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CRITICAL REVIEW OF LITERATURE ON FIRM CHARACTERISTICS AND FINANCIAL STABILITY OF DEPOSIT TAKING SACCOS IN KENYA

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Abstract: **This study sought to carry out a critical review of literature on firm characteristics and financial stability of Deposit Taking SACCOs in Kenya. It was found that several studies have been done on firm characteristics and financial stability nexus. The studies are however characterized by several research gaps as the studies were largely on other countries and not Kenya. With respect to these research gaps, the study recommends that empirical researches can done on firm characteristics and financial stability of SACCOs in Kenya. Additionally, the moderation effects of the operational environment on the relationship between firm characteristics and financial stability can be examined.**

Keywords: **Firm Characteristics, Operating Environment, Financial Stability and Deposit Taking SACCOs.**

1. INTRODUCTION

1.1 Background of the Study

Savings and Credit Co-operatives (SACCOs) are user-owned financial institutions that offer both savings and credit services to their members (Alukwe, Ngugi, Ogollah & Orwa, 2015). 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. Over the last decade, regulators of financial institutions have tightened the capital requirement particularly following the 2007-2009 financial crises. This is because capital has long been recognized as one of the key factors to be considered when the safety and soundness of a particular financial institution is being assessed (Osei-Assibey & Asenso, 2015). Gudmundsson, Ngoka-kisinguh and Odongo (2013) posit that the main reason for the hastened build-up of capital is the perception that stronger financial institutions are likely to withstand financial turbulences and therefore increase financial sector stability.

Firm characteristics include characteristics within the firm that determine how a frim allocate resources to generate revenue (Mwangi, Kaijage & Ganesh, 2021). These include firm size, capital structure, efficiency among others. Firm size for instance reflects how large an enterprise is in infrastructure and employment terms. The size of a firm is one of the major drivers of operational costs. Firm size is one of the most influential characteristics in organizational studies. Kellermanns, Walter, Crook, Kemmerer and Narayanan (2016) provides a summary and overview of the importance of firm size. Firm size has also been shown to be related to industry sunk costs, concentration, vertical integration and overall industry profitability. Larger SACCOs are more likely to have more layers of management, greater number of departments, increased specialization of skills and functions, greater centralization and greater bureaucracy than smaller SACCOs.

Firm stability refers to the distance of an individual bank from insolvency and failure. Since the onset of the GFC SACCO stability has been at the top of policy makers agenda across advanced and developing countries (Creel, Hubert & Labondance, 2015). Operating environment which is usually determined by macroeconomic policy, gross domestic

product, inflation, interest rates and political stability are indicators of the overall state of a countries economy. They influence the extent to which nations citizens utilize the financial sector. More favourable macroeconomic conditions are expected to increase the financial inclusion of a population. Higher incomes allow for higher levels of savings which in turn are likely to be held in financial accounts (Adusei, 2015).

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 (Bwana & Mwakujonga, 2013) and in recent years the SACCO sector has faced tough challenges globally as noted by (Kivuvo & Olweny, 2014) to include mission drifts, income generation, compliance, competition, insufficient capital among many others. The sectors financial stability impacts broadly on the nation's economic growth and employment creation. Kenya is an interesting case study for Africa given that it has the largest and the most vibrant SACCO sub sector in the continent commanding 67% and 62% of the total assets and deposits/savings respectively (SASRA, 2011).

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 (Kinyua, 2013).

1.2 Statement of the problem

The deposit taking SACCOs are actually observed to be controlling more than 78% of the total deposits and assets of the SACCO industry (Opala, 2014). Despite this, the sector has seen profit declined by 30.0 percent in the year to June 2020 and assets quality deteriorated, with the ratio of non-performing loans to gross loans increasing from 12 percent in December 2019 to 13.1 percent in June 2020 (Koskei, 2020). SACCOs industry high interest expenses to income ratio and disruptions in members' livelihoods elevated funding and credit risks, respectively hence pointing to stability issues (Kenya Financial Stability Report, 2020). The SASRA allowed SACCOs to restructure and renegotiate loans to ease pressure on their members facing difficulties in repaying loans leaving a lot of deposit taking SACCOs to face stability challenges (Kenya Financial Stability Report, 2020).

Previous studies conducted in this area include Opala (2014) who focused on effect of financial stability on the performance of deposit taking SACCOs in Nairobi County. Amina (2016) focused on the effect of core capital on the financial performance of Deposit Taking Saccos in Nairobi County. Njeru (2016) on the other hand focused on effect of liquidity management on financial performance of deposit taking saving and credit co-operative society in Kenya and finally, Njenga and Jagongo (2019) focused on the effect of financial management decisions on financial performance of selected non-deposit taking SACCOs in Kiambu County, Kenya.

1.3 Objective of the Study

This study sought to carry out a critical review of literature on the effect of firm characteristics on financial stability of Deposit Taking SACCOs in Kenya.

2. LITERATURE REVIEW

2.1 Theoretical Review

Buffer Capital Theory proposed by Calem and Rob (1999). The buffer theory predicts that financial institutions in this case Saccos must maintain a level of capital above the required minimum (a buffer of capital). The costs of falling below the minimum required level of capital are both explicit and implicit. The theory further posits that financial institutions approaching the regulatory minimum capital ratio may have an incentive to boost capital and reduce risk in order to avoid the regulatory costs triggered by a breach of the capital requirements. Poorly capitalized financial institutions may also be tempted to take more risk in the hope that higher expected returns will help them to increase their capital (Ochei, 2013).

This effectively opines that the relationship between capital adequacy and efficiency can either be positive or negative depending on the risk-taking behaviour of the institution. High expected returns and high equity capital ratio can each serve as a buffer against portfolio risks to reduce the probabilities of incurring the costs of financial distress/bankruptcy, so firms with high expected returns owing to high profit efficiency can hold lower equity ratios.

Economic Efficiency Theory as introduced by Samuelson (1979) states that companies should structure their output to achieve the lowest possible cost per unit produced. Fixed costs are shared out among the number of units produced, while the variable costs are relative. Due to the combination of fixed and variable costs in a business, then, low levels of output are inefficient because fixed costs are shared out across a relatively small number of units (Leibenstein, 1978). Economies of scale can be enjoyed above optimal production but the apparent benefit is often offset by additional costs because the existing systems will be overworked. The point of maximum operational efficiency is achieved at the level of output at which all available economies of scale are taken advantage of in the short run, but short of the level at which the diseconomies of overstraining existing systems come into play (Murillo-Zamorano, 2004). However, the optimal level of productive efficiency can be raised by increasing the capacity of existing systems in the long run (Teece, 1982).

Liquidity Preference Theory was proposed by John Keynes and it indicates that most of investors tend to prefer short term securities over long term securities (Keynes, 1973). In Keynes view, the crucial way that lending rates impact the level of cumulative output is via their influence on their scheduled investment disbursements. Dimand and Robert (2008) indicate that Profit seeking organizations do their investment mainly through physical capital such machinery and raw materials and expect to earn from them other than from interest cost of loan of investment finance. Keynes in the liquidity preference theory advocates for government to come up with adequate monetary policy to manage interest rates. However, Keynes believes that there are other factors that affect investment demand schedule and therefore monetary policy alone cannot achieve the desirable levels of investment and maintain full employment. Walsh (2010) also posited that there exists a relationship between investment demand and commercial banks' lending rates sensitive adjustments.

2.2 Empirical Review

Karim, Chan and Hassan (2010) conducted a study on bank efficiency and non-performing loans using evidence from Malaysia and Singapore. Cost efficiency was estimated using the stochastic cost frontier approach assuming normal-gamma efficiency distribution model proposed by Greene (1990). The cost efficiency scores were then used in the second stage Tobit simultaneous equation regression to determine the effect of non-performing loans on bank efficiency. The Tobit simultaneous equation regression results clearly indicated that higher non-performing loan reduces cost efficiency.

Fiordelisi, Marques-Ibanez and Molyneux (2011) studied the relation between bank efficiency, risk and capital ratios. The study was broader than an assessment of the efficiency impact of capital ratios. They used Granger-causality tests in a GMM dynamic panel framework to examine consider three dimensions of efficiency cost efficiency, revenue efficiency, and profit efficiency and notably examine reverse causality, both from efficiency to capital and from capital to efficiency. They find that the less efficient banks tend to take on more risk and that better capitalized banks perform better in terms of efficiency

Dang (2013) conducted a study on Institution investments and efficiency in transition economies. Perpetual Inventory Method was used to construct capital series for these countries, and then stochastic production frontier analysis was used to estimate the efficiency scores and effects of institutions investments at the same time. The empirical results showed that better institutions investments are associated with higher efficiency.

Pessarossi and Weill (2013) sought to determine whether capital requirements affected bank efficiency. The study investigated the relation between capital ratio and bank efficiency for Chinese banks over the period 2004−2009, taking advantage of the profound regulatory changes in capital requirements that occurred during the period to measure the exogenous impact of an increase in the capital ratio on banks' cost efficiency. The study found that such an increase has a positive effect on cost efficiency, the size of which depends to an extent on the bank's ownership type. The results therefore suggested that capital requirements can improve bank efficiency

Kisengo (2014) investigated the effect of firm characteristics on performance of the microfinance sector in Nakuru, Kenya. The objective of study was to examine the effect of firm characteristics on the performance of the microfinance sector in Kenya. The study adopted correlational research design. A census was done on the 48 institutions registered with AMFI and operating in Nakuru. Primary data was collected using questionnaires. This was supplemented with secondary

data. Data on firm characteristics and organizational performance was summarized using descriptive statistics. The relationship between firm characteristics and performance of MFIs was examined using correlation. The effect of firm characteristics on performance of microfinances was determined by regression analysis. Findings revealed that firm characteristics have a significant positive effect on performance of MFIs. Structure related characteristics had the greatest while capital related had the least effect on performance of microfinances. It is recommended that practitioners address and nurture firm characteristics to improve on performance of the sector

Nyangeri (2014) focused on the effect of firm characteristics on the financial performance of pension schemes in Kenya. The study attempted to establish the effect of firm characteristics on financial performance of pension schemes in Kenya. More specifically, the study sought to determine the effect of membership age, fund size, fund design and density of contribution on the financial performance of pension schemes in Kenya. The quantitative data collected was analyzed by the use of both descriptive and inferential statistics using statistical package for social sciences (SPSS) version 20. There were strong, significant and positive correlations between ROI and: Density of contributions, Fund value, Fund size, and Fund returns. Weaker, significant and positive correlations were established between ROI and Fund design and Age.

Sanghani (2014) conducted a study on the effect of liquidity on the financial performance of non-financial companies listed at the Nairobi Securities Exchange. The objective of the study was to establish the effect of liquidity on the financial performance of non-financial companies listed at the NSE. Secondary data was collected from NSE and multiple regression analysis used in the data analysis. The study revealed that liquidity positively affect the financial performance of non-financial companies listed at the NSE. The study established that current ratio positively affects the financial performance of non-financial companies listed at the NSE. The study also revealed that an increase in operating cash flow ratio positively affects the financial performance of non-financial companies listed at the NSE.

Nikoo (2015) conducted a study on impact of capital structure on banking performance using evidence from Tehran Stock Exchange. Based on financial statements of Iranian banks for the period 2009-2014, the study established a model to measure the effect of capital structure on the bank efficiency measured by return on assets (ROA), return on equity (ROE) and earnings per share. It was found that capital structure has positive impact on bank performance. The significant levels were positive between dependent variable and independent variable which were used in the study such as ROE, EOA, EPS and debut to equity.

Another study by Azhar (2015) sought to investigate impact of liquidity and management efficiency on profitability using an empirical study of selected power distribution utilities in India. The study consists a sample of 23 power distribution utilities operating in India for the period of 2006 until 2013. Therefore, the total panel (balanced) observations are 207. The return on capital employed was used as a measure for profitability explaining dependent variable, whereas a current ratio, quick ratio, absolute cash ratio, debtor turnover ratio, creditor turnover ratio, collection efficiency, interest coverage ratio are representing independent variable. Statistical tools such as correlation and Generalized Least Squares (GLS) regression were applied. Debtor's turnover ratio, collection efficiency and interest coverage ratio showed a significant impact while quick ratio, absolute liquid ratio and creditor's turnover ratio show an insignificant impact on profitability of selected sample utilities

Similarly, Demirgünes (2016) focused establishing the effect of liquidity on financial performance evidence from Turkish Retail industry. The stationarity of series and the co-integration relationship between them are tested by the unit root test of Carrioni-i-Silvestre et al. (2009) and the co-integration test of Maki (2012), respectively. Co-integration coefficients are estimated by Stock and Watson (1993) dynamic OLS method. Finally, causal relationships between the series are tested by Hacker and Hatemi (2012) bootstrap causality test. Results of Maki (2012) test showed that the series are co-integrated in the long-run. While long-run parameters estimated posit a significantly positive relationship between financial performance and liquidity, causality test does not indicate any direction of causality between the series

3. FINDINGS AND CONCLUSIONS

This study sought to carry out a critical review of literature on firm characteristics and financial stability of Deposit Taking SACCOs in Kenya. It was found that several studies have been done on firm characteristics and financial stability nexus. The studies are however characterized by several research gaps as the studies were largely on other countries and not Kenya. Notably, different countries operate based on varying regulatory guidelines as such the findings of the previous studies cannot be generalized for Kenya.

4. RECOMMENDATIONS

In view of the conclusions of this study, a number of studies were done on firm characteristics and financial stability relationships. With respect to the research gaps as documented in the findings and conclusion, this study recommends that empirical researches can done on SACCOs in Kenya rather than commercial banks which is largely the case in empirical literature. Additionally, the moderation effects of the operational environment on the relationship between firm characteristics and financial stability can be examined.

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