

EFFECT OF INSTITUTIONAL CAPITAL ON INSTITUTION'S FINANCIAL STABILITY OF DEPOSIT-TAKING SACCOS IN KENYA

^{1*} **Michael Kifworo**
markkifworo@gmail.com

^{2**} **Mary Kiveu**
marykiveu2015@gmail.com

^{3***} **Peter Njuguna**
petnmaina@gmail.com

^{1,2,3} *Multimedia University Of Kenya*

Abstract: *The deposit-taking Savings and Credit Cooperatives (SACCOs) sector is a crucial component of the financial industry contributing significantly to Kenya's economic growth. However, there is still a challenge on adequate regulatory to enhance compliance given that majority of the SACCO members are small and thus may be technically and financially constrained to meet the tight liquidity requirements set by SASRA. The general objective of this research inquiry was to explore the effects of capital composition (structure) decisions on the institution's financial stability. The study used a populace of one hundred and seventy-four Deposit Taking Savings & Credit Co-operatives Societies (DTSs) that filed their report for the period ranging from 2014 to 2018 was considered. Data analysis was done through inferential and descriptive statistics. The correlation and regression features of the Statistical Package for Social Sciences (SPSS) Version 20 were used in the analysis of data. The data showed a degree of variation between the capital structure decision of the deposit-taken SACCOs in Kenya. There was a positive correlation between the institutional capital and institutional capital to total assets ratio, core capital, total deposits ratio, and total assets to total loans ratio. This study will provide academics and other researcher with relevant information regarding the influence of financing approaches on the growth of deposit-taking SACCOS in Kenya and will help the management of the deposits and credit cooperative societies in implementing viable financial guidelines.*

Keywords: *institutional capital, capital composition, financial stability, deposit taking SACCO*

1. INTRODUCTION

Institutional capital is the collectively owned wealth of a cooperative and it's the total of the capital reserves, the retained profits and the net income yet to be closed to the retained earnings account. They are generated internally and help in financing the society's operation. Retained Profit is the proportions of profits or surplus of the business that are usually withheld by the SACCOs for financing purposes. They are usually not allocated to members and it's a long-term source of funds which are only distributed on liquidation of the SACCOs. The more the profits are being retained, the better for the society to meet its financial obligation driving the performance of DTS up.

Capital Reserves are the part of profits which are withheld by the cooperative for a particular purpose such as to finance long term future projects. They are not contributed as dividend to shareholders. They include share premium, profits on reissue of forfeited shares, capital redemption Reserves, development rebate reserves. These reserves add to the capital structure of the DTS and help it meet their financial obligation which has a positive significant effect on the operation performance of these DTS.

In Kenya, the SACCO Regulations (2010) establishes a core capital for SACCOs and aims at improving the efficiency and effectiveness of how they conduct their businesses. The improved effectiveness will result in better productivity thus improving financial stability which is a key measure of productivity in monetary terms (SACCO Regulations, 2010). Section 9 of the SACCO regulations established the importance of core capital which dictates that SACCOs must maintain sufficient capital that can protect its members' deposits and further protect creditors against losses arising from business risks. Business risks are measured in monetary terms through the financial performance of the SACCO. Thus, according to Sacco Society Regulatory Authority (SASRA) as a measure of safety and soundness, adequate capital should result in the financial stability of SACCOs which will enable the smooth running of their activities which promotes public confidence (SASRA, 2017).

According to Societies Act (2008), core capital entails members fully paid up shares, related reserves, retained profits, donations and grants which whatsoever should not be depleted unless the SACCO is to be liquidated. In other words, Core Capital= paid shares + reserves + retained profits + donations, whereas, Institutional Capital= core capital – member's share capital. Institutional capital is the part of the core capital belonging to the SACCO and which cannot be claimed by any society member (SASRA, 2008).

State of Financial Stability of SACCOS in Kenya

Pandey, (2014) describes financial stability as a state in which financial systems and institutions become resilient to economic inconsistencies such as effectively managing financial risks, arranging payments as well as intermediating financial funds. Financial systems play an integral role in the sustainability of an economy such as enabling effective financial intermediation between savers and borrowers, ensuring efficient allocation of scarce resources. Furthermore, financial stability depicts a situation where there are smooth financial intermediation processes and high confidence of the public in the operations of critical financial markets and institutions within an economy. Therefore, financial stability is the effective and efficient financial intermediation process operations encompassing governments, firms, and households through various financial institutions and supported by numerous financial arrangements (Opala, 2014). Kimani, (2007) describes financial stability as a condition where financial systems such as financial markets, infrastructure, and intermediaries absorb financial imbalances and shocks and also automatically adjust to mitigate the possibility of severe disruptions in the financial intermediation process such as impairment in the effective allocation of savings to lenders. Many studies on financial systems stability have focused on the vulnerabilities and risks of the financial systems as they are relatively easy to quantify, analyze, and understand. For the purpose of this study the definition of financial stability will be adopted as defined by Pandey (2014) as a state in which financial systems and institutions become resilient to economic inconsistencies such as effectively managing financial risks, arranging payments as well as intermediating financial funds.

The growth of SACCOs largely depends on their effective performance as this enables them to attract members. Effective management of SACCO activities will enable them to meet their short and long term financial obligations which will be reflected in more satisfied stakeholders and financial stability (Adebayo et al., 2011). The emergence of SACCOs in Kenya has significantly contributed to the culture of savings which forms an important step towards wealth accumulation. Thus, employees upon their retirement, happily go home having saved enough to take them through their retirement period.

SASRA greatly contributes to the cooperative sector in Kenya and supports initiatives through the development and implementation of viable recommendations and programs such as developing effective legislation to safeguard members' savings, suggesting relevant corporate governance guidelines, and automating business

processes in the SACCO sector. In attempts to make Kenya's cooperative and savings sector the best, SASRA frequently benchmarks with more established SACCO sectors worldwide on ways of meeting the changing loan demands by members by adopting adequate and relevant financial legislation. SASRA was developed as a response mechanism to the increasing emergence of SACCOs countrywide with no clear legal guidelines developed to control their operations (SSA, 2008).

In 2015, the SACCO industry sector's assets registered a positive growth of 12.7% with loans taking the lion's share of the balance sheet assets at 73.5%. In the same year, SASRA renewed operational licenses of 181 DTSS to strengthen the sector (GOK, 2016) The Sacco Industry total assets had accumulated to reach close to Kshs 0.5 Trillion at the beginning of 2018 depicting a growth rate of 0.13 from the year 2017. The accumulated total loans on the other side increased to reach Kshs 0.33 Trillion reflecting a growth level of 0.12 from the previous year; at the same time, member deposits grew to reach Kshs 0.305 Trillion reflecting a growth rate of 0.12 from the previous year (SASRA, 2018)

According to GOK (2016), the Deposit-Taking SACCOs have grown above 12% across critical performance measurements and brags of 75% deposits and total assets in the savings sector. Additionally, research has shown that Kenyan savings sector has Ksh. 5 billion net assets which translate into 54% of the deposits and net assets. However, even with the convincing positive trends in the development of cooperative societies in Kenya, there still exists a challenge on adequate regulatory to enhance compliance given that majority of the SACCOs are small and thus may be technically and financially constrained to meet the tight liquidity requirements set by SASRA. Additionally, with stiff competition expected to continue growing from the more established and large depository institutions such as commercial banks, the DTSS may quit from their primary functions and focus on other beneficial activities (GOK, 2016).

Mumanyi (2014) sought to identify the opportunities and challenges SACCOs face in Mombasa County. Her research inquiry asserted that insufficient capital was one of these constraints, and that despite this draw back; opportunities were available to SACCOs as they had a significant positive impact on economic growth and development including capital build up. It was recommended in this study that policymakers and governments need to formulate policies and strategies that will ensure SACCOs are financially viable (Mumanyi, 2014).

Deposit Taking SACCOs (DTSS) in Kenya

DTSS are organizations which accept both drawing and non-drawing deposits. Deposits which can be withdrawn are referred to as demand deposits since members can access them anytime while those that cannot be withdrawn are normally used in place of collateral and is only payable upon cessation of one's membership (SASRA, 2018). The SACCO sector being a crucial component of the financial industry contributes significantly to Kenya's economic growth. The International Monetary Fund (IMF) report published in 2011 indicated that depository SACCOs command a commendable stake of the assets of the entire saving sector in Kenya and contribute to roughly 0.4 of the country's Gross Domestic/National Product (GDP). In Kenya, SACCOs are regulated under the Department of Industrialization and Enterprise Development which oversees societies' registration and compliance. However, with the establishment of SASRA as the sole regulatory authority for savings and credit societies under the SACCOs Act of 2008, deposit-taking organizations were moved to SASRA for supervision and regulation. The SACCO Act of 2008 was published on June 2010 and required all SACCOs operating FOSA to apply for licenses from SASRA (SASRA, 2015).

The main objective of the enactment of various prudential regulations on deposit-taking SACCOs was to promote a transparent and accountable savings sector. This was in line with the financial reforms which aimed at expanding access to financial services, fostering improved financial stability, operation, and stability among

financial service organizations or providers. The challenges that face the implementation of SACCO legislation vary significantly due to the variety and size of SACCOs (SASRA, 2015). However, inadequate technical skills at the management and board level are the key challenges. Other areas that need continuous attention are managerial capacity, governance, automation and management of credit. SASRA regulates and supervises the following operational aspects of deposit-taking SACCOs; risk provisioning and classification of assets, maintaining a balance between asset and liability liquidity, accepting deposits and advancing loans, ensuring adequate financial reporting, information preservation, and business continuity and deposit guarantee fund (SASRA, 2015).

Whereas deposit-taking SACCOs account for less than 10% of all SACCOs in Kenya, they make up for 80% of the deposits and assets and in the savings and credit industry. Depository saving and non-deposit taking societies are regulated by SASRA and are spread all over the 47 counties in Kenya. The SASRA findings of 2016 showed that Nairobi County alone accounts for 39 registered depository SACCOs. Non-depository societies entail those organizations that only major on sourcing for funds elsewhere for lending to its members at affordable interest rates. On the other hand, depository societies are those that encourage and accept members' savings which cannot be withdrawn any soon and are only refundable upon withdrawal of membership. Such deposits are thus, used as security for advancing loans to registered members of that particular society (SASRA, 2014).

Other than the primary roles of accepting deposits and advancing credit facilities, DTSs also offer a range of banking services that include; making payments, demand deposits, and micro-banking services; Automatic Teller Machines (ATM) as provided for under the SACCO Act, 2008. The new Act ensures that financial stability of the DTSs is guaranteed as well as protecting the investments and deposits of the members which are in line with the financial stability to ensure SACCOs remain liquid capable of meeting members' demand for advances and loans. SACCOs are crucial in achieving financial inclusion and expansion and subsequent realization of Kenya's long term strategic national growth and development plans. As part of Kenya's macro-economic targets, rate of savings were anticipated to rise to 0.3 of GDP through improved financial deepening, creating credit referencing and streamlining SACCOs to raise institutional capital. Although not recognized as an autonomous industry, the SACCO sector will play an important role in the funds' mobilization for investment activities necessary for the implementation of the Kenyan flagship programs (Sasra, 2015).

According to SASRA (2015), The SACCOs Act of 2008 and other fundamental financial regulations established give strict guidelines which DTS are expected to fully comply with to maintain the financial stability of a Sacco. One of these regulations includes the provision of maintaining core capital within the society which caters for crucial activities such as supporting new members' activities as well as absorbing loses in the event of infrequent occurrences. The requirement for maintenance of a minimum amount of capital helps in protecting deposits reduces members' anxieties and as such improves the confidence of the members on the operations of SACCOs (SASRA, 2015).

Financial stability of SACCOs can be measured through various mechanisms, one of them being the total loan to total deposit fraction. This ratio depicts the SACCOs' ability to fund their lending operations through the deposits generated internally and the recommended ratio is 80% to 70% for deposits and loans respectively which allows such organizations to remain with substantial liquid funds for investments. The aggregate total loans to total deposits ratio for the DTS in 2017 was at 108% much above the acceptable ratio of between 70% and 80%. This upward trend shows that the demand for credit facilities still outweighs the savings to finance these loan requirements which implies several DTS are not able to meet demand for their members' loan. To

remain efficient, the SACCOs have to meet this excess demand by sourcing for funds externally such as loans mostly from Cooperative Bank of Kenya and KUSSCO. Interestingly, only 17 DTS met the required ratio of total credits to total savings below 70% which indicated a significant drop from 21 DTS which had adhered to this ratio requirement as at 2016 and 2017, an indication that there was an increased demand for credit facilities in DTS.

Furthermore, there was an increase of DTS which maintained a total loan to total deposit ratio 100% and above, rising from 102 institutions to 104 institutions in 2016 and 2017 respectively, compromising on DTS's ability to maintain a liquidity cushion for other investments (SASRA, 2017). This problem is worse in DTS where members are mostly working in government departments and public universities where SACCO deposits are deducted and delayed in remittance by the employers (SASRA, 2017) This has affected the ability of SACCOs to give loans to members while other SACCOs are forced to borrow debt capital on high-interest rates in order to satisfy members demands for loans.

SACCOs need to adopt adequate capital structure decisions to meet the loans and credits demand by members since the normal savings by the SACCO members funds may not be an adequate source of financing. This is because the majority of Kenyans are turning to SACCOs because the commercial banks are avoiding issuing retail loans to customers hence creating funding deficit in SACCOs.

Other related studies have been done and the findings were closely related in terms of the legislations governing operations of SACCOs and factors that threaten their development.

Moreover, Opala (2014) scientifically researched on the factors that influence the financial operation performance of SACCOs and revealed that among the factors affecting the financial performance of SACCOs included; adequacy of the management, size of the society, capital structure and adequacy, liquidity.

Majority of the above studies for example; (Opala, (2014), looked at financial performance of SACCOs, Mumanyi (2014) sought to identify the opportunities and challenges SACCOs face among others) have examined the financial stability and performance of SACCOs. None investigated the effect of financial decisions that ensure the financial stability of DTS enabling them to meet the demand for loans by their members without violating the capital adequacy as required by SASRA. This research therefore, aimed at answering the question; Do Capital composition (structure) influence the institution's financial stability of DT SACCOs in Kenya?

This study will help the management of the deposit-taking SACCOs in implementing viable financial guidelines. This will increase the SACCO's funding and hence, ensure growth in terms of profitability and general membership. Secondly, the study will be relevant to the government and related agencies i.e. SASRA in helping them to understand how financing strategies relate to SACCO growth and development. This knowledge will help in developing regulatory requirements and policies, especially on capital adequacy to minimize risk and achieve objectives of financial access and inclusion. Finally, the study will provide academics and other researcher with relevant information regarding the influence of financing approaches on the growth of deposit-taking SACCOs in Kenya. Therefore, this research forms a strong background for further research adding value to the overall body of knowledge in this subject.

Problem statement

Despite all the reforms advanced by SASRA to safeguard member deposits, two SACCOs licenses were revoked in 2018 (SASRA, 2018) and also two more in 2017 (SASRA, 2017) main cause being lack of liquidity due to poor capital structure planning. However, the studies do not specify on the relationship between

institutional capital, share capital and debt capital with Institutional capital/total assets, Core capital/Total assets and Total loans/Total deposits. Therefore, this study seeks to examine the effects of capital composition (structure) decisions on the institution’s financial stability of deposit-taking SACCOs in Kenya.

Study objectives

The general objective of this research inquiry was to examine the effects of capital composition (structure) decisions on institution’s financial stability with a specific objective to establish the Effect of institutional capital on institution’s financial stability of deposit-taking SACCOs in Kenya.

Scope of the study

This research investigated the overall financial stability of deposit-taking SACCOs found in, Kenya for the period ranging from 2014 to 2018. Data was sourced and analyzed in early 2020. However, it only focused on deposit taking SACCOs registered and licensed by SASRA operating in Kenya. DTS was selected due to double regulation and specifically the fact that it is highly regulated by SASRA hence data integrity is in check. Trade-off theory, M & M irrelevant theory and Pecking order theory provided a theoretical understanding of capital structure of firms. 174 SACCOs that filed their report for the period ranging from 2014 to 2018 was considered. To make the study a success, it analyzed the respective SACCOs financial documents for the study period covering the last five years from 2014 to 2018.

2. RESEARCH METHODOLOGY

The research study used the descriptive research design which was fundamentally concerned with explaining the underlying characteristics of a given phenomenon or population. The target population for the study was the DT SACCOs licensed and regulated by SASRA in Kenya. Presently, 174 licensed DTSs are licensed and regulated by SASRA in Kenya (SASRA, 2018).

This study utilized secondary data from SASRA. The secondary data was obtained from the submitted financial data of the DTSs which was available with SASRA, covering a period of between 2014 and 2018. SASRA being the regulatory authority of all deposit taking SACCOs it was able to give the most accurate and reliable financial reports of these DTSs, thus made the study a success. Secondary data sources such as; financial statements, journals, SACCO Act, internet and other research projects were used to build the literature. Data analysis was done through inferential and descriptive statistics. The correlation and regression features of the Statistical Package for Social Sciences (SPSS) Version 20 was used in the analysis of data. The analyzed data was presented in form of tables and graphs.

This research inquiry used the below regression model;

$$Y = \alpha + \beta_1 X_1 + \varepsilon \quad \text{where; (1)}$$

Y = the financial stability of deposit-taking SACCOs (core capital to total asset ratio; total loans to total deposit fraction and core capital to total deposit fraction).

α = Constant Term

β_1 to β_3 = Regression Coefficients

X_1 = institutional capital

ε = Standard error term

3. FINDINGS

Table 1: Descriptive Statistics

	Mean	Std. Deviation	N
Core capital/Total deposits	2.27	4.49	174
Total loans/Total deposits	1.56	3.16	174
Institutional capital/total assets	1.68	3.39	174

Table 1 presents the test results on descriptive statistics of the Deposit Taking SACCOs in Kenya. The data shows a degree of variation between the capital structure decision of the Deposit Taking Savings and Credit Co-operatives Societies in Kenya. The total number of observations was 174. The core capital to total deposits varies significantly between the DTS at a standard deviation of 4.49 which is relatively the highest. Total loans to total deposits vary significantly between the DTS at a standard deviation of 3.16. The institutional capital to total assets varies significantly between the DTS at a standard deviation of 3.39.

Therefore, we can deduce there is distribution of the data for each of the dependent variables under a common central tendency. More so, there is closeness to the mean for each of the observed variables. Therefore, all of the data fall under the standard deviations of the means which ascertains that the data is valuable for the study.

Regression Analysis

Table 2: Model summary for Institutional Capital versus Institutional capital/total assets, core capital/Total deposits and Total Loans/total deposits

Source	Dependent Variable	Type III Sum of Squares	df	Mean Square	F
Corrected Model	Institutional capital/total assets	1795.67 ^a	1	1795.67	1589.84
	Core capital/Total assets	3147.51 ^b	1	3147.51	1590.62
	Total loans/Total deposits	1572.74 ^c	1	1572.74	1740.23
Intercept	Institutional capital/total assets	31.09	1	31.09	27.52
	Core capital/Total assets	62.73	1	62.73	31.70
	Total loans/Total deposits	26.31	1	26.31	29.11
Institutional Capital	Institutional capital/total assets	1795.67	1	1795.67	1589.84

	Core capital/Total assets	3147.51	1	3147.51	1590.62
	Total loans/Total deposits	1572.74	1	1572.74	1740.23
Total	Institutional capital/total assets	2482.03	174		
	Core capital/Total assets	4384.58	174		
	Total loans/Total deposits	2155.24	174		

a. $R^2 = .902$ (Adjusted $R^2 = .902$)

b. $R^2 = .902$ (Adjusted $R^2 = .902$)

c. $R^2 = .910$ (Adjusted $R^2 = .910$)

As per the model summary, the correlation coefficient, R, for Institutional capital to total assets was 0.902, indicating a strong positive correlation between the institutional capital and institutional capital to total assets ratio. The adjusted R squared indicates a total of 0.902, a 90.2% ratio of the fluctuation in the dependent variable. Therefore, 90.2% of the institutional capital to total assets is predicted from the independent variable. It means that institutional capital for SACCOS can explain 90.2% of the institutional capital to total assets ratio.

The correlation coefficient, R, for core capital to total deposits was 0.973, indicating a strong positive correlation between the institutional capital and core capital to total deposits ratio. The adjusted R squared indicates a total of 0.90, a 90% ratio of the deviation in the dependent variable. Therefore, 90.2% of the core capital to total deposits ratio is predicted from the independent variable. It means that institutional capital for SACCOS can explain 90.2% of the core capital to total deposits assets ratio.

The correlation coefficient, R, for Total loans to Total deposit ratio was 0.910, indicating a strong positive correlation between the institutional capital and Total loans to Total deposit ratio. The adjusted R squared indicates a total of 0.910, a 91% proportion of the variance in the dependent variable. Therefore, 91% of the Total loans to total deposit is predicted from the independent variable. It means that institutional capital for SACCOS can explain 91% of the Total loans to total deposit ratio.

Table 3: MANOVA Analysis for Institutional Capital versus Institutional capital: total assets, core capital: Total deposits and Total Loans: total deposits

Effect		Value	F	Hypothesis df	Error df	Sig.	ηp^2
Intercept	Pillai's Trace	.16	10.85 ^b	3.00	170.00	.00	.08
	Wilks' Lambda	.83	10.85 ^b	3.00	170.00	.00	.08
	Hotelling's Trace	.19	10.85 ^b	3.00	170.00	.00	.08
	Roy's Largest Root	.19	10.85 ^b	3.00	170.00	.00	.08

Institutional Capital	Pillai's Trace	.91	591.91 ^b	3.00	170.00	.00	.57
	Wilks' Lambda	.08	591.91 ^b	3.00	170.00	.00	.57
	Hoteling's Trace	10.46	591.91 ^b	3.00	170.00	.00	.57
	Roy's Largest Root	10.46	591.91 ^b	3.00	170.00	.00	.57

The results from Wilks' Lambda indicate that the value for institutional capital is 0.087, $F(3,10) = 591.98$ and $P < 0.5$ at 0.00. Hence, we reject the null hypothesis that institutional capital has no influence on MANOVA derived dependent variables. The η^2 is 0.51, thus, 57.1% of the variability of the MANOVA derived combined dependent variables is being accounted for by the institutional capital.

Table 4: Correlation Coefficient for Institutional Capital versus Institutional capital: total assets, core capital: Total deposits and Total Loans: total deposits

Dependent Variable	Parameter	B	Std. Error	t	Sig.
Institutional capital/total assets	Intercept	.453	.086	5.247	.000
	Institutional Capital	4.789E-7	1.201E-8	39.873	.000
Core capital/Total assets	Intercept	.643	.114	5.630	.000
	Institutional Capital	6.340E-7	1.590E-8	39.883	.000
Total loans/Total deposits	Intercept	.416	.077	5.396	.000
	Institutional Capital	4.482E-7	1.074E-8	41.716	.000

The institutional capital to total assets ratio intercept is 0.453. A unit variance in the institutional capital, while maintaining other factors constant, lead to a 0.0000004784 change in institutional capital to total assets ratio. Further, the p-value for the institutional capital is $0.0001 < 0.05$, implying that the institutional capital has influence on the institutional capital to total assets fraction.

The core capital ratio to total assets intercept is 0.643. A unit variance in the institutional capital, while holding other factors constant, lead to a 0.0000006340 change in core capital to total assets ratio. Further, the p-value for the institutional capital is $0.0001 < 0.05$, implying that the institutional capital has influence on the core capital ratio to total assets.

The total loans ratio to total assets intercept is 0.416. A unit increase in the institutional capital, while maintaining other factors constant, lead to a 0.0000002481 change in total loans to total assets ratio. Further, the p-value for the institutional capital is $0.0001 < 0.05$, implying that the institutional capital has influence on the total loan's ratio to total assets.

Summary

The general objective of this research was to explore the effects of capital structure decisions on the financial stability of deposit-taking SACCOs in Kenya. The study used a populace of one hundred and seventy-four DT SACCOs licensed and regulated by SASRA in Kenya as at 31st December 2018. The study used secondary data obtained from the financial parameters of the SACCOs and the SASRA website covering 2014 – 2018 for all the DT SACCOs.

The study found out that there is a positive correlation between the institutional capital and institutional capital to total assets ratio, core capital to total deposits ratio and total assets to total loans ratio. It is evident through the p-value of 0.000, which is below the significance level of 0.005. It implies that SACCOs should maintain a high institutional capital which is a key indicator of their financial stability.

The regulatory authority which is an oversight of the SACCOs and protects members' interests will focus on the institutional capital to determine financial stability for the firm. Adequate institutional capital will ensure that firms have adequate cash to meet member's interests. Well-established Deposit Taking Savings and Credit Co-operatives Societies have an adequate institutional capital. They undertake capital structure decisions to ensure they remain attractive to the members and have financial stability in the market. Therefore, institutional capital is a key aspect in the capital structure for SACCOs in Kenya.

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