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Revenue diversification and financial performance of savings and credit co-operatives in Kenya

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ABSTRACT

This study examines the influence of revenue diversification on the financial performance of 212 deposit-taking savings and credit co-operatives (SACCOs) in Kenya over the period 2008–2013. An analysis of other factors influencing the financial performance of SACCOs is carried out. The findings show that increased dependence on non-interest income is associated with higher returns. The study also finds that SACCOs with more diversified revenues experience returns that are volatile. According to the findings, SACCOs with less concentrated revenue streams are associated with higher volatility in returns. Other drivers of financial performance include size, capital base, loan to assets, leverage and cost to income ratio. The study provides empirical evidence on possible regulatory and size influences on the relationship between revenue diversification and financial performance. Compared to unlicensed SACCOs, the study finds limited diversification benefits in licensed SACCOs. Finally, the results show that revenue diversification is beneficial to smaller SACCOs. This implies that as SACCOs in Kenya grow, a cautious diversification strategy is necessary as it influences financial performance and the stability of returns.

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1. Introduction

This study examines the influence of revenue diversification on the financial performance of savings and credit co-operatives (SACCOs) in Kenya. The study also examines other factors which influence the financial performance of SACCOs in Kenya. In recent years, the SACCO sector has witnessed far-reaching changes in the regulatory landscape, growth and financial performance. According to McKillop and Wilson (2011), deregulation and technological innovation has allowed financial institutions to diversify and attract a growing income from non-interest sources. With the growth in Kenyan SACCOs and the conversion into front-office "bank-like" operations, the stability and performance of the SACCOs becomes important. This means that SACCOs in Kenya have diversification opportunities similar to commercial banks, which seems limited by regulation. However, prior studies such as Demsetz and Strahan (1997), DeYoung and Roland (2001), Smith, Staikouras, and Wood (2003), DeYoung and Rice (2004), Stiroh (2004), Hahm (2008) and Köhler (2013) have focused on diversification in commercial banks.

Despite major developments in the SACCO sector, only a few studies such as Esho, Kofman, and Sharpe (2005) and Goddard, McKillop, and Wilson (2008) have examined diversification in credit unions.[1] This is partly because SACCOs are financial organizations whose customers are both members and owners and as such, are not exposed to wider customer base as with commercial banks. However, recent regulatory reforms in 2008 and 2010 have enabled SACCOs to diversify and serve as many as over 150,000 members as depicted by SACCOs in this study. The expansion in SACCOs and growth in membership has necessitated tapping into more stable revenue sources. For instance, SACCOs in Kenya have built building complexes, started investment companies and engaged in other non-interest income sources.

To ensure safety of member funds and soundness in the SACCO sector, the regulations prohibit SACCOs from engaging in certain revenue generating activities such as foreign trade, trusts, land and transactions with non-members. This raises an interesting question as to whether the current interest and non-interest revenue sources permissible to SACCOs are capable of guaranteeing improved financial performance. Borda-Rodriguez and Vicar (2014) establish that one of the key determinants of a SACCO's survival is its ability to develop alternative sources of income, which seems limited by regulation in the case of Kenyan SACCOs. We examine this conjecture

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[1] Elsewhere, savings and credit co-operatives (SACCOs) are referred to as credit unions or financial co-operatives.

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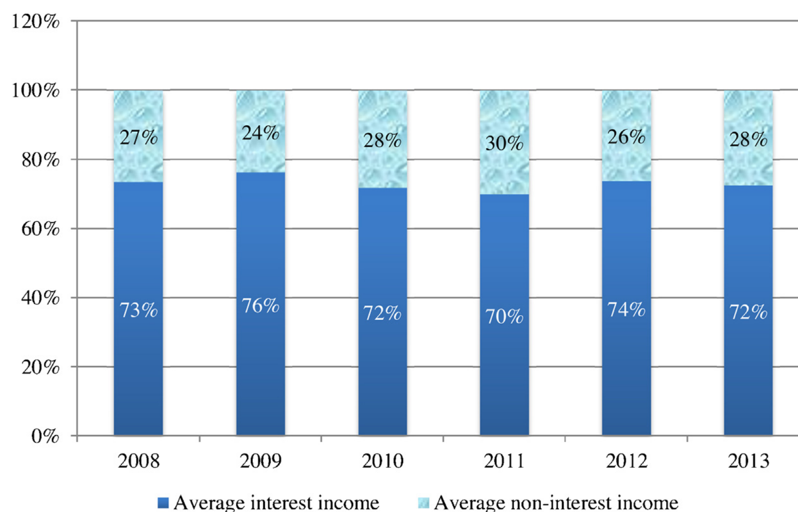

Fig. 1. Trends in interest and non-interest income for the period 2008–2013.
Source: SACCO audited annual reports for the period 2008–2013.

by investigating any regulatory influences on revenue diversification and financial performance by deposit-taking SACCOs in Kenya.

Since revenue diversification in deposit-taking financial institutions implies a shift from interest-based income to non-interest income (Stiroh, 2004), it becomes particularly important where a financial institution has a single core source of revenue that constitutes a major share of the total revenue. In SACCOs, over 70% of the revenue is largely derived from interest on loans taken by members. According to the SACCO Societies Regulatory Authority (SASRA) (2013), interest revenue by deposit-taking SACCOs in Kenya rose from 84.9% in 2012 to 86% in 2013. In 2013, SACCOs in Kenya recorded increases in both the return on assets (ROA) and return on equity (ROE) by 12% and 1% respectively. The revenue from investments in Kenyan SACCOs dropped from 4.9% in 2012 to 3.1% in 2013 while other operating revenue (i.e., salary processing fees, membership fees etc.) increased from 10.2% in 2012 to 10.9% in 2013 (SASRA, 2013). As shown in Fig. 1, the proportion of average non-interest to total revenue increased slightly from 27% in 2008 to 28% in 2013.

Therefore, this study seeks to examine whether the seemingly low proportion of non-interest income should be of any concern to SACCOs in Kenya. More specifically, the study examines the influence of revenue diversification on the financial performance of SACCOs in Kenya. The study also examines regulatory and size influences on the association between revenue diversification and financial performance of SACCOs in Kenya. The remainder of the paper is structured as follows: Section 2 presents a background on Kenya's SACCO sector. Section 3 presents the literature review, while Section 4 discusses the methodology adopted in this study and the results thereof. Finally, Section 5 concludes the paper.

2. Background of Kenya's SACCO sector

The World Economic Forum's (WEF's) Global Competitiveness Report (2014–2015), ranks Kenya in the 90th position globally and 6th in Sub-Saharan Africa (World Economic Forum (WEF), 2014). Kenya has been classified as a low-income country which is in the early stages of economic development. As a developing economy, the economy of Kenya is heavily reliant on natural resources such as agricultural commodities. This explains why the initial focus of SACCOs in Kenya was to support farmers. In the 1990s, Kenya experienced a number of banking failures, which created a push for improvement in corporate governance and development of capital markets. Kenya is also one of the leading countries with a vibrant credit union sector in Africa. According to McKillop and Wilson (2011), Kenya is the only African country with SACCOs in the transition stage, denoting the importance of the sector to Kenya's economic empowerment and savings mobilization as envisioned in vision 2030.[2]

A co-operative organization is viewed as an autonomous association of individuals who are voluntarily united with the objective of meeting common economic, social and cultural needs and aspirations through a mutually owned and democratically controlled enterprise (ICA, 2015). The membership in a co-operative is based on common bond, which is shared by savers and borrowers based on a community, organizational, religious or employee affiliation (WOCCU, 2008). Among the various types of co-operatives are the SACCOs which provide savings and credit facilities to members drawn from a certain geographical region, social grouping or organization (McKillop & Wilson, 2011). SACCOs are self-help co-operative financial organizations whose aim is to promote economic and social goals of its membership and wider local communities (Hyndman & McKillop, 2004; McKillop & Wilson, 2011).

In Kenya, the first co-operative, a farmers co-operative was established in 1908 (Alila & Obado, 1990). This was the Lumbwa Co-operative Society. Later on, other agriculture-based co-operatives such as the Kenya Co-operative Creameries (KCC) and the Kenya Farmers Association (KFA) were registered in 1931. In 1931, the Co-operative Ordinance was enacted to regulate the operations of co-operatives. However, the 1931 Ordinance did not allow Africans to participate in co-operatives. Indigenous Kenyans were involved in co-operative activities after the passing of the Co-operative Societies Ordinance of 1945 which replaced the first Co-operative Ordinance of 1931. Between 1932 and 1969, 1834 co-operative societies had been registered. The growth and challenges experienced in the co-operative sector led to the enactment of Co-operative Societies (Amendment) Act No. 2 of 2004 which amended the Co-operative Societies' Act No. 12 of 1997. Due to the growing importance and complexity of SACCO operations, the SACCO Societies' Act was enacted in 2008. The Act of 2008 led to the creation of SASRA as a regulator for deposit-taking activities. Consequently, the SACCO Societies Regulations, 2010 for deposit-taking SACCOs

[2] The economic pillar in Kenya's Vision 2030 envisions the achievement of a well-functioning financial system and establishment of Kenya as a leading financial center in Eastern and Southern Africa.

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