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IMPACT OF CAPITAL ADEQUACY ON FINANCIAL PERFORMANCE OF SAVINGS AND CREDIT COOPERATIVES SOCIETIES IN MERU COUNTY

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ABSTRACT

The goal of this report is to establish how capital adequacy influences the monetary performance of Meru County's licensed deposit-taking credit and savings cooperative institutions. The Pecking Order Theory was used in the study. The researcher used an expressive research design. The study focused on thirteen accredited deposit-taking SACCOS in Meru County. A catalogue of all certified deposit-compelling saccos in Meru County was used in the analysis. The survey method was used since the sample size was restricted. To achieve the aims of the research, quantitative information was scrutinized using the SPSS, which comprised both expressive and inferential statistics (SPSS version 25). To make conclusions, the study findings were analyzed, summarized, and presented using various eloquent statistical procedures. The study found out that there was a positive and significant relationship between capital adequacy and financial performance of Meru County's licensed deposit-taking credit and savings cooperative institutions. The study recommended that the executive must ensure that sufficient credit management controls are in place to guarantee that there is always optimal cash where there are strategies in place during low cash and surplus cash since either side will add to the organization's liquidity risk. Secondly, there is a need to critically examine in depth the cash management issues in both the external and internal environments that might impact cash management in institutions and to identify mitigating measures. Lastly, liquidity risk management should involve the management team's projected cash and collateral needs, as well as the use of secondary sources of liquidity.

Key Words: *Capital Adequacy, SACCOs, Deposit Taking*

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INTRODUCTION

Liquid assets have just become restricted and the liquidity risk has increased in many firms, producing gains or losses. Financial institutions have developed complex, tremendously difficult liquidity management programs to coordinate their work since liquidity correlates positive performance (Agbada & Osuji, 2013). Cooperative societies are an autonomous organization of persons who voluntarily come together in joint and independently managed businesses, which function under the principles of cooperatives, to accomplish their mutual economic and social requirements (Jacob, 2014).

In Kenya, Ongore &Kusa (2013) analyzed why banks failed in Kenya. In 2014, Fredrick scrutinized the influence of liquescence risk policies on commercial firms in Kenya, and found that the value of assets and liquidity were the major factors contributing to bank failures. According to Mwandia (2014), under the anticipation of projected earnings, SACCOs should use their resources more efficiently. Diversity, accomplishment, transformation and replacement of long-term assets are the basic solution to investment (Makori & Jagongo, 2013). Apuoyo (2015) said that a financial institution's financial success was based on its capacity to predict, prevent and detect risks and perhaps to deal with risk losses. Thus, a financial institution should evaluate how much risk affects assets while deciding on the allocation of resources for assets. Ngeche (2017) noted that financial institutions are vulnerable to liquidity risk since they perform numerous activities involving cash and other liquid assets. This is the danger that when a financial institution seeks to withdraw money, it may fail to satisfy its financial commitments to investors. This will impact the reputation of SACCOs in Meru County, which may raise capital cost and hamper the financial performance of the institution.

The liquidity as defined by the Central Bank of Kenya (2016) refers to any financial institution's capacity to finance a rise in assets while at the same time fulfilling its liabilities without unwanted losses. The ability of financial institutions to acquire cash or loan requirements, or their liquidity free of increased expenditure in the process are usually evaluated. The management of liquidity is thus highly important to achieve the immediate and long-term goals of each financial organization. Dang (2011) states that there is a high liquidity in some financial institutions to avoid spending on specific investments that are likely to generate more profits. Uzhegova (2010) highlighted that the profitability of a financial institution is strongly related to the liquidity level.

Fiscal success is a critical aim that all companies, especially profit-making ones, strive towards (Yahaya & Lamidi, 2015). The extent to which an organization’s aims were met is referred to as performance (Yahaya & Lamidi, 2015). According to Apuoyo (2015), organizational performance refers to how well an association exploits its properties from its primary function of shepherding business and the subsequent creation of profit. In terms of financial yearly reports, competence may also reflect an organization's general well-being.

During their early phases, SACCOs functioned in a planned rather than market-oriented setting. The Kenyan cooperative movement may be traced back to 1908, when a cooperative was formed in Kericho to seek a better market for tea (Kamonjo, 2016). To safeguard members' investments and, eventually, the country's economic prosperity, the government amended the rules in 2004 and reversed its role in overseeing and monitoring the operations of SACCO organizations (Alukwe et al., 2015).

In Kenya, deposits taking SACCOs have witnessed a fast growth in the recent past. SACCOs are formed by members with the objective of mobilizing savings for the purpose of creating sources of credit for its members at competitive rates of interest (Moturi & Mbiwa, 2015). Since many of the members tend to be in low income brackets, by their very nature, SACCOs are aimed at alleviating poverty. They are part of the co-operative movement which supports 45% of Kenya's economic activities, and it is

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therefore one of the options for achieving sustained economic growth (Marwa & Aziakpono, 2015).

There are approximately 17,000 listed cooperatives in Kenya, and somewhat more than 150 deposit-taking SACCOs approved by SASRA, with Meru County having thirteen (13) deposit-taking SACCOs licensed by SASRA. The crusade is estimated to have more than Kenya Shillings 500 billion in investments and more than Ksh 650 million in investment, as well as directly employing about 500,000 people. SACCOs provide roughly 4% of gross domestic profit, and a lot of individuals rely on the SACCO movement for a living. SACCO liquidity administration in Kenya is overseen by the Sacco Society Act of 2008. It requires Sacco Unions to retain 15% of deposits and short-term loans in liquid assets in order to conduct their businesses successfully (SASRA, 2019).

Deposits taking SACCOs have continued to expand their physical presence and operations to various parts of the country, with a total of 464 physical branches spread out in different parts of the country being recorded in 2017. Further to head office locations which are channels of delivery, DT-SACCOs account for almost 638 physical financial delivery channels spread across the country. Even though there is evidentially high concentration of these physical branches in about a third of all the counties, it is noteworthy that the branch networks of SACCOs are generally situated in small market and trading centers, in which they are the only known formal financial institution, thereby heavily deepening the availability of financial services to the Kenyan populace.

Problem Statement

The number of SACCOs created in Kenya with the aim of establishing financial intermediation, serving as a connection between savings and lending institutions, has grown significantly in recent years. As of December 31, 2020, the Securities and Exchange Commission of Kenya supervises and licenses 175 deposit-taking SACCOs in Kenya (SASRA). One possible reason is the SASRA's stringent rules regulating deposit-taking SACCOs. SASRA rules require all SACCOs to maintain a minimum principal requirement of 10% of total assets, 8% of all deposits, and 8% of SACCO equity as a percentage of aggregate assets (SASRA, 2019).

Despite their importance in the national economy DT SACCOs in Kenya are characterized by unsatisfactory member service delivery and poor performance, leading to collapse, closure and restriction (Mathuva, Muthuma & Kiweu, 2016). In the year 2017, two DT-SACCOs had their licenses revoked and 12 DT-SACCOs were operating on conditionally restricted half-year licenses for failing to meet their financial obligations. In addition, even though total income in SACCOS had been increasing for the past five year, non-performing loans had been on the increase, having increased from5.23% in 2017 to 6.14% in the year 2018, (SASRA, 2019).

The deposit and loan portfolio in SACCOs amounts to about 34 percent of national savings and about 24 percent of outstanding domestic credit (CBK Report, 2018). It is undeniable fact that member's loan demand is very high and incompatible compared with the availability of funds. This follows that SACCOs face a risks arising from liquidity shortage and this has been a major cause of failure of many financial cooperatives. SACCOs convert immediately available savings deposits into loans with longer maturities.

The overall performance of Deposit Taking Sacco in Kenya has been declining drastically as measured by ROE and interest margin to gross income. According to the Sacco Supervision Report (2016) Non-performing loans increased from 5.12 percent in 2015 to 5.23 percent in 2016, indicating elevated credit risk. This was driven mainly by the increase on the non-performing loans from Kshs 13.21 Billion in 2015 to Kshs 15.57 Billion in 2016. Liquid assets to saving Deposits (Liquidity Ratio) reduced from 55.9 percent in 2015 to 49.95 percent in 2016, indicating the decline in liquidity thereby posing liquidity risk. Many DT Saccos are often unable to meet their short term obligations to their members, particularly the disbursement of loans. The interest

spread has not been relatively stable from 2011 to 2016. Operating Expense to Total Assets Ratio increased from 5.13 percent in 2015 to 5.44 percent in 2016, indicating elevated operational risk. These risks faced by Saccos if not properly managed have the potentials to affect the financial performance of the Saccos and at extreme cases leads to their winding up (Olando, et al.,. 2020).

Kimathi (2013) and Mugo, Njeje, and Otieno (2015) examined the variables that affect the liquidity risk management methods of Kenyan microfinance businesses. In his 2010 analysis on the impact of liquidity risk supervision on the financial performance of profit-making banks in Kenya, Oludhe (2010) discovered a statistically substantial correlation between the CAMLS constituents and financial performance. Ngaari (2016) reconnoitered the influence of risk management methods on the profitability of publicly listed Kenyan commercial banks. The financial concert of financial institutes is undoubtedly affected by a wide range of risk factors; yet, little study has been done locally to consider the consequence of liquidity peril management methods on financial performance. Previously, academics and researchers focused on banks and SACCOs in general. This study used panel data regression to improve on prior research on the outcome of liquidity menace management methods in deposit-taking SACCOs. In addition, the findings of the empirical studies revealed that no study has been conducted to examine influence of capital adequacy on financial performance of DT Saccos in Kenya. Further there is no consensus as to whether proper capital adequacy leads to financial performance; this contradicting finding necessitates a study on effects of capital adequacy on the financial performance of licensed deposit taking SACCOs in Kenya.

Objective of the Study

The purpose of this study was to look into the effects of capital adequacy on the financial performance of licensed deposit taking SACCOs in Kenya, specifically in Meru County. The study answered the following research question;

- How does capital adequacy affect the financial performance of licensed deposit-taking SACCOs in Meru County, Kenya?

LITERATURE REVIEW

Theory of Pecking Order

The Pecking order postulation assumes that incomplete information between a firm's management and investors is solely responsible for leverage choices. Investors are expected to be wary of the stock offering, according to the companies. As a consequence, companies prefer to fund their investments first with retained profits, then with debt, and lastly with equity if the previous two choices fail to provide the entire amount of money needed for investments (Calabrese, 2011). This approach ignores the presence of target leverage, in which retained profits are prioritized in terms of financing fresh investment and equity such as stocks, is prioritized last (Bontempi & Golinelli, 2001).

Myers and Majluf developed the Pecking order hypothesis in 1984 to explain the consequences of knowledge asymmetries between outsiders and insiders of the business. If the company's own resources are inadequate to support its investments, debt financing may be used. When debt financing is no longer beneficial to the company (i.e., when the expenses of debt financing exceed the advantages of debt financing), the company may issue stock as equity (Raza, 2014).

Because managers do not favor issuing additional equity in the form of stocks, the theory of pecking order predicts that most companies with significant financial requirements will end up with a very high debt ratio (Al-Tally, 2014). Financial leverage, according to this idea, has a major effect if external finance is only sought when internal funding is inadequate. As a consequence, a SACCO in serious financial difficulty has no choice except to issue stock; if the excess continues, the SACCO will inevitably become a net lender. This hypothesis describes how SACCO performance is influenced by capital leverage techniques. The importance of the

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pecking order hypothesis in this research is that it explains why most of the best-performing financial institutions borrow less. They are able to do so because they do not need outside financing. Financial firms that are less successful borrow because they do not have enough internal money to invest in capital. More significantly, this hypothesis shows how profitability and financial leverage are inversely related in the business.

Empirical Exploration

Capital Adequacy and Financial Performance

The fundamental aspect of regulation of the financial sector is capital requirement. Setting capital requirements is a major policy issue for regulators across the world. It received more prominence after 2007/2008 financial crises that led to the review of Basel capital requirements. Motivated by ensuring stability in the SACCOs, which entered to more risky business of deposit taking, SASRA issued prudential guidelines which require DTS to hold a minimum of KSh. 10 Million as core capital. In addition they should hold a core capital of not less than eight per cent (8%) of the total deposits liabilities (SASRA. 2019).

As set out by SASRA, core capital represents the sum of; share capital, statutory reserves, retained earnings/accumulated losses, the net surplus after tax, capital grants (Equity in nature), general reserves (include all loss) and other reserves, fewer deductions, investments in subsidiary and equity instruments of other Institutions, and other deductions (Said & Tumin, 2012). Total deposits were measured as the sum of deposits from members, including interest and deposits from all other sources including interest. The core capital to total deposit requirements has the potential of impeding the ability of the DTS to aggressively pursue a savings mobilization strategy. Once the minimum 8% threshold has been achieved, it becomes imperative that any additional savings must be accompanied by an equivalent proportionate increase in the levels of core capital if the DTS is to remain in compliance (Sharma, 2017).

Because capital plays a significant role in minimizing bank closures and depositor losses when a bank shuts, a financial organization with sufficient capital can withstand losses (Kamau, 2015). According to Ejoh and Iwara (2014), excessive capital leads to poorer earnings because risk-averse financial institutions miss possible investment possibilities, resulting in shareholders' requests for a lower return on capital in exchange for less risks. Even if capital is costly in terms of anticipated returns, according to Gavila and Barbra (2012), financial institutions with substantial capital have a lower risk of going bankrupt and are less likely to seek money from outside sources, especially in emerging countries where borrowing is difficult. As a consequence, financial institutions with sufficient capital benefit more than those with inadequate capital. Capital sufficiency ultimately affects how effectively SACCOs can manage balance-sheet shocks, according to Mwandia (2014).

The bank's capacity to utilize hazards such as operational and credit risk is then calculated using the capital adequacy ratio. Both organizational and non-organizational capital are included in the SACCO capital design. Organizational capital includes customers' everlasting and non-retractable stocks, legal reserves, universal reserves, maintained income or accrued losses, current yearly returns, and borrowed money. Adjusted funds, temporary funds, and un-shared funds are the three types of non-organizational capital (Rehema, 2013). Because clients are more susceptible to instability, sufficient capital helps a financial institution's liquidity. Financial instability is exacerbated by a lack of capital. A sufficient amount of money encourages fund growth and protects against insolvency. A key element in evaluating capital adequacy is meeting capital requirements.

Shahchera (2012) considered at the link amid Malaysian banks' capital adequacy and their financial performance. The main aim was to see how capital adequacy affected Sacco's performance. The research relied on the loanable money and agency theories. A descriptive study

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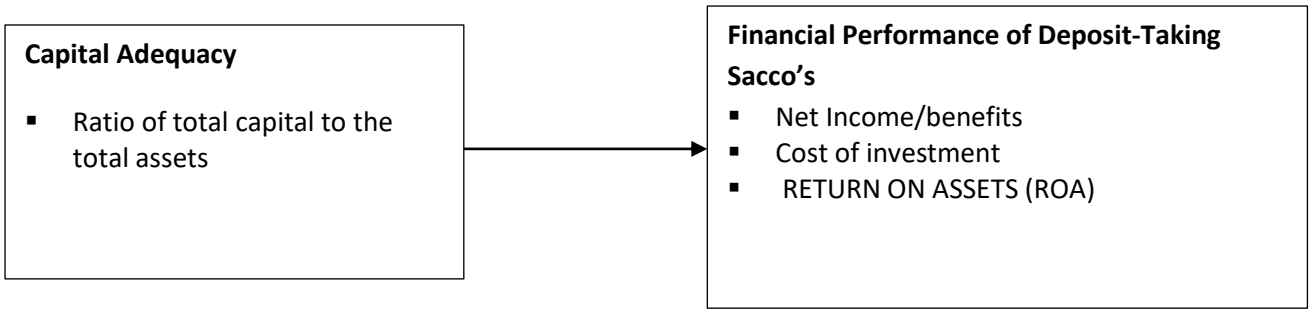
approach was employed with a goal of 25 Saccos in Meru County. The Sacco's yearly reports were used to collect secondary data. This means that Malaysian banks' capital sufficiency had no effect on their performance. The capacity of a SACCO's equity to absorb shocks is known as capital adequacy (Kosmidou, 2013). In order to promote performance, capital is required. Customers are worried about the financial institutions' capital, which they believe is insufficient to guarantee the safety of their savings. Deposits and capital funds play a significant role in capital adequacy, as defined by the capital-asset ratio, which is a prerequisite for all financial institutions' long-term existence.

Conceptual Framework



Independent Variable **Dependent Variable**

Figure 1: Conceptual Framework

METHODOLOGY

The primary goal of this research was to see if capital adequacy affects bank performance. The descriptive research method was used. The sampling frame for the study was an incline of all formally registered deposit-taking SACCOS in Meru County from the Meru County SASRA database. There were currently 175 deposit-taking SAACOs licensed in Kenya as of December 31, 2020. Concurring to Mugenda and Mugenda (2008), when the intended population is insignificant, the entire focused population is sampled, so the scholar sampled all 13 licensed deposit taking SACCOs in Meru County and thus used the census sampling method.

The use of questionnaire for data collection was considered appropriate since the data was generated from primary source. Structured questionnaire was therefore used to collect data from the sampled SACCOs employees. Secondary data was gathered by the researcher to supplement the primary data gathered via the questionnaire.

RESULTS

Effect of Capital Adequacy Management

There were several statements on the effect of capital adequacy Management on the Financial Performance of SACCOs in Meru County by applying a 5-scale rating whereby: 1= Not at all, 2. Little Extent 3= Moderate Extent 4=Large Extent 5. Very Large Extent. Table 1 showed the results.

Table 1: Capital Adequacy Management on Financial Performance

Capital adequacy	Mean	Std. Dev
My SACCO has a formal capital adequacy plan in place	3.6563	0.74528
The capital plan helps my SACCO to clearly define strategies for addressing liquidity shortfalls in emergency situations	3.5625	0.80071
The capital adequacy plan in my SACCO is regularly tested to ensure that it is operationally sound	3.4375	0.94826
Senior management team are charged with coordinating liquidity risk plans	3.4375	0.94826
The major aim of having a capital adequacy plan is to provide a framework for analyzing a liquidity crisis situation	3.6875	0.73780
SACCOs formulate policies to manage a range of stressful financial environments in current or future times	3.5312	0.84183
Extent of funding management affects financial performance	3.6563	0.70066

With a mean of 3.6563 and a standard deviation of 0.74528, SACCO has a documented contingency funding strategy in place. With a mean of 3.5625 and a standard deviation of 0.80071, the financing plan assists my SACCO in clearly defining solutions for handling liquidity deficiencies in emergency scenarios. My SACCO's capital adequacy is frequently assessed to verify that it is tactically sound, and the mean and standard deviation were 3.4375 and 0.94826, respectively. The average of the senior leadership team entrusted with orchestrating liquidity risk plans was 3.4375, with a standard deviation of 0.94826.

Financial Performance of SACCOs

There were several statements on the Financial Performance of SACCOs in Kenya by applying a 5scale rating whereby: 1= Not at all, 2. Little Extent 3=Moderate Extent 4= Large Extent 5. Very Large Extent as shown in table 2 below.

Table 2: Financial Performance of SACCOs

Financial Performance	Mean	Std Dev
Maximum returns on the capital employed in the business	3.5938	0.7562
Increase in asset base of the SACCOs	3.6563	0.7878
Better performance of the SACCO's loan book	3.4688	0.9156
High returns on investment	3.75	0.7182

The mean and standard deviation of maximum returns on capital employed in the business are 3.5938 and 0.7562, respectively. The increment in SACCO asset base was 3.6563, with a standard deviation of 0.7878. The loan book of the SACCO performed better, with a mean of 3.4688 and a standard deviation of 0.9156. The average return on investment was 3.75, with a standard deviation of 0.7182.

CONCLUSION AND RECOMMENDATION

It has been proven that adequacy is one of the most critical hazards impacting financial performance. Proper finance management methods assist SACCOs in maintaining a level of operating capital during times of stress. The amount of liquidity in a SACCO is managed through cash flow and assets management. The management of capital adequacy has an impact on financial performance. A contingency funding plan's main goal is to provide a framework for analyzing a liquidity crisis situation. The extent to which funding is managed has an impact on financial performance. The findings are congruent with those of Magara (2013), who indicated that anytime SACCOs enhance the efficacy of their internal controls, their financial performance improves dramatically. SACCOs' financial performance tends to improve as their asset base grows. SACCOs perform better and provide higher returns on investment.

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The analysis indicated that capital adequacy has an impact on SACCO financial performance. The study finds that cash flow management has a substantial impact on SACCO financial success. Cash flow management has a beneficial impact on SACCO financial performance.

The study determined the extent to which capital adequacy impacts the performance of Kenyan SACCOs. The report specifically advises; the study intended to determine the influence of liquidity risk management on financial performance of savings and credit cooperative organizations through a survey of SACCOs in Kenya. In order to continue increasing their financial performance, banks should develop and adopt current risk measuring methodologies such as Risk-Adjusted Return on Capital, according to the research. The executive must ensure that sufficient credit management controls are in place to guarantee that there is always optimal cash where there are strategies in place during low cash and surplus cash since either side will add to the organization's liquidity risk.

A survey of SACCOs was conducted to assess the influence of liquidity risk management on the financial performance of savings and credit cooperative organizations. According to the report, there are external elements that might impact finance management, posing a larger risk in the institution's operations. As a result, there is a need to critically examine in depth the cash management issues in both the external and internal environments that might impact cash management in institutions and to identify mitigating measures.

Recommendation for Further Research

The study focused largely on capital adequacy of the liquidity risk management practices, which influence the financial performance of SACCOs. If research like that could be done in others sectors of the economy, the banking industry as a whole would gain immensely. The companies in this study comprised companies over 3 years, and thus it would be beneficial for the banking industry if studies were conducted at various stages of age to examine the influence of each dimension of the liquidity risk.

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