACCOs in Kenya limited to regulations with regard to capital adequacy requirements. The research will be carried out among FOSA operating SACCOs within the Nairobi region.

The study had a time scope of the past five years spanning from 2010 to 2015. The period of study begins with the establishment of SASRA as the regulatory body for SACCOs in Kenya.

1.7 Definition of Terms

1.7.1 Capital Adequacy

Capital adequacy is a “measure of the financial strength of a financial institution, usually expressed as a ratio of its capital to its assets” (Saunders and Cornett, 2011, p. 612).

1.7.2 Savings and Credit Cooperative Societies (SACCOs)

Savings and Credit Co-operatives (SACCOs) are “user-owned financial institutions that offer both savings and credit services to their members” (Tache, 2006). They are also referred to as credit unions in some parts of the world.

1.7.3 BOSA –Back office Savings Activity/Account.

This is the SACCO activity where members Save on a regular basis but cannot withdraw the deposits unless they are leaving the SACCO (Procasur Africa, 2012).

1.7.4 FOSA – Front Office Savings Activity/Account.

This is the SACCO activity where withdrawable deposits are held and members can withdraw them at will depending on the product features (Procasur Africa, 2012).
1.7.5 Capital

Capital refers “principally to the funds contributed by the owners of a financial firm” (Rose and Hudgins, 2005, p.483).

1.7.6 Core Capital

Core Capital may be defined as fully paid up members’ shares, retained earnings, disclosed reserves, grants and donations all of which are NOT meant to be expended unless on liquidation of the Sacco society (WOCCU, 2005).

1.7.7 Institutional Capital

WOCCU (2005) defines institutional capital as “the total of the SACCO’s regulatory reserve account, undivided or retained earnings, special reserves, and net income that has yet to be closed to the retained earnings account.”

1.7.8 Risk-weighted Assets

These refer to loans that are held by a financial institution as assets that have been categorized into baskets according to their various associated risk (Basel Committee on Banking Supervision, 1999).

1.7.9 Credit Risk

Credit risk is defined as the inability to repay loans in accordance with the contractual agreement (McKillop & Wilson, 2014).

1.8 Chapter Summary

In this chapter, the history of the co-operative movement in Kenya with specific reference to SACCOs is advanced. It is evident that the shift from state control to control by members necessitates regulation by the government to ensure that the needs of the members are the focal point of operations, and to ensure that SACCO operations are sustainable. The key area of government regulation of SACCOs has been with respect to capital requirements.

The next chapter constitutes the literature review. In this chapter, the paper sought to address the case for capital adequacy with respect to other deposit-taking financial institutions, primarily commercial banks. An analysis of the challenges that these institutions face in their efforts to comply with prudential guidelines of capital adequacy
was also forthcoming. Of interest, also, were strategies that these institutions have undertaken to adhere to capital adequacy regulations, as enforced by their respective regulatory bodies.

Chapter three presents the framework of the research detailing the research design employed, sampling techniques used, data collection methods undertaken and the processes carried out in data analysis.

Chapter four presents the findings of the study obtained by administering the data instrument. These results are presented in tables and charts illustrating the responses to the research questions.

Chapter five constitutes a discussion of the findings in relation to the literature reviewed. It also presents the conclusions drawn from the study and outlines recommendations for further study.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter seeks to review literature on the effect of capital adequacy regulations on deposit taking SACCOs. The chapter is divided into three broad categories in response to the study’s research questions. The first section reviews the current regulation on capital adequacy and enumerates some of the benefits that accrue as a result of adherence to this regulation. The second section analyses the various strategies that different SACCOs have undertaken to comply with the regulation set forth. The third and final section evaluates some of the challenges that these SACCOs have experienced in efforts to comply with the set regulations.

2.2 Benefits of Adhering to Capital Adequacy Regulations

2.2.1 Meeting Regulatory Standards

One key aspect common to various sectors that make up any economy is the presence of a body with authority to determine standards of operation for the sector involved. In the financial sector, regulators are defined for each type of financial institution. For commercial banks, the Federal Reserve or Central Bank is the regulatory authority. In Kenya banks are regulated by the Central Bank of Kenya, whereas insurance companies are regulated by the Insurance Regulatory Authority. Deposit-taking SACCOs are regulated by Sacco Societies Regulatory Authority, SASRA.

2.2.1.1 Central Bank of Kenya Prudential Guidelines

These guidelines apply to institutions licensed under the Banking Act of Kenya. The Central Bank of Kenya (CBK) dictates minimum capital requirements as they apply to commercial banks and non-bank financial institutions. These guidelines have been heavily influenced by the Basel Accord. It states that an institution’s minimum capital requirement will be calculated by dividing the total capital by the sum of the risk-weighted assets for credit risk, market risk and operational risk. Institutions under these guidelines are required to maintain a core capital of not less than eight per cent of total risk weighted assets plus risk weighted off-balance sheet items, and not less than eight per
cent of its total deposit liabilities; and a total capital of not less than twelve per cent of its
total risk weighted assets plus risk weighted off-balance sheet items. In addition, they
must maintain a capital conservation buffer of 2.5 percent over and above these minimum
ratios to enable the institutions withstand future periods of stress (Central Bank of Kenya,
2006). This is shown in the table 2.1 below.

Table 2.1: Capital Requirements: Commercial Banks in Kenya

<table>
<thead>
<tr>
<th></th>
<th>Core Capital to Risk Weighted Assets</th>
<th>Total Capital to Risk Weighted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Ratio</td>
<td>8.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Conservation Buffer</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Minimum plus Conservation Buffer</td>
<td>10.5%</td>
<td>14.5%</td>
</tr>
</tbody>
</table>

2.2.1.2 SASRA Prudential Guidelines

According to the SACCO Act of 2008, SACCOs have to provide a minimum core capital
of not less than KES 10 million as shown in their financial statements. However, newly
founded SACCOs have to provide this evidence through submission of bank statements.
All SACCOs have to comply with three capital adequacy ratios as stipulated in the
Regulations. The Regulatory requirements on these are that the SACCOs are to have and
maintain at all times a core capital of not less than KES10 Million, a core capital of not
less than ten percent of total assets, an institutional capital of not less than eight per cent
of total assets and a core capital of not less than eight per cent of total deposits.WOCCU
PEARLS guidelines provide for10-20% member share capital and 10% institutional
capital (WOCCU, 2005)

According to the PEARLS standards, prescribed by WOCCU, institutional capital should
represent 10% of the SACCO’s total assets. WOCCU maintains a higher than Basel
standard of 10% of total assets because SACCOs typically face higher risk in volatile,
minimally regulated markets with high levels of geographic concentrated risk
(Richardson, 2002).
It follows, then, that a SACCO that wishes to undertake FOSA operations must consider capital adequacy, at the bare minimum for purposes of meeting regulatory requirements, to ensure continual licensing by SASRA – which is on an annual basis.

2.2.2 Credit Risk Management

One of the primary income-generating activities of depository institutions of any kind is advancement of loan facilities to their clients. Depository institutions play a crucial role in modern economies due to their ability to transform liquid deposits from the liability side of their balance sheets into loans as illiquid assets on the asset side (McKillop & Wilson, 2014).

Doing this, they create liquidity for both depositors and borrowers who in turn can then realize their most desired consumption or investment plans, respectively. This kind of transformation provided by financial institutions is a source of risks of which credit risk, the risk of borrower default, is probably the most important one. This poses a risk to the organisation; the risk that funds lent out will not be recovered as per the agreement constituting the principal amount and the interest (Welzel & Pausch, 2002).

The Basel Accord exemplifies regulation of capital on an international scale. From, the 1980s regulators in the banking sector concluded that regulatory control over risk taking by banks is best centered around a bank’s owner’s and thus focusing on capital. According to Rose and Marquis (2008), the main premise was that when a bank chooses to take more risk, owners should increase their financial commitment by supplying more capital. Since shareholder capital is expensive to raise, and can be lost completely if the bank fails, it follows that owners will monitor risk more closely and ensure prudent management of the bank. If a depository institution suffers losses it will reduce the value of operating profits. However large provision for debts may be greater than the operating profits and these excess losses will have to be absorbed by the bank’s capital (Goacher, 2003). Sufficient capital is therefore necessary for risk management within banks and other financial institutions with demand deposits such as deposit taking SACCOs.

This applies to other financial institutions as well. This set the ball rolling for international banking regulatory standards which have formed a basis for regulation of other depository institutions aside from commercial banks. While Basel standards are not directly applicable to the Credit Union industry, the capital standards creation process for
the Credit Union industry is influenced by the Basel standards. This is exemplified in view of the provision of the SACCO Act 2008 whose structure closely resembles that of Basel. In addition the Act provides for the establishment of a risk reserve out of the SACCOs profits to safeguard loss of capital.

### 2.2.3 Public Confidence

“Money and capital markets and the financial institutions that operate within them depend heavily on public confidence” (Rose and Marquis, 2008, p.95). The financial system works to channel credit funds to their most productive uses only if individuals and businesses are willing to save and entrust their savings to financial institutions and only if other businesses and institutions are willing to rely on the financial system to provide credit to support their consumption and investment. Government regulation with regard to capital adequacy assures the public of the soundness of the institutions they interact with as depositors or borrowers (Rose and Marquis, 2008).

According to Rose and Hudgins (2005), capital adequacy promotes public confidence and reassures creditors (including depositors) concerning an institution’s financial strength. Capital must be sufficient enough to reassure borrowers that the financial institution will be able to meet their credit needs even if the economy takes a turn for the worse.

The financial community creates in the public a certain level of confidence. This confidence is strengthened by external checks by credit agencies, through scrutiny of published accounts and by bank regulation through prudential supervision. As such, government regulation serves to promote public confidence in the financial system, so that savings flow smoothly into productive investment, and payments for goods and services are made speedily and efficiently. This secures the national payment system. Unless the public is confident enough in the safety of their funds, placed under management of financial institutions, they will withdraw their savings thereby reducing volume of funds available for investment and in the long-run stunting the growth of the economy (Gleeson, 2006).

Capital adequacy requirements generally aim to increase the stability of a SACCO by decreasing the likelihood of failure, this move is also seen to promote public confidence in the institution. Regulation offers a basis of rating the performance of a financial
institution and hence public opinion is formed. The public will have confidence in an institution that meets regulatory requirements (Kivuvo & Olweny, 2014).

Regulation of capital also brings confidence in the SACCOs, which is a prerequisite for the SACCO sub sector to attract new members and professionals who have shied away due to perceived bad governance practices. A prudentially regulated and financially sound SACCO business attracts new business, offers better financial services, effective governance mechanisms and lower risks of failure, for instance a number of government initiatives have approached SASRA to issue them with a comprehensive list of licensed SACCOs through which they can channel devolved funds (SASRA, 2011).

2.2.4 Safety Net

A safety net refers to a set of policies designed to prevent loss of capital that may lead to bank failure (Demirguc-Kunt, 2000). Policymakers often argue that the safety net is essential for a healthy banking system and the economy. A key element of a safety net is prudential regulation and supervision as is accounted for in capital adequacy regulations. The safety of depositors’ funds remains the major concern of bank regulators worldwide. It is in this respect the capital adequacy regulation becomes relevant and important. According to Demirguc-Kunt, capital held by banks in accordance with set regulations provides a buffer against risky assets therefore hedging against failure.

In most countries, capital regulations attempt to provide this assurance, since a well-capitalized financial institution will have a cushion of protection. The main concept is to create a capital buffer that insulates the safety net from loss by forcing the institution to recapitalize or close if a certain threshold is crossed. Whichever methods of providing a safety net are used, the important issue is to remember that the purpose of prudential regulation and supervision is to retain an adequate capital cushion in the banks that would act as a credible margin of private loss on bank shareholders and uninsured creditors. In essence, as long as the capital remains above the threshold, there exists a safety net to protect depositors’ funds (Wilcox, 2011).

According to Gleeson (2006), the capital adequacy ratio is an important measure of “safety and soundness” for depository institutions because it serves as a buffer or cushion for absorbing losses. Thus, it has become one of the major benchmarks for SACCOs.
2.2.5 Providing Adequate Capital for Operations

Deposit-taking SACCOs hold members deposits that may be withdrawn at any time by the members. These are demand deposits as they are held by the SACCO at the convenience of the member. As such, these act as liabilities to the SACCO. Deposit-taking SACCOs in this manner carry out functions similar to commercial banks (Duncan, Njeru, Member & Tirimba, 2015).

One of the primary roles of capital in depository institutions is to support their operations by absorbing shocks from unexpected events. The greater the proportion of operations that is financed by capital, the more likely an institution will survive periods of adversity. Capital provides a cushion to fluctuations in earnings so that the institution can continue to operate in periods of loss or negligible earnings. It also provides a measure of reassurance to the members that the organization will continue to provide financial services (Wilcox, 2011).

Capital is integral to cash management within deposit taking institutions. Holding sufficient amount of capital, allows for injection of more cash into working capital during periods of cash shortages, whereas withdrawal of cash is done in periods of surpluses. The availability of funds that are not part of demand deposits reduces operational risk allowing for successful business operations in the short term (Duncan et al., 2015).

2.2.6 Increased Lending Capacity

Capital ratio is the proportion of capital with regard to risky assets, in this case, loans. The ability of a financial institution to lend to its customers may be determined by its capital ratio. If the institution holds capital to the extent that its capital ratio is greater than industry requirements, it then has room to increase its loan portfolio. Generally speaking, institutions with higher capital-asset ratios are given more freedom to manage their portfolios (Rose & Marquis, 2008).

Kibui and Moronge (2014) argue that savings and credit cooperatives with adequate capitalization and substantial deposits have a larger capacity to lend. The inverse is true, SACCOs with low capitalization struggle to avail funds to lend to their members and concurrently comply with capital adequacy regulations. Therefore, a SACCO that exceeds the required ratios is free to increase and diversify their loan portfolio which in the long
run increases potential income generated as loans are the primary income generating instrument for SACCOs.

Mulwa (2013) reinforces this premise with the conclusion that the number and volume of loans given by a SACCO were linked to the amount of funds at the disposal of the SACCO. The results of the study showed that the majority of respondents agreed that their SACCOs gave more loans when they had more funds. This implies that most of the SACCOs would increase the volume and number of loans when they had the funds. Thus adequate capital results in increased lending capacity.

2.2.7 Provides a Base for Future Growth of SACCO

Financial stewardship is paramount to the growth of a SACCO. In their study, they argue that SACCOs in Kenya have been investing over the years with the objective of maximizing their wealth. As is the case with all investments, wealth maximization is a key objective whenever SACCOs have chosen an investment avenue from a universe of possible investment vehicles. Lack of sufficient growth of SACCOs’ wealth has made it difficult for them to absorb their operational losses, which has threatened their sustainability. This has led to the losses being absorbed by members’ savings and share capital, hence loss of members’ savings (Olando, et al, 2013).

Savings mobilization should hence be backed by adequate institutional capital which ensures permanency, provide cushion to absorb losses and impairment of members’ savings (Evans, 2001). The institutional capital which comprises the core capital and less share capital is mainly accumulated from appropriation of the surpluses as retained earnings.

Therefore, SACCOs should strive to maximize on the earnings to build the institutional capital as it ensures the permanence and growth of the SACCOs even in turbulent economic times (Evans, 2001). In fact, it helps the SACCOs to grow and, remain economically and financially viable. Essentially, SACCOs ought to generate income sufficient to cover all its operational costs, and enhance the institutional capital. As such, adherence to capital adequacy requirements serves to support growth as a free source of funds is available from retained earnings as opposed to external borrowings.
2.2.8 Prevent Insolvency

The ability of a financial institution to meet demand for deposit withdrawals and other cash outflows is a visible indicator of its viability. If a credit union cannot meet depositor withdrawal requirements, general creditor expenses, or if it is forced to significantly limit new lending, a lack of member confidence can develop (Llewel, 2006). Thus core capital which was mainly lacking in SACCOs before legislation is a cushion to retain cash in the business as a way of improving liquidity.

Ademba (2011) reports on cash management and insisted that cash management must be the most important item for financial institutions to avoid panic withdrawals and hence the SACCOs must maintain cash and cash equivalents of 15% ratio to short term deposits and short term liabilities. Without adequate provisioning the SACCO insolvency risk increases and the SACCOs financial base continuously weakens. Weak liquidity can be overcome by strong capital position.

2.3 Challenges in Complying with Capital Adequacy Requirements

2.3.1 Separating Capital from Member Deposits

The regulation of capital requirements has come with its challenges. For banks and other financial institutions that are regulated under the Basel Accords, a major challenge has been in attaining the minimum requirements. Another challenge has been in the definition of tier 1 and tier 2 capital and subsequent calculation of the relevant risk ratios, based on appropriate weighting of risk assets. This has posed a major setback in meeting the deadlines set for compliance with relevant regulation (Auer, Pfoestl, & Kochanowicz, 2011).

Similar challenges are being faced by SACCOs in the country. A number of SACCOs cannot meet the minimum capital requirements and ratios, especially within the period specified by SASRA for implementation. SASRA specifies a four year period for complete compliance with capital regulations starting from the date of original licensing. Failure to meet with these regulations results in delicensing of the SACCO in question (Cooperative Bank of Kenya, 2008).

Some SACCOs have not separated capital from members’ deposits. This is necessary as the capital, institutional capital - institutional capital refers to the portion of core capital that cannot be claimed by an individual which constitutes retained earnings, reserves,
grants and donations - that is used to determine capital adequacy, must be separate from that which members have a claim on. In addition, many SACCOs have not separated members’ contributions to adequately account for portions that constitute withdrawable deposits and those portions that make up share capital and ultimately constitute the institution’s share capital. SACCOs also face difficulties in comprehending constitution of the core capital and subsequent calculation of the capital ratios (SASRA, 2012).

In a bid to separate capital from member deposits, SACCOs have been retaining more earnings thus paying out lower dividends. The SACCOs are faced with the hard choice of reducing payouts to members who have been earning higher returns for their deposits. The savings institutions were not retaining any earnings before introduction of the new rules in 2010. The institutional capital threshold is set at a minimum of eight per cent of total assets but as at the end of 2012 the industry average was five per cent. The Kenya Police Sacco was among the first to retain earnings taking Sh300 million in 2012 that helped push its capital adequacy ratio to eight per cent from five per cent (Ngigi, 2013).

SACCOs have been forced to offer members incentives for raising the capital that cannot be withdrawn from the institution. Police Sacco paid a dividend rate of 17 per cent for share capital compared to 9.5 per cent paid on deposits. Nation Sacco paid a dividend of 18 per cent in 2012, helping it meet the individual members’ share capital level of two per cent of total assets. The high rate of return is meant to compensate for lack of capital gains and exits which other investment options enjoy (Ngigi, 2013).

### 2.3.2 Definition of Capital and Calculation of Ratios

Among depository institutions, the adoption of Basel III regulations has posed a number of challenges. The functional challenges include developing specifications for the new regulatory requirements, such as the mapping of positions (assets and liabilities) to the new liquidity and funding categories in the Leverage Capital Ratio calculation as well as to the stricter defined capital categories. As such, many depository institutions have developed some difficulties in calculation of risk ratios as Basel III specifies three different methods to be used. It poses a challenge to determine the best method applicable to the financial institution in question (Auer, Pfoestl, & Kochanowicz, 2011).

The same has held true for SACCOs. As at 2012, the industry average core capital for SACCOs was 8.6 per cent. Unlike in the banking sector where the core capital
requirement is set at a flat figure of Sh1 billion the Sacco members’ input varies with the asset position each year. This has posed a challenge as the calculation of ratios depends on members input that is variable. This means that there is no constant base in the calculation of such ratios and in the absence of an integrated financial information system the SACCO would not be able to accurately define the ratios required for capital adequacy. A number of SACCOs, especially the smaller ones that lack such integrated financial information systems have to rely on auditor’s reports to determine their position with regard to the minimum stipulated requirements (Ngigi, 2013).

### 2.3.3 Reduced Pay-out on Members’ Funds

One of the main ways SACCOs raise institutional capital is by retaining surpluses. These surpluses are as a result of gains from various investment ventures. In a bid to retain surpluses members’ dividends are forfeited. This is due to the inverse relationship between retention ratio and dividend pay-out ratio. The SACCOs are now faced with the hard choice of reducing payouts to members who have been earning higher returns for their deposits. The savings institutions were not retaining any earnings before introduction of the new rules in 2010 (Olando et al, 2013).

In addition, the SACCO Act Sec 21(5), states that “a SACCO society shall not pay dividends unless it has complied with the prescribed capital adequacy”. Given that institutional capital has proved more difficult to raise than share capital, and that institutional capital is raised primarily from reserves, SACCOs have been forced to reduce and in some extreme cases do away with dividends in order to ensure compliance with SASRA regulations and guarantee another year of licensing to continue operations (Kenya Law Reports, 2008).

### 2.3.4 Recruitment of New Members

According to the Co-operative Societies Rules (2004), a co-operative society is required to make by laws, among other matters, on its area of operation and membership common bond (Rule 7(i)(c)(Kenya Law Reports, 2008). This implies the definition of the co-operatives common bond may limit its scope and field from which to draw its membership. In a bid to increase capital, many SACCOs have resigned to breaking the common bond, allowing for a larger sweeping net to recruit new members. Some have conducted members’ recruitment drives.
The above phenomenon has created stiff competition between SACCOs to gain membership from the general public. For some SACCOs especially those with less reach in terms of scope of operations. These “smaller” SACCOs bear the brunt as larger SACCOs easily increase their membership exponentially. With relative stagnation in membership, these institutions cannot effectively increase their share capital thus impeding successful achievement of industry regulations (Mumanyi, 2014).

2.3.5 Restricted Avenues for Investment

As per the provisions of the Sacco Act, credit unions’ permissible investments in securities are limited to a list prescribed by state regulations. For instance, the Sacco Societies Act of Kenya specifies the various investments that SACCOs in Kenya can make. Sec 38 (1) of the Act states that “the funds of a Sacco society may be invested in securities, obligations or other debt instruments issued or guaranteed by the government or any agency of the government; deposits, obligations or other accounts of deposit-taking institutions under the Banking Act (Cap 488); shares, stocks, deposits in, loans to or other obligations of any Sacco society or cooperative society (Kenya Law Reports, 2008).

Sec 38(3) of the Act prohibits a Sacco society from purchasing or acquiring any land or any interest or right therein except when it’s reasonably necessary for the purpose of conducting the Sacco’s deposit-taking business. However, credit unions rely heavily on government securities and savings deposits to provide liquidity to meet deposit withdrawals and accommodate members’ credit needs. The uses of funds for SACCO are the SACCOs’ investments which include loans - which take a major share - , financial investments, liquid investments, non-financial investments and other investments in regulated financial institutions (Kenya Law Reports, 2008).

Without access to supplementary capital credit unions are restricted in their ability to respond to changes in conditions. This results in a cyclic effect. Since external means of raising capital through investment are restricted, credit unions faced with loan losses and or with lower capital ratios have to restrict the growth of their assets. To build capital by retaining earnings, these credit unions would also have incentives to close branches, reduce employment, and charge higher interest rates on loans, thereby limiting their services to their members (Mulwa, 2013).
2.3.6 Reduced Lending Capacity

In a bid to meet the capital ratio, SACCOs cannot take on too much debt, and must increase capital instead. Although the extended implementation timeline is intended to mitigate the impact, significant increases to capital and liquidity requirements may lead to a reduction in the capacity for banking activity – lending or, at the very least, a significant increase in the cost of provision of such lending (Olando et al., 2013).

Reduced lending capacity slows down the investment activity of the SACCO. If the SACCO cannot lend more to its members it forfeits a large proportion of their income in form of interest. This in turn results in low earnings and hence less money can be set aside as reserves. Therefore, in the long run a SACCO cannot survive without meeting capital requirements as it has a direct impact on its income generating activities (Lagat, Mugo, & Otuya, 2013).

2.4 Strategies for Meeting Capital Adequacy Requirements

2.4.1 Increasing Capital

Given the minimum requirements laid out by SASRA, a core capital of not less than ten per cent of total assets; a core capital of not less than eight per cent of its total deposit liabilities; and an institutional capital of not less than eight per cent of its total assets, it is in the best interest of the SACCO to implement as their major strategy objectives that would lead to the increase of the absolute value of capital. Such strategies would include issuing new capital, increasing membership base, diversifying product base, investing in capital assets and adjusting dividend pay-out ratio which are discussed hitherto. (SASRA, 2012)

2.4.1.1 Issuing New Capital

It would seem the most straightforward way to increase an institution's capital would be to issue out new capital. For publicly listed companies this would take the form of an IPO or rights issue that would in effect bring in publicly held funds into the organization as share capital. This has been particularly evident among Kenyan banks as they strived to meet minimum capital requirements as dictated by the Central Bank of Kenya. Co-operative bank of Kenya went public in 2008 to boost its capital holdings, whereas Kenya
Commercial Bank and Family Bank launched rights issues in 2010 and 2012 respectively (Kivuvo & Olweny, 2014).

For SACCOs, raising share capital may be more complicated than it is for commercial banks. First and foremost share purchases are only open to individuals who are members of the given SACCO. This reduces the reach in terms of investor pool when searching for funds. Share capital within the SACCO is represented by members’ contributions that cannot be withdrawn even on exit from the SACCO. These shares are however transferrable between members (Ngigi, 2013).

Regardless of the constraints involved, SACCOs have still managed, over the past few years, to raise their capital levels. One of the most common policies employed has been to increase the minimum share capital within the SACCO. Since share capital is not withdrawn even on termination from membership, this tactic ultimately increases capital proportionately to the number of members registered within the SACCO. Another approach has been to offer optional share purchase to members during dividend pay-out which follows the principle of stock options. Alternatively, some SACCOs have opted to instigate additional share purchase through share drives. Irrespective of the strategies used, increasing members’ share capital has been instrumental in facilitating efforts to meet the minimum capital requirements as prescribed by SASRA and has been a relatively cost-effective method (SASRA, 2012).

2.4.1.2 Increasing Membership Base

According to the Co-operative Societies Rules (2004), a co-operative society is required to make by laws, among other matters, on its area of operation and membership common bond (Rule 7(i)(c). This implies the definition of the co-operatives common bond may limit its scope and field from which to draw its membership. The existence of this common bond places restrictions on individuals admitted into membership of the institution. Mumanyi (2014) argues that adherence to the common bond is an obstacle as the success of any co-operative is based on a wide membership for a strong and secure capital base. Over time, and with the advent of SASRA’s regulations it has been increasingly evident that insisting that membership be confined to individuals within the common bond will be at the detriment of the success of the SACCO.
The success of any co-operative is based on a wide membership for a strong and secure capital base. In recent times, SACCOs which are regulated by SASRA have become very active in recruiting new members within the common bond who will be allowed to buy shares to fund growth plans. In addition, in order to grow their share capital, SACCOs have been forced to break, or in some cases re-define, their common bond so as to attract new members who also contribute to the share capital requirements. Major efforts have been made to extend the common bond to include members’ spouses and adult children (Ndiege, Haule, & Kazungu, 2013). This has been fruitful in some arenas, however, in most cases, spouses tend to be members of other SACCOs. As a result, many SACCOs have resigned to breaking the common bond, allowing for a larger sweeping net to recruit new members. Some have conducted members’ recruitment drives.

To grow their share capital, SACCOs have also been forced to cut their common bond so as to attract new members who also contribute to the share capital requirements. Some conducted members recruitment drives last year. Though the recruitment has helped SACCOs to raise their core capital it did not help them grow institutional capital which is proving to be the main problem (SASRA, 2011).

In 2007, the membership base of Deposit taking SACCOs was estimated at 955,162. As at 2012 this number had almost doubled to 2,544,001. This represents a 166% increment in membership with the greatest increase being in the years 2009 to 2012. This strategy has been successful as new members must contribute to minimum share capital holdings. Furthermore, new members will continue to contribute regularly to the SACCO in order to qualify for other facilities such as loans (SASRA, 2012).

2.4.1.3 Diversifying Product Base

Saunders and Cornett (2011) argue that the primary objective of a credit union is to satisfy the depository and borrowing needs of its members. This dictates providing products that meet the needs of members both savings products and loan products. The more extensive the product base offered to members, the greater the likelihood that uptake of products per member will increase. With increased uptake of products, it follows that deposits and share capital held by the SACCO will increase. In addition, income generated from increased uptake of loan facilities will result in growth of institutional capital (Kipkosgey & Njeru, 2014).
To raise more funds, the modern day credit unions have expanded their investments in services; some sell life insurance, others act as brokers for group insurance plans where state permits. Many credit unions are now active in offering 24 – hour automated services, financial planning services, retirement savings, home equity and first mortgage loans and payment services, all with a view to increasing their income reserves (Mulwa, 2013).

Some of the account facilities operated by SACCOs were junior savings accounts, salary accounts, normal savings accounts and special savings accounts like; Christmas packages and school fees packages. Loan facilities offered by SACCOs include normal loans, school fees loans, emergency loans, refinance (top-up) loans, new members introduction (baggage and passage) loans, express (instant) loans, special advance loans, asset purchase loans, Salary advance, tender advance, FOSA loans, crop advance and BOSA loan advance (Mulwa, 2013).

2.4.1.4 Adjusting Reserve - Dividend Payout

Institutional capital as defined earlier refers to accumulated reserves from retained earnings that no member of the SACCO can claim. Prior to the Act coming into effect, most of the annual earnings of the SACCO were distributed among its members (Olando et al, 2013). To increase their institutional capital, a portion of the SACCO’s earnings should be set aside in reserves used to cover losses from unforeseen or catastrophic problems. Since institutional capital is owned collectively by the membership with no individual direct claim on the capital, these reserves should allow the SACCO to support high returns on savings, maintain low costs on loans, create additional reserves or invest in additional products and services.

Allocation of reserves, in effect reduces the amount of earnings available for pay-out to members usually in the form of dividends. The reserve ratio refers to the percentage of earnings reserved in relation to total earnings and is inversely proportional to the dividend pay-out ratio (Saunders and Cornett, 2011). Thus in order, to increase institutional capital, a SACCO may reserve more earnings increasing their reserve ratio.

2.4.1.5 Investing in Capital Assets

Investment opportunities available to SACCOs are to a large extent spelt out in the SACCO Act. The Act provides for SACCO Societies to make financial investments
provided that those held in non-government securities do not account for more than forty per cent of its core capital or five percent of its total deposit liabilities. These securities may include government securities and shares, stock and deposits in commercial banks and other institutions licensed by the banking act. Such investments, however, may not be obtained for speculation but rather should be held to maturity. In spite of the restriction, careful investment in such ventures can yield a revenue stream for the SACCO that may supplement their institutional capital.

2.4.2 Managing Risk-weighted Assets

More often than not the loans of a financial institution are the major assets that generate a major share of income. Loan is the major asset of commercial banks and other depository institutions from which they generate income. The quality of loan portfolio therefore determines the profitability (Decamps, 2004).

As the SACCO works to increase the absolute value of its capital, it would also be prudent to pay attention to the other variable that affects the capital ratio, namely risk-weighted assets. These in lay-mans’ terms refer to the loans the SACCO has granted its members in return for a fixed, or variable, return in the form of interest. In order to achieve minimum requirements of a core capital of not less than ten per cent of total assets; a core capital of not less than eight per cent of its total deposit liabilities; and an institutional capital of not less than eight per cent of its total assets – where two of the required ratios are hinged to the value of total assets of the SACCO – prudential management of the loan portfolio would be an effective strategy if undertaken by the SACCO. Such strategies may include – but are not limited to – stricter credit rating, increasing lending rates, writing of non-performing loans, matching share contributions to loan amounts guaranteed, and reduced payment periods (Lagat, et al, 2013).

Sound lending procedures in financial institutions involve identifying high-risk loan applicants, modifying lending conditions such as security requirements and monitoring repayments. On the one hand Sacco managers need to reduce the risk of loan default because the institutions financial viability is weakened by the loss of principal and interest, yet on the other hand SACCOs operate under objectives of maximizing benefits to members which include the social role of providing loans to help members achieve their standard of living goals. These social roles conflict with financial viability of
SACCOs if managers become less stringent in the lending practices to assess and monitor the credit risk of member borrowers (Lagat, *et al*, 2013).

### 2.4.2.1 Stricter Credit Rating and Analysis

According to Basel committee (1999) on the management of credit risk, it was observed that many credit problems reveal basic weaknesses in the credit granting and monitoring processes. The study noted that many credit problems would have been avoided or mitigated by a strong internal credit process. They noted too that many banks find carrying out a thorough credit assessment a substantial challenge.

Credit policy provides guidelines on handling and management of loans to members within a SACCO. The purpose of the credit policy is to ensure that the society does not get into financial difficulties by approving loans to members in excess of fluids available by facilitating efficient and effective loans processing, approval and recoveries. SACCOs use different risk mitigation strategies in credit risk management such as guarantors, securities, shareholding and insurance. They also use various parameters such as outstanding debt, bankruptcies, delinquencies, late payments and new applications for rating credit worthiness when giving new loans (Kibui & Moronge, 2014).

Integral to credit analysis is determination of the credit-worthiness of members by examining sources of repayment and credit history for repeat borrowers. Sources of repayment may be obtained by close scrutiny of member inflows not limited to scrutiny of financial statement from other depository institutions that the member is engaged with. For salaried employees, this may involve examination of their monthly pay-slips to determine the net pay-out. In general, lending requirements within the SACCO entail a minimum period of active membership, minimum deposits, waiting period after clearance of loans before maturity, and waiting period after boosting of deposits (Lagat, Mugo, & Otuya, 2013).

### 2.4.2.2 Increasing Lending Rates

According to Bwana & Mwakujonga (2013), the major attraction of the public to SACCOs has been the low lending rates and high dividend pay-outs. They argue however that SACCOs may need to do engage in Cost pricing to ensure their margins are met while operating in an increasingly competitive environment. Cost pricing matches the
price on a given product to the costs involved in provision of the product to determine the revenue stream of the product.

Young and Barigye (2007) also postulate the same hypothesis. They argue that the introduction of new products or diversification of product base within SACCOs should be subject to the process of cost accounting. This would provide a theoretical basis to increase lending rates albeit marginally to observe greater than marginal increments in revenue.

2.4.2.3 Writing off Non-performing Loans

Non-performing loans refer to loans that are in a state of default. This is a scenario in which the borrower does not comply with scheduled repayments and thus leads to a loss of principal and interest. One of the internal strategies of dealing with non-performing loans is through adequate provision for bad loans. This is supported by the loanable funds theory. For a SACCO to be successful, it must disburse loans and collect loan repayments from the members as per contractual documents. The impact of not collecting loan repayments are: direct reduction on SACCOs’ liquidity and direct reduction on profitability (Owen, 2007).

When provision for loan loss is not deducted from the comprehensive income, the income statement will be overstated and if the entity (credit Union) pays dividends it will be paying from capital which is illegal. Paying dividends from capital threatens a firms going concern and if it is done periodically over a number of years, it can lead to insolvency (Saunders & Cornet, 2011).

Allowance for loan loss is a contra asset account on the balance sheet used for off-setting losses on loan assets. It is the management’s best estimates of probable losses in the remainder of the portfolio as at the balance sheet date. Allowance for loan loss is a provision or reserve estimated showing the amount of loans made past due and likely to continue in default. The Sacco Act of (2008) defines allowance for loan loss as an amount aside in the statement of financial position (Balance Sheet) to recognize probable loan losses so that the true value of the loan portfolio is fairly stated. The provision for loan losses is defined by the same Act as an expense in the income statement to reflect an increase in the probability of losses due to uncollected loans (Kahuthu, Muturi, & Kiweu, 2015).
Provision for loan losses, may appear to reduce surplus for a short period but because of the pressure it puts on management on loan recoveries, the SACCOs eventually improve on liquidity and profitability. In addition, continual provision for loan losses, cushions against the shock inflicted when faced with actual non-performing loans, thus writing them off (Kahuthu, Muturi, & Kiweu, 2015).

2.4.2.4 Matching Share Contributions to Loan Amounts Guaranteed

SACCOs offer loans to their members from the deposits that they hold. This is one of the main attractions towards membership. SACCOs play an integral role in financial inclusion offering loans to individuals who do not meet the requirements of commercial banks. In addition, they offer these loans at rates lower than commercial banks with less stringent terms and conditions (Kibui & Moronge, 2014).

Members borrowing funds from their SACCOs provide their own share as security for the loan as well as sworn declaration of guarantors – also members of the SACCO together guaranteeing the loan amount against their own shares in the institution. Given the close knit structure of the SACOs, more often than not members guarantee each other against loan default whereas they take up loans themselves for which their fellow members guarantee them creating a contagion in which one default could lead to several others (Procasur Africa, 2012). This can be prevented by closer monitoring and placing threshold of maximum amounts that can be guaranteed by each member based on the deposits that they hold.

2.4.2.5 Reduced Payment Periods

Depository institutions play a crucial role in modern economies due to their ability to transform liquid deposits from the liability side of their balance sheets into loans as illiquid assets on the asset side (McKillop & Wilson, 2014). The maturity of these financial instruments is thus mismatched as deposits are on demand and are therefore short-term in nature. On the other hand, loans tend to be long-term in nature with their repayment periods spanning longer than one year.

As a result of this mismatch, SACCOs should vary the repayment periods for their various loan products. In addition, varying the repayment period of an individual product depending on the member’s repayment ability ensures that loan maturity is staggered within each product. As such, the SACCO is better able to match its deposits to
disbursements. The longer loans remain outstanding the greater the liquidity risk posed to the institution (Kibui & Moronge, 2014)

2.5 Chapter Summary

In this chapter, the paper addresses the case for capital adequacy with respect to other financial institutions, primarily commercial banks. The paper has evaluated the requirements with respect to commercial banks and the Basel Accord established by the Bank of International Settlement. It also specifies the requirements for commercial banks in Kenya as outlined by the Central Bank of Kenya as well as the requirements for SACCOs specified by SASRA in the prudential guidelines.

An analysis of strategies that these institutions have undertaken to adhere to capital adequacy regulations, as enforced by their respective regulatory bodies, has also been described. This was done with comparison to commercial banks for strategies that are also applicable to SACCO industry.

Finally the challenges that these institutions face in their efforts to comply with prudential guidelines of capital adequacy has been covered, with specific reference to SACCOs in Kenya and reviewing specific situations that have been encountered.

The next chapter seeks to describe the manner in which the research was carried out with reference to the overall design of the research, the population and sampling design, as well as the techniques to be used in data collection and data analysis.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter sought to identify and explain in detail the methods that were used in the study undertaken. It specifies the research design, population and sampling design. It describes the methods that were used in drawing a sample from the population under study as well as the sample size used in collection of data. The chapter also provides insight into the data collection methods and techniques that were used in analyzing the data collected.

3.2 Research Design

According to Cooper and Schindler (2000) research design is the blueprint for fulfilling objectives and answering research questions. It forms the “framework for the collection and analysis of data to answer the research question and meet research objectives providing reasoned justification for choice of data sources, collection methods and analysis techniques” (Saunders, Lewis and Thornhill, 2012, p.680).

The study adopted a descriptive survey design. According to Saunders et al, (2012), descriptive research attempts to describe, explain and interpret conditions of the present. The purpose of a descriptive research is to examine a phenomenon that is occurring at a specific place and time. A descriptive research is concerned with conditions, practices, structures, differences or relationships that exist, opinions held, processes that are going on or trends that are evident. Descriptive survey designs are used in preliminary and exploratory studies to allow researchers to gather information, summarize, present and interpret for the purpose of clarification. This study sought to analyse the effect of capital adequacy regulation, a process that is ongoing in the financial sector. The phenomenon was to be studied as to how it affects SACCOs.

Descriptive survey design is employed because it guarantees breadth of information and accurate descriptive analysis of characteristics of a sample which can be used to make inferences about population. Orodho (2002) says that descriptive survey is a method of collecting information by interviewing or administering a questionnaire to a sample of individuals. As such, a descriptive study proved ideal as it allowed the researcher to take
a sample of the SACCOs under study for the purpose of data collection and findings can then be generalized to the entire population.

3.3 Population and Sampling Design

3.3.1 Population
The population under study is Deposit-taking SACCOs, commonly referred to as FOSAs. These refer to SACCOs that offer front office services to their members such as savings and other transactional accounts much like commercial banks offer. The SACCOs under study are those whose head offices are within Nairobi County.

The number of licensed FOSAs with head offices in Nairobi was 35 as per SASRA records for the year 2014.

3.3.2 Sampling Design
According to Cooper and Schindler (2000), a sample is a subset, or some part, of a larger population. This section seeks to describe the manner in which the sample was chosen for study and the size of the resultant sample.

3.3.2.1 Sampling Frame
Sampling frame refers to the list of elements from which a sample may be drawn; also called working population. It is a complete and correct list of population members only. According to Saunders et al (2012), the definition of a sampling frame for a study determines the method of sampling to be used and the extent to which the sample can be generalized to the entire population. They argue that the sampling frame should be as complete, accurate and up to date as possible.

The sampling frame for this study was the list of licensed FOSA operating SACCOs for the year 2014 obtained from Sacco Societies Regulatory Authority (SASRA). From this list, the working population, that is the SACCOs operating head offices within Nairobi, was obtained.

3.3.2.2 Sampling Technique
A census study occurs if the entire population is very small or it is reasonable to include the entire population (for other reasons). It is called a census sample because data is gathered on every member of the population.
A census was carried out while conducting the study as all 35 SACCOs making up the sampling frame were studied.

3.3.2.3 Sample Size

The sample to be used for study was of all the deposit-taking SACCOs within Nairobi County. These are 35 in number.

3.4 Data Collection Methods

The study involved the collection of data using the structured questionnaires and interviews with selected persons. This enabled the researcher to collect primary data.

The focus of the research was to carry out an intensive study of the capital adequacy regulatory compliance with the questionnaire divided under the following categories. Section one the institutional profile, section two the benefits that have accrued from compliance with capital adequacy regulations, section three strategies that the SACCO has undertaken to comply and section four the challenges the SACCO has encountered in compliance.

3.5 Research Procedures

A pilot study was carried out to establish the effectiveness of the data instrument. Four SACCOs were chosen at random, questionnaires were filled and the results analysed before launching the research on the full scope of respondents.

The research was carried out by administering questionnaires and conducting discussions with personnel working within SACCOs. These personnel mainly consisted of employees of the SACCO such as the operations managers for the head-office branch and committee members. These respondents were chosen as they were most likely to hold the information required for the study as they are directly involved in the administration of the SACCO.

The questionnaires were aimed at creating the institutional profile, as well as answering the specific research questions: the benefits that have accrued from compliance with capital adequacy regulations, strategies that the SACCO has undertaken to comply and the challenges the SACCO has encountered in compliance.
3.6 Data Analysis Methods

Responses received were coded and processed by computer through the Statistical Package for Social Science (SPSS) software. Data was analyzed using descriptive statistics. Descriptive statistics helps to summarize the overall tendencies in data, provide an understanding of how varied scores might be, and provide insight into where one score stands in comparison with others (Creswell, 2005). Descriptive statistics: frequency and percentiles were largely applied.

Further analysis was done to establish correlation between different institutional profiles and responses of each of the three research questions. This was done to determine whether the effect of regulation on the SACCOs varies with the institutional profile. The data was represented in a tabular form, bar graphs and pie charts generated using SPSS software.

3.7 Chapter Summary

The chapter details the design of the research as a descriptive study that sought to detail the effect of capital adequacy regulation on SACCOs. The population under study was the FOSA operating SACCOs within Nairobi County whereby a census was taken of all the 35 SACCOs operating within the county.

Data collection has been specified to be carried out by means of questionnaires and interviews with respondents being chosen randomly from within the SACCOs. Analysis was later undertaken using SPSS software to determine any correlations, frequencies and means within the data.

The next chapter presents the finding of the study collected using the data instrument. The findings are presented in form of table, bar graphs and pie charts generated using SPSS software.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

The chapter provides findings and results on the effect of capital adequacy regulations on savings and credit cooperative societies in Kenya. The purpose of the study was to investigate the effect of capital adequacy regulations on savings and credit cooperative societies in Kenya by answering the questions: What benefits have accrued to SACCOs as a result of adherence to capital adequacy regulations? What challenges have SACCOs faced in complying with capital adequacy requirement? and What strategies have SACCOs undertaken to meet the requirements for capital adequacy? Descriptive statistics have been used to discuss the findings of the study.

4.2 General Profile

This section provides the information on the response rate, the years of operation, membership base, sponsoring entity, capitalization and branch network of the SACCOs that participated in the study. This information provides a basic understanding of the respondent based on the given variables which were used to enrich the analysis by providing different angles of understanding the responses received during the research.

4.2.1 Response Rate

Response rate refers to the percentage of data collected given the original sample selected. The study had a sample size of 35 respondents from FOSA operating SACCOs in Nairobi County. The response rate is captured below in Table 4.1.

<table>
<thead>
<tr>
<th>Category</th>
<th>Respondents</th>
<th>Response Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responded</td>
<td>30</td>
<td>86%</td>
</tr>
<tr>
<td>Didn't Respond</td>
<td>5</td>
<td>14%</td>
</tr>
<tr>
<td>Total Respondents</td>
<td>35</td>
<td>100%</td>
</tr>
</tbody>
</table>
From, the table, the response rate was noted to be 86%. The response rate is considered adequate to make conclusions for the study as observed by Mugenda and Mugenda, (2003), that 50% response rate is sufficient, 60% good and any rating above 70% is considered very good.

### 4.2.2 Years of Operation

Respondents were requested to indicate the number of years that the institution had been in operation clustered into categories of less than 5 years, 5 to ten years, and more than 10 years, as presented in Figure 4.1.

![Figure 4.1: Years of Operation](image)

The study revealed, as presented in Figure 4.1 above, that a significant majority, 73.3% of the respondents, had been in operation for periods greater than 10 years, 20% had been operation between 5 and 10 years, whereas a minority of 6.7% had operated for less than 5 years.

### 4.2.3 Membership Base

Membership base is one of the indicators to the size of the institution. Respondents were requested to indicate the number of members that the institution had clustered into categories of less than 1000 members, 1000 to 5000 members, 5000 to 10000 members and more than 10000 members, as presented in Figure 4.2.
Figure 4.2: Membership Base

As indicated in Figure 4.2, the study revealed that the majority of respondents had a membership base greater than 10,000 members represented by 56.7% of the respondents. 23.3% had a membership of between 1,000 and 5,000 members, 16.7% had a membership of between 5,000 and 10,000 members, and a minority of 3.3% had membership of less than 1,000 members.

4.2.4 Sponsoring Entity

As discussed earlier, SACCOs can be categorised with regard to the underlying entity sponsoring membership at inception constituting the common bond. The study sought to find out the sponsoring entity of the given respondents categorised as teacher-based, government based, farmer based, private-institution based and community based. Figure 4.3 displays the findings.

The study revealed 43.3% of the respondents are sponsored by government institutions while 30% are sponsored by private institutions. Respondents sponsored by farmer based institutions, teacher based institutions and community institutions were represented by 16.7%, 6.7% and 3.3% respectively of the total number of respondents interviewed.
4.2.5 Pre-regulation Capitalization

The subject matter of the study is the effect of capital adequacy regulation. As such, of great relevance was the capitalisation levels of the respondents before the regulation kicked in. Results are represented in Figure 4.4.
The study showed that the greatest percentage of respondents met the minimum capital requirement of KES10 million represented by 86.7% of the respondents. The minority were below the minimum requirements represented as 6.7% below KES3 million, 3.3% holding capital ranging between KES3 million and KES5 million, and a further 3.3% reporting capital between KES5 million and KES10 million.

4.2.6 Current Capitalization

The study also sought to gauge the level of capital currently held by the various respondents as shown in Figure 4.5.

![Figure 4.5: Current Capitalization](image)

The study indicated that 46.7% of the respondents are currently holding capital in excess of KES400 million. 23.3 of the respondents have capital levels ranging between KES50 million and KES 100 million. Respondents holding capital ranging between KES100 million and 400 million represented 20% of total observations. 10% of the respondents have capital below 50 million.

4.2.7 Branch Network

The number of branches that an institution operates shows the scope of its operations and may be an indicator of the size of the institution. The study sought to find out the number of branches each respondent was operating from. The results are shown in Figure 4.6.
Figure 4.6: Branch Network

The study revealed that the majority, 53.3%, of respondents were conducting their operations from 3 or less branches. Respondents operating with between 3 and 5 branches were represented by 16.7% as were those operating more than 10 branches. 13.3% of the respondents are operating between 5 and 10 branches.

4.3 Benefits of Adhering to Capital Adequacy Regulations

This section presents findings on the benefits of capital adequacy regulations to the SACCOs. The respondents were required to respond with regard to the extent to which they have benefited in the prescribed ways to the regulations along the following parameters: not at all, slightly, significantly, greatly. The benefits under investigation were meeting regulatory requirements, 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.

4.3.1 Meeting Regulatory Requirements

Majority, 46.7%, of the respondents agreed that attention to capital adequacy was greatly beneficial in meeting regulatory requirements, whereas 43.3% stated that it was
significant in meeting regulatory requirements. 10% of the respondents asserted that it was slightly beneficial in meeting capital requirements as represented in Figure 4.7.

Figure 4.7: Meeting Regulatory Requirements

4.3.2 Managing Credit Risk

Out of the total respondents interviewed, 43.3% answered that capital adequacy was significantly relevant in their efforts of managing credit risk, whereas 36.7% found it to be greatly significant. A minority of 16.7% and 3.3% respectively were of the opinion that it was slightly significant and not at all significant as illustrated in Figure 4.8 below.

Figure 4.8: Managing Credit Risk
4.3.3 Improved Public Confidence

The study sought to reveal the extent to which adherence to capital adequacy regulation improved public confidence in the institutions involved. The findings are represented in Figure 4.9 below.

![Pie chart showing public confidence](image)

**Figure 4.9: Improved public confidence**

Fifty seven per cent of those respondents answered that adherence to said regulation had greatly influenced public confidence, whereas 33.3% stated that it had significantly improved public confidence. 6.7% said that it had slightly influenced public confidence and 3.3 stated that there was no particular influence on public confidence.

4.3.4 Providing a Safety Net for Members’ Deposits

Respondents were required to assess the extent to which capital adequacy provides a safety net for their members’ deposits. The results are illustrated below in Figure 4.10.
Figure 4.10: Safety net for Deposits

Out of the total respondents 46.7% stated that capital adequacy had significantly provided for a safety net for deposits while 43.3% viewed that it had to a great extent provided for the safety net. 6.7% deemed it to have a slight effect on the provision of a safety net and 3.3% regarded it irrelevant in the provision of a safety net.

4.3.5 Providing Adequate Capital for Operations

The study also required the respondents to evaluate the degree to which adherence to the regulation in question ensured sufficient capital to conduct institutional operations. The findings are represented in Figure 4.11 below.

Figure 4.11: Adequate capital for operations
Forty three percent of the respondents deemed the regulations to greatly impact the sufficiency of capital available to maintain operational capacity, whereas 40.0% of respondents deemed the regulations significant. Ten percent of respondents stated that regulations had no impact on sufficiency of capital where as 6.7% viewed regulation as slightly influencing the sufficiency of capital.

4.3.6 Increased Lending Capacity

The respondents were asked to provide information about the extent to which capital adequacy had led to increased lending capacity. The results are represented below in Figure 4.12.

![Pie Chart](image)

**Figure 4.12: Increased lending capacity**

Of the respondents, 46.7% stated that capital adequacy greatly influenced lending capacity where as 43.3% said that there was a significant influence on lending capacity. 6.7% stated that capital adequacy slightly influenced lending capacity and 3.3% stated that there was no influence.

4.3.7 Provides a Base for Future Growth

Fifty percent of the respondents stated that capital adequacy greatly influenced the SACCOs ability to provide a base for growth where as 43.3% asserted that it had a significant influence. Three percent maintained that it had only a slight influence and a further 3.3% stated that it had no influence at all. Figure 4.13 illustrates these responses.
4.3.8 Prevent Insolvency

The study also required the respondents to assess the extent to which capital adequacy contributes toward the solvency of the SACCO. The results are represented in Figure 4.14 below.

Forty percent of the respondents stated that capital adequacy greatly influenced solvency whereas a further 40% stated that it had a significant influence. Seventeen percent stated that it had a slight influence and 3.3% said that it had no influence at all.

4.3.8 Correlation: Benefits of Capital Adequacy Regulations

The findings on the benefits of capital adequacy were tested for correlation against the variables that were studied in the general institutional profile. Of the seven variables
constituting the benefits of capital adequacy regulations, all variables had insignificant correlation at significance level of 0.01. At significance level of 0.05, there was significant correlation between provision of a safety net and membership levels of -0.328. This implies a negative correlation between provision of a safety net and membership levels.

**Table 4.2: Correlation: Benefits of Capital Adequacy Regulations**

<table>
<thead>
<tr>
<th>Benefits of Capital Adequacy Regulations</th>
<th>Years Of Operation</th>
<th>Membership</th>
<th>Sponsoring Entity</th>
<th>Original Capital</th>
<th>Current Capital</th>
<th>Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meeting Regulatory Standards</td>
<td>-.024</td>
<td>-.104</td>
<td>.132</td>
<td>-.040</td>
<td>.007</td>
<td>-.041</td>
</tr>
<tr>
<td>Improved Public Confidence</td>
<td>.020</td>
<td>-.038</td>
<td>.115</td>
<td>.191</td>
<td>.301</td>
<td>.174</td>
</tr>
<tr>
<td>Safety Net</td>
<td>-.013</td>
<td>-.328*</td>
<td>-.129</td>
<td>-.003</td>
<td>.088</td>
<td>.110</td>
</tr>
<tr>
<td>Operational Capital</td>
<td>-.059</td>
<td>-.155</td>
<td>-.059</td>
<td>.152</td>
<td>.175</td>
<td>.165</td>
</tr>
<tr>
<td>Managing Credit Risk</td>
<td>-.260</td>
<td>-.193</td>
<td>.046</td>
<td>.195</td>
<td>.186</td>
<td>.038</td>
</tr>
<tr>
<td>Increased Lending Capacity</td>
<td>-.130</td>
<td>-.106</td>
<td>-.130</td>
<td>.016</td>
<td>.221</td>
<td>.283</td>
</tr>
<tr>
<td>Base For Growth</td>
<td>-.165</td>
<td>-.207</td>
<td>-.217</td>
<td>.253</td>
<td>.191</td>
<td>.172</td>
</tr>
<tr>
<td>Prevent Insolvency</td>
<td>.162</td>
<td>.001</td>
<td>-.185</td>
<td>.005</td>
<td>.228</td>
<td>.160</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level; **. Correlation is significant at the 0.01 level

**4.4 Challenges in Complying with Capital Adequacy Requirements**

This section outlines the findings of the study with regard to the challenges that SACCOs have faced in complying with set regulations. The respondents were required to indicate the extent to which the given challenges had affected them adversely along the following parameters: not at all, slightly, significantly, greatly. The challenges being evaluated were as follows: separating capital from members’ deposits, definition of capital and calculation of ratios, reduced pay-out on members’ funds, recruitment of new members, restricted avenues for investment, and reduced lending capacity.

**4.4.1 Separating Capital from Members’ Deposits**

Respondents were required to provide information as regards the extent to which separating members’ deposits had posed a challenge in complying with capital adequacy regulations. A majority of 53.3% stated that it had no bearing whereas 26.7% stated that it posed a slight challenge. 20% of the respondents said that it had a significant effect. These findings are depicted in Figure 4.15 below.
4.4.2 Definition of Capital and Calculation of Ratios

With regard to definition of capital and calculation of ratios, 43.3% of respondents stated that it posed a slight challenge towards meeting capital requirements. 33.3% said that it did not pose any challenge. Thirteen percent stated that it posed a significant challenge whereas 10% stated that it posed a great challenge as shown in Figure 4.16 below.
4.4.3 Reduced Pay-out on Members’ Funds

The respondents were asked to ascertain the extent to which reduced pay-outs to members was a challenge in meeting the required capital levels. A majority of 50% stated that it presented a slight challenge whereas 23.3% stated that it posed no challenge at all. 20% said that it posed a significant challenge while a minority of 6.7% stated that it was a great challenge. Figure 4.17 below shows these findings.

Figure 4.17: Reduced pay-out

4.4.4 Recruitment of New Members

Thirty seven percent of the respondents stated that recruitment of new members posed a slight challenge in meeting with capital requirements whereas 20% stated that it posed a significant challenge. A further 20% stated that it was a great challenge while 23.3% stated that it posed no challenge at all. Figure 4.18 below illustrates these results.
4.4.5 Restricted Avenues for Investment

The respondents were asked to give information on the extent to which restricted avenues for investment posed a challenge in meeting with capital requirements. 60% answered that it posed a slight challenge. 16.7% stated that it was a significant challenge while 13.3% said that it was a great challenge. 10% stated that it did not pose any challenge.
4.4.6 Reduced Lending Capacity

The respondents were required to provide information on the extent to which reduced lending capacity had posed a challenge in meeting capital requirements. Fifty percent stated that it was a slight challenge whereas 30% stated that it was no challenge at all. Thirteen percent stated that it posed a significant challenge.

Figure 4.20: Reduced lending capacity

4.4.7 Correlation: Challenges in Complying with Capital Adequacy Requirements

The findings of the study regarding challenges in complying with capital adequacy requirements were correlated against the variables of the general profile. All correlation was insignificant at significance level of 0.01. At significance level of 0.05, correlation was significant between separating deposits from capital and both original and current capitalization at 0.349 and 0.324 respectively.
4.5 Strategies for meeting capital adequacy requirements

This section outlines the findings of the study with regard to the strategies that SACCOs have put in place in order to comply with set regulations. The respondents were required to indicate the strategies that have enabled them to meet capital requirements along two categories, those that involve increasing capital base and those that involve managing risky assets.

4.5.1 Increasing Capital

The respondents were required to state the extent to which a myriad of strategies have contributed to attaining and maintaining capital requirements: issuing new capital, increasing membership, diversifying product base, adjusting their reserve ratio and investing in capital assets.

4.5.1.1 Issuing New Capital

Forty percent of respondents said that issuing new capital is a strategy that is greatly effective in meeting capital requirements and 33.3% were of the opinion that it is significantly effective. Seventeen percent believe it to be slightly effective where as 10% did not believe it was effective as illustrated in Figure 4.21 below.

Table 4.3: Correlation: Challenges - Capital Adequacy Requirements

<table>
<thead>
<tr>
<th></th>
<th>Years Of Operation</th>
<th>Membership</th>
<th>Sponsoring Entity</th>
<th>Original Capital</th>
<th>Current Capital</th>
<th>Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separating Deposit From Capital</td>
<td>-.048</td>
<td>.227</td>
<td>-.090</td>
<td>.349*</td>
<td>.324*</td>
<td>.268</td>
</tr>
<tr>
<td>Definition of Ratios</td>
<td>-.020</td>
<td>.083</td>
<td>.078</td>
<td>.209</td>
<td>.240</td>
<td>.078</td>
</tr>
<tr>
<td>Member Recruitment</td>
<td>-.068</td>
<td>.029</td>
<td>-.060</td>
<td>.179</td>
<td>.248</td>
<td>.080</td>
</tr>
<tr>
<td>Reduced Pay-outs</td>
<td>.233</td>
<td>-.158</td>
<td>.092</td>
<td>-.262</td>
<td>-.170</td>
<td>-.296</td>
</tr>
<tr>
<td>Restricted Investment</td>
<td>.091</td>
<td>.052</td>
<td>.149</td>
<td>.099</td>
<td>.155</td>
<td>.173</td>
</tr>
<tr>
<td>Reduced Lending Capacity</td>
<td>-.054</td>
<td>-.010</td>
<td>-.031</td>
<td>.089</td>
<td>.047</td>
<td>.191</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level; **. Correlation is significant at the 0.01 level
4.5.1.2 Increasing Membership

Of the respondents, 46.7% stated that increasing membership had greatly influenced their ability to meet capital requirements whereas 43.3% stated it had a significant influence. Ten percent of the respondents stated that it had a slight influence. The findings are shown in Figure 4.22 below.

Figure 4.22: Increasing membership

4.5.1.3 Diversifying Product Base

Of the respondents, 26.7% replied that diversifying product base has had great impact on capital adequacy where as 53.3% stated that there is a significant influence on capital
adequacy. Seventeen percent of respondents stated that it had a slight influence and 3.3% replied that it had no influence at all. The results are represented in Figure 4.23 below.

![Figure 4.23: Diversifying product base](image)

4.5.1.4 Adjusting Reserve Ratio

Twenty percent of the respondents answered that adjusting reserve ratio had a great impact on capital adequacy. Forty percent stated that this strategy had a significant influence on capital adequacy while 30% said that it had a slight influence. A minority of 10% answered that adjusting the reserve ratio did not have an impact on capital adequacy as represented in Figure 4.24 below.
Figure 4.24: Adjusting reserve ratio

4.5.1.5 Investing in Capital Assets

Twenty percent of respondents regarded investing in capital assets as having a great impact on capital adequacy; another 20% stated that it had as significant influence; a further 20% stated that it had no influence at all whereas the majority of 40% of respondents stated that it had a slight impact as represented in Figure 4.25 below.

Figure 4.25: Investing in capital assets
4.5.1.6 Correlation: Strategies for Increasing Capital

The study sought to evaluate the correlation between strategies for increasing capital and the variables constituting the general profile. Given significance at a level of 0.05, issuing new capital had a positive correlation of 0.292 with current capitalization. Capital asset investment had a positive correlation of 0.325 with Original capitalization and 0.333 with number of branches. Correlation was insignificant at a level of 0.01 of significance.

Table 4.4: Correlation: Strategies for Increasing Capital

<table>
<thead>
<tr>
<th></th>
<th>Years Of Operation</th>
<th>Membership</th>
<th>Sponsorin g Entity</th>
<th>Original Capital</th>
<th>Current Capital</th>
<th>Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuing New Capital</td>
<td>0.021</td>
<td>-0.152</td>
<td>0.145</td>
<td>0.168</td>
<td>0.292*</td>
<td>0.107</td>
</tr>
<tr>
<td>Increasing Membership</td>
<td>-0.090</td>
<td>0.015</td>
<td>0.172</td>
<td>0.059</td>
<td>0.095</td>
<td>0.192</td>
</tr>
<tr>
<td>Diversifying Products</td>
<td>-0.175</td>
<td>0.026</td>
<td>-0.304</td>
<td>-0.104</td>
<td>-0.182</td>
<td>0.124</td>
</tr>
<tr>
<td>Adjust Dividend</td>
<td>-0.049</td>
<td>-0.028</td>
<td>0.096</td>
<td>-0.043</td>
<td>0.039</td>
<td>0.129</td>
</tr>
<tr>
<td>Capital Asset Investment</td>
<td>0.093</td>
<td>0.404</td>
<td>-0.170</td>
<td>0.325*</td>
<td>0.172</td>
<td>0.333*</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level; **. Correlation is significant at the 0.01 level

4.5.2 Managing Risky Assets

The respondents were required to state the extent to which a myriad of strategies have contributed to attaining and maintaining capital requirements: stricter credit rating, increased lending rates, writing-off non-performing loans, matching share contributions to amounts guaranteed and reduced payment periods.

4.5.2.1 Stricter Credit Rating

The respondents were asked to give information as to the extent to which strict credit rating has facilitated the meeting of capital adequacy requirements. 36.7 % stated that stricter credit rating had a significant impact and 33.3% were of the opinion that the impact was great. 26.7% stated that it had a slight impact and a final 3.3 % stated that it had no impact at all. These results are represented in Figure 4.26 below.
4.5.2.2 Increasing Lending Rates

Of respondents, 43.3% stated that increasing lending rates had no impact on ability to meet capital adequacy requirements whereas 30% stated that it had a slight impact. Further, 16.7% stated that it had a significant impact and 10% stated that it was a great influence. Figure 4.27 is a representation of these results.

4.5.2.3 Writing off Non-performing Loans

The respondents were required to provide information on the extent to which writing off non-performing loans had aided the institution meet capital adequacy requirements. 46.7% stated that it had a slight influence, 43.3% said that it had no effect at all whereas 10% stated that it had a slight effect as represented in Figure 4.28.
4.5.2.4 Matching Share Contributions to Loan Amounts Guaranteed

Of the respondents, 36.7% stated that matching contributions to loans guaranteed significantly influenced meeting capital requirements whereas 33.3% stated that it greatly influenced ability to meet capital adequacy requirements. Further, 13.3% said that it influenced slightly and 16.7% said that it had no impact on meeting capital requirements. These findings are depicted in Figure 4.29 below.
4.5.2.5 Reduced Payment Period

Of the respondents, 30% stated that reduces payment periods had a significant impact on the ability of the institution to meet capital adequacy requirements whereas 26.7% stated that it had a great impact on capital adequacy requirements. A further 26.7% stated that this strategy had a slight impact on capital adequacy requirements while 16.7% said that it had no effect at all as shown in figure 4.30 below.

![Figure 4.30: Reduced payment periods](image)

4.5.2.6 Correlation: Strategies for Managing Risky Assets

Correlation was analysed between strategies for managing risky assets and elements of the institutional profile. At a significance level of 0.01 all correlation was found to be insignificant. However, at significance level of 0.05, correlation between strict credit rating and the sponsoring entity was significant at -0.266. Matching contributions to loans guaranteed was significantly correlated at 0.296; whereas reduced payment period was significantly correlated with the sponsoring entity and number of branches at -0.339 and 0.335 respectively.
Table 4.5: Correlation: Strategies for managing risky assets

<table>
<thead>
<tr>
<th></th>
<th>Years Of Operation</th>
<th>Membership</th>
<th>Sponsoring Entity</th>
<th>Original Capital</th>
<th>Current Capital</th>
<th>Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strict Credit Rating</td>
<td>.025</td>
<td>-.234</td>
<td>-.266*</td>
<td>-.115</td>
<td>-.033</td>
<td>-.081</td>
</tr>
<tr>
<td>Write Off Bad Loans</td>
<td>-.090</td>
<td>.143</td>
<td>-.070</td>
<td>.230</td>
<td>.131</td>
<td>.265</td>
</tr>
<tr>
<td>Increase Lending Rates</td>
<td>0.000</td>
<td>.164</td>
<td>-.239</td>
<td>.033</td>
<td>-.033</td>
<td>.047</td>
</tr>
<tr>
<td>Match Contributions to Loans Guaranteed</td>
<td>.204</td>
<td>.075</td>
<td>-.095</td>
<td>.070</td>
<td>.154</td>
<td>.296*</td>
</tr>
<tr>
<td>Reduced Payment Periods</td>
<td>.204</td>
<td>.087</td>
<td>-.339*</td>
<td>.047</td>
<td>.141</td>
<td>.335*</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level; ** Correlation is significant at the 0.01 level

4.6 Chapter Summary

The chapter presents the findings from analysis of the data collected during the study. These results are presented in both graphical and tabular form. Section 4.2 provides the profile of respondents, Section 4.3 presents analysis of the benefits of capital adequacy regulations, Section 4.4 presents analysis of the strategies used to meet the capital adequacy regulations and Section 4.5 presents analysis of the challenges faced in meeting capital adequacy regulations.

The next chapter presents a discussion of these findings in detail. It also provides conclusion of the study and recommendations that have accrued as a result of the study.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSION & RECOMMENDATIONS

5.1 Introduction

This chapter presents a discussion of the findings of the research, summary and conclusion of these findings as well as recommendations for future research.

5.2 Summary

The purpose of the study was to investigate the effect of capital adequacy regulations on SACCOs in Kenya. This was undertaken by a study of the deposit-taking SACCOs in Nairobi County. The study sought to answer three questions: Why is it necessary for SACCOs to adhere to capital adequacy regulations? What challenges have SACCOs faced in complying with capital adequacy requirements? What strategies have SACCOs undertaken to meet the requirements for capital adequacy?

The study employed the design of a descriptive study. The population under study was the deposit-taking operating SACCOs within Nairobi County whereby a census was taken of the 35 SACCOs operating within the county. Respondents were chosen at random from among the administration and management of the individual SACCOs. Data collection was carried out by means of questionnaires and informal interviews with respondents and analysis was done using SPSS software to determine any correlations and frequencies within the data.

The results from analysis of the data collected during the study were presented in both graphical and tabular form; providing the profile of respondents, analysis of the benefits of capital adequacy regulations, analysis of the strategies used to meet the capital adequacy regulations and analysis of the challenges faced in meeting capital adequacy regulations mainly in form of frequencies. Correlation was calculated individually between the benefits of regulation, strategies employed challenges faced and general profile of the respondents.

The study concluded that SACCOs had profited 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.

The SACCOs had engaged in strategies to meet capital adequacy. Of these strategies, SACCOs found issuing new capital, increasing membership base, diversifying product base, adjusting dividend pay-out ratio, stricter credit rating, matching share contributions to loan amounts guaranteed and reduced payment periods to be most effective.

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.

5.3 Discussion

5.3.1 Benefits of Adhering to Capital Adequacy Regulations

This section presents findings on the benefits of capital adequacy regulations to the SACCOs. The respondents were required to respond with regard to the extent to which they have benefited in the prescribed ways to the regulations along the following parameters: not at all, slightly, significantly, greatly. The benefits under investigation were meeting regulatory requirements, 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.

The larger proportion of respondents stated that capital adequacy was beneficial in meeting regulatory requirements; this is in line with the Sacco Act (2008) that prescribes minimum capital requirements for deposit taking SACCOs.

Majority of the respondents answered that capital adequacy was influential in enabling the institution to manage credit risk. Goacher (2003) also states that holding sufficient capital in a financial institution allows the said institution absorb a greater proportion of risk. In addition, Rose and Marquis (2008) argue that regulation of capital as prescribed by the Basel accord directly impacts management of credit risk. SASRA prudential guidelines are structured around the Basel accord thus capital adequacy regulation facilitates credit risk management within SACCOs.

The study found that a wide majority of the respondents believed capital adequacy regulations have led to improved public confidence to varying degree; greatly and
significantly. Rose and Hudgins (2005) argue that capital adequacy promotes public confidence as it serves as government assurance of an institution’s financial stability. Kivuvo and Olweny (2014) reiterate this view stating that regulation provides a platform to rate financial institution performance since the public will have more confidence in institutions that have met these regulatory requirements.

Demirguc-Kunt (2000) states that capital held by institutions as per regulation provides a safety net for deposits by absorbing losses that would otherwise place deposits at risk. In line with the above observations, the greatest proportion of respondents stated that one of the benefits of capital adequacy regulation is that it provides a safety net for members’ deposits. It was evident that a negative correlation existed with membership base implying that SACCOs with lower membership base viewed provision of a safety net to be a great benefit compared to those with greater membership which due to their size may have other methods of guaranteeing member deposits.

Majority of the respondents deemed capital adequacy regulations to have jointly a significant and great impact on the capital available to maintain operations within the SACCO. According to Wilcox (2011), sufficient capital within an institution enables continuity of operations even during periods of low earnings. Duncan et al (2015) supports this view stating that holding appropriate levels of capital enables maintenance of working capital levels thus stabilizing operations in the short term.

The largest proportion of respondents stated that capital adequacy positively impacts their lending capacity to varying extent; significantly and greatly. The respondents stated that capital requirements instigated by SASRA led to increased lending capacity. Kibui and Moronge (2014) also state that SACCOs with sufficient capital have a higher propensity to lend funds to their members. In addition, according to Mulwa (2013) argues that the volume of loans disbursed is directly proportional to the volume of deposits it holds on behalf of its members.

Majority of the respondents stated that capital adequacy greatly impact the SACCO’s growth base. According to Evans (2001), institutional capital as prescribed by SASRA prudential regulations ensures permanency as it cushions against losses that would be otherwise be absorbed by member’s deposits. Adherence to said regulations helps the SACCO grow and maintain economic and financial health.
The respondents stated that capital adequacy positively impacted the ability of the SACCO to prevent insolvency. Ademba (2012) reinforces this view stating that weak insolvency can be covered by a strong capital position that allows for proper cash management in the short term period.

5.3.2 Challenges in Complying with Capital Adequacy Requirements

The regulation of capital requirements has come with its challenges. A number of SACCOs cannot meet the minimum capital requirements and ratios, especially within the period specified by SASRA for implementation. SASRA specifies a four year period from original licensing for complete compliance with capital regulations failure to which results in delicensing (Co-operative Bank of Kenya, 2008). The challenges being evaluated were as follows separating capital from members’ deposits, definition of capital and calculation of ratios, reduced pay-out on members’ funds, recruitment of new members, restricted avenues for investment, and reduced lending capacity.

According to SASRA (2011) a number of SACCOs had not separated capital from members’ deposits as well as separating members’ contributions to properly identify withdrawal deposits and share capital. To the contrary, the study found that this was no longer as significant a challenge for the majority of the respondents. However, it posed a greater challenge among those with higher capital before and after the onset of regulation.

As in earlier discussions, SACCOs especially the smaller ones lacking in integrated financial systems have struggled to accurately define their position as regards compliance with the ratios prescribed in SASRA’s prudential guidelines. (Ngigi, 2013) Majority of the respondents viewed that this was no longer a challenge to them.

Given that institutional capital is raised primarily from reserves, SACCOs have been forced to reduce and in some extreme cases do away with dividends in order to ensure compliance with SASRA regulations and guarantee another year of licensing to continue operations contrary to periods before licensing when they were not required or inclined to retain significant earnings as a trade-off for members’ dividends (Olando, et al, 2013). The study found that the aspect of reduced pay-outs on members’ funds posed generally only a slight challenge to the SACCOs overcome by providing members with other incentives.
At the very core of co-operatives lies a common bond which may limit the scope and field from which to draw its membership. In response to the new guidelines, many SACCOs have broken the common bond, allowing for a larger pool from which to recruit new members creating stiff competition to gain membership from the general public. (Mumanyi, 2014) The study’s findings fell in line with this postulation as generally the respondents stated that recruiting new members posed a significant challenge.

The provisions of the SACCO Act (2008) mentioned earlier largely restrict avenues within which a SACCO may make investments. Without such access to supplementary capital, SACCOs faced with loan losses and or with lower capital ratios have to restrict the growth of their assets and growth of the institution at large. (Mulwa, 2013) The findings of the study were in tandem with this view as respondents largely stated that restricted avenues for investment posed a challenge to their efforts to meet capital requirements.

In order to meet the capital ratio, SACCOs cannot take on too much debt, and must increase capital instead. This is because increases to capital and liquidity requirements have led to a reduction in the capacity for lending. Reduced lending capacity slows down the income generating activity of the SACCO (Olando, et al, 2013). The study findings fell in line with this theory; majority of respondents indicated that reduced lending capacity was a challenge brought about by increased capital requirements.

5.3.3 Strategies for Meeting Capital Adequacy Requirements

This section outlines a discussion on the findings of the study with regard to the strategies that SACCOs have put in place in order to comply with set regulations.

Increasing capital was discussed earlier as one of the broad strategies a financial institution can use to meet capital requirements. The respondents were asked the extent to which the following strategies, geared at directly increasing capital base, have impacted their efforts of attaining and maintaining capital requirements: issuing new capital, increasing membership, diversifying product base, adjusting their reserve ratio and investing in capital assets.

According to SASRA (2012), SACCOs have on the whole employed increasing capital as a strategy towards meeting prudential regulations as pertains to capital requirements. This has been through increasing minimum share capital per member and offering additional
share purchase. Majority of the respondents asserted that issuing new capital was both greatly and significantly effective in meeting capital requirements. Positive correlation with levels of current capitalization implied that SACCOs currently with a larger capital base had benefited more from issuing new capital as compared to others.

The largest proportion of respondents asserted that increasing membership had a positive impact on their ability to meet capital requirements. Randhawa and Gallardo (2003) argue that wide membership is necessary within a SACCO to provide a strong capital base and thus ensure the success of the institution. In addition, according to SASRA (2011), recruitment of new members has enabled SACCOs to increase their capital base and meet regulatory requirements.

Among the respondents, it was widely held that diversifying product base had a positive impact on capital adequacy. Kipkosgey and Njeru (2014) assert that the more diverse the products offered by a SACCO the more likely that the product ratio per customer will increase. This increases, proportionately, the share capital and deposits of members and leads to income generated from increased uptake of products directly impacting institutional capital. Accordingly, Mulwa (2013) states that modern day SACCOs have expanded the range of services that they offer in order to increase their earnings and reserves.

In order to increase institutional capital, SACCOs need to retain more earnings and set them as reserves. This constitutes an adjustment in the dividend to reserve ratio resulting in increased institutional capital at the expense of members receiving less dividends (Olando, et al, 2013). This is in tandem with the findings of the research where the respondents stated that adjusting the reserve ratio had a positive impact on their ability to meet capital requirements.

As discussed earlier, the Sacco Act (2008) provides for SACCO Societies to invest provided that financial investments held in non-government securities do not account for more than forty per cent of core capital or five percent of its total deposit liabilities and are not to be obtained for speculation but rather should be held to maturity. Respondents stated that investing in capital assets had not been an influential stratagem as they viewed the Sacco Act to be quite restrictive as pertains to such investment. However, those SACCOs with larger current capital base and more branches asserted a greater benefit
accrued from investing in capital assets as opposed to those with less capitalization and operating with fewer branches.

A financial institution may alternatively meet capital adequacy requirements by managing closely its risky assets. This broad range of strategies may also be employed co-currently with the strategies that involve increasing capital. In this study, the respondents were required to state the extent to which a myriad of strategies have contributed to attaining and maintaining capital requirements: stricter credit rating, increased lending rates, writing-off non-performing loans, matching share contributions to amounts guaranteed and reduced payment periods.

According to Decamps (2004), profitability of a deposit taking institution is largely determined by the quality of its loan portfolio. This is seen to hold true as two of required ratios, under SASRA prudential guidelines, are tied to the value of total assets held by the SACCO. Effective management of the loan portfolio through sound lending procedures invariably reduces the risk of default, thus maximising return on said assets (Lagat, et al, 2013).

According to the study by Basel Committee (1999), it was observed that a large proportion of credit problems could be avoided by strong internal credit processes. The findings from respondents irrevocably pointed towards the fact that stricter credit rating was integral in managing their loan portfolios. Kibui and Moronge (2014) reinforce this view stating that credit policy outlining guidelines on handling and management of loans is useful in risk mitigation within the SACCO.

The major attraction of the public to SACCOs has been the low lending rates and high dividend pay-outs. However, cost pricing (matching the price of a product to the costs involved in providing it) has been postulated to be important for SACCOs to determine and thus eventually increase revenue streams from their products (Bwana & Mwakujonga, 2013). The same argument is brought by Young and Barigye (2007) stating that cost pricing provides a theoretical basis to increase lending rates albeit marginally to observe greater than marginal increments in revenue. On the contrary, respondents stated that increasing lending rates has not been a strategy employed as they seek to maintain low lending rates so as to continue to attract membership and easily market their loan products.
For a SACCO to be successful, it must disburse loans and collect loan repayments from the members as per contractual agreement. The impact of not collecting loan repayments are: direct reduction on SACCOS’ liquidity and its profitability (Owen, 2007). Writing off non-performing loans is done by allocating funds as provision for loss. Continual provision for loan losses, cushions against the shock inflicted when faced with actual non-performing loans, thus writing them off (Kahuthu, et al, 2015). In spite of these arguments respondents were of the opinion that writing off non-performing loans had only a slight impact on their ability to meet capital requirements.

As discussed earlier, SACCOs contribute greatly to financial inclusion offering loans to individuals who do not meet the requirements of commercial banks offering more favourable terms and conditions. The web created by members guaranteeing each other against loan default from their deposits more often than not creates scenarios whereby a member guarantees loans beyond the capacity of their deposits (Kibui & Moronge, 2014).

This can be prevented by closer monitoring and placing threshold of maximum amounts that can be guaranteed. This was in line with the responses received from questionnaires. Respondents stated that matching share contributions of their members to the loan amounts guaranteed positively influenced their ability to manage their loan portfolio. Of these responses, there was significant correlation with the number of branches of operation, indicating that those SACCOs operating with more branches viewed matching share contributions to loan amounts guaranteed as more significant a strategy than those with fewer branches.

Generally, the respondents were of the opinion that reduced payment periods had a positive impact on the ability to manage risky assets and hence meet capital requirements. According to McKillop and Wilson (2011), a mismatch is created due to long term assets being financed by demand deposits which are short term in nature. It is therefore in the interest of the SACCO to vary repayment periods for their loan products such that repayment periods are reduced for some of their products to attempt and correct the imbalance. Those operating with a wider branch network viewed reduced payment period as more noteworthy as compared to those with fewer branches.
5.4 Conclusion

5.4.1 Benefits of Adhering to Capital Adequacy Regulations

The study concluded that SACCOs had largely benefited from the imposed capital adequacy regulations. The SACCOs had profited 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.

5.4.2 Challenges in Complying with Capital Adequacy Requirements

The study concluded that 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. SACCOs were found to have overcome the following challenges of separating capital from members’ deposits and definition of capital and calculation of ratios.

5.4.3 Strategies of Meeting Capital Adequacy Requirements

The study concluded that SACCOs had engaged in increasing capital. Such strategies consisted: issuing new capital, increasing membership base, diversifying product base, adjusting dividend pay-out ratio and investing in capital assets. Of these strategies, SACCOs found issuing new capital, increasing membership base, diversifying product base, and adjusting dividend pay-out ratio to be most effective. Investing in capital assets was less effective due to numerous restrictions imposed by the government.

With regard to strategies geared towards meeting capital requirements by managing risky assets, the study concluded that stricter credit rating, matching share contributions to loan amounts guaranteed and reduced payment periods were invaluable approaches. Increasing lending rates and writing of non-performing loans were found to be less effective as strategies.
5.5 Recommendations

5.5.1 Recommendations for Improvement

5.5.1.1 Benefits of Adhering to Capital Adequacy Regulations

Overall SACCOs have benefited from the introduction of capital adequacy regulations. The study recommends that managers of the SACCOs closely adhere to the requirements provided by regulation so as to continue to reap the benefits discussed in this study.

The study recommends that the government through SASRA and the Ministry of Industry and Co-operative development continue to provide an enabling environment for the SACCOs to continue to flourish through beneficial legislation.

5.5.1.2 Challenges in Complying with Capital Adequacy Requirements

During the study it was noted that some of the SACCOs had overcome some of the highlighted challenges such as separating capital from members’ deposits and definition of capital and calculation of ratios.

To the management of SACCOs, the study recommends more cooperation within KUSCCO to enable the SACCOs jointly overcome the challenges they still face such as recruitment of members.

To the government, the study recommends that through SASRA monitoring and evaluation reports on SACCOs and their response to prudential guidelines be transcribed and availed to new SACCOs seeking licensing. The study also recommends that SASRA provide more training and forums for the executives within the SACCOs to enable them meet requirements within stipulated grace periods.

5.5.1.3 Strategies of Meeting Capital Adequacy Requirements

Some of the strategies highlighted in the study were found not to reap benefit to the SACCO. These were increased lending rates, writing off non-performing loans and investment in capital assets.

To the managers of the SACCOs, the study recommends a review of their lending rates via cost pricing methods to ensure that though the rates remain competitively low they yield adequate revenue to offset costs involved in provision of these products.
The study also recommends that the government reviews legislation concerning investments made by SACCOs in order to open up avenues that the SACCOs can engage in and thus maximize wealth for their shareholders.

5.5.2 Suggestions for Further Study

This study was limited to SACCOs of Nairobi County hence its findings cannot be generalized to the whole of the SACCO sector in Kenya. A study may be done to investigate the effect of capital adequacy regulations on savings and credit cooperative societies in other parts of the country.

The study concluded that overall SACCOs have benefited in a myriad of way from the regulations as pertains to capital adequacy. However, there remains room for further study on the challenges the SACCOs continue to face in meeting and maintaining required capital levels. Research on ways to overcome these challenges especially taking into account variables that comprise the institutional profile such as membership base, branch network and length of operation would be forthcoming. These challenges include reduced pay-out on members’ funds, recruitment of new members, restricted avenues for investment, and reduced lending capacity.
REFERENCES


Procasur Africa. (2012). In pursuit of ideas to develop Savings and Credit Cooperatives: Learning from Kenyan Saccos. *An Overview of SACCOs in Kenya* (pp. 5-15). Nairobi: PROCASUR.


APPENDICES

APPENDIX 1: DATA INSTRUMENT-QUESTIONNAIRE

TOPIC: EFFECT OF CAPITAL ADEQUACY REGULATIONS ON SAVINGS AND CREDIT COOPERATIVE SOCIETIES IN KENYA: A STUDY OF DEPOSIT-TAKING SACCOS IN NAIROBI COUNTY

Introduction: The purpose of this questionnaire is to collect data on the effect of capital adequacy regulations on savings and credit cooperative societies in Nairobi County. Once the data is collected the information will be used to inform in the enhancement and development of the regulatory provision and to add to the academic research that exists.

SECTION 1: INSTITUTIONAL PROFILE

1. How many years has the SACCO being operating as a FOSA
   - <5yrs □
   - 5-10yrs □
   - >10yrs □

2. What is the total number of members currently?
   - <1,000 □
   - 1,000-5,000 □
   - 5,000-10,000 □
   - >10,000 □

3. What is the sponsoring entity?
   - Teacher based □
   - Government based □
   - Farmers based □
   - Private institute based □
   - Community based □

4. What was the capitalization level before licensing?
   - < 3M □
   - 3-5M □
   - 5-10M □
   - >10M □

5. What is the current capitalization level (Millions)?
   - <50M □
   - 50-100M □
   - 100-400M □
   - >400M □

6. How many branches does the FOSA have?
   - < 3 □
   - 3-5 □
   - 5-10 □
   - >10 □
SECTION 2: BENEFITS OF CAPITAL ADEQUACY REGULATION

a) To what extent have the following benefits accrued to the SACCO as a result of adhering to capital adequacy regulations?

   Not at all, 2- Slightly, 3- Significantly, 4-Greatly

<table>
<thead>
<tr>
<th>Benefits</th>
<th>1 Not at all</th>
<th>2 Slightly</th>
<th>3 Significantly</th>
<th>4 Greatly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meeting regulatory requirements</td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Improved Public confidence</td>
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<tr>
<td>Safety net for members deposits</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Providing adequate capital for operations</td>
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</tr>
<tr>
<td>Managing credit risk</td>
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<tr>
<td>Increased lending capacity</td>
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<tr>
<td>Provides a base for future</td>
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<td></td>
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<tr>
<td>Growth of SACCO</td>
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<td></td>
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<tr>
<td>Prevent insolvency</td>
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<tr>
<td>Others (specify)</td>
<td></td>
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</tbody>
</table>

SECTION 3: STRATEGIES UNDERTAKEN TO MEET CAPITAL REQUIREMENTS

a) Increasing Capital

To what extent have the outlined strategies aided in meeting capital requirements in your SACCO?

1-Not at all, 2- Slightly, 3- Significantly, 4-Greatly

<table>
<thead>
<tr>
<th>Strategies</th>
<th>1 Not at all</th>
<th>2 Slightly</th>
<th>3 Significantly</th>
<th>4 Greatly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuing new capital</td>
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<td></td>
<td></td>
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<tr>
<td>Increasing membership base</td>
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<td></td>
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<tr>
<td>Diversifying product base</td>
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<tr>
<td>Adjusting dividend payout</td>
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<tr>
<td>Investing in capital assets</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Others (specify)</td>
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</tbody>
</table>
b) Decreasing Risk Weighted Assets

To what extent have the outlined strategies aided in meeting capital requirements. 1-Not at all, 2- Slightly, 3- Significantly, 4-Greatly

<table>
<thead>
<tr>
<th>Strategy</th>
<th>1 Not at all</th>
<th>2 slightly</th>
<th>3 significantly</th>
<th>4 greatly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Writing off Nonperforming loans</td>
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<tr>
<td>Increasing lending rates</td>
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<tr>
<td>Stricter credit rating and analysis</td>
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<tr>
<td>Matching share contributions to loan amounts guaranteed</td>
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</tr>
<tr>
<td>Reduced payment periods</td>
<td></td>
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<td></td>
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<tr>
<td>Others (specify)</td>
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<tr>
<td><strong>SECTION 4: CHALLENGES IN MEETING CAPITAL REQUIREMENTS</strong></td>
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<tr>
<td>a) To what extent does the SACCO face the outlined challenges?</td>
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<td>1-Not at all, 2- Slightly, 3- Significantly, 4-Greatly</td>
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<tr>
<td>Separating member deposits from capital</td>
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<tr>
<td>Defining and calculation of ratios</td>
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<tr>
<td>Recruitment of new members</td>
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<td>Reduced member pay outs</td>
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<td>Restricted avenues for investment</td>
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<td>Reduced lending capacity</td>
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<td>Others (specify)</td>
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