The Effect of Credit Regulation on Financial Performance of Deposit-Taking Savings and Credit Cooperative Societies in Kenya.

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ABSTRACT

Credit regulation is a critical component of prudential oversight in the cooperative financial sector, aimed at safeguarding assets and ensuring the sustainability of Deposit-Taking Savings and Credit Cooperative Societies (DT-SACCOs). This study investigates the effect of credit regulation on the financial performance of DT-SACCOs in Kenya. Utilizing secondary panel data from 175 SACCOs between 2018 and 2023, the study measured credit regulation through non-performing loans (NPLs) and debt service coverage ratios, while financial performance was assessed using return on assets (ROA). Employing fixed-effects panel regression, the findings reveal a statistically significant positive relationship between effective credit regulation and financial performance. SACCOs with robust credit policies exhibited lower NPL levels and higher profitability. The study concludes that strengthening credit appraisal frameworks and enforcing regulatory compliance enhances SACCO resilience and financial viability. It recommends continuous staff training, updated credit policies, and real-time credit risk monitoring to sustain financial performance in the SACCO sector.

Introduction

Deposit-Taking Savings and Credit Cooperative Societies (DT-SACCOs) play a pivotal role in Kenya's financial inclusion landscape, offering accessible financial services to a significant portion of the population, particularly in underserved rural and peri-urban areas (Ndung'u & Mutinda, 2022). As micro-financial institutions, their capacity to mobilize savings and extend credit makes them instrumental in promoting socio-economic development (Wangechi & Mugetha, 2023). However, the very nature of their operations exposes them to considerable credit risk, which if not properly managed, can erode their financial base and undermine sustainability (Nduta, 2013). This necessitates robust credit regulation frameworks that balance access to credit with institutional stability and performance.

Credit regulation, as a subset of prudential regulation, refers to the rules, guidelines, and supervisory measures instituted to ensure that credit issuance practices are sound, transparent, and aligned with financial viability objectives (Kariuki, 2017). The SACCO Societies Act No. 14 of 2008 and the Sacco Societies (Deposit-Taking Sacco Business) Regulations of 2010 require all licensed SACCOs to maintain written credit policies that outline loan appraisal procedures, collateral requirements, loan limits, creditworthiness assessments, and mechanisms for handling non-performing loans (SASRA, 2020). Despite the presence of such regulatory frameworks, numerous DT-SACCOs continue to report high levels of loan delinquency, weak recovery structures, and deteriorating asset quality issues that have raised concerns about their long-term financial health (Mwanja, 2021).

From a theoretical standpoint, the 5C's Model of Credit Appraisal (Myers & Forgy, 2005) underpins modern credit risk management practices. The model emphasizes evaluating borrowers based on five critical dimensions: character, capacity, capital, collateral, and conditions. When integrated into regulatory compliance frameworks, the 5Cs model enables SACCOs to distinguish between high-risk and low-risk borrowers, reduce default rates, and enhance financial sustainability. In essence, credit regulation serves as a control mechanism that imposes discipline on lending operations and fosters accountability within financial institutions (Mwanja, 2021).

The link between credit regulation and financial performance hinges on the capacity of SACCOs to implement regulatory guidelines effectively. Financial performance is typically assessed using profitability indicators such as Return on Assets (ROA) and Return on Equity (ROE). Poor adherence to credit regulation often results in an accumulation of non-performing loans (NPLs), which erodes profitability, weakens member confidence, and exposes the SACCO to liquidity constraints (Kargi, 2011). Conversely, SACCOs with effective credit policies tend to exhibit better loan portfolio quality and improved financial metrics, validating the assumption that regulatory compliance positively influences performance outcomes.

Kenya's SACCO sector has undergone significant transformation over the past decade, driven by increased regulation, digital innovation, and expanding market outreach. According to SASRA (2023), DT-SACCOs control over KES 600 billion in assets and serve more than five million members. However, the sector is also marred by governance weaknesses, inadequate credit appraisal mechanisms, and poor enforcement of lending policies challenges that compromise institutional performance and justify regulatory interventions (SASRA, 2020). Furthermore, the dynamic nature of credit markets, influenced by macroeconomic volatility and changing borrower behaviour, presents additional challenges for SACCOs in maintaining optimal loan book quality.

Empirical studies have shown mixed results regarding the efficacy of credit regulation. While Kariuki (2017) found that credit risk identification and appraisal positively affect SACCO performance, other studies like Okeyo et al. (2023) highlight that stringent credit rules can sometimes limit financial outreach, especially among low-income members. This creates a conceptual tension between regulation for stability and flexibility for growth, necessitating context-specific studies that explore the nuances of credit regulation in the cooperative sector. In light of these theoretical, conceptual, and contextual dimensions, this study seeks to examine the effect of credit regulation on the financial performance of DT-SACCOs in Kenya. By doing so, it aims to generate empirical evidence that informs regulatory policy, improves credit management practices, and supports sustainable SACCO operations in a competitive financial landscape.

Statement of the Problem

Credit regulation is critical to the financial stability and sustainability of Deposit-Taking Savings and Credit Cooperative Societies (DT-SACCOs). In Kenya, the SACCO Societies Act of 2008 and SASRA's regulatory framework mandate DT-SACCOs to implement robust credit policies, conduct thorough borrower appraisals, and limit exposure to credit risk. Despite these frameworks, many SACCOs continue to experience rising non-performing loans (NPLs), poor loan recovery, and weak enforcement of credit policies, which have adversely affected their financial performance (SASRA, 2020). Several SACCOs have been placed under regulatory watch or deregistered due to non-compliance with credit standards. This raises concerns about the effectiveness of existing credit regulations in improving financial outcomes (Okeyo et al., 2023). While previous studies have examined general prudential regulation or focused on microfinance institutions, limited empirical research has isolated the effect of credit regulation on SACCO performance in Kenya using longitudinal data. Additionally, conceptual tensions remain on whether strict credit regulations enhance or restrict financial inclusion and growth (Mwanja, 2021). This gap in contextual and empirical understanding hinders evidence-based policy reforms. Therefore, this study seeks to investigate the effect of credit regulation on the financial performance of DT-SACCOs in Kenya, with a view to strengthening credit governance and enhancing the sector's resilience and profitability.

Literature Review

This study is anchored on the 5C's Model of Client Appraisal, developed by Myers and Forgy (2005), a widely adopted theoretical framework in credit risk assessment and financial regulation. The model outlines five key dimensions used to evaluate the creditworthiness of borrowers: Character, Capacity, Capital, Collateral, and Conditions. These five elements form the foundation of prudent credit management, offering a comprehensive tool to identify, measure, and mitigate credit risk a crucial function in the operations of Deposit-Taking Savings and Credit Cooperative Societies (DT-SACCOs).

Character refers to the borrower's integrity and willingness to repay the loan. It is often evaluated through past credit behaviour, employment history, or reference checks. In a SACCO setting, where lending is often relationship-based, character assessment plays a vital role in trust-building and ensuring timely repayment (Abedi, 2000). Weak credit regulation may overlook character checks, increasing the likelihood of loan defaults and thereby eroding financial performance. Capacity pertains to the borrower's ability to repay the loan from current and future income. This requires an analysis of income statements, cash flow forecasts, and debt-to-income ratios. In the cooperative finance sector, especially in SACCOs targeting informal or low-income earners, capacity assessment is critical to avoid over-indebtedness and ensure cash flow sustainability for both the borrower and the institution (Nduta, 2013). Credit regulation frameworks mandate

SACCOs to ensure thorough evaluation of repayment ability, hence safeguarding financial health.

Capital is the net worth or financial strength of the borrower, often assessed by analyzing assets versus liabilities. For SACCOs, lending to individuals or businesses with adequate capital provides a cushion in case of default. This aligns with regulatory expectations for SACCOs to prioritize secure lending and minimize exposure to high-risk portfolios (Kariuki, 2017). Without proper capital assessment, SACCOs risk concentrating their loan book in vulnerable or undercapitalized borrowers. Collateral is the security pledged by borrowers to mitigate lender risk. It represents a secondary source of repayment in case of default. DT-SACCOs are required by regulation to ensure all loans are fully secured and that no member is over-guaranteed (Sacco Societies Act, 2008). Inadequate collateral policies or failure to enforce collateralization can lead to systemic credit risk, especially when NPLs rise and recovery becomes difficult.

Conditions relate to the broader economic, regulatory, and market environment affecting the borrower. This includes interest rate volatility, inflation, employment trends, and sectoral dynamics. SACCOs must consider these macro-level factors when structuring credit facilities. The 5C's model encourages lenders to adapt credit policies to current conditions, ensuring that risk exposure is minimized during economic downturns or sector-specific shocks (Simkovic, 2016). Collectively, the 5C's model supports a structured and standardized approach to credit appraisal that is essential for regulatory compliance and sustainable financial performance. It justifies the need for enforceable credit policies and internal credit control systems within SACCOs (Martin-Barrado & Gomez-Baya, 2024). Where the 5C's are systematically applied, SACCOs are more likely to maintain high-quality loan portfolios, reduce default rates, and improve profitability indicators such as Return on Assets (ROA) and Return on Equity (ROE) (Wangechi & Mugetha, 2023). The model also aligns with prudential regulation objectives, particularly those outlined by the SACCO Societies Regulatory Authority (SASRA), which requires that SACCOs develop written credit policies, enforce loan limits, appraise borrowers using objective criteria, and monitor loan performance (SASRA, 2020). Thus, the 5C's model is not only a theoretical lens but also an operational guide for compliance with credit regulation in Kenya. Based on the foregoing discussion, the theoretical foundation leads to the formulation of the following hypothesis for empirical testing:

> **H_0**: There is no statistically significant relationship between credit regulation and financial performance of Deposit-Taking Savings and Credit Cooperative Societies in Kenya.
> **H_1**: There is a statistically significant positive relationship between credit regulation and financial performance of Deposit-Taking Savings and Credit Cooperative Societies in Kenya.

Similar Studies

Empirical research on the relationship between credit regulation and financial performance in financial institutions reveals mixed and sometimes inconclusive findings, particularly in the context of Savings and Credit Cooperative Societies (SACCOs). While a number of studies affirm the positive impact of sound credit management on institutional performance, significant limitations in scope, methodology, and contextual relevance persist. Kariuki (2017) conducted a study on the effect of credit risk management practices on the financial performance of DT-

SACCOs in Kenya. The study concluded that credit analysis, mitigation strategies, and credit risk identification have a statistically significant and positive effect on SACCO profitability. However, the study focused primarily on internal credit risk practices rather than compliance with formal regulatory frameworks such as those established by the SACCO Societies Regulatory Authority (SASRA). As a result, the research falls short of addressing whether adherence to credit regulation through standardized credit policies, mandatory collateralization, and board-approved loan ceilings directly influences financial performance.

Similarly, Nduta (2013) examined the impact of credit risk ratios on the operational efficiency of microfinance institutions in Kenya. The findings indicated that higher non-performing loans (NPLs) correlate with reduced efficiency and profitability. However, this study focused on microfinance institutions, which differ significantly from SACCOs in terms of governance structures, regulatory oversight, and member-based lending models. Thus, its generalizability to DT-SACCOs remains limited.

Other scholars such as Magnifique (2013) and Kargi (2011) also explored credit risk and performance in commercial banks in Rwanda and Nigeria respectively. Their studies confirmed a significant relationship between effective credit supervision and profitability. Nevertheless, the financial systems and institutional structures in these countries differ from Kenya's SACCO sector, limiting contextual relevance. Moreover, these studies emphasized credit risk management from a banking perspective, without considering the unique cooperative principles and compliance obligations that define SACCO operations.

Additionally, there is evident of empirical gap is the scarcity of studies that isolate credit regulation compliance as distinct from general credit risk management as a determinant of SACCO financial performance. Most available literature broadly categorizes credit management practices without distinguishing between internally driven strategies and regulatory mandates enforced by supervisory bodies like SASRA. For instance, Kariuki (2017) did not measure compliance with SASRA's specific regulatory instruments such as the requirement for written credit policies, debt service coverage ratio standards, or borrower appraisal thresholds.

Furthermore, methodological limitations abound. Many studies utilize cross-sectional designs, failing to capture longitudinal trends in credit regulation compliance and performance outcomes. This limits the ability to assess cause-effect relationships over time. Others apply ordinary least squares (OLS) regression, which does not control for unobserved heterogeneity across SACCOs or account for time-specific effects methodological shortcomings addressed in this study through the use of panel data and fixed-effects modelling.

Conceptually, there remains ambiguity in the literature about whether stricter credit regulations may impede lending flexibility, especially to low-income or high-risk members. While credit regulation is assumed to enhance portfolio quality and profitability, it may also restrict access to credit, especially when applied rigidly. This tension between regulatory compliance and financial inclusion has not been adequately explored in SACCO-specific studies in Kenya.

Methods

This study adopted a positivist research philosophy, which emphasizes objective analysis and the use of quantifiable data to derive valid conclusions (Mugenda & Gitau, 2009). The research followed a descriptive research design, enabling the study to systematically describe the relationship between liquidity regulations and financial performance of Deposit-Taking Savings and Credit Cooperative Societies (DT-SACCOs) in Kenya. The descriptive design was chosen as it facilitates the collection, analysis, and presentation of empirical data to explain the effect of credit regulation on financial performance (Gatu et al., 2023). This approach is particularly relevant when examining cause-and-effect relationships in financial studies, ensuring clarity and replicability of findings (Pyrczak & Bruce, 2011).

The target population for the study consisted of all 175 Deposit-Taking SACCOs (DT-SACCOs) registered by the SACCO Societies Regulatory Authority (SASRA) in Kenya as of December 2017 (SASRA Report, 2020). Given the manageable size of the population, the study employed a census survey approach, allowing data to be collected from all 175 DT-SACCOs. Census sampling was chosen to ensure comprehensive coverage and to eliminate potential sampling bias (Kothari, 2011). This approach enhances the reliability and generalizability of the findings across the entire population of DT-SACCOs in Kenya (Waithaka, 2012).

The study utilized secondary data collection sheets to gather panel data from audited financial reports of DT-SACCOs spanning five years (2018–2022). These reports were sourced from SACCOs' annual financial statements and SASRA databases. Credit regulation was proxy measured using non-performing loans and debt service coverage ratio, while financial performance was measured using Return on Assets (ROA). The study employed panel data regression analysis, which combines cross-sectional and time-series data, allowing for more robust analysis and improved estimation accuracy (Gatu, Njehia & Kimutai, 2023). Panel data is particularly useful for controlling unobserved heterogeneity and capturing dynamic relationships over time (Wooldridge, 2010). Pre-estimation diagnostic tests such as normality tests, multicollinearity tests, and unit root tests were performed to validate data suitability for analysis (Mwaniki, 2018).

Results

Table 4.1 offer insight into the credit regulation practices and financial performance of DT-SACCOs in Kenya during the period under review (2018–2023). The Debt Service Coverage Ratio (DSCR), with a mean of 4.46 and a standard deviation of 0.42, indicates that, on average, SACCOs generate over four times the cash needed to cover their debt obligations. This suggests a strong capacity among most DT-SACCOs to manage debt servicing and maintain financial stability. However, the mean Non-Performing Loans (NPLs) figure of KES 21.48 billion, coupled with a high standard deviation of KES 10.12 billion, reflects significant variance in credit risk exposure across institutions. While some SACCOs manage to control default rates, others struggle with substantial loan defaults, indicating gaps in borrower vetting, loan monitoring, or enforcement of credit regulations. The relatively high minimum NPL value (KES 14.67 billion) suggests a sector-wide systemic risk rather than isolated cases. The Return on Assets (ROA), the proxy for financial performance, has a mean of 3.78% and a standard deviation of 2.36%, showing considerable variability in profitability across SACCOs. While some institutions achieve double-digit ROA, others barely exceed 1%, pointing to differences in operational efficiency, asset utilization, or risk management practices.

Table 1 Descriptive Statistics

Variable	Mean	Standard Deviation (SD)	Minimum	Maximum
Debt Service Coverage Ratio (DSCR)	4.46	0.42	0.01	1.84
Non-Performing Loans (KES Billions)	21.48	10.12	14.67	25.79
Return on Assets (ROA) (%)	3.78	2.36	0.97	12.33

Source: Njoki Dissertation (2024).

Table 2 Summary of Pre-estimation Test Results

Test	Method	Key Figures	Outcome
Normality	Skewness/Kurtosis	Skewness: -1.20 to 1.10; Kurtosis: 2.30 to 3.90	Normality assumption met
Linearity Test	Scatter Plots	Linear relationships observed	Linearity assumption met
Multicollinearity Test	VIF	1.67 to 1.92	No multicollinearity
Panel Unit Root Test	Levin-Lin-Chu Test	Liquidity (-3.45, $p < 0.01$);	Stationary data confirmed
Hausman Test	χ^2 Test	$\chi^2(4) = 18.67$, $p = 0.002$	Fixed-effects model preferred

The pre-estimation diagnostic tests in Table 2 above indicate that the model assumptions are satisfied. The Normality Test shows that the data is approximately normally distributed with skewness and kurtosis values within acceptable ranges. The linearity test confirms linear relationships among the variables, while the multicollinearity test reveals no significant correlation between predictors, as indicated by VIF values between 1.67 and 1.92. The panel unit root test confirms that the liquidity variable is stationary, with a significant p-value, ensuring reliable time-series analysis. Finally, the Hausman Test indicates that a fixed-effects model is preferred, as individual-specific effects are correlated with the explanatory variables.

As shown in Table 3, the model's performance is summarized by the following statistics: the within R-squared is 0.1121, the between R-squared is 0.6421, and the overall R-squared is 0.4743. The F-statistic for the model is 6.02, with a p-value of 0.0002, indicating that the model is statistically significant. The fixed effects regression results show that credit regulation, proxied by non-performing loans (NPLs), has a negative and statistically significant effect on the financial performance of Deposit-Taking SACCOs in Kenya. The coefficient for credit regulation is -0.124 with a p-value of 0.00, indicating that this relationship is significant at the 1% level. This negative coefficient implies that as the level of non-performing loans increases suggesting weaker enforcement of credit regulation or poor loan management practices the Return on Assets (ROA) declines. In essence, DT-SACCOs with higher rates of loan default experience a deterioration in financial performance. This confirms that ineffective borrower appraisal, lax enforcement of credit policies, and poor recovery mechanisms undermine profitability and sustainability

Table 3 Findings on Fixed Effects Model

Number of Observations						524
Number of panels						105
R-sq	Within					0.1121
	Between					0.6421
	Overall					0.4743
	F (4,104)					6.02
	Prob > F					0.0002
Performance	Coef.	Robust St.Err.	t-value	p-value	[95% Conf	Interval]
Credit regulation	0.186	0.032	5.81	0.00	0.157	0.328
Constant	14.648	2.657	5.51	0	9.379	19.918

*** p<.01, ** p<.05, * p<.1*

Discussion

The findings of this study confirm the research hypothesis that credit regulation significantly affects the financial performance of Deposit-Taking SACCOs in Kenya. Specifically, the negative and statistically significant relationship between non-performing loans (NPLs) and return on assets (ROA) suggests that poor credit regulation reflected in weak appraisal systems, lax enforcement of lending policies, and inadequate recovery strategies detracts from financial performance. This aligns with the premise that effective credit regulation is essential for minimizing default risk and enhancing institutional sustainability. The rejection of the null hypothesis affirms that improved compliance with regulatory credit standards, such as those mandated by SASRA, contributes positively to financial stability and profitability among SACCOs.

These findings are well grounded in the 5C's Model of Client Appraisal (Myers & Forgy, 2005), which provides the theoretical lens for assessing borrower creditworthiness. The model underscores that proper evaluation of a borrower's character, capacity, capital, collateral, and external conditions is critical in reducing loan default risk. When SACCOs rigorously apply these principles within a regulatory framework, they are better able to maintain a healthy loan portfolio and achieve stronger financial outcomes. The results also corroborate earlier studies, such as those by Kariuki (2017) and Kargi (2011), which found that credit risk management directly impacts financial performance. However, this study goes further by explicitly linking regulatory compliance rather than internal practices alone to performance, thus filling a significant empirical gap in SACCO-focused literature.

Implications

This study concludes that credit regulation has a significant and negative relationship with the financial performance of Deposit-Taking SACCOs in Kenya, as measured by return on assets (ROA). The negative effect arises from elevated levels of non-performing loans (NPLs), which signal weaknesses in credit policy enforcement, borrower vetting, and loan recovery mechanisms. These findings support the theoretical assertions of the 5C's Model of Client Appraisal, emphasizing the need for rigorous borrower assessment and prudent credit issuance. Ultimately, the results underscore that compliance with regulatory credit standards is not merely a formality but a determinant of SACCO profitability and institutional health.

Based on the findings, SACCOs should strengthen their credit regulation frameworks by regularly updating credit policies, ensuring strict adherence to appraisal guidelines, and enhancing the enforcement of loan security and repayment structures. SASRA should also intensify regulatory audits and offer capacity-building programs to improve SACCOs' credit risk management capabilities. Additionally, SACCOs should invest in real-time credit monitoring systems and staff training to identify and manage emerging credit risks early. By reinforcing compliance with credit regulation, SACCOs can significantly reduce non-performing loans and enhance their long-term financial performance and sustainability.

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