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## NON-PERFORMING LOANS AND FINANCIAL STABILITY OF DEPOSIT TAKING SACCOS REGULATED BY SASRA

Rahab Ntoiti and Dr.Ambrose Jagongo

## **NON-PERFORMING LOANS AND FINANCIAL STABILITY OF DEPOSIT TAKING SACCOS REGULATED BY SASRA**

<sup>1\*</sup> Rahab Ntoiti

PhD. Candidate: Department of Accounts and Finance, Kenyatta University

\*Corresponding Author's E-mail: rahabntoiti@gmail.com

<sup>2</sup> Dr. Ambrose Jagongo

Department of Accounts and Finance, Kenyatta University

### **Abstract**

**Purpose:** The study sought to investigate the effect of non-performing loan on financial stability of deposit taking SACCOs in Kenya.

**Materials and Methods:** The study adopted a desktop methodology. Desk research refers to secondary data or that which can be collected without fieldwork. Desk research is basically involved in collecting data from existing resources hence it is often considered a low cost technique as compared to field research, as the main cost is involved in executive's time, telephone charges and directories. Thus, the study relied on already published studies, reports and statistics. This secondary data was easily accessed through the online journals and library

**Results:** Nonperforming loans and their effect on the financial stability of SACCOs using have not been adequately featured in any of the studies reviewed. This leaves a gap that needs to be filled. SACCOs play a very vital role in the financial intermediation in the Kenyan economy and their uniqueness in operations. This study will therefore focus on filling this gap.

**Unique contribution to theory, practice and policy:** the study findings of this study will assist the regulators of Sacco's SASRA to formulate stringent policies to tame the rising cases of non-performing loans. The findings of this study will be useful to SACCOs within Nairobi County in evaluating how effective their approach to managing NPLs has been. This will enable them to identify the gaps in their management of NPLs and adjust accordingly.

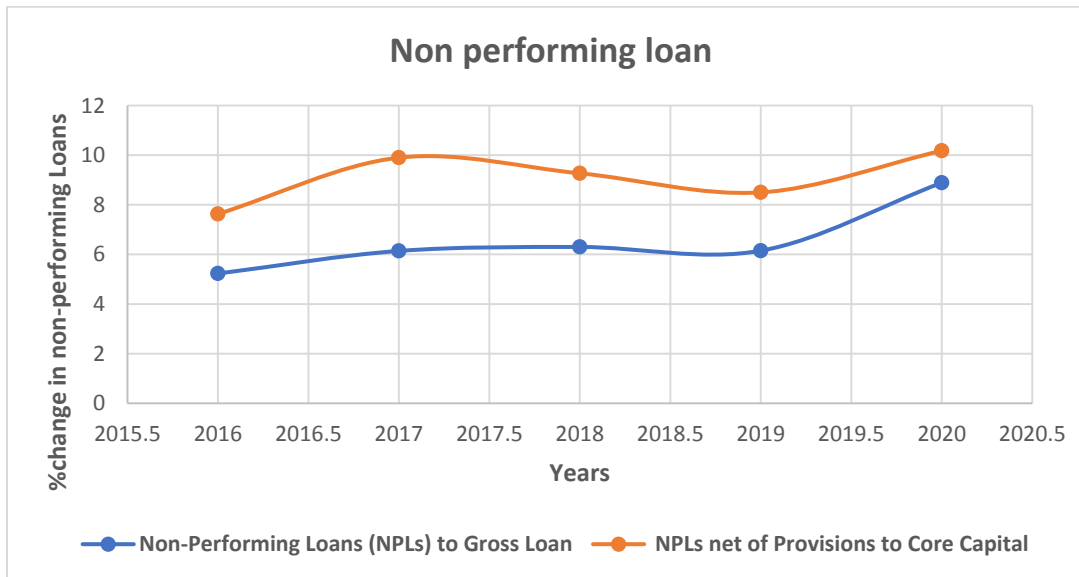
**Keywords:** *Non-Performing Loan, Financial Stability, Deposit Taking Saccos*

## 1.0 INTRODUCTION

The cooperative movement dates to 1849 with the first cooperative union which was formed in Germany, in Canada a Sacco union was formed in 1901 and over the years the movement has spread to almost all the countries of the world (Mutiso, 2019). In Africa, Ghana is cited to be the first country to adopt the cooperative movement in 1959 which later spread to many of the African countries including Nigeria, Uganda and Tanzania (Obure & Muturi, 2015). The main objective of the Saccos' was to improve the livelihood of the members through mobilizing deposits and extending credits to the members in these countries.

In Kenya the Sacco movement dates back to 1908 according to the Kenya Union of Savings and Credit Cooperatives (KUSCCO, 2019). Over the years, Saccos have experienced tremendous growth in terms of numbers as well as financial capacity. The Sacco sub sector in Kenya can be described as two-tiered given the range of financial services to members and regulatory regime (SASRA Act 2008). The traditional Savings and Credit Cooperative Societies (Saccos), described in law as Non-Deposit Taking Saccos provide a limited range of savings and credit products, are registered and supervised under the Cooperative Services Act, CAP 490. The Deposit Taking Saccos (DTS) besides the basic savings and credit products, also provide basic 'banking' services (demand deposits, payments services and channels such as quasi banking services commonly known as ATMs), FOSA and are licensed and supervised under the Sacco Societies Act of, 2008. The general trend is that Saccos start as non-deposit taking Sacco business and grow to deposit taking Sacco business to expand the range of financial services to members (Wang, & Wafula, 2016)

Saccos provide savings, credit and investment opportunities to individuals and members (SASRA 2017). A large proportion of Saccos asset comprise issued loans to members (SASRA supervisory report 2019). Some these loans given out by the SACCOs unfortunately become non-performing hence eventually declared bad debts with adverse consequences on overall financial stability of the SACCOs. The issue of non-performing loans (NPL) is becoming an increasing problem that threatens the sustainability and performance of SACCOs in Kenya. Currently the rate of NPLs are on the rise and this has caused much problems in sustainability of SACCOs in addition, adversely affecting the balance sheet, operations in terms of liquidity, Lending capacity, profitability, debt- servicing capacity, and ability to raise additional capital. Adequate management of loan delinquency risk in financial institutions is critical for the survival and growth of such institutions. With SACCOs the issue of loan delinquency is of even greater concern because of the higher levels of perceived risks resulting from some of the characteristics of clients and business conditions that they find themselves in (Maina, 2016).

**Figure 1: Trend of Non-Performing Loans**

Source: SASRA supervisory report 2020

Over years as shown in the graph above (Sasra supervisory report 2020) shows that non-performing loans have been increasing since 2016. The Authority continues to be very concerned with the ever-growing amounts of non-remitted deductions which some employers continue to owe to DT-SACCOs. For example, the total amount of non-remitted funds as at September, 2020 stood at a staggering Kshs 5.04 Billion compared to Kshs 3.87 Billion as at September 2019. To worsen the scenario, the highest proportion of the non-remitted funds owed to the DT-SACCOs amounting to Kshs 4.31 Billion related to repayment of loans. Consequently, all the loans which were expected to be repaid with these non-remitted deductions remains non-performing and to the DT-SACCO system was being denied liquidity in the equivalent of the same sums. (SASRA supervisory report 2020).

According to Waweru (2018), in Kenya, SACCO have managed to accumulate funds running into billions of shillings, and many members have benefited from them. However, in the last few years, many of these institutions have experienced serious financial challenges that have led to some of them winding up or becoming dormant, resulting in a loss of funds for members. Saccos are supposed to be financially sustainable in order to cover all their transaction costs, maintain a consisted return on equity and consequently function without subsidies (Njoronge, 2018).

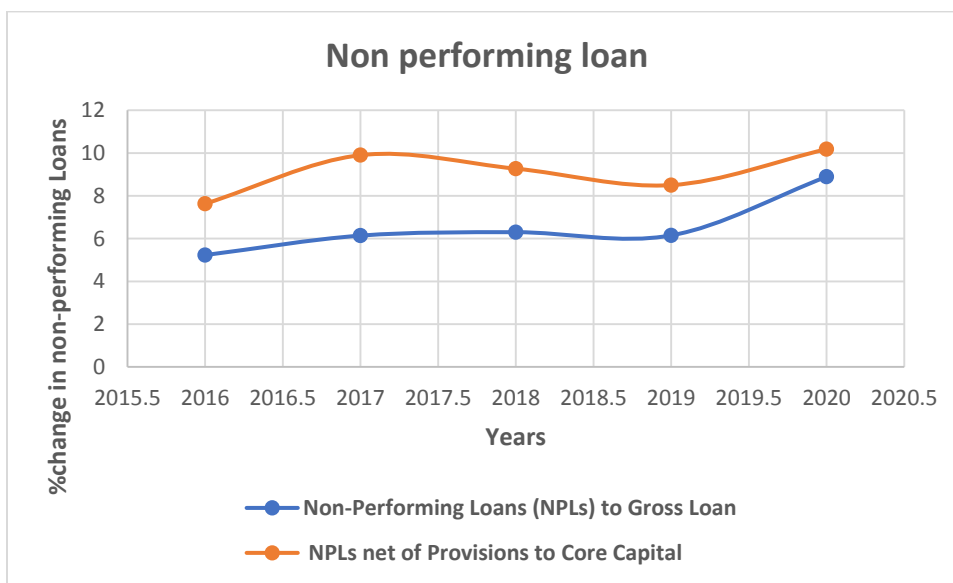
### 1.1.1 Non-performing loans

According to Kroszner(2015), non-performing loans are those loans that are no longer being serviced by a loanee. According to Saccos ACT of (2008) it expressly defines non-performing loans as to those loans in the portfolio that are more than 90 days overdue on interest or principal repayments and are disclosed in the supplemental financial statement information. In the resent past SACCOs in Kenya have experienced a rapid rise in the level of non-performing loans leading to liquidity among the SACCOs this has also lead to members receiving low dividends.

The issue is so serious that the provisions in the law have been enacted to guide treatment of non-performing loans in Saccos.

Non-performing loans ratio is equal to value of non-performing loans divided by the total value of the loan portfolio (including non-performing loans before the deduction of specific loan-loss provisions (SASRA act 2008). Higher non-performing loans ratios means that an organization is not recovering the loans given out as expected. SASRA has pegged a ratio of 5% as the maximum loan default ratio that licensed SACCOs should hold at any time (lipunga,2015). However, this has not been the case for many years as illustrated in the graph below. Non-performing loans has been increasing every year.

**Figure 2: Trend of Non-Performing Loans**



**Source: SASRA supervisory report 2020**

The SACCO Societies Act (Cap 490B) and the Regulations provides for prudential norms and requirements which SACCOs are required to fully comply with in order to maintain financial stability (SASRA, 2013). The key requirements include core capital and capital adequacy ratios, asset quality, non-earning assets, liquidity requirements, limits on external borrowing and equity investments; and generation of earnings. These are supplemented by regulatory guidelines issued by the Authority from time to time, together with financial best practices (SASRA, 2017). The regulatory framework requires SACCOs to maintain minimum core capital of Kshs 10 million, together with the following capital adequacy ratios: core capital to total assets, core capital to deposit liabilities and institutional capital to total assets at the ratios of 10 percent, 8 percent and 8 percent respectively (SASRA, 2019).

### 1.1.2 Financial stability of saccos

The key parameters for monitoring and reporting the financial stability and safety of deposit taking financial institutions include capital adequacy, quality of the assets, the earnings and the liquidity (SASRA annual supervision report 2020). Insolvency is a major risk to SACCO's hence

a source of finance instability. Kenya's enhanced regulatory requirement in this sector has emphasized on capital adequacy requirement for SACCOs at1d developed financial reporting standard that is required to be complied with by all the Deposit Taking SACCOs (SASRA annual supervision report 2019)

According to SASRA supervision report (2017) a total of 176 DT SACCOs started operations of which two of the DT SACCOs failed in their financial obligation, leading to a revocation of their respective licenses. This effectively left a total of 174 DT-SACCOs in operation in the country. It is also noted in the same report that there was no new SACCO society that was licensed during the year 2017, with a total of five applications being rejected for failing to meet the prescribed minimum licensing threshold, out of the seven application which were pending at the beginning of the year. The remaining two are still under consideration (SASRA supervision annual report 2017).

### **1.1.3 Relationship between Non-performing Loans and financial stability of deposit taking Saccos**

Nonperforming loans have an effect on the financial stability (capital adequacy, quality of the assets, the earnings and the liquidity) of Institutions because loans are assets that need to generate returns for an organization and when loans given out are not recovered together with interest then it implies that more resources will need to be committed towards provision for nonperforming loans and additional costs was used in financing recovery efforts. These costs and provisions consume a huge portion of the profits earned by SACCOs thereby retarding their financial performance Mombo (2013).

The level of nonperforming loans in an organization determines how profitable that organization is. Mombo (2013) confirms that nonperforming loans in deposit taking microfinance institutions account for the greatest percentage of the variance in the profitability of these institutions. Mwangi (2016) observed that there is an inverse relationship between the amounts of nonperforming loans and the financial performance. He further noted that when nonperforming loans are high, the financial performance measured by return on assets is low.

### **1.1.4 Sacco subsector**

Kenya's Sacco industry is among the biggest in Africa with 5.7 percent of total assets to GDP ratio, followed by Rwanda and Ethiopia, with 3.0 percent and 0.7 percent, respectively (Table 1). According to the Kenya Financial Sector Stability Report (2020), Growth of the Saccos industry has leveraged on rapid adoption of technology and innovations in the provision of financial services and products coupled with the opening up of the common membership bond. In addition, enhanced legal and regulatory environment have helped Saccos industry to grow and be accessed by 28.4 percent of the adult population as at December 2019, the highest in Africa. (The Kenya Financial Sector Stability Report, 2020). Sacco Assets to GDP Ratio of Selected African Countries Country Assets in 2019 (USD) Nominal GDP (USD), 000s Total Assets/GDP Ratio

**Table 1: Gross Domestic Product**

Country	Assets in 2019 (USD)	Nominal GDP (USD), 000s	Total Assets/GDP Ratio
Kenya	5,567,147,218	97,403,600	5.72%
Rwanda	308,481,890	10,209,000	3.02%
Ethiopia	635,000,000	91,166,000	0.70%
Ghana	297,683,637	67,077,000	0.44%
South Africa	22,039,604	604 358,839,000	0.01

Source: World Council of Credit Unions

Savings and Credit Cooperative Societies (SACCOs) play a fundamental role in Kenya's financial sector through assisting members save money and advance credit to interested members. DT-SACCO is part of the larger Sacco sub-sector in Kenya which comprises the deposit-taking and the non-deposit taking Sacco Societies. The deposit-taking segment of the sub-sector is composed of those Sacco Societies which undertake both withdrawable and non-withdrawable deposits. Whereas the non-withdrawable deposits portion of the business may be used as collateral and are not refundable unless on withdrawal from membership, the withdrawable deposits portion of the business can be accessed by the members at any time<sup>13</sup>. Statistics show that non-performing loans in the DT-SACCOs stood at 5.12%, 5.23% and 6.14% as at 2015, 2016 and 2017 respectively which indicates fluctuating financial performance (SASRA, 2017). This rate is relatively high compared with the World Council of Credit Unions (WOCCU) recommended industry average of 5%; and particularly given that the credit lending model in the DT-SACCOs is mostly premised on guarantor-ship, which is meant to cushion DT-SACCOs against bad loans. It also demonstrates that, notwithstanding the fact that the loans and credit advances by Deposit Taking-SACCOs -are guarantee backed, they are still susceptible to default, and thus additional measures to address the risks ought to be put in place (SASRA, 2017). While withdrawable savings deposits do not comprise significant portion of the balance sheet, Deposit Taking-SACCOs are usually faced with liquidity mismatch when issuing loans based on multiplier of savings.

## 1.2 Statement of the problem

A large proportion of Saccos asset comprise issued loans to members (SASRA supervisory report 2019). Some these loans given out by the SACCOs unfortunately become non-performing hence eventually declared bad debts with adverse consequences on overall financial stability of the SACCOs. The issue of non-performing loans (NPL) is becoming an increasing problem that threatens the sustainability and performance of SACCOs in Kenya. Currently the rate of NPLs are on the rise and this has caused much problems in sustainability of SACCOs in addition, adversely affecting the balance sheet, operations in terms of liquidity, Lending capacity, profitability, debt- servicing capacity, and ability to raise additional capital. Adequate management of loan delinquency risk in financial institutions is critical for the survival and growth of such institutions.

The issue of increasing non-performing loans over years has become a big issue with sacco regulatory authority SASRA report (2020). For example, the total amount of non-remitted funds as at September, 2020 stood at a staggering Kshs 5.04 Billion compared to Kshs 3.87 Billion as

at September 2019. To worsen the scenario, the highest proportion of the non-remitted funds owed to the DT-SACCOs amounting to Kshs 4.31 Billion related to repayment of loans. Consequently, all the loans which were expected to be repaid with these non-remitted deductions remains non-performing and to the DT-SACCO system was being denied liquidity in the equivalent of the same sums. (SASRA supervisory report 2020). In addition Statistics show that non-performing loans in the Deposit Taking-SACCOs stood at 5.12%, 5.23% and 6.14% as at 2015, 2016 and 2017 respectively which indicates fluctuating financial performance (SASRA, 2017).

Various researchers have conducted studies on NPLs as follows: Mombo (2013). The effect of nonperforming loans on the financial performance of deposit taking microfinance institutions in Kenya, Manyunda (2014), the effect of nonperforming loans on the financial performance of savings and credit Co-operative societies in Nairobi County and concluded that there is a strong relationship between return on assets and independent variables firm performance & non-performing loans ratio. Sporta and Mbatia (2019), carried a study on Effects of firm's Return on Assets on non-performing loans of deposit taking Sacco's in Africa-case study Kenya and concluded that increased nonperforming loans reduces Return on assets which has an impact on financial performance of SACCOs.

Studied by Koskei (2020) conducted a study on Non-performing Loans and Banks' Financial Stability in Kenya; Evidence from Commercial Banks and concluded that on-performing loans in Kenya's commercial banks affects the banks financial stability. The studies conclusively established that non-performing loans in Saccos and affects banks and saccos financial stability. NPLs thus require adequate response from affected institutions in order to manage and minimize their impact. To the knowledge of the researcher no research has been conducted on the effects of nonperforming loans on the financial performance of SACCOs in Kenya yet the sector has a high growth rate and contributes significantly to the Kenyan economy. The research therefore intends to fill the knowledge gap by investigating the effects of NPLs on the financial performance of deposit taking SACCOs in Nairobi County.

The study findings recognized the effects of non-performing loan on the various aspects of financial performance. Most of the of studies that have been done on the relationship between non-performing loans and financial stability have only been done in the banking sector hence their findings cannot be generalized in the SACCO sub sector in Kenya, hence there is need to address the gap. The research therefore intends to fill the knowledge gap by investigating the effects of non-performing loan on financial stability of deposit taking SACCOs in Kenya.

## **1.2 Theoretical Review**

### **Information asymmetry theory**

Information asymmetry theory was first applied by Akerlof (1970). The theory states that it may be complex to differentiate between good and bad borrowers and this may lead to adverse selection and moral hazard problems. The theory describes a situation where one party has more information than another party in a transaction. The other party with less information is more likely to make decisions that are not in line expectations of the market (Ambrus et al., 2018). SACCOs offer loans based on their members saving. For instance, many SACCOs prove credit services of up to 3 times a member's savings. However, the economic environment plays an

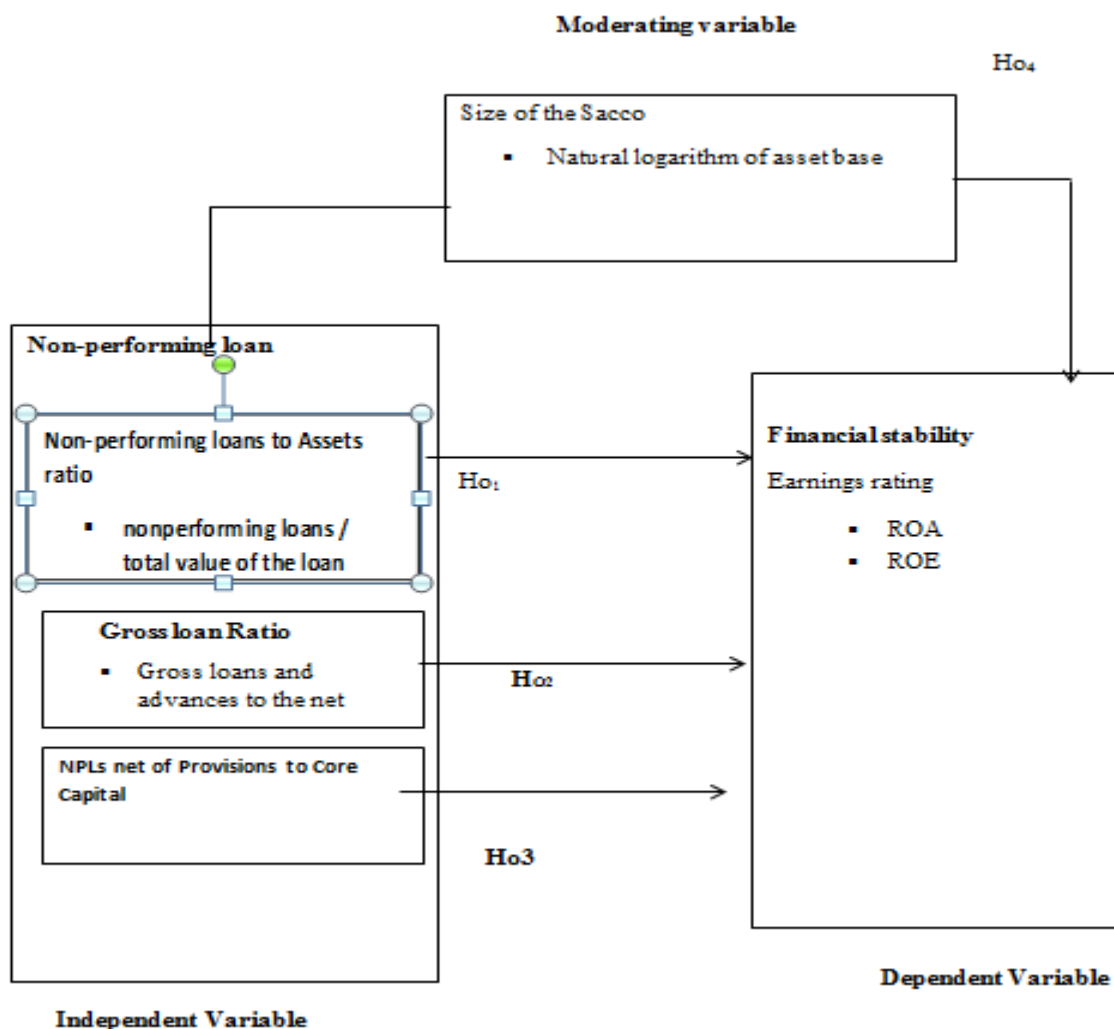


important role in loan advancements. Asymmetric Information Theory asserts that SACCOs should have adequate information about the economy. The lenders should have adequate information relating to the provision of loans to their members.

### 1.3 Conceptual Framework

The conceptual framework demonstrates correlation, between dependent and independent variables. Independent variable include nonperforming loan which will be measured by non-performing loan ratio, gross loan ratio and NPLs net of Provisions to Core Capital. While dependent variable includes financial stability which will be measured by earnings rating.

**Figure 3: Conceptual Framework**



## 2.0 METHODOLOGY

The study adopted a desktop methodology. Desk research refers to secondary data or that which can be collected without fieldwork. Desk research is basically involved in collecting data from existing resources hence it is often considered a low cost technique as compared to field research, as the main cost is involved in executive's time, telephone charges and directories. Thus, the study relied on already published studies, reports and statistics. This secondary data was easily accessed through the online journals and library.

## 3.0 RESULTS

Nikolov and Popovska (2016); Rahmat (2020); Bhatt Ebba (2016); Loice (2020); Kipai, Gudda2, Rukaria3 (2020); Mutiso (2019); Gitonga, 2014; focused on performing loans and their effect on the financial stability of commercial banks and microfinance institutions leaving out the SACCOs. The study findings recognized the effects of non-performing loan on the various aspects of financial performance. The studies that have been done on the relationship between non-performing loans and financial stability have only been done in the banking sector hence their findings cannot be generalized in the SACCO sub sector in Kenya, hence there is need to address the gap. The research therefore intends to fill the knowledge gap by investigating the effects of non-performing loan on financial stability of deposit taking SACCOs in Kenya.

## CONCLUSIONS AND RECOMMENDATIONS

The study will be beneficial to the academicians and researchers; they will be furnished with relevant information regarding non-performing loans and financial stability of the deposit taking savings and credit cooperative societies. This will also contribute to the general body of knowledge and form a basis for further research.

The regulator, the study findings of this study will assist the regulators of saccos SASRA to formulate stringent policies to tame the rising cases of non-performing loans.

The findings of this study will be useful to SACCOs within Nairobi County in evaluating how effective their approach to managing NPLs has been. This will enable them to identify the gaps in their management of NPLs and adjust accordingly.

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