

**THE EFFECT OF REGULATION ON FINANCIAL PERFORMANCE OF
SAVINGS AND CREDIT COOPERATIVE SOCIETIES (SACCOS)
OFFERING FRONT OFFICE SERVICE ACTIVITY (FOSA) IN KENYA**

BY

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DECLARATION

This project is my original work and has not been presented for award of a degree in any other university.

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DEDICATION

To my parents Mr Joackim Wamalwa and Mrs. Electina Wamalwa who have always been a source of inspiration, joy and support in my pursuit for better life.

To my beloved wife, Elizabeth Mutethya and sons Crispin and Calvin Simiyu for supporting and encouraging me while undertaking this study.

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I thank the almighty God for seeing me through this project.

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Finally, I thank my entire family for the encouragement and support during the entire period of my study.

May the almighty God bless you all.

ABSTRACT

This study was on the effect of regulation on financial performance of savings and credit cooperative societies (SACCOs) offering front office service activity (FOSA) in Kenya.

The study used descriptive research design. A survey was done to establish the impact of regulation on the performance of FOSA SACCOs in Kenya. There are about 122 such SACCOs in Kenya of which a sample was taken using systematic random sampling. Data was collected by use of questionnaire method which had both structured and unstructured questions. It was analyzed mainly by use of descriptive statistics such as the charts and graphs measures of central tendency. In addition, an advanced statistical technique such as regression was also used.

Following the study findings it was possible to conclude that the introduction of governance regulations had impacted positively on the financial performance of SACCOS. The specific governance practices that had a positive relationship with financial performance included; election of an independent board, the constitution of independent board committees, subjecting directors and senior management to vetting by SASRA and separation of the responsibilities of the board and the management. It was possible to conclude that introduction of prudential regulations had impacted positively on the financial performance of SACCOS. The specific prudential guidelines that had an effect on financial performance were; prudential regulation on capital adequacy, prudential regulations on the extent of external borrowing, prudential regulations on asset categorization and provisioning, prudential regulations on maximum loan size and prudential regulations on insider lending. It was possible to conclude that introduction of reporting regulations had impacted positively on the financial performance of SACCOS. The specific reporting guidelines that had an effect on financial performance were; monthly reporting to SASRA on capital adequacy liquidity and deposits, reporting on quarterly risk classification of assets and loan loss provisioning and investment returns and reporting on annual audited financial statements.

The study recommended that the managers of the SACCOs to emphasize on prudential regulations, governance regulation and reporting regulations as doing so would improve the financial performance of SACCOs.

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LIST OF ACRONYMS

ASCA	Accumulating Savings and Credit Association
BOSA.....	Back Office Savings Activities
BSC	Balanced Score Card
CCS	Cooperative Credit Scheme
FOSA.....	Front Office Service Activity
ICT	Information and Communication Technology
KNFC	Kenya National Federation of Cooperatives
KUSCCO	Kenya Union of Savings and Credit Cooperatives
OECD	Organization for Economic Cooperation and Development
SACCO.....	Savings and Credit Cooperative Societies
SASRA	Sacco Societies Regulatory Authority
SHG-PACS.....	Self Help Groups- Primary Agricultural Cooperative Societies)

CHAPTER ONE

INTRODUCTION

1.1: Background of the Study

Savings and Credit Co-operatives (SACCOs) are community membership-based financial institutions that are formed and owned by their members in promotion of their economic interests (Ahimbisibwe, 2007). A cooperative society can run two activities namely; FOSA and BOSA. Back Office Savings Activities (BOSA) is where the SACCO operates their services such as loans, and repayments but don't have a Banking hall/bank kind of service. Such SACCOs do not offer direct access to cash and clients either wait or get referred to main Banks. A Front Office Savings Activities (FOSA) on the other hand, operates banking hall and therefore offers banking hall services (SACCO briefs, 2011).

1.1.1 Financial and Non-Financial Performance Measures

Guest et al (2003) defined performance as outcomes, end results and achievements (negative or positive) arising out of organizational activities. Guest et al (2003) argued that it is then essential to measure strategic practices in terms of outcomes. Guest et al (2003) advocated for the adoption of a stake holders perspective which would ensure that all stakeholders are taken into account when defining outcomes. The need to adopt a stakeholders approach meant that multiple measures of performance outcome would be a better approach in managing stakeholders' expectations. This point of view was anchored on the popularity of the 'balanced scorecard' concept by Kaplan & Norton (1992), whose intention was to ensure that all the interests of the various stakeholders were taken into account. The Balanced Score Card (BSC) is a performance management tool that enables a company to translate its vision and strategy into a tangible set of performance measures. However, it is more than a measuring device. The scorecard provides an enterprise view of an organisation's overall performance by integrating financial measures with other key performance indicators around customer perspectives, internal business processes, and organisational growth, learning, and innovation. Kaplan and Norton (1992) describe the innovation of the balanced scorecard as follows: "The balanced scorecard retains traditional financial measures. But financial measures tell the story of past events, an adequate story for industrial age companies for

which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology, and innovation (Kaplan and Norton, 2006).

1.1.2: Regulation

In legal and economic literature, there is no fixed definition of the term ‘regulation’. In this study, regulation will be taken to mean the employment of legal instruments for the implementation of social-economic policy objectives (Hertog, 1999). A characteristic of legal instruments is that individuals or organizations can be compelled by government to comply with prescribed behavior under penalty of sanctions. Corporations can be forced, for example, to observe certain prices, to supply certain goods, to stay out of certain markets, to apply particular techniques in the production process or to pay the legal minimum wage. Sanctions can include fines, the publicizing of violations, imprisonment, an order to make specific arrangements, an injunction against withholding certain actions, or closing down the business (Hertog, 1999).

A distinction is often made between economic and social regulation, for example Viscusi, Vernon and Harrington (1996). Economic regulation consists of two types of regulations: structural regulation and conduct regulation (Kay and Vickers, 1990). ‘Structural regulation’ is used for regulating market structure. Examples are restrictions on entry and exit and rules against individuals supplying professional services in the absence of recognized qualifications. ‘Conduct regulation’ is used for regulating behavior in the market. Examples are price control, rules against advertising and minimum quality standards. Economic regulation is mainly exercised on natural monopolies and market structures with limited or excessive competition (Hertog, 1999).

Social regulation comprises regulation in the area of the environment, labor conditions (occupational health and safety), consumer protection and labor (equal opportunities and so on).

1.1.3 Regulation and Performance of SACCOs

The introduction of structural adjustment programs heralded the liberalization of the cooperative sector. Market friendly regulations were put in place to rid the cooperative sector of the colonial mentality as well as the over involvement of the state in cooperative matters (Develtere , 2008). In response to SAPs, the state had to withdraw its traditional supportive role to the cooperatives in order to remain in tandem with the spirit of liberalization. Support services like audit, supervision and management training were the first to be withdrawn by the state in many countries, but without a replacement with an alternative institution that could perform the functions. Governments followed up this measure by cutting down the size of the cooperative development department that previously provided the withdrawn services (International Co-operative Alliance - ICA, 1996). The expectation was that cooperatives would henceforth organize themselves for the provision of these services (Develtere , Pollet , Wanyama, 2008).

In many countries, the state restructured the legal framework to give complete autonomy to cooperatives as a means of enabling them to fit in the emerging competitive market economy. This could only be done through legal reforms that promoted the development of co-operatives in tandem with the ICA co-operative principles of voluntary and open membership; democratic member control; member-economic participation; autonomy and independence; education, training and information; co-operation among co-operatives; and concern for community. It was envisaged that this would make the management of cooperatives democratic and professional, and thereby transform them from dependent organizations to self controlled and self-reliant business associations capable of competing with other private enterprises on the market. In addition, the liberalization of the market attracted new actors in the economic sectors where cooperatives hitherto enjoyed monopoly status. The market now comprised of many sellers and buyers, who were guided, not by ownership, but by efficiency, competitive pricing and transparency (Develtere, 2008).

1.1.4: Regulation and Performance of SACCOs in Kenya

Cooperative development in Kenya, like in most African countries, has generally traversed two main eras, namely, the era of state control and that of liberalization. The first era, which

saw the origin and substantial growth of cooperatives under state direction, conditioned these organizations to emerge as dependent agents and/ or clients of the state and other semi-public agencies. By serving as instruments for implementing government socio-economic policies, cooperatives were engulfed into state politics to the extent that the failures of state policies found expression in the cooperative movement. This partly explains why literature on cooperatives in this era is awash with more stories of cooperative failure than stories of cooperative success. Such failures contributed to calls for the liberalization of the cooperative movement in the early 1990s (Hussi *et al*, 1993; Lindberg, 1993).

With the argument that state control was stifling the performance of cooperatives and that their potential contribution to development could only be realized if they operated according to market principles, cooperative development was pushed into the second era that was characterized by economic liberalization. Consistent with the new economic environment that was sweeping across Africa in the 1990s, Kenya introduced new policy and legislation in 1997 in order to liberalize cooperatives. The resultant framework sought to facilitate the development of commercially autonomous, member-based cooperative organizations, which would be democratically and professionally managed, self-controlled and self-reliant business enterprises. Whereas cooperative development in Kenya during the first era is well documented in the existing literature, the second era of cooperative development is yet to be adequately researched and understood.

It is over a decade since the introduction of liberalization measures in Kenya, yet since then very little is known about the unfolding status of the cooperative movement. The few studies available tend to focus on disparate economic sectors of the cooperative movement, rather than providing comprehensive accounts that inform of the current status and functioning of cooperatives. To illustrate, studies have focused on savings and credit (Evans, 2002); agriculture (ICA, 2002); and dairy production (Staal et al, 1997; Owango et al, 1998). Given the circumstances, a number of pertinent questions have not been investigated since the late 1990s. For instance, have cooperatives survived the stiff competition of the liberalized market or have they withered away? What has been the organizational response of cooperatives to the new economic environment into which they were suddenly plunged? Are

cooperatives faring comparatively better or worse than they did in the first era of cooperative development?

1.2: Statement of the Problem

In many countries, the state restructured the legal framework to give complete autonomy to cooperatives as a means of enabling them to fit in the emerging competitive market economy. The area of regulation and the performance has received much scholarly attention. Some studies such as Temple et al (2005) suggest that strict regulation hinders the adoption of existing technologies through reduced competitive pressures or spillovers and hence negatively affecting performance. However, Berr (2008) argues that, while there is much discussion of the negative impacts of regulation, some regulation can have a positive indirect impact on productivity. Regulation of FOSA SACCOs in Kenya is done by Sacco Societies Regulatory Authority (SASRA). The two most significant pieces of regulation that govern FOSA SACCOs include; the new SACCO Societies ACT 2008 and the SASRA Regulations 2010.

Majority of the studies in Africa and Kenya tend to concentrate of the role of cooperative movement in mobilizing credit and savings culture (Evans, 2002, Ahimbisibwe, 2007). Others have concentrated on the growth and evolution of cooperative societies. For instance, Gamba and Kombo (2008) analyzed the evolution, growth and decline of the cooperative sector and argued that on the whole, cooperatives have been unable to provide farmers with credit and farm inputs for financing production. Another study Wanyama (2009) assessed whether the cooperative movement in Kenya had survived the liberization and concluded that a quick appraisal of the situation reveals that cooperatives have largely survived the market forces and continued to grow in number, membership and income. The above studies indicate that there exists differing opinions as to how cooperative societies have fared under different regulation regimes. A study on the regulation and performance of cooperative societies would therefore bridge the knowledge gap brought about by the lack of conclusiveness of reviewed literature. Such as study would therefore be instrumental in reducing the heat to light ratio on this discourse. In addition, the current study observes that the studies by

Wanyama (2009) used qualitative data obtained from macro levels to reach their conclusions. The current study attempts to adopt a micro analysis whereby the level of perceived effectiveness of regulations on each SACCO will be measured against its performance, which renders the results of the current study more appropriate for informing policy at a micro level. The researcher question therefore is; what is the impact of regulation on the performance of FOSA SACCOs in Kenya? The study will focus on the deposit taking (FOSA) SACCOs because they are subjected to more regulations to deal with the increased scope of deposit taking services.

1.3: Objective of the Study

The objective of the study is to assess the effect of regulation on the financial performance of SACCOs with a specific focus on front office SACCO activities (FOSA's) in Kenya

1.4. Value of the Study

The study may be of value to several parties. These parties may include the Government ministry in charge of cooperative development, the SACCO regulatory authority (SASRA), Sacco management, Sacco members, and the student fraternity.

The Government of Kenya through the ministry of cooperative development may use the findings of this study as a blue print to inform policy on the area of regulation. The SACCO regulatory authority may use the findings of this study to pinpoint areas of poor regulation. The authority may adopt this study as its baseline study on the impact of regulation of the performance of SACCOs.

The SACCO management may find the results of this study useful since the results will highlight the causal effect of regulation on the performance of the SACCOs. The management may therefore use the study as a blue print on which areas of regulation add most value to the performance of the SACCO.

Students in the area of cooperative development, finance, law, economics and management may find this study a valuable addition to literature. They may therefore use the study findings to advance their knowledge on the area of regulation and its impact on the performance of SACCOs.

CHAPTER TWO

LITERATURE REVIEW

2.1: Introduction

This chapter entails a review of the theories that have been advanced on regulation, discussion of studies done both locally and internationally on the impact of regulation on performance, the regulatory framework of SACCOs in Kenya as well as financial and non-financial performance measures of performance.

2.2: Theoretical Review

This section makes a distinction between three types of theories of regulation: public interest theories, the Chicago theory of regulation and the public choice theories. The Chicago theory is mainly directed at the explanation of economic regulation; public interest theories and public choice theories envisage in addition to that an account of social regulation. The core of the diverse theories is discussed as well as the criticisms that have been leveled at them.

2.2.1: Public Interest Theories of Regulation

The first group of regulation theories account for regulation from the point of view of aiming for public interest. This public interest can be further described as the best possible allocation of scarce resources for individual and collective goods. In western economies, the allocation of scarce resources is to a significant extent coordinated by the market mechanism. In theory, it can even be demonstrated that, under certain circumstances, the allocation of resources by means of the market mechanism is optimal (Arrow, 1985). Because these conditions are frequently not adhered to in practice, the allocation of resources is not optimal and a demand for methods for improving the allocation arises (Bator, 1958). One of the methods of achieving efficiency in the allocation of resources is government regulation (Arrow, 1970; Shubik, 1970). According to public interest theory, government regulation is the instrument for overcoming the disadvantages of *imperfect competition*, *unbalanced market operation*, *missing markets* and *undesirable market results*.

In the first place, regulation can improve the allocation by facilitating, maintaining, or imitating market operation. The exchange of goods and production factors in markets

assumes the definition, allocation and assertion of individual property rights and freedom to contract (Pejovich, 1979). The guarantee of property rights and any necessary enforcement of contract compliance can be more efficiently organized collectively than individually. Furthermore, the costs of market transactions are reduced by property and contract law.

The freedom to contract can, however, also be used to achieve cooperation between parties opposed to market operation. Agreements between producers give rise to prices deviating from the marginal costs and an inefficient quantity of goods is put on the market. *Antimonopoly legislation* is aimed at maintaining the market operation through monitoring the creation of positions of economic power and by prohibiting competition limiting agreements or punishing the misuse thereof.

2.2.2. Criticism of Public Interest Theory

The theory that regulation can be explained as an answer to market failures has been criticized from several points of view. (a) In the first place, criticism has been directed at the *theory of market failure* underlying the explanation of government regulation (Cowen, 1988). In practice it appears that the market mechanism itself is often able to compensate for any inefficiency. There, regulation is uncalled for. (b) In the second place, the original theory assumes that *government regulation is effective* and can be implemented without great cost (Posner, 1974). So precisely the transaction costs and information costs, which underlie market failure, are assumed to be absent in the case of government regulation. This assumption has been criticized in both empirical and theoretical research. (c) Public interest theory usually assumes that regulation can be accounted for as aiming for economic efficiency. Interpreted in this way, the theory is unable to explain why on occasions other objectives such as procedural fairness or redistribution are aimed for at the expense of economic efficiency (Joskow and Noll, 1981, p. 36). (d) A final point of criticism is that public interest theory is *incomplete*. In the first place, the theory does not indicate how a given view on the public interest translates into legislative actions that maximize economic welfare (Posner, 1974).

2.2.3: Sophisticated Public Interest Theory

Criticism of the public interest theory has led to a more serious public interest theory (Noll, 1983, 1989a). According to the naïve public interest theory, regulation can be accounted for

by market failure under conformance to the conditions of the Coase theorem. This implies the assumption of absence of transaction costs and freely available, conveniently processed information in the political process. By letting go of these assumptions, a more sophisticated version of the public interest theory comes about. Is it possible to see regulation as an answer to market failure when account is taken of transaction costs and information costs? In the presence of transaction costs, regulation can form a more efficient solution to market failure than private negotiations between the parties involved. Costs of organization can also be avoided when for example in the case of environmental pollution, politicians bundle the preferences of those negatively affected. In the case of flawed information, political entrepreneurs can detect the causes of market failure and report them to those involved. In this way, knowledge about, for example, accidents can be picked up through safety regulations in factories. Regulation may be more efficient in this case because the government can obtain information less expensively. On the one hand, the government can enforce the provision of information about accidents, for example, on the other hand information is often a byproduct of other government activities. This sophisticated version of the public interest theory does not therefore require regulation to be perfect. It does, however, assume that market failure exists, that regulation is the most effective means of combating it and that regulation does not continue to exist once the costs exceed the benefits. This theory also assumes that politicians support open decision-making processes and spread information widely about the effects of market results and regulation. According to this theory, then, regulation can be accounted for as the *efficient* solution to market failure. The problems stated under section 2.1.2 are not, however, solved with this version.

2.2.4: Private Interest Theories of Regulation

After the public interest theory had fallen into disrepute through empirical and theoretical research, the *capture theory* was developed mainly by political scientists; for a discussion see Posner (1974). This theory assumes that in the course of time, regulation will come to serve the interests of the branch of industry involved. For example, it is assumed that legislators subject the branch to additional regulation by an agency if misuse of the economic position of power is detected. In the course of time, other political priorities arrive on the agenda and the monitoring of the regulatory agency by legislators is relaxed.

The agency will tend to avoid conflicts with the regulated company because it is dependent on this company for its information. Furthermore, there are career opportunities for the regulators in the regulated companies. This leads in time to the regulatory agency coming to represent the interests of the branch

2.2.5: The Chicago Theory of Regulation

In 1971 a start was made on the development of a theory of regulation called by some *the economic theory of regulation* (Posner, 1974) and by others *the Chicago theory of government* (Noll, 1989a). ‘The Theory of Economic Regulation’ by Stigler (1971) appeared in that year. His central proposition was that ‘as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit’. The benefits of regulation for a branch of industry are obvious. The government can grant subsidies or ban the entry of competitors to the branch directly so that the level of prices rises. In the second place, the government can maintain minimum prices more easily than a cartel. In the third place, the government can suppress the use of substitutes and support complements. An example of support to complements is the subsidizing of airports for the benefit of airlines. A demand will therefore arise on the one hand for government regulation. The political decision-making process on the other hand makes it possible for branches of industry to exploit politics for its own ends. For this proposition, Stigler makes use of the insights of Downs (1957) and Olson (1965). In the political decision-making process, interest groups will exercise political influence, as opposed to individuals. Individuals will not participate because forming an opinion about political questions is expensive in terms of time, energy and money, while the benefits in terms of political influence will be negligible. A representative democracy would more readily honor the strongly felt preferences of majorities and minorities than the less passionately expressed preferences.

2.3: General Literature Review

This section reviews the regulatory framework of the SACCOs in Kenya and discusses the main elements of SACCO legislation that are supposed to have an effect on the growth and performance of SACCOs.

2.3.1: Cooperative Development Policy in Kenya

Sessional Paper No. 6 of 1997 on “Cooperatives in a Liberalized Economic Environment” (Republic of Kenya, 1997a) provides the current policy framework for cooperative development in Kenya. The policy was formulated after the liberalization of the economy, which necessitated the withdrawal of state control over the cooperative movement. The aim of the policy was to make cooperatives autonomous, self-reliant, self-controlled and commercially viable institutions. The role of the government was redefined from one that sought to control cooperative development, to one that now seeks to regulate and facilitate their autonomy.

Nevertheless, the Ministry of Cooperative Development and Marketing has since realized some inconsistencies and inadequacies of the 1997 policy. For instance, it has been noted that this policy was largely silent on the government’s catalytic and supportive role in the development of cooperatives. It has also been observed that the policy largely remained out of step with the Cooperative Societies (Amendment) Act of 2004, particularly in provision of guidance for cooperatives that seek to venture into emerging high growth sectors of the economy; improve capitalization; and engage in mergers to take advantage of economies of scale. Most importantly, the policy does not provide for the separation of the responsibilities of elected management committees from managerial staff responsibilities. Consequently, management decisions are still made by elected leaders that may not be qualified managers.

In response to the inadequacies of the 1997 policy, the Ministry has formulated a revised policy framework titled “Kenya Cooperative Development Policy 2008”. The main theme of the new policy is ‘expanding the economic space for sustainable cooperative growth in Kenya’. Its main focus is on restructuring, strengthening and transforming cooperatives into vibrant economic entities that can confront the challenges of wealth creation, employment creation and poverty reduction as private business ventures.

The Cooperative Societies (Amendment) Act of 2004 (Republic of Kenya, 2004a) is the current basic legislation that guides the formation and management of cooperatives in Kenya. It has its origins in the Cooperative Societies Act, Cap. 490 of 1966, which was revised in

1997 into the Cooperative Societies Act Chapter 12 of 1997 (Republic of Kenya, 1997b). The reforms contained in the revised Act sought to reduce the strict state supervision of cooperatives, in order to support the liberalization of cooperative enterprise.

The legislation stipulates that the roles to be undertaken by government include: 1. creating the policy and legal framework for development of cooperatives; 2. improving the growth and development of cooperatives by providing the requisite services for their organization, registration, operation, advancement and dissolution; 3. developing partnerships with cooperatives through consultative processes that are focused on policy, legislation and regulation.

In addition to this legislation, there is the SACCO Societies Act of 2008 (Republic of Kenya, 2008b) that provides for the licensing, regulation, supervision and promotion of savings and credit cooperatives by the SACCO Societies Regulatory Authority. Thus, this Act provides for the establishment of the SACCO Societies Regulatory Authority whose functions will include licensing SACCOs to carry out deposit-taking business as well as regulating and supervising SACCOs.

2.3.2: Specific Elements of FOSA SACCOs Regulation

Similar to other deposit-taking financial institutions in Kenya, FOSA SACCOs have to comply with a wide range of regulatory provisions in their day-to-day operations.

There are governance rules that must be followed by FOSA SACCOs. At a minimum, the Board of Directors (elected at the Annual General Meeting) have to establish an audit committee and credit committee. It will also be their responsibility to establish appropriate policies on credit, investment, human resource, savings, liquidity, information preservation, dividend, and risk management.

A major change on governance is that directors and senior management are subject to vetting (fit and proper test) by SASRA.

The separation of the responsibilities of the Board and the management has been clearly outlined in the Regulations to ensure transparency and accountability in the running of the SACCO.

The deposit taking SACCOs are also expected to comply with prudential regulations which include clear standards regarding, among others, capital, liquidity, the extent of external borrowing, asset categorization and provisioning, maximum loan size, and insider lending.

There are various reporting requirements for SACCOs; monthly (capital adequacy, liquidity, and deposits), quarterly (risk classification of assets and loan loss provisioning, investment returns, financial performance) and annual (audited financial statements) reporting requirements to SASRA.

SASRA has the authority to inspect the premises and the records of a SACCO and to prescribe enforcement actions in case of deficiencies including the appointment of a statutory manager. Non-compliance with legal requirements carries clearly specified penalties and includes removal from office of directors and other responsible officers.

SACCOs have to establish deposit insurance schemes. Once licensed, member deposits will be protected in the event of collapse of a SACCO. SASRA will in the future set up a Deposit Guarantee Fund and SACCOs will be expected to contribute to this.

Opening, closing, and relocating branches and other places of business require prior approval by SASRA.

SACCOs shall continue to operate according to co-operative principles and deal with members only. Serving members only is the main reason why interest and other income earned from loans to members is exempt from income tax.

SACCOs will have to pay a levy (published in the Gazette notice), which shall be used to finance the operations of SASRA.

2.4: Financial Performance Measures

Performance Measures are quantitative or qualitative ways to characterize and define performance. They provide a tool for organizations to manage progress towards achieving predetermined goals, defining key indicators of organizational performance and Customer satisfaction. Performance Measurement is the process of assessing the progress made (actual) towards achieving the predetermined performance goals (baseline). Measurement is managed using output measures and outcome measures.

Traditional, financially based performance measurement approaches have a number of serious drawbacks (Kaplan & Norton,1992). These include the element of outcome focus. Established financial indicators such as turnover and profit before tax are outcome indicators. They only alert us when things have gone wrong and the effect is being felt in the balance sheet. Such indicators and measures don't provide us with an indication of when things may go right or wrong in the future. In short, these measures are lagging not leading indicators - they do not provide us with an early warning system.

Another drawback is the drivers of business success. Financial measures alone do not assess and measure the parts of the organization that create the customer value that in turn delivers profit. A more holistic approach is needed that helps managers – like physicians – to examine the state of health of the entire body corporate.

The Strategy into action drawback is also associated with financially based performance measurement approaches. Many business plans paint favourable future financial returns but don't explain explicitly what must be done to achieve the planned returns. A well-managed scorecard project will identify and measure the key activities needed to deliver planned performance.

Finally, strategic communication, involvement and ownership is a drawback with financially based performance measurement approaches. Traditional, financially based plans are difficult to communicate across the organization. The fact is that most business strategies are

not communicated in ways everyone can understand. A well constructed scorecard is an effective communication vehicle.

2.5: Non-Financial Performance Measures

The concept was borne out of the observation that traditional performance measurement systems – management accounting based systems that were largely based upon financial performance indicators – would be inadequate to steer organizations of the future. Refers to any quantitative measure of either an individual's or an entity's performance that is not expressed in monetary units. Non-financial performance measures are sometimes considered to be leading indicators of future financial performance, while current financial performance measures such as earnings or return on assets are commonly considered to be trailing measures of performance

The Balanced Scorecard is based on the simple premise that we must understand and measure the true drivers of financial success (Kaplan and Norton (2004). The Balanced Scorecard identifies three broad areas called “perspectives” of the corporate body that must be examined that in turn deliver the final dimension of the balanced scorecard - financial success. These include; learning and growth perspective; internal business processes perspective and the customer perspective.

Attainment of financial objectives – growth, lower costs and above all increases in shareholder value is driven by other dimensions or perspectives in the organization. It all starts with “Learning and Growth” perspective. Skills, culture, leaders and management information that are aligned to the organization's strategy will create effective and efficient business process. Effective and efficient product delivery, customer relationship, innovation, regulatory and environmental processes in turn make sure that the organization's offerings meet and exceed the needs of customers. The components of the organization's offerings to its customers (products, services relationships and brand) are shown in the Customer perspective. Satisfied customers and efficient business processes combine to produce

growth, lower costs and better use of the organisation's capital – the result being increase in shareholder value.

The key to the success of the Balanced Scorecard is its simplicity – essentially seeing an organization from four key perspectives – one driving another. Financial results are driven first by people. People with the right skills, motivation and information create effective and efficient processes, which in turn deliver products, relationships and services that create value for the customer. Customer value in turn delivers profit to meet the organization's financial objectives.

2.6: Empirical Review

This section reviews the local and international studies that argue for and against government regulation of SACCOs. The section also reviews studies on the impact of regulation on the performance of SACCOs.

2.6.1: Regulation and Performance of SACCOs (Local and International studies)

Misra (2008) conducted a study on the linkage of the primary agricultural credit society in India and concluded that models linking community-based associations with financial institutions have tremendous potential to expand outreach in remote areas. Associations in many forms (Accumulating Savings and Credit Associations-ASCAs, Self-Help Groups, savings and credit associations, even farmer or fisher associations) already have a strong presence in rural areas. They provide convenient and flexible access for members in light of few or no alternatives. Linkages can provide these associations with additional value such as access to larger loans, a safe place for savings and the potential for a broader range of services including graduation to individual member services. The author also argued that the regulation and supervision of the SHG-PACS (Self Help Groups- Primary Agricultural Cooperative Societies) linkage system suffers from multiple layers of inadequacy. The Cooperative Credit Scheme (CCS) itself “is said to suffer the problem of dual control. It also suffers from a surfeit of rules and no regulation. It suffers from too many supervisors and no supervision. It has too many owners and no ownership” (Price Waterhouse Coopers, 2006). The CCS is regulated both by state laws as cooperative societies and bank laws for banking

business. However, PACS are not regulated by the Banking Regulation Act thus leaving them under the regulatory purview of the state, which in cases such as the current PACS is also partial owner of the cooperatives. Reforms are now on the anvil for the CCS and this is possibly an ideal time to see how a stronger space can be carved out for SHGs in the overall system.

Ahimbisibwe (2007) set out to investigate whether SACCOs in Uganda have an effect on members' saving culture. The study used a sample of 57 members, 3 board members and 3 management staff randomly selected from the three counties made up of fifteen sub counties which make up Ntungamo District. Data was collected by use of questionnaire instrument and interviews, observation and focus group discussions. Results were computed and analysed using Pearson Chi-square tests and linear regression model in SPSS which attempted to test the relationship and impact of the variables on saving culture. The findings by Ahimbisibwe (2007) indicated that that SACCOs positively influence saving culture.

Wanyama (2009) conducted a study on the survival of the cooperative movement in Kenya as a results of the liberization which happened over a decade ago. The author attempted to highlight the current trends, structural organization and performance of cooperatives in Kenya. The datum that informs their report were obtained from qualitative interviews in October 2008, which were undertaken in Nairobi with selected leaders of cooperative organizations. These key informants also facilitated access to some documents that contained statistical and other secondary data..These cooperative organizations included; a) Kenya National Federation of Cooperatives (KNFC);b) Cooperative Bank of Kenya;(c) Cooperative Insurance Company (CIC); d) Cooperative College of Kenya; (e) Kenya Union of Savings and Credit Cooperatives (KUSCCO); and (f) The Office of the Commissioner of Cooperatives in the Ministry of Cooperative Development and Marketing. Results from Wanyama (2009) revealed that cooperatives have largely survived the market forces and continued to grow in number, membership and income. The market forces have triggered a structural transformation that has seen the fading away of the inefficient cooperatives, including the National Federation and some cooperative unions, as primary cooperatives seek better service provision. Similarly, cooperatives are increasingly diversifying their activities

and introducing innovative ventures in order to respond to their members' needs. The well-adapted cooperatives are subsequently recording better performance than they did in the previous regulation era. However, the study by Wanyama (2009) was only descriptive and lacked the statistical rigour that is employed in the current study. In addition, the study by Wanyama (2009) failed to apply the balance scorecard concept in their measurement of performance.

Wanyama et al (2009) conducted a study on how African cooperatives had fared after the liberalization. The authors attempted to obtain qualitative insights into the strengths and weaknesses of the cooperative movement in the countries with a view to assessing the real and potential impact of cooperatives on reduction of poverty through creation of employment; generation of economic activities; enhancement of social protection; and improvement of the voice and representation of vulnerable groups in society. The researchers, one in each of the eleven countries, first of all used qualitative rapid assessment methodology to collect data at the national level using semi-structured interviews with key informants in the cooperative sector. This was followed by in-depth interviews with leaders and members in selected cooperative societies at the local level with a view to generating case studies to illuminate on the findings from the national level. The eleven countries are Ethiopia, Egypt, Kenya, Uganda, Rwanda, South Africa, Nigeria, Ghana, Niger, Senegal and Cape Verde. The results by Wanyama et al(2009) indicated that cooperatives in the 11 Africa countries have survived the market forces and continued to grow in number and membership. In addition, the authors concluded that Cooperatives in Africa are re-examining their organizational forms and diversifying their activities in response to members' interests and needs.

Gamba and Kombo (2008) conducted a study on the evolution, growth and decline of the cooperative sector in Kenya. The authors argued that the performance of cooperatives in a liberated environment has been poor. In particular, agricultural cooperatives had on the whole, been unable to provide farmers with credit and farm inputs for financing production. The poor performance of agricultural cooperatives after liberalization was due to the hasty

implementation of the policies and this underscored the need for training and preparedness for such reforms.

Crafts (2006) noted that regulation can result in resources being directed towards compliance rather than the creation of productive output. Secondly, regulations can impose constraints on the choice of production techniques (e.g. by preventing the use of inputs) or lead to a misallocation of resources (e.g. by imposing certain activities). While the former effect will result in a reduction in the level of productivity as the output from factor inputs reduces, the latter effect can actually reduce the longer term growth rate of productivity through reductions to the level of technological progress. However, Crafts (2006) suggests that the direct impact of compliance costs, while important, is likely to only have a relatively small impact on productivity when compared to the other channels, illustrating this with an estimate that if administration costs doubled from 1.5 per cent of GDP to 3 per cent of GDP, this would possibly lead to a 0.15 per cent per year reduction in productivity growth. This impact should not be underestimated, particularly in the case of smaller firms which are limited in their capacity to absorb such costs, as a result of a lack of management time to deal with compliance and an inability to exploit the same economies of scale as larger firms. Crafts (2006), however, notes that there is currently limited evidence on the costs of regulation, hence inhibiting the ability to make international comparisons and to quantify accurately the impact on productivity in the UK. Crafts (2006) focuses on the negative impacts arising when regulations create barriers to entry (he gives the examples of compliance costs or licensing). These barriers can constrain the intensity of competition – and can also discourage the formation of firms as new firms find it harder to enter existing markets and compete with incumbent firms. This diminishing of competitive pressures can then reduce firms' incentives to innovate or to imitate (impeding technological diffusion).

Berr (2008) asserts that the more important effects, with respect to productivity, are likely to be the indirect impacts of regulation on the level of competition and enterprise, and hence of innovation and investment. Unlike the direct impacts however, the literature has suggested that these effects can be both negative and positive. Berr (2008) also argues that while there is much discussion of the negative impacts of regulation, some regulation can have a positive

indirect impact on productivity. Regulatory frameworks can drive productivity growth by promoting competition and facilitating an improved investment and innovation climate, despite the fact that the individual regulations that comprise them will impose some direct compliance costs on to firms. The existence of an appropriate corporate governance framework, for example, is a pre-condition for enterprise and investment, and a key determinant of company performance (by reducing agency costs). Equally, the existence of a robust competition framework is vital to ensure that the productivity-enhancing effects of competition can be realised.

Griffith and Harrison (2004) focus on this issue by investigating the impact of the level of rents (as a proxy for entry barriers and as suggested by a measure of mark-ups) on macroeconomic outcomes including productivity. Looking at cross country relationships over the 1980-2000 period, they find that countries with lower levels of mark-ups have higher growth rates of productivity (and improved innovation and investment) although they caution that they have not been able to control for all the other economic factors which contribute to productivity performance.

Scarpetta and Tressel (2002), using a panel of 23 industries in manufacturing and business services in 18 Organization for Economic Cooperation and Development (OECD) countries over the 1984-1998 period, find that strict product market regulation can reduce productivity, with a greater effect for companies behind the technology frontier. They interpret this as suggesting that strict regulation hinders the adoption of existing technologies through reduced competitive pressures or spillovers. A number of studies have looked at this issue within the ICT sector, where it is suggested that entry barriers resulting from regulation have an adverse impact on productivity growth. The adoption and dissemination of technology in this sector is heavily dependent on the entry of new firms (often small firms), which are more sensitive to regulatory barriers. Indeed the strong productivity performance of the US in the mid-1990s has been attributed in part to the less restrictive regulatory framework, which facilitated rapid ICT investment and innovation, in marked contrast to the major European competitors.

Aghion et al (2006) in a micro-level study investigate the impact of technologically advanced entry (through the foreign firm entry rate) on innovation in incumbent firms. They use manufacturing plant data for the UK (from the Annual Respondents Database) and for the US (NBER manufacturing productivity database) over the 1987-1993 period. They find that the significance of entry barriers varies from sector to sector depending on the level of technology, and suggests that the incentives to innovate are sharper when firms are in sectors which are closer to the technology frontier. This implies that tackling barriers to entry created by regulation will be a necessary but not a sufficient condition for securing productivity improvements.

Indirect impacts can also arise where regulations impede the adjustment of labour markets. Scarpetta and Tressel (2002) find evidence to suggest that, where strict employment protection legislation raises the costs of hiring and firing workers and hence of labour adjustment in response to technical changes, this can reduce incentives to innovate, and hence productivity growth. This is supported by Gust and Marquez (2002) who looked specifically at the IT sector in 13 countries over the 1992–1999 period and found that restrictive labour market practices, as measured by the OECD employment protection index, had negative effects on investment. They suggest that firms delay hiring the more skilled workers who are complementary to productivity-enhancing investment decisions, and who are needed to exploit the potential of new IT spending, and consequently this delays the adoption and diffusion of new technology.

Standards regulations provide a key enabling mechanism for the widespread diffusion of major technologies, and hence are productivity enhancing. Temple et al (2005) found that the growth in standards as measured by the BSI catalogue accounted for 13 per cent of labour productivity growth in the post-war period. Common standards across countries (e.g. EU wide) can be important in facilitating innovation, notably in major technology based innovation, where the role of scale is important. Also, regulation can play a further role in facilitating innovation through providing a shared framework for interoperability where developments require network economies (e.g. EU telecoms regulation).

2.7: Chapter Summary

The area of regulation and the performance has received much scholarly attention. Some studies such as Temple et al (2005) suggest that strict regulation hinders the adoption of existing technologies through reduced competitive pressures or spillovers and hence negatively affecting performance. However, Berr (2008) argues that, while there is much discussion of the negative impacts of regulation, some regulation can have a positive indirect impact on productivity.

Majority of the studies in Africa and Kenya tend to concentrate of the role of cooperative movement in mobilizing credit and savings culture (Evans, 2002, Ahimbisibwe, 2007). Others have concentrated on the growth and evolution of cooperative societies. For instance, Gamba and Kombo (2008) analyzed the evolution, growth and decline of the cooperative sector and argued that on the whole, cooperatives have been unable to provide farmers with credit and farm inputs for financing production. Another study Wanyama (2009) assessed whether the cooperative movement in Kenya had survived the liberization and concluded that a quick appraisal of the situation reveals that cooperatives have largely survived the market forces and continued to grow in number, membership and income. The above studies indicate that there exists differing opinions as to how cooperative societies have fared under different regulation regimes. A study on the regulation and performance of cooperative societies would therefore bridge the knowledge gap brought about by the lack of conclusiveness of reviewed literature.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter discussed the type of research design, population, target population, sampling frame, sample, sample size, sampling technique, instruments to be used, pilot test and data analysis.

3.2: Research Design

Research design refers to how data collection and analysis are structured in order to meet the research objectives through empirical evidence economically (Chandran, 2004; Cooper and Schindler, 2006).

This study was a descriptive study and took a correlational design. Correlational research is a research design that attempts to show causal relationship between a set of independent and dependent variables (Sekaran 2006; Cooper and Schindler, 2006). The correlation research design was preferred by this study since this study sought to show causal relationship between regulation and performance of FOSA SACCOs.

3.3: Population

A population refers to an entire group of individuals, events or objects having a common observable characteristic (Mugenda and Mugenda, 2003). The population of the study was all the FOSA SACCOs in Kenya (SACCO briefs, 2011). The choice of FOSA SACCOs as the population of the study was informed by the observation that FOSA SACCOs face more stringent regulation from the regulators than Non FOSA SACCOs. The population was all the 122 FOSAs licensed by SASRA to offer deposit taking services (SACCO briefs, 2011).

3.4: Sample

A sampling frame is a list of population from which a sample was drawn (Leary, 2001). It is the source material or device from which list of all elements within a population that can be

sampled is drawn. The sampling frame for this study was the list of FOSAs SACCOs as indicated in SASRA website www.sasra.go.ke/. The sampling frame was retrieved as at 31st May 2012.

A sample is a subset of a population (Mugenda and Mugenda, 2003). Mugenda and Mugenda (2003) recommend a sample size of 10% or more of the population. In line with this, the sample size of 10% would be 12 FOSAs. However, the study took a sample of 50% of the FOSAs since 10% will yield a very small sample size. Therefore, 50% of 122 will be 61. Therefore, 61 FOSAs constitute the study sample.

To obtain the 61 FOSAs, a systematic random sampling approach was undertaken. This implied that every second FOSA on the sampling frame was included in the sample.

3.5: Data Collection

The preferred data collection instrument is a questionnaire. A questionnaire is a list of research or survey questions asked to respondents and designed to extract specific information. Each item in the questionnaire was used to address a specific objective, research question or hypothesis study. A questionnaire can contain open or closed questions or it can be a mix of both closed and open questions (Cooper and Schindler, 2007).

The questionnaire had five main parts; a part on demographic information on FOSAs and a part on governance regulation, a part on prudential regulation and a part on reporting regulation and final part on the financial performance of SACCOs measured by Return on Assets (ROA)

3.5.1 Data Validity and Reliability

The reliability of the data was tested using cronbach alpha statistic. A cronbach statistic of more than 0.7 implies that the data collection instrument is reliable (Cronbach, 1951).

3.6: Data Analysis

The data analysis included regression analysis conducted using Statistical Package for social sciences (SPSS17). The financial indicator of performance was profitability.

Regulation was measured using three constructs; governance regulations, prudential standards and reporting standards

To achieve the first objective, a regression equation was used to check the relationship between regulation and the profitability. The model was based on the assertions in the literature review indicating that there exists a relationship between regulation and performance. For instance, Crafts (2006) noted that regulation can result in resources being directed towards compliance rather than the creation of productive output.

$$1) Y = a + b_0 X_1 + b_1 X_2 + b_2 X_3 + e$$

Where;

Profitability was measured as the Return on Assets (ROA)

$Y =$ Profitability

$X_1 =$ Governance

$X_2 =$ prudential guidelines

$X_3 =$ Reporting standards

$a =$ constant

$b_0, b_1, b_2 =$ regression coefficients

$e =$ error term

Profitability was measured by return on Assets (ROA) while the specific regulatory requirements were used to define and measure governance, prudential guidelines and reporting standards in SACCOs.

The sign of the regression coefficient indicated whether the relationship was positive or negative. The strength of the relationship was measured by the reported p values. A p value of less than 0.05 indicated that a relationship was strong or significant.

A t-test was used to obtain the explanatory power of the model.

CHAPTER FOUR

DATA ANALYSIS

The findings were presented in this chapter. The presentation of the findings was done in line with research objectives. The descriptive results were presented first followed by the inferential statistics (analytical model). The results were discussed in later section.

4.1 Demographic Information

This section presented the demographic characteristics of the data. Specifically, the category of SACCO and the period of existence were investigated.

4.1.1 Category Type

The study sought to establish the category type of the SACCOs. The findings were presented in figure 4.1. From the study findings, majority 48% of the respondents indicated agricultural firms, 39% were profession firms while 13% were parastatal and government firms. These findings imply that most SACCOs deal with either agricultural or professional firms as opposed to dealing with government parastatals. This could have a further implication on the profitability of SACCOs.

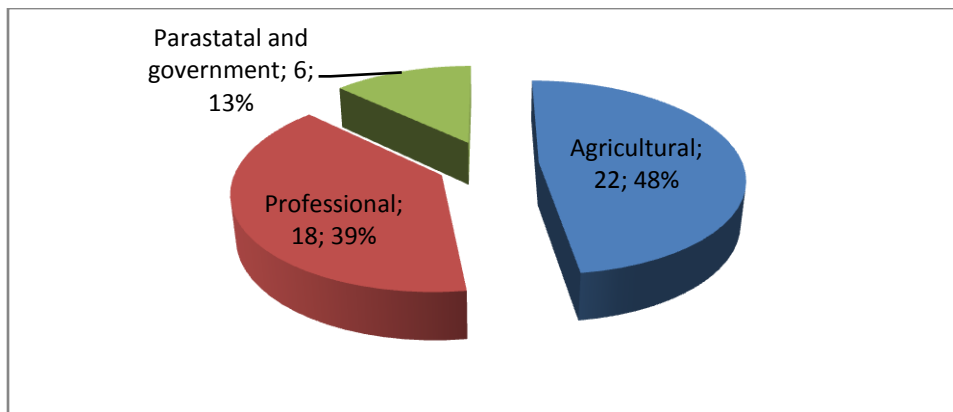


Figure 4. 1: Category type

Source: Research findings

4.1.2 Period of Existence

The study sought to establish the period of existence of the firms. The findings were presented in figure 4.2. From the study findings, majority 62% of the respondents indicated

they had been in the business for over 10 years followed by 16% of the respondents who had been in existence for a period of between 6 to 10 years while an equal share of 11% each had been in existence for a period between 2 to 5 years and less than 1 year consecutively. These findings imply that most SACCOs have been in existence for quite a longer period of time. This could have a further implication on the profitability of SACCOs.

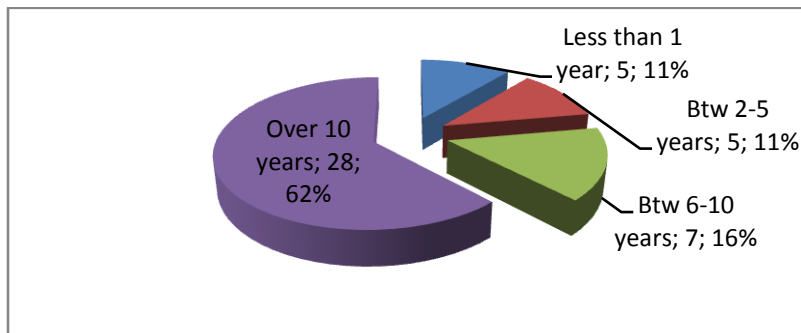


Figure 4. 2: Period of Existence

Source: Research findings

4.2 Effect of Governance Regulation on the Financial Performance of SACCOs

The study sought to establish the effect of governance regulation on the financial performance of SACCOs. The findings were presented in figure 4.3. From the study findings, majority 44.4% of the respondents strongly agreed with the statement that election of an independent board had an impact on the financial performance of SACCOs while 33.3% of the respondents simply agreed with the statement and an equal share of 11.1% each either disagreed or neither agreed nor disagreed consecutively.

On the other hand, another majority of 44.4% strongly agreed to the statement that the constitution of independent board committees had an impact on the financial performance of SACCOs followed closely by 40% of the respondents who agreed with the statement. 11.1% of the respondents neither agreed nor disagreed while 4.4% disagreed with the statement.

A majority of 42.2% strongly agreed with the statement that subjecting directors and senior management to vetting by SASRA had an impact to the financial performance of SACCOs

while 37.8% of the respondents simply agreed and 15.6% respondents neither agreed nor disagreed. Only 4.4% of the respondents disagreed with the statement.

Finally, the study findings indicated that majority 44.4% of the respondents strongly agreed with the statement that separation of the responsibilities of the board and the management had an impact on the financial performance of the SACCOs. Forty percent (40%) of the respondents agreed with the statement while 13.3% neither agreed nor disagreed but 2.2% disagreed with the statement. These findings imply that management of SACCOs requires stable, independent leadership in their governance system for them to produce positive financial performance. An introduction of governance regulations may have led to positive financial performance.

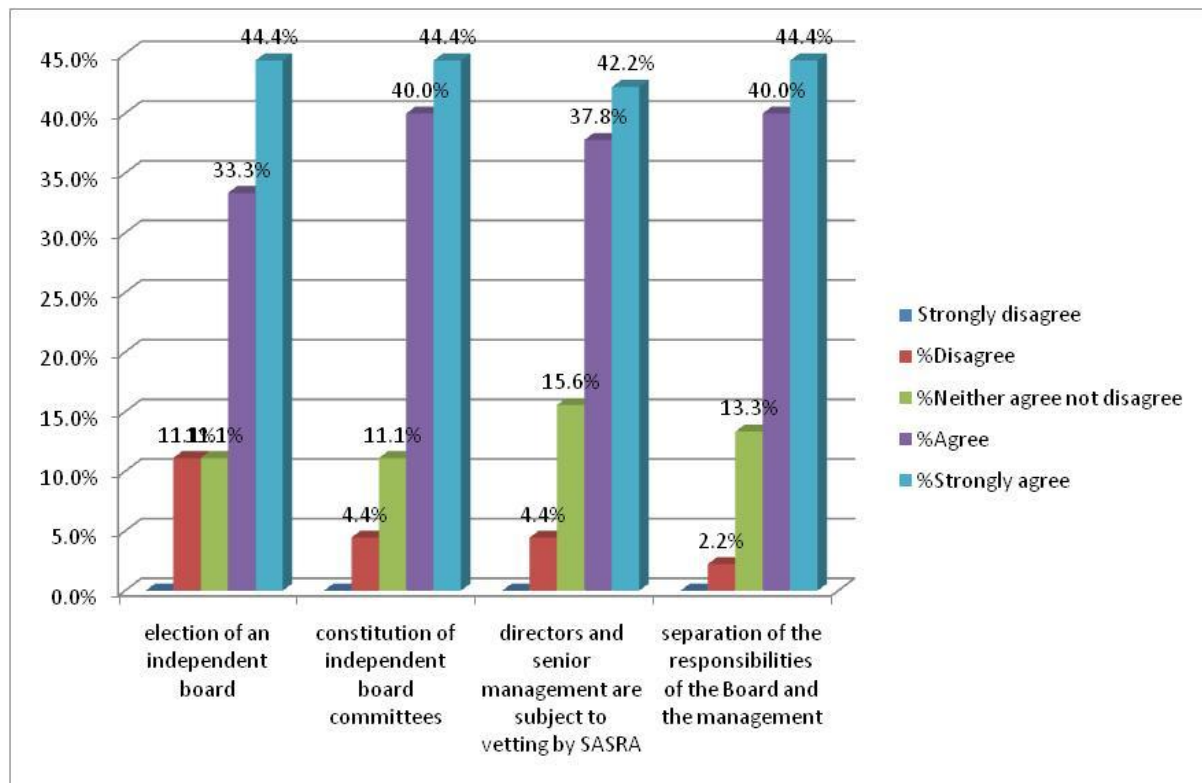


Figure 4. 3: Governance Regulations

Source: Research findings

4.3 Effect of Prudential Regulation on the Financial Performance of SACCOs

The study sought to establish the effect of prudential regulation on the financial performance of SACCOs. The findings were presented in figure 4.4. From the study findings, majority 53.3% of the respondents agreed with the statement that prudential regulation on capital had an impact on the financial performance of SACCOs while 26.7% strongly agreed and 15.6% of the respondents neither agreed nor disagreed with the statement. Only 4.4% of the respondents disagreed with the statement. On the other hand, majority 53.3% of the respondents agreed with the statement that the prudential regulations on the extent of external borrowing had an impact on the financial performance of SACCOs followed by 26.7% of the respondents who strongly agreed with the statement. However, 15.6% of the respondents neither agreed nor disagreed while 4.4% disagreed with the statement.

A majority 44.4% of the respondents agreed with the statement that prudential regulations on asset categorization and provisioning had an impact on the financial performance of SACCOs while 35.6% respondents strongly agreed and 15.6% neither agreed nor disagreed. Only 4.4% of the respondents disagreed with the statement.

In addition, majority 48.9 % of the respondents agreed and another 31.1% strongly agreed bringing to a total of 80% of those who agreed with the statement that prudential regulations on maximum loan size had an impact on the financial performance of the SACCOs, while 15.6% neither agreed nor disagreed but 4.4% disagreed with the statement. Finally, majority 48.9% of the respondents agreed and another 31.1% of the respondents strongly agreed with the statement that prudential regulations on insider lending had an impact on the financial performance of the SACCOs, while 15.6% respondents neither agreed nor disagreed and 4.4% of the respondents disagreed with the statement. The findings imply that the introduction of prudential regulations in managing their financial performance.

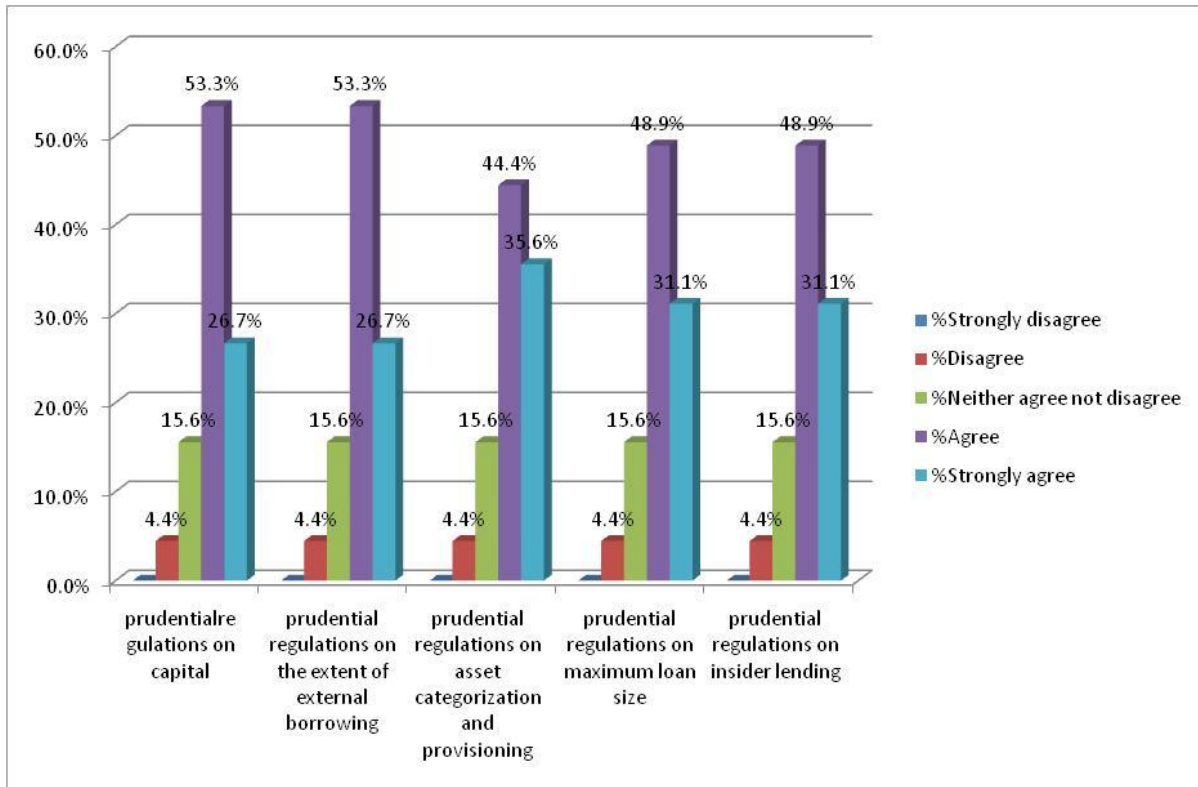


Figure 4. 4: Prudential Regulations

Source: Research findings

4.4 Effect of reporting Regulation on the Financial Performance of SACCOs

The study sought to establish the effect of reporting regulation on the financial performance of SACCOs. The findings were presented in figure 4.5. From the study findings, majority 53.3% of the respondents agreed and another 28.9% of the respondents strongly agreed bringing to a total of 82.2% of those who agreed with the statement that monthly reporting to SASRA on capital adequacy liquidity and deposits had an impact on the financial performance of SACCOs while 15.6% of the respondents neither agreed nor disagreed and 2.2% respondents disagreed with the statement. Furthermore, the findings indicated that majority 48.9% of the respondents agreed and another 33.3% of the respondents strongly agreed bringing to a total of 82.2% of those who agreed with the statement that quarterly risk classification of assets and loan loss provisioning investment returns and financial performance had an impact on the financial performance of SACCOs, while 15.6% of the respondents neither agreed nor disagreed and 2.2% respondents disagreed with the statement.

A majority 62.2% of the respondents agreed and another 24.4% of the respondents strongly agreed bringing to a total of 86.6% of those who agreed with the statement that annual audited financial statements had an impact to the financial performance of SACCOs while 11.1% respondents neither agreed nor disagreed and 2.2% disagreed with the statement. The findings imply that proper reporting methods are required in managing the financial performance of SACCOs. The findings further imply that the introduction of reporting regulation had a positive effect on financial performance of SACCOs.

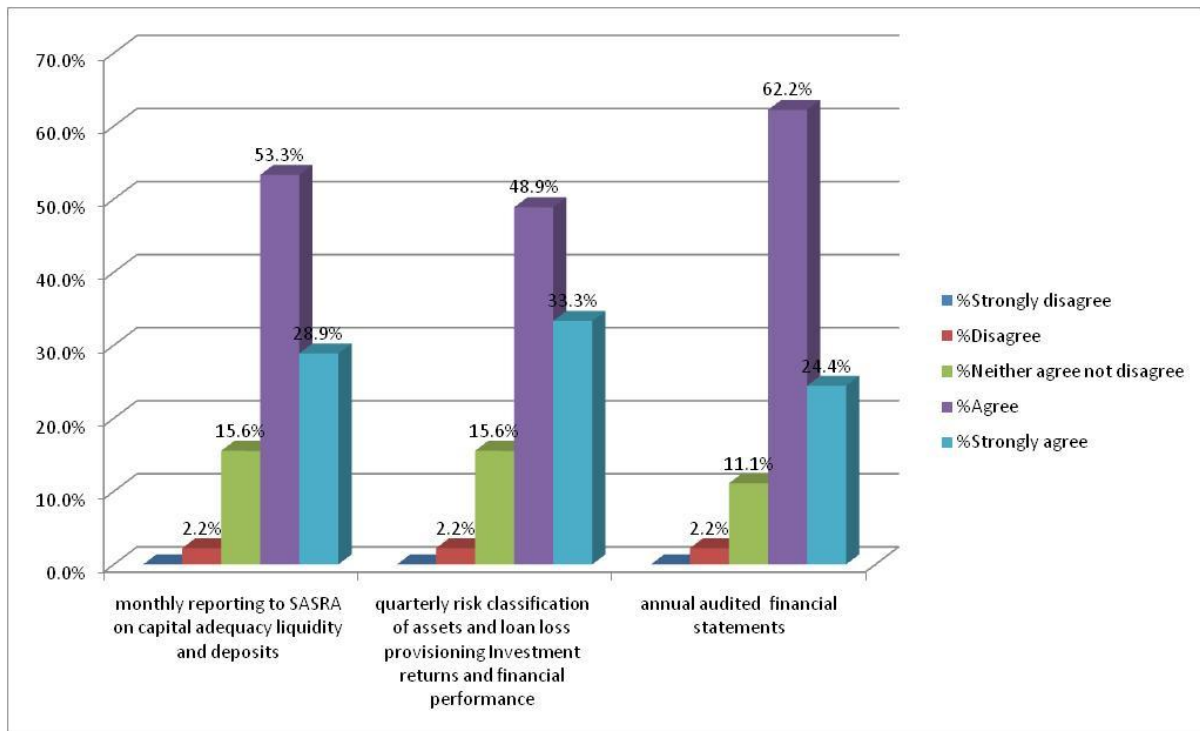


Figure 4. 5: Reporting Regulations

Source: Research findings

4.5 Profitability of FOSA

The study sought to establish the trend analysis for returns on assets for duration of the study. Results are presented in figure 4.6. Results indicated that the average returns on assets for the 45 FOSAs for year 2004 were 1.31% while return on assets for 2005 were 1.50%. In the year 2006 ROA grew to 1.85% and in the year 2007 it increased to 2.10%. However, in the year

2008 ROA dropped drastically to 1.27%. In the following year 2009 ROA slightly increased to 1.44% and in the year 2010 it grew to 1.51%. In 2011 ROA increased even further hitting 2.97%.

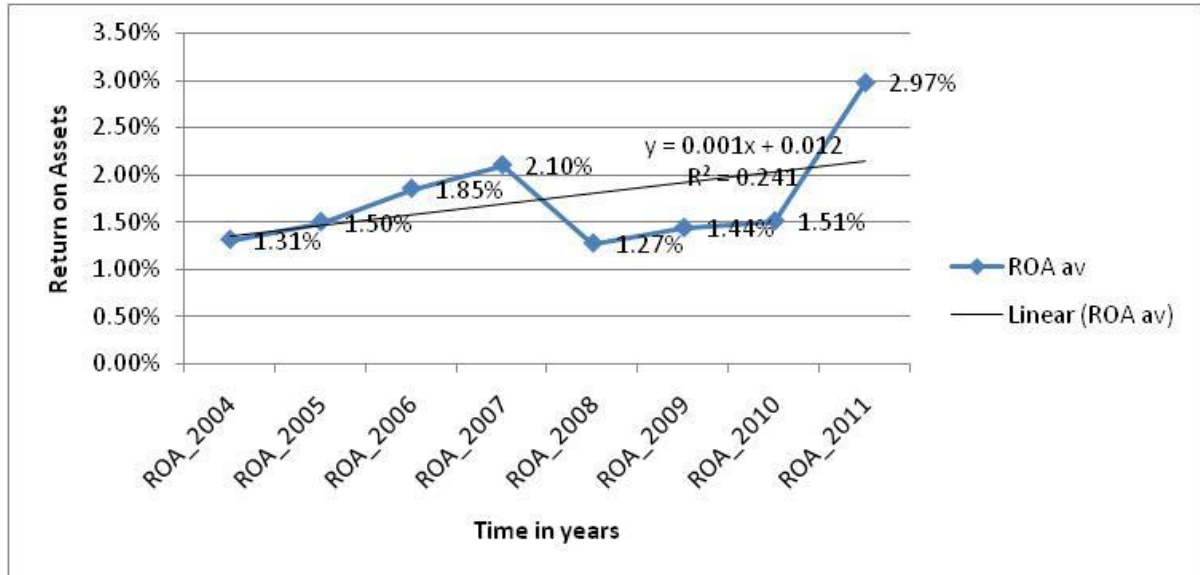


Figure 4. 6: Profitability of FOSA

Source: Research findings

4.6 Analytical Model

Regression analysis was conducted to empirically determine whether independent variables were a significant determinant of financial performance. Regression results in table 4.1 indicate that the goodness of fit for the regression between independent variables and financial performance is satisfactory. An R squared of 0.573 indicates that 57.3% of the variances in return on assets are explained by the variances in the independent variables. This also implies that 42.7% of the variances in financial performance cannot be explained by the independent variables and is actually attributed to variables not included in the model.

Table 4. 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.757 ^a	.573	.541	.106150

a. Predictors: (Constant), Reporting, Prudential, governance

Source: Research findings

ANOVA statistics indicate that the overall model was significant. This was supported by an F statistic of 18.304 and p value of 0.000. The reported probability was less than the conventional probability of 0.05 (5%) significance level. The ANOVA results imply that the independent variables are good joint predictors of financial performance. The ANOVA results also indicate that predicting financial performance through independent variable yields better results than predicting financial performance through the mean.

Table 4. 2: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.619	3	.206	18.304	.000 ^a
	Residual	.462	41	.011		
	Total	1.081	44			

a. Predictors: (Constant), Reporting, Prudential, governance

b. Dependent Variable: Average ROA

Source: Research findings

The relationship between introduction of governance regulation and financial performance is positive and significant ($b_1=0.069$, p value, 0.003). This implies that the introduction of governance regulations leads to an increase in financial performance by 0.069 Units. The relationship is significant because the p value of 0.003 is less than the critical p value of 0.05.

The relationship between introduction of prudential regulations and financial performance is positive and significant ($b_1=0.061$, p value, 0.005). This implies that the introduction of

prudential regulations leads to an increase in financial performance by 0.061 Units. The relationship is significant because the p value of 0.005 is less than the critical p value of 0.05.

The relationship between introduction of prudential regulations and financial performance is positive and significant (b1=0.084, p value, 0.003). This implies that an introduction of reporting regulations leads to an increase in financial performance by 0.084 Units. The relationship is significant because the p value of 0.003 is less than the critical p value of 0.05.

Table 4. 3: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.861	.123		6.975	.000
	governance	.069	.022	.377	3.181	.003
	Prudential	.061	.020	.307	2.980	.005
	Reporting	.084	.027	.377	3.167	.003

a. Dependent Variable: Average ROA

Source: Research findings

$$\text{ROA} = 0.861 + 0.069\text{Governance Regulations} + 0.061\text{Prudential Regulations} + 0.084\text{Reporting Regulations}$$

4.7 Summary and Interpretations of Findings

The study findings in figure 4.3 indicated that majority 77. 7% of the respondents agreed with the statement that election of an independent board had an impact on the financial performance of SACCOs . On the other hand, majority 84.4% of the respondents agreed to the statement that the constitution of independent board committees had an impact on the financial performance of SACCOs. A majority of 80% agreed with the statement that subjecting directors and senior management to vetting by SASRA had an impact to the financial performance of SACCOs. Finally, the study findings indicated that majority 84.4%

of the respondents agreed with the statement that separation of the responsibilities of the board and the management had an impact on the financial performance of the SACCOs. These findings imply that management of SACCOs requires stable, independent leadership in their governance system for them to produce positive financial performance.

The descriptive results were supported by regression results. Regression results indicated that the relationship between introduction of governance regulation and financial performance is positive and significant ($b_1=0.069$, p value, 0.003). This implies that the introduction of governance regulations leads to an increase in financial performance by 0.084 Units. The relationship is significant because the p value of 0.003 is less than the critical p value of 0.05.

The findings agree with those in Berr (2008) which argue that regulatory frameworks can drive productivity growth by promoting competition and facilitating an improved investment and innovation climate, despite the fact that the individual regulations that comprise them will impose some direct compliance costs on to firms. The existence of an appropriate corporate governance framework, for example, is a pre-condition for enterprise and investment, and a key determinant of company performance (by reducing agency costs). Equally, the existence of a robust competition framework is vital to ensure that the productivity-enhancing effects of competition can be realised. The findings disagree with those in Temple et al (2005) who suggest that strict regulation hinders the adoption of existing technologies through reduced competitive pressures or spillovers and hence negatively affecting performance.

Results findings in figure 4.4 indicated that majority 53.3% of the respondents agreed with the statement that introduction of prudential regulation on capital had an impact on the financial performance of SACCOs while 26.7% strongly agreed and 15.6% of the respondents neither agreed nor disagreed with the statement. Only 4.4% of the respondents who disagreed with the statement. On the other hand, majority 53.3% of the respondents agreed with the statement that the prudential regulations on the extent of external borrowing had an impact on the financial performance of SACCOs followed by 26.7% of the

respondents who strongly agreed with the statement. However, 15.6% of the respondents neither agreed nor disagreed while 4.4% disagreed with the statement.

A majority 44.4% of the respondents agreed with the statement that prudential regulations on asset categorization and provisioning had an impact to the financial performance of SACCOs while 35.6% respondents strongly agreed and 15.6% neither agreed nor disagreed. 4.4% respondents disagreed with the statement.

In addition, majority 48.9 % of the respondents agreed and another 31.1% strongly agreed bringing to a total of 80% of those who agreed with the statement that prudential regulations on maximum loan size had an impact on the financial performance of the SACCOs, while 15.6% neither agreed nor disagreed but 4.4% disagreed with the statement. Finally, majority 48.9% of the respondents agreed and another 31.1% of the respondents strongly agreed with the statement that prudential regulations on insider lending had an impact on the financial performance of the SACCOs, while 15.6% respondents neither agreed nor disagreed and 4.4% of the respondents disagreed with the statement. The findings imply that most SACCOs adopt prudential regulations in managing their financial performance.

The descriptive results were supported by regression results. Regression results indicated that the relationship between introduction of prudential regulations and financial performance is positive and significant ($b_1=0.061$, p value, 0.005). This implies that the introduction of prudential regulations leads to an increase in financial performance by 0.061 Units. The relationship is significant because the p value of 0.005 is less than the critical p value of 0.05. The findings agree with those in Wanyama (2009) who assessed whether the cooperative movement in Kenya had survived the liberalization and concluded that a quick appraisal of the situation reveals that cooperatives have largely survived the market forces and continued to grow in number, membership and income.

From the study findings, majority 53.3% of the respondents agreed and another 28.9% of the respondents strongly agreed bringing to a total of 82.2% of those who agreed with the statement that monthly reporting to SASRA on capital adequacy liquidity and deposits had an impact on the financial performance of SACCOs while 15.6% of the respondents neither agreed nor disagreed and 2.2% respondents disagreed with the statement. Furthermore, the

findings indicated that majority 48.9% of the respondents agreed and another 33.3% of the respondents strongly agreed bringing to a total of 82.2% of those who agreed with the statement that quarterly risk classification of assets and loan loss provisioning investment returns and financial performance had an impact on the financial performance of SACCOs, while 15.6% of the respondents neither agreed nor disagreed and 2.2% respondents disagreed with the statement.

A majority 62.2% of the respondents agreed and another 24.4% of the respondents strongly agreed bringing to a total of 86.6% of those who agreed with the statement that annual audited financial statements had an impact to the financial performance of SACCOs while 11.1% respondents neither agreed nor disagreed and 2.2% disagreed with the statement. The findings imply that proper reporting methods are required in managing the financial performance of SACCOs.

The descriptive results were supported by regression results. Regression results indicated that the relationship between introduction of reporting regulations and financial performance is positive and significant ($b_1=0.084$, p value, 0.003). This implies that an introduction of reporting regulations leads to an increase in financial performance by 0.084 Units. The relationship is significant because the p value of 0.003 is less than the critical p value of 0.05. The finding agree with those in Temple et al (2005) who noted that regulation can play a further role in facilitating innovation through providing a shared framework for interoperability where developments require network economies. The finding contrast with those in Gamba and Kombo (2008) who conducted a study on the evolution, growth and decline of the cooperative sector in Kenya. The authors argued that the performance of cooperatives in a liberated environment has been poor. The findings also disagree with those in Crafts (2006) who noted that regulation can result in resources being directed towards compliance rather than the creation of productive output. Secondly, regulations can impose constraints on the choice of production techniques (e.g. by preventing the use of inputs) or lead to a misallocation of resources (e.g. by imposing certain activities). The diversion of resources could reduce the profitability of firms.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

Chapter one discussed the problem statement and the objectives of the study. The study aimed to determine the effect of regulation on financial performance of savings and credit cooperative societies (SACCOs) offering front office service activity (FOSA) in Kenya.

Chapter two discussed the literature review, that is, the theories backing the study. These theories were Public Interest Theories of Regulation, Sophisticated Public Interest Theory, Private Interest Theories of Regulation and the Chicago Theory of Regulation. The empirical evidence of the study was also given.

Chapter three presented the research methodology. The chapter discussed the type of research design, population, and target population, sampling frame, sample, sample size, sampling technique, instruments to be used, pilot test and data analysis.

Chapter Four addressed the results of the study. The general objective of this study was to assess the effect of regulation on the financial performance of SACCOs with a specific focus on Front Office Service Activities (FOSA's) in Kenya. A sample size of forty five (45) respondents was drawn from a population of various SACCOs in Kenya. For purposes of collecting primary data, the researcher developed and administered a questionnaire and the results obtained were analyzed using Microsoft Excel and Statistical Package for Social Sciences (SPSS).

The study sought to establish the effect of the introduction of governance regulation on the financial performance of SACCOs. The study findings indicated that majority of the respondents strongly agreed with the statement that election of an independent board had an impact on the financial performance of SACCOs. Descriptive results also indicate that majority agreed with statement that the constitution of independent board committees had an impact on the financial performance of SACCOs. A majority of respondents agreed with the

statement that subjecting directors and senior management to vetting by SASRA had an impact to the financial performance of SACCOs. A majority of respondents indicated that they agreed with the statement that separation of the responsibilities of the board and the management had an impact on the financial performance of the SACCOs. These findings imply that management of SACCOs requires stable, independent leadership in their governance system for them to generate positive financial performance. The findings were supported by regression results. Regression results indicated that the relationship between introduction of governance regulations and financial performance is positive and significant.

The study sought to establish the effect of the introduction of prudential regulation on the financial performance of SACCOs. Results findings indicated that majority of the respondents agreed with the statement that prudential regulation on capital had an impact on the financial performance of SACCOs. A majority of respondents indicated that they agreed with the statement that the prudential regulations on the extent of external borrowing had an impact on the financial performance of SACCOs. A majority of the respondents agreed with the statement that prudential regulations on asset categorization and provisioning had an impact to the financial performance of SACCOs. In addition, majority of the respondents agreed with the statement that prudential regulations on maximum loan size had an impact on the financial performance of the SACCOs. Finally, majority of the respondents agreed with the statement that prudential regulations on insider lending had an impact on the financial performance of the SACCOs. The findings were supported by regression results. Regression results indicated that the relationship between introduction of prudential regulations and financial performance is positive and significant.

From the study findings, majority of the respondents agreed with the statement that monthly reporting to SASRA on capital adequacy liquidity and deposits had an impact on the financial performance of SACCOs. Furthermore, the findings indicated that majority of the respondents agreed with the statement that quarterly risk classification of assets and loan loss provisioning investment returns and financial performance had an impact on the financial performance of SACCOs. A majority of the respondents agreed with the statement that annual audited financial statements had an impact to the financial performance of SACCOs.

The findings imply that reporting regulations are required in managing the financial performance of SACCOs. The findings were supported by regression results. Regression results indicated that the relationship between introduction of reporting regulations and financial performance is positive and significant.

5.2 Conclusions

Following the study findings it was possible to conclude that the introduction of governance regulations had impacted positively on the financial performance of SACCOS. The specific governance practices that had a positive relationship with financial performance included; election of an independent board, the constitution of independent board committees, subjecting directors and senior management to vetting by SASRA and separation of the responsibilities of the board and the management.

It was possible to conclude that introduction of prudential regulations had impacted positively on the financial performance of SACCOS. The specific prudential guidelines that had an effect on financial performance were; prudential regulation on capital adequacy, prudential regulations on the extent of external borrowing, prudential regulations on asset categorization and provisioning, prudential regulations on maximum loan size and prudential regulations on insider lending.

It was possible to conclude that introduction of reporting regulations had impacted positively on the financial performance of SACCOS. The specific reporting guidelines that had an effect on financial performance were; monthly reporting to SASRA on capital adequacy liquidity and deposits, reporting on quarterly risk classification of assets and loan loss provisioning and investment returns and reporting on annual audited financial statements.

5.3 Policy Recommendations

The study recommended that the managers of the SACCOs should emphasize on prudential regulations. Specifically, SACCOs should ensure that they observe prudential regulations on capital, prudential regulations on the extent of external borrowing, prudential regulations on

asset categorization and provisioning, prudential regulations on maximum loan size and prudential regulations on insider lending.

The study also recommends that governance regulations should be adhered to in order to improve financial performance. Specifically, the study recommends that governance regulations such as election of an independent board, governance regulations such as constitution of independent board committees, governance requirement that directors and senior management are subject to vetting (fit and proper test) by SASRA and governance requirement for the separation of the responsibilities of the Board and the management should be adhered to. The adherence to these governance guidelines would foster better SACCO performance.

The study recommends that SACCOs need to adhere to reporting regulations. Specifically, SACCOs need to ensure that they adhere to reporting requirement to SASRA on monthly capital adequacy, liquidity, and deposits. They also need to adhere to reporting requirement to SASRA on quarterly risk classification of assets and loan loss provisioning, Investment returns and financial performance. Furthermore, SACCOs management should ensure adherence to reporting requirement to SASRA on annual audited financial statements

5.4 Limitations of the Study.

The study was limited to the extent of respondent's honesty. The accuracy of responses is an inherent limitation in all studies and this study is no exception. The study did not address all other factors that affect financial performance, the more the reason an r squared of 57.3% was achieved. A host of other variables explaining 42.7% of the dependent variable were intentionally left out of the model.

The study did not address the effect of interest rate regimes on the financial performance of SACCOs. An increase in the interest rates may lead to low loan uptake and hence reduce the profitability of SACCOs. In addition, interest rate fluctuation within the period may have influenced the asset quality. That is high incidence of nonperforming loans.

The study did not establish the credit management practices that SACCOs use. Such practices may have impacted on the financial performance of SACCOs. Such credit management practices included the 5 Cs of lending and the Know Your Customer (KYC) Policy.

The results also have limited application as far as sectoral differences are concerned. The results may not apply to the manufacturing sector or to the public sector because the regulations are different and the industry environment is different in those sectors.

5.5 Areas of Further Study

It is suggested that further areas of study should be to investigate other determinants of Sacco performance. Such a study would focus on capital adequacy, liquidity and operating efficiency.

Future studies should focus on the effect of interest rate regimes on the financial performance of SACCOs. It may be important to investigate whether an increase in the interest rates may lead to low loan uptake and hence reduce the profitability of SACCOs. In addition, it may be important to examine whether interest rate fluctuation within the period may have influenced the asset quality. Therefore, such a study would give insights on what effect such interest rates had on non performing loans.

In addition, an in-depth study on governance of SACCOs may be conducted. Further studies should also focus on the strategic responses adopted by SACCOs in response to turbulent environment. The study would consider the porter five forces framework and how the elements of competition affect the competitive environment of SACCOs.

A key area of concern in future studies is the credit risk management practices of SACCOs. A study in this area would purpose to investigate the credit risk management practices and whether they adhere to best practice.

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QUESTIONNAIRE FOR SACCOs

This questionnaire is meant to assess the effect of regulation on the financial performance of SACCOs operating Front Office Service Activities (FOSA) in Kenya

Section A: FOSA Information

Name of SACCO (Optional) _____

- i. Category type (please tick as appropriate)
 - a) Agricultural
 - b) Professional
 - c) Parastatal and government

- ii. Period of existence of Sacco
 - a. Less than 1 year
 - b. Btw 2-5 years
 - c. Btw 6-10 years
 - d. Over 10 years

Section B: Impact of Governance Regulation on the Financial Performance of SACCOs

This Section is concerned with assessing whether regulation affects financial performance of SACCOs in Kenya. Please mark (x) in the box which best describes your agreement or disagreement on each of the following statements.

Statement	Strongly disagree	Disagree	Neither agree not disagree	Agree	Strongly agree
	1	2	3	4	5
1. Introduction of governance regulations such as election of an independent board has improved the profitability of SACCOs					
2. Introduction of governance regulations such as constitution of independent board					

Statement	Strongly disagree	Disagree	Neither agree not disagree	Agree	Strongly agree
	1	2	3	4	5
committees has improved the profitability of SACCOs					
3. The introduction of governance requirement that directors and senior management are subject to vetting (fit and proper test) by SASRA has improved the profitability of SACCOs					
4. The introduction of governance requirement for the separation of the responsibilities of the Board and the management has improved the profitability of SACCOs					

Section C: Impact of prudential Regulation on the Financial Performance of SACCOs

This Section is concerned with assessing whether prudential regulation affects financial performance of SACCOs in Kenya. Please mark (x) in the box which best describes your agreement or disagreement on each of the following statements.

Statement	Strongly disagree	Disagree	Neither agree not disagree	Agree	Strongly agree
	1	2	3	4	5
1. Introduction of prudential regulations on capital has improved the profitability of					

Statement	Strongly disagree	Disagree	Neither agree not disagree	Agree	Strongly agree
	1	2	3	4	5
SACCOs					
2. Introduction of prudential regulations on the extent of external borrowing has improved the profitability of SACCOs					
3. Introduction of prudential regulations on asset categorization and provisioning has improved the profitability of SACCOs					
4. Introduction of prudential regulations on maximum loan size has improved the profitability of SACCOs					
5. Introduction of prudential regulations on insider lending has improved the profitability of SACCOs					

Section D: Impact of reporting Regulation on the Financial Performance of SACCOs

This Section is concerned with assessing whether reporting regulation affects financial performance of SACCOs in Kenya. Please mark (x) in the box which best describes your agreement or disagreement on each of the following statements.

Statement	Strongly disagree	Disagree	Neither agree not disagree	Agree	Strongly agree
	1	2	3	4	5
1. Introduction of regulation on reporting requirement to SASRA on monthly capital adequacy, liquidity, and deposits has improved the profitability of SACCOs.					
2. Introduction of regulation on reporting requirement to SASRA on quarterly risk classification of assets and loan loss provisioning, Investment returns and financial performance has improved the profitability of SACCOs.					
3. Introduction of regulation on reporting requirement to SASRA on annual audited financial statements has improved the profitability of SACCOs.					

Section E: Profitability of FOSA

Year	ROA
2004	
2005	
2006	
2007	
2008	
2009	
2010	
2011	

Thank you

APPENDIX

Appendix I: List of FOSA SACCOs Licensed By SASRA

<u>S/NO.</u>	<u>NAME OF SACCO</u>	<u>S/NO.</u>	<u>NAME OF SACCO</u>
1	ACO	29	HAZINA SACCO
2	AFYA	30	IMENTI
3	ASILI	31	IRIANYI TEA
4	BANDARI	32	JAMII
5	BARAKA.MTG	33	KAKAMEGA TCHRS
6	BARINGO FARMERS	34	KEIYO TEACHERS
7	BARINGO TEACHERS	35	KENPIPE SACCO
8	BIASHARA	36	KENVERSITY
9	BINGWA-KT	37	KENYA BANKERS
10	BORABU TG	38	KENYA CANNERS
11	BUNGOMA TCHRS	39	KENYA POLICE
12	BURETI TEA	40	KERICHO TEA - KH
13	BUSIA TESO TEACHERS	41	KIAMBAA DAIRY
14	CHAI(KTDA)	42	KIAMBU UNITY
15	CHEMILIL SACCO	43	KILIFI TEACHERS
16	CHEPSOL TG	44	KINGDOM
17	CHUNA	45	KIPSIGIS TCHRS
18	COMOCO	46	KITE
19	DIMKES SACCO	47	KITUI TEACHERS
20	DIOCESE OF MERU	48	KMFRI
21	EGERTON UNIVERSITY	49	KONAIN
22	EMBU TEACHERS	50	KURIA TEACHERS
23	FARIJI	51	LENGO
24	FORTUNE	52	MACADAMIA
25	FUNDILIMA		SACCO/JIJENGE
26	GITHUNGURI DAIRY	53	MAGADI SACCO
27	GUSII MWALIMU	54	MAGEREZA
28	HARAMBEE SACCO	55	MAISHA BORA

<u>S/NO.</u>	<u>NAME OF SACCO</u>	<u>S/NO.</u>	<u>NAME OF SACCO</u>
56	MARAKWET TEACHERS	86	NTIMINYAKIRU RURAL
57	MARSABIT TEACHERS	87	NYAMBENE ARIMI
58	MATHIRA FMRS	88	NYAMIRA TEA FMRS
59	MAUA METHODIST	89	NYANDARUA TCHRS
60	MERU MWALIMU	90	NYERI TEACHERS
61	MERU NORTH FARMERS	91	ORTHODOX
62	MERU SOUTH FMRS	92	RUKURIRI TG/COUNTY
63	METROPOLITAN		SACCO
64	MOMBASA PORT	93	SAFARICOM
65	MOMBASA TEACHERS	94	SAMBURU TRADERS
66	MUDETE TG	95	SHERIA SACCO
67	MUHIGIA	96	SIAYATCHRS
68	MUMIAS O'GROWERS	97	SIMBA CHAI
69	MUNGANIA TG /DAIMA	98	SIRAJI
70	MURAMATI	99	SOT TEA GROWERS
71	MURANG'A TCHRS	100	SOTICO
72	MURATA	101	SOUTH IMENTI TG
73	MWALIMU	102	STIMA
74	MWITO	103	SUKARI
75	NACICO	104	TAI - KTG
76	NAFAKA SACCO	105	TAIFA - NYERI DFCS
77	NAKU	106	TAITA TAVETA TEACHERS
78	NAKURU TEACHERS	107	TEMBO
79	NANDI HEKIMA	108	TENHOS
80	NAROK TEACHERS SACCO	109	THARAKA NITHI TRS
81	NASSEFU	110	THIKA DISTRICT TEACHERS
82	NATION STAFF	111	TRANS-NZOIA TCHR
83	NDEGE CHAI *	112	UKULIMA
84	NDOSHA	113	UNITED NATIONS
85	NITHI TEA GROWERS SACCO	114	UNIVERSAL TRADERS

S/NO. NAME OF SACCO

115 WAKENYA PAMOJA
116 WAKULIMA DAIRY
117 WANAANGA
118 WANANCHI - NTG

S/NO. NAME OF SACCO

119 WANANDEGE
120 WARENG TCHRS
121 WASHA
122 WAUMINI