A research agenda on portfolio diversification, government regulations, and the financial performance of deposit-taking SACCOs in Nairobi County, Kenya

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ABSTRACT

The purpose of this study is to examine the relationship between portfolio diversification, government regulations, and the financial performance of DT SACCOs in Nairobi County, Kenya. It aims to determine the impact of financial asset investment on the financial performance of deposit-taking SACCOs in Nairobi County, Kenya; the impact of loan portfolios on the financial performance of deposit-taking SACCOs in Nairobi County; and the moderating effect of government regulations on the relationship between portfolio diversification and the financial performance of deposit-taking SACCOs in Nairobi County, Kenya. Capital market theory, modern portfolio theory, risk aversion theory, arbitrage portfolio theory, and decision-making theory will serve as the study’s foundation. For the period under review, secondary data will be collected from audited annual financial statements included in SASRA reports.

Introduction

SACCOs continue to be the world’s largest and most prevalent providers of financial services (Sacco Societies Regulatory Authority, 2020; Aketch, 2021). They offer savings, credit, and insurance services to a substantial portion of the population. (Jepkorir et al., 2019) The 2010 economic liberalization in Kenya ushered in new changes and heightened competition in the lending industry, posing significant challenges for SACCOs. The fragmentation of the financial industry, which resulted in the formation of formal and informal segments, suggests that different segments adopted diverse strategies for addressing issues such as high transaction costs, risk management, resource mobilization, grants, and capitalization.

In addition to providing loans and investment services, SACCOs protect the money and other assets of their members. The principal source of revenue for SACCOs is credit creation (Kamau, 2015; Ssengendo, 2016). By engaging in this transaction, both the lender and borrower are exposed to substantial risk. The possibility of a member failing to fulfill contractual obligations by the due date poses a significant threat to the efficient operation of a SACCO. On the other hand, a SACCO with a high credit risk has a substantial risk of insolvency, placing the financial security of its members at risk (Gatimu et al., 2018). Among the risks SACCOs encounter, investment risk is one of the most significant concerns. Due to the high degree of risk posed by the SACCOs’ diversification of financial products and services, consumers must exercise extreme caution and sound judgment.

In essence, the majority of SACCOs generate credit for their consumers through the deposits of their members. During the credit origination process, SACCOs are exposed to a high default risk, which could result in financial hardship or even bankruptcy. SACCOs are susceptible to a variety of financial risks, including credit, systemic, and liquidity risks (Mutua, 2016). When there is a credit

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risk, the lender is uncertain as to whether the loan will be repaid in accordance with the terms of the agreement. This includes the default risk, which indicates a low likelihood that the lender will be able to recover both the principal and interest paid by the borrower. To preserve deposits, the regulator must ensure that the organization can at least pay a portion of the outstanding balance (Amina, 2016).

As the sample portfolio's stock count increases globally, for instance in Malaysia (unsystematic risk), the investment portfolio for Malaysia Stock Market stocks decreases, and so on, until each portfolio is sufficiently diversified. The data frequency level has a substantial effect on variations in the size of the stock portfolio required for optimal portfolio diversification. On the Malaysian stock exchange, diversification is applicable to both Sharia-compliant and non-Sharia-compliant equities. In addition, Sharia-compliant equities reduce risk by requiring fewer securities in a portfolio (Norsiman et al., 2019). Diversification at the functional, regional, and loan portfolio levels improves bank stability in India. According to research on Indian institutions, diversification has strengthened resilience. Banks can diversify their credit portfolio by making loans available to a wider variety of enterprises. Despite the fact that banks typically offer analogous financial products to multiple industries, the reduction of industry-specific risk may have diversification benefits. Alternately, producing advances of varying sizes diversifies the loan portfolio (Chandramohan et al., 2022).

Locally, financial institutions improve their financial performance by diversifying their portfolio income sources to include both interest income and non-interest income. Non-interest incomes include share trading financial gains, bank assurance income, dividend financial gains, commercial activity gains, and non-interest fees and commissions on banking products (Chepkorir, 2018). Deposit-taking Kenyan SACCOs frequently hold a diverse portfolio of assets. They maintain a variety of assets, such as stocks, securities, and real estate, to diversify portfolios and ensure that members' deposits are not subject to the performance of a single or a small number of investments. Obiero (2019) explains that the performance of DT-SACCOs is primarily dependent on the diversity of their portfolios, particularly with regard to the best-performing assets that reflect the organizations' financial performance.

This study aims to (i) assess the effect of financial asset investment on the financial performance of deposit-taking SACCOs in Nairobi County, Kenya; (ii) determine the effect of loan portfolio on the financial performance of deposit-taking SACCOs in Nairobi County; and (iii) assess the moderating effect of government regulations on the relationship between portfolio diversification and the financial performance of deposit-taking SACCOs in Nairobi County, Kenya.

Literature Review

Theoretical and Conceptual Background

Portfolio Diversification of Deposit Taking SACCOs

Portfolio diversification is the process of allocating financial assets into portfolios based on the risk and financial return related to each particular asset. Diversification involves combining many investments into a single portfolio. According to Qu (2019), portfolio diversification is the process of combining different assets to reduce the overall risk of an organization's total portfolio. In order to strengthen their strengths and opportunities and improve their performance, SACCOs in Kenya are diversifying their portfolios by introducing new products that are relevant to their current line of business, providing quasi-banking services, and introducing mortgage facilities (Njoka, 2016).

In most circumstances, a well-balanced portfolio of many investment types will produce higher returns with lower risk than any one type of investment, improving the performance and stability of the economy. In order to find the optimum collection of investments that generate significant returns with little risk, several institutions, including deposit-taking SACCOs, have used portfolio diversification as a strategy. Many studies have been conducted on the impact of portfolio diversification on organizational performance. Several studies have found a favourable association between portfolio diversification and long-term profitability improvement, whereas other studies have demonstrated a negative relationship.

Diversifying an organization's portfolio involves investing in a variety of financial assets and engaging in a variety of business ventures in an effort to lower overall investment risk and prevent the performance of a portfolio from being harmed by the underperformance of a single security (Hill, 2020). Asuma (2022) claims that DT SACCO financial performance may be improved by spreading money among various investments and activities rather than depending on a single activity or investment for returns. Portfolio diversifications are done by spreading capital throughout various investments and assets, such as securities or real estate, and typically result in longer-term capital gains. Even at its most basic level, portfolio diversification can be achieved by simply spreading an investment among a variety of assets to reduce unsystematic risk. Diversification increases business profitability by increasing asset deployment, lowering distress costs, and improving debt capacity (Musenge & Jagongo, 2017). The performance of a portfolio as a whole is evaluated in terms of risk-adjusted return. The goal of portfolio diversity is to lower risk without lowering yield or return. Risk can be decreased or eliminated by the investment company by combining assets into a portfolio.

Government Regulation on SACCOs

The Sacco Act of 2008, approved by the Kenyan parliament, established direct government regulation of SACCOs. The laws were prompted by the necessity to provide suitable structures and prudential norms to SACCOs, particularly those engaged in deposit-taking activities known as Front Office Services Activity (FOSA). The FOSAs conduct banking transactions with members of the
public, the majority of whom are not FOSA members. Since the SACCOs were not regulated by the Central Bank of Kenya or the Banking Act, the government imposed direct regulation via SASRA.

The Sacco Act No. 14 of 2008 was expected to have an impact on the functioning and reporting of SACCOs. SACCOs must deposit 10% of their total member deposits, or a minimum of Kenya Shillings ten million, to a statutory deposit fund in SASRA, which serves as deposit insurance. SACCOs are also required to recruit qualified bookkeepers, and the Chief Executive Officer of a SACC O must hold a Master's Degree in a business-related discipline. The Act demands that all SACCO members be homogeneous. This suggests that SACCOs should be made up of Kenyans with similar backgrounds. These regulatory reforms are expected to have an immediate and long-term impact on SACCOs. As these issues are directly addressed by the Act, the impact will mostly be on the loaning services provided by SACCOs, the savings deposit, the composition of SACCO membership, and the qualification of SACCO staff.

Savings and credit societies are among the few commercial entities in both industrialized and developing countries that survived the 2008 financial catastrophe. This was despite the fact that the sector was not strictly regulated because to the SACCOs' people-centered business approach. The Act established SASRA, whose duty includes licensing, regulating, and overseeing SACCO societies that accept deposits (KUSCCO, (2003)). According to World Council of Credit Unions (WOCCU, 2006) prudential regulation is a type of financial regulation whose primary goal is to reduce risk in financial systems. Capital adequacy requires SACCOs to meet the following criteria: core capital of at least ten million shillings; core capital of at least ten percent of total assets; institutional capital of at least eight percent of total assets; and core capital of at least eight percent of total deposits.

Financial Performance of Deposit Taking SACCOs

Performance, according to Mehralian et al. (2017), is the accomplishment of an objective or a common aim. It entails completing a task and having it evaluated against predetermined standards. Organizational performance reveals the degree to which the firm's strategic goals have been achieved. Oh (2019) elaborates on the definition of performance by emphasizing the management style of businesses and the value that is provided to the many stakeholders. Muswere (2020) defines firm performance as a company's innate capacity to fulfill its objective, which can be accomplished via ongoing commitment to attaining goals. As a result, it is multifaceted and includes both financial and non-financial performance components.

Financial performance, in particular, results from an organization's processes, technologies, policies, and strategies, and is expressed or quantified in monetary terms. It results from the many business operations carried out by a particular firm (Przychodzen & Przychodzen, 2015). Financial performance refers to the capacity to operate financially, efficiently, and effectively, as well as the ability to withstand any adverse economic conditions and environmental hazards while making the best use of available resources and opportunities at the lowest possible cost. The financial performance of a company serves as the management's guide in determining the policies and strategies that should be modified to increase organizational sustainability.

Determining financial performance includes calculating ROA, ROE, sales growth, ROI, market share growth, and EBIT (Ali, 2020). Financial performance is a purely arbitrary metric that shows how effectively a company is using its resources to create income. Financial performance in particular shows the overall financial health of any given organization over a given period of time (Muhammad et al., 2015). Figures are frequently used to link comparable businesses in related industries. In general, accounting measures of financial performance represent the past or short-term performance, while market measures the long-term financial performance (Delmus et al., 2015).

Deposit Taking SACCOs in Nairobi County

The Nairobi County is Kenya's principal economic and cultural centre generating 60 per cent of Kenya's GDP (Mundia, 2017). Savings and Credit Co-operatives (SACCOs) forms part of the larger cooperative movement that encompasses user-owned financial institutions offering savings and credit services to their members (Tache, 2006). Cooperatives comprise autonomous associations of individuals joined together voluntarily with the aim of meeting shared socio-economic as well as cultural needs and aspirations via a jointly owned and democratically controlled organization (SASRA, 2020).

Savings and Credit Cooperative Societies are incorporated for the purposes of mobilizing savings, advancing credit facilities and offering financial advisory services to its members (Sebhatu, 2012). Savings and Credit Cooperative Societies are key players in the financial sector of a country through provision of savings and credit advancements. Apart from the aforementioned roles, SACCOs engage in economic growth-based activities such as security investments and housing functions meant to provide more returns to the members. SACCOs are principally divided into two major classifications that are differentiated by the nature of savings and deposits they mobilize from their members (Ndiego et al., 2014). SACCOs are either non-deposit taking or deposit-taking institutions. The non-DT-SACCOs are those that mobilize deposits from their members which are strictly utilized as collateral for credit facilities. The DT-SACCOs are those that apart from SACCO general services, they take demand deposits and withdraw-able savings accounts similar to the ones offered by a banking institution.

Conventional financial institutions such as commercial banks consider the poor and low-income earners as high risk and difficult to serve because the small loans they need are costly to make and maintain (Ndiego et al., 2014). Therefore, they are perceived as low profitable and high risk, hence the reason for being ignored. SACCOs provide a variety of services to the poor, low-income
households and small enterprises to enable them to be economically empowered. Access to savings and credit services as a strategy of improving livelihoods and mechanism for poverty alleviation has gained prominence particularly in the developing countries. This has resulted in the emergence of DT-SACCOs, which has increased access to financial services. However, some DT-SACCOs have struggled to continue operating consistently for significant number of years in Sub-Saharan Africa.

Financial performance of DT-SACCOs from 2016-2021 as shown by ROA has also been fluctuating consistently. In 2016 it was 2.45 percent, increased to 2.69 percent in 2017, and in 2018 it decreased to 2.40 percent. In 2019 it rose again to 2.60 percent, and in 2020 it increased to 2.65 percent again, while in 2021 it was 1.59 percent. Consequently, liquid assets to total assets ratio showed a similar trend in the same period. In 2016 it was 12.49 percent and 2017 11.85 percent, and 11.77 percent,11.62 percent ,14.43 percent and 14.96 percent in 2018,2019,2020 and 2021 respectively (SASRA, 2021)

Average growth rates in the total deposits of large tiered SACCOs reflected higher growth rates in 2017/2021, while small tiered SACCOs reflected diminishing growth rates; in 2018/2018 it was 8.69 percent, 7.64 per cent in 2018/2019 and 7.51 per cent in 2019/2020 against that of large tiered SACCOs at 12.32 percent,12.17 percent and 11.32 percent in the same period (SASRA, 2020). If the trend continues then, small tiered SACCOs would lose their market competitiveness against large tiered SACCOs

Portfolio diversification and financial success in deposit-taking savings and credit cooperative societies within Nairobi County have not yet been linked by prior studies. Also, there are different findings regarding the impact of portfolio diversification on financial performance in various contexts and industries. Portfolio diversification has been demonstrated in certain research to increase financial performance over time

Government regulations have shown to have an effect portfolio diversification and financial performance internationally, but this has not been given much attention empirically among DT-SACCOs in Nairobi County. Portfolio diversification effects on company performance have so far been the subject of mixed, ambiguous, and inconsistent empirical findings especially among developing countries. By examining the scenario with regard to deposit-taking SACCOs in Nairobi County, this research aims to close conceptual and contextual gaps and give more concrete evidence of the link between portfolio diversification and financial performance. Specifically, the study will examine the effect of real estate investments, financial assets investment, and loan portfolio on financial performance of deposit-taking SACCOs in Nairobi County.

Theoretical Framework

The study was anchored on Modern Portfolio Theory. The theory was conceptualised in Harry Markowitz’s 1952 article, which included the Markowitz model. It was the first theory to present modern portfolio theory. The theory's fundamental premise is that risk-averse traders can put together a variety of assets, such as portfolios, to increase or snowball projected return in a specific phase of market-related risk, with higher returns naturally entailing greater risk (Valls et al., 2022). Choosing a group of investments to make up a portfolio for a business is known as MPT. This concept states that an investor tries to assume the least amount of market risk possible in order to obtain the highest level of returns for a specific investment portfolio. It recommends combining investments in a strategy that will maximize long-term profits while reducing market risk through diversity. Every entity's goal is to maximize long-term profits while minimizing excessive short-term market risk, which is the cornerstone of their investment philosophy (Ahmad, 2020).

A high-risk asset type or security can be held by an individual, but when it is paired with a variety of other asset types or investments, the entire portfolio can be balanced so that its risk is lower than some of the underlying assets or investments. This is in accordance with MPT. According to MPT, a portfolio's expected return should be maximized for any given level of risk. Investors must choose between risk and expected return for portfolios that match this requirement, known as efficient portfolios, because a higher expected return necessitates taking on more risk (Ahmad, 2020).

By carefully selecting the ratios of various assets, MPT seeks to maximize portfolio expected return for a given level of portfolio risk or, equivalently, minimize risk for a given level of expected return, according to Fabo-Brandi and dos Santos (2020). Assuming rational investors and efficient markets, this suggests that DT-SACCOs can lower the overall variance of the portfolio return by combining various portfolios with imperfectly positively linked returns. The MPT formulates the idea of investing diversification analytically with the goal of choosing investments with collectively lower risks than any one product. The idea of portfolio diversification in this study is supported by MPT since it helps Saccos analyse investment possibilities in terms of the risks and expected returns and efficiently allocate resources among the portfolios to boost financial performance.

Empirical Review

Keli (2021) studied the effect of real estate investments on financial performance of pension funds in Kenya. The 1340 pension funds of Kenya were the intended audience. There were 134 pension funds in the sample. Data for the research variables were taken from RBA for the years 2016 to 2020. According to the study, the performance of Kenyan pension funds was positively and significantly impacted by real estate investments, fixed income investments, and listed equity. The study also discovered that the performance of Kenyan pension funds was unaffected significantly by fund size. While the study focused on pension funds in Kenya, this study will focus on DT-SACCOs in Nairobi County. Real estate investments, fixed income investments and listed equity were the independent
factors, while the current study will focus on real estate financing, loans, insurance investment and financial assets proxies by government bonds.

Muli (2016) evaluated the impact of real estate investment choices on DT-SACCOS’ financial performance. The purpose of the analysis was to determine how real estate investment choices affected the financial performance of DT-SACCOS. During a time, frame of 2006 to 2015, an empirical investigation was done. The study's 12 DT-SACCOS served as its population. Investment choices, including those to invest in real estate, were the independent variable. Karl person correlation and multivariate analysis were used to analyse the data. The study’s findings showed a strong correlation between financial performance and real estate investing choices. In a five-year study on the relationship between real estate finance and the financial performance of 11 banks that are commercially registered on the Nairobi Stock Exchange. Odhiambo (2017) analysed data from annual reports. Investigated was the impact of real estate finance on the financial performance of commercial banks. Data from the annual indicators on the websites of the individual banks, the Nairobi Stock Exchange, and the Central Bank of Kenya were utilized in the analysis. The inquiry discovered that mortgage finance, in particular, had a significant impact on the financial performance of publicly traded commercial banks. Finding out how real estate finance affects the financial performance of DT-SACCOS and not banks is the main focus of the current study.

Aduda and Obondy (2021) explored the connection between the size of the portfolio and the financial success of DT-SACCOS in Kenya. The study’s objective was to ascertain how the performance of the DT-financial SACCOS was impacted by the size of the portfolio. One of the independent variables was investment in the stock and bond markets. Ninety companies, all of which are members of KAIG, participated in the test. Secondary data were used, with 45 companies serving as the sample size.

Bond markets provided the greatest returns, according to the findings of the regression analysis, and it was established that this had a positive influence on the Saccos’ financial performance. However, the study did not include other portfolios in the analysis hence the findings were inconclusive. In addition, the moderating effect of government regulations on financial performance was not factored in the analysis.

Obiero (2019) examined the effects of portfolio diversification on the financial performance of investment companies listed at NSE. The specific variables were bond investments, equity investments, mutual fund investments and real estate investments and return on investments. The theoretical framework was informed by portfolio theory, Black-Litterman theory and capital asset pricing model. The study adopted descriptive research design. The five listed investment companies at the NSE formed the target population of this study. Data was collected covering 6 years from 2014 to 2019. The results revealed a negative and insignificant relationship between bond investments and return on investments for the investments firms at Nairobi Securities Exchange. There was a positive and significant relationship between Equity investments and ROI, while mutual funds’ investments had a negative and insignificant relationship. Real estate investments revealed a positive and significant relationship with ROI for the investment firms at NSE. With the mixed outcomes, this study seeks to find out how portfolio diversification influences performance of deposit-taking SACCOS

Cavaliere et al. (2021) looked into the impact of portfolio diversification on risk management practices among commercial banks in Italy. The study used a quantitative approach and distributed the survey to a specific group of participants, and the results of a regression test were observed. According to Pearson Correlation analyses, market risk, liquidity risk, loan risk, and solvency risk were all closely related. Nonetheless, the balance sheet was used to focus on the ratios' effects on net income during 2017 and 2018. The results demonstrated that net income increased in direct proportion to risk management ratios. Yet, the focus of this study was on commercial banks in Italy, a developed country.

Githaka et al. (2017) found that SACCOS offered different loan types depending on the relationship of the borrower with the SACC. For instance, gross loans and SACC loans were offered to other borrowers and SACC members respectively. The findings indicated that members repaid their loans as scheduled meaning delinquency cases were minimal. The researchers noted another classification of loans called performing loans (PL) which a majority of the respondents settled that they are performing. When loans are performing, the borrowers are able to repay them and, in the process, improve the profitability of the SACC and at the same time help the SACC maintain its funding liquidity thereby reducing funding liquidity risks. However, the study did not incorporate other portfolios other than loans which perhaps would have changed the nature of the correlation.

Wamalwa (2012) explored the effect of regulation on financial performance of SACCOS offering FOSA services in Kenya. The research design for the study was descriptive. The findings demonstrated that the implementation of governance regulations had a positive effect on SACCOS's financial performance. As part of this, an independent board is elected, independent board committees established, directors and senior management subjected to SASRA screening, and the roles of the board and management separated. Also, the implementation of prudential regulations such as those on capital adequacy, the amount of external borrowing, asset classification and provisioning, maximum loan size, and insider lending had a positive effect on the financial performance of SACCOS.

Githira (2008) looked at the variables influencing the diversification tactics used by Kenyan insurance companies. A cross-sectional survey research design was used for this investigation. Semi-structured questionnaires were utilized to gather primary data from the top management of the insurance businesses, which were the study's intended audience—all insurance companies in Kenya. The study's conclusions showed that government regulatory regulations have.
Conclusions

It is expected that savings and credit cooperative societies will contribute to a nation's financial transformation. However, the majority of DT SACCOs in Kenya are unable to consistently satisfy the needs of their members due to inadequate financial performance. DT SACCOs have not been able to endure over the long term due to their inability to adapt to the dynamics of the financial markets. A evaluation of the portfolio decisions made by SACCOs in Nairobi County, Kenya, reveals concerns that have adversely affected their financial performance. The portfolio decision is one of the shareholders' primary concerns at DT SACCO. This is because a SACCO's portfolio decisions affect its financial performance. Diversification of the portfolio is a crucial response to the changing financial needs of the SACCO's members. Sadly, deposit-taking SACCOs in Nairobi County have not fully implemented portfolio diversification, and those that have done so have done so inefficiently, rendering the majority of them financially untenable.

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