



The Effect of Retained Earnings on Financial Intermediation of Deposit Taking Saccos in Kenya

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Abstract

This study examined the effect of retained earnings on the financial intermediation of deposit-taking Savings and Credit Cooperative Societies (SACCOs) in Kenya. Financial intermediation, measured by the loan-to-deposit ratio, is critical for mobilizing savings and providing affordable credit to underserved households and small enterprises. Using a causal-explanatory longitudinal design, the study analyzed panel data from 130 licensed DT-SACCOs over the period 2019–2024, with retained earnings as the explanatory variable. Descriptive statistics revealed considerable variation in retained earnings and intermediation efficiency across SACCOs, with a positive correlation ($r = 0.622$) between retained earnings and lending capacity. Random Effects Generalized Least Squares (RE-GLS) regression results indicated that retained earnings had a significant positive effect on financial intermediation ($\beta_1 = 0.499$, $p < 0.05$), implying that internally generated funds enhance liquidity, capital adequacy, and loan provision. The findings highlight that surplus retention is more effective than reliance on short-term debt in sustaining lending operations. Policy implications include encouraging SACCOs to adopt surplus retention strategies and for regulators to promote internal capitalization to strengthen institutional resilience and improve intermediation efficiency.

Keywords: Retained earnings, financial intermediation, SACCOs, Loan-to-deposit ratio, Kenya.

1.1 Background of the Study

Financial intermediation is the process through which financial institutions channel funds from surplus units (savers) to deficit units (borrowers) to facilitate productive investment and economic growth (Ferguson & McKillop, 2020). It represents the core function of financial institutions such as banks, microfinance entities, and Savings and Credit Co-operative Societies (SACCOs). Through this process, financial intermediaries perform maturity transformation, risk pooling, and liquidity creation, thereby supporting credit access and capital formation within an economy (Ergano et al., 2023; Ferguson & McKillop, 2020). In the context of SACCOs, financial intermediation entails mobilizing members' savings and allocating these funds as affordable credit, particularly to small enterprises and low-income households underserved by commercial banks (Millan, Kamau, & Ibua, 2023). Effective intermediation is therefore essential for economic inclusion and local development, as it facilitates liquidity circulation and empowers households and businesses to invest, consume, and expand operations (Ndung'u & Mutinda, 2022).

The efficiency of financial intermediation is largely influenced by the financial structure of the institution. Financial structure refers to the composition of an institution's liabilities and equity, specifically the relative proportions of long-term debt, short-term debt, retained earnings, and share capital used to finance operations and asset growth (Mwatu, 2018; Maina & Gichohi, 2023). In SACCOs, financial structure determines how effectively deposits are mobilized and converted into loans while maintaining liquidity and regulatory compliance. Studies indicate that an optimal balance between internal funds and external borrowings improves lending efficiency and reduces financial distress (Chege,

Mwangi, & Otieno, 2023). Overreliance on short-term liabilities can weaken liquidity and increase refinancing risk, whereas long-term financing aligns with loan maturity profiles and retained earnings provide a self-financing buffer that strengthens liquidity and institutional resilience (Muriithi, Kimathi, & Kilonzo, 2022).

Empirical evidence from Kenya's SACCO sector highlights the significance of retained earnings in financial intermediation. Research by Muturi, Mwangi, and Kariuki (2023) shows that retained earnings and long-term debt enhance SACCOs' credit capacity, while share capital, though essential for regulatory compliance, has a limited direct impact on lending performance. Similarly, Komen, Mwangi, and Mutua (2024) found that SACCOs with higher capitalization and diversified financing portfolios achieved greater loan-to-deposit ratios, a key measure of intermediation efficiency. These findings underscore that financial structure is not merely a funding mechanism but a strategic determinant of intermediation performance. In Kenya, deposit-taking SACCOs have grown into major financial intermediaries, mobilizing over KSh 1 trillion in savings and controlling more than one-third of domestic deposits (SASRA, 2024). Despite this growth, intermediation effectiveness varies widely due to differences in financial structure, governance, and capitalization. Many SACCOs face constraints from inadequate internal funds, heavy reliance on short-term debt, and low retention of surpluses, which often result in liquidity imbalances and limited credit expansion (Ndung'u & Wekesa, 2023). Strengthening internal capital, particularly retained earnings, has therefore become a key policy priority under the prudential guidelines of the Sacco Societies Regulatory Authority (SASRA, 2024).

The theoretical foundation of this study draws on the Modigliani and Miller Capital Structure Relevance Theory, which posits that financing choices affect firm performance in the presence of market imperfections such as taxes and agency costs. In SACCOs, such imperfections influence lending capacity and member welfare. The Modern Theory of Financial Intermediation (Diamond & Dybvig, 1983) explains how financial institutions transform illiquid assets into liquid liabilities, emphasizing that stable, long-term funding enhances deposit mobilization and credit delivery. Additionally, the Agency Cost Theory (Jensen & Meckling, 1976) highlights that internal capital, especially retained earnings, reduces agency conflicts and monitoring costs, while the Buffer Capital Theory (Calem & Rob, 1999) asserts that maintaining adequate equity cushions institutions against risk and supports sustainable intermediation. Together, these theories provide a robust conceptual basis for examining the role of retained earnings in enhancing SACCOs' intermediation efficiency.

1.2 Statement of the Problem

Deposit-taking SACCOs play a pivotal role in Kenya's financial system by mobilizing savings and providing affordable credit, particularly to low-income households and small enterprises underserved by commercial banks. Despite their critical role in promoting financial inclusion and local development, the effectiveness of SACCOs in performing financial intermediation varies considerably across institutions. Empirical evidence indicates that differences in financial structure particularly the composition of internal funds such as retained earnings significantly influence lending capacity and liquidity management. Many SACCOs remain constrained by low retention of surpluses, heavy reliance on short-term debt, and limited capitalization, resulting in liquidity imbalances and reduced ability to extend credit to members (Ndung'u & Wekesa, 2023; Muturi, Mwangi, & Kariuki, 2023). While studies have examined SACCO performance, capital adequacy, and governance, few have systematically explored the role of retained earnings as a determinant of intermediation efficiency. The lack of focused research on how internally generated funds enhance credit provision and stabilize liquidity creates an empirical and policy gap. Understanding the effect of retained earnings on financial intermediation is therefore essential for guiding SACCOs' financial management strategies, improving lending efficiency, and supporting the broader agenda of financial inclusion in Kenya.

1.3 Research Objective

To assess the effect of retained earnings on financial intermediation of deposit taking SACCOs in Kenya.

1.4 Research Hypothesis

H_0 : There is no significant effect of retained earnings on financial intermediation of deposit taking SACCOs in Kenya.

1.5 Significance of the Study

This study contributes to the limited empirical literature on the relationship between retained earnings and financial intermediation in deposit-taking SACCOs in Kenya. For scholars, it provides evidence on how retained earnings influences intermediation efficiency, offering a basis for further research on SACCO financial structures. For policymakers and regulators, the findings inform the design of prudential guidelines that promote sustainable funding and enhanced credit delivery. SACCO management benefits from insights on optimizing retained earnings to improve liquidity stability, lending capacity and overall intermediation efficiency. Additionally, SACCO members benefit indirectly through improved credit access, institutional stability, and increased confidence in SACCO governance, supporting deeper financial inclusion.

2.1 Theoretical Framework

This study was underpinned by the Modern Theory of Financial Intermediation.

2.1.1 The Modern Theory of Financial Intermediation

The Modern Theory of Financial Intermediation, championed by prominent economists like Franklin Allen, Anthony M. Santomero, and others, represents a paradigm shift in understanding the role and functioning of financial intermediaries (Santomero, 1997). Initially developed in the late 20th century, this theory has evolved significantly, reflecting ongoing financial innovations and market dynamics. The theory posits that financial intermediaries, such as banks or SACCOs, play a crucial role beyond mere conduits for channeling funds between savers and borrowers. Instead, they are seen as institutions that optimize the allocation of resources by addressing market imperfections, reducing information asymmetry, and offering specialized services to meet the diverse needs of both depositors and borrowers (Allen & Santomero, 2001).

Santomero (1997) highlighted that financial intermediary, through their expertise and information advantages, provide valuable services like risk pooling, transformation of maturities, and monitoring of investments. This concept of risk transformation elucidates how intermediaries mitigate risks by converting risky assets into more palatable, diversified portfolios for investors. Moreover, Allen and Santomero (2001) emphasized the significance of financial intermediaries in reducing transaction costs and enhancing market liquidity. They highlighted how SACCOs, through their role in pooling resources and providing liquidity, facilitate economic activities by efficiently allocating funds to productive sectors. However, critiques of the Modern Theory of Financial Intermediation, as articulated by Barth et al. (2012) and Berger and Bouwman (2013), question its assumptions and applicability in dynamic market environments. They argue that the theory overlooks the complexities arising from changing market structures, technological advancements, and regulatory challenges. Additionally, critics highlight the potential systemic risks posed by financial intermediaries due to interconnectedness and leverage, as witnessed during financial crises.

In the context of researching the effect of retained earnings on financial intermediation within deposit-taking SACCOs in Kenya, the Modern Theory of Financial Intermediation serves as a theoretical foundation. Understanding the intermediary functions highlighted by Santomero (1997) and Allen and Santomero (2001) allows researchers to explore how SACCOs leverage their expertise and information advantage to optimize resource allocation. By integrating insights from Barth et al. (2012) and Berger and Bouwman (2013), researchers can critically assess the applicability of this theory to SACCOs in Kenya. This involves considering the evolving market structures, technological advancements, and regulatory frameworks that impact SACCO operations, thereby informing a nuanced analysis of how financial structures within SACCOs influence their intermediation capacities.

2.2 Conceptual Framework

The study was guided by the following conceptual framework.

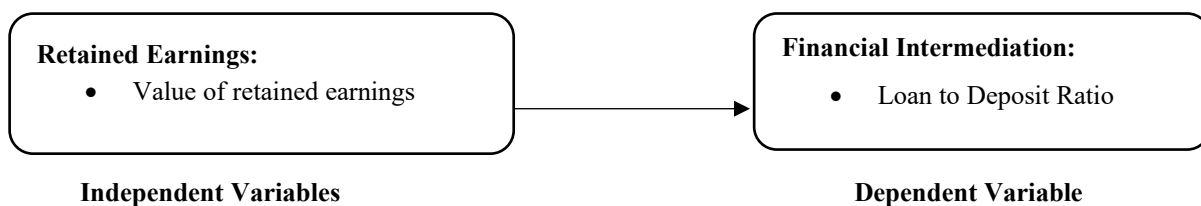


Figure: 2.1 Conceptual Framework

Source (Author, 2025)

Retained earnings constitute one of the most important internal financing sources for deposit-taking Savings and Credit Cooperative Societies (SACCOs), directly influencing their capacity to intermediate funds, sustain lending operations, and enhance financial stability. As accumulated profits reinvested into the institution rather than distributed as dividends, retained earnings strengthen the equity base of SACCOs, thereby enhancing their ability to expand credit and absorb potential financial shocks. According to Muriithi, Kimathi, and Kilonzo (2022), internally generated capital such as retained earnings provides SACCOs with a stable and low-cost source of financing that minimizes dependence on external borrowing and reduces exposure to interest rate volatility. This aligns with the Pecking Order Theory, which posits that institutions prefer internal financing due to lower information asymmetry and transaction costs.

Empirical findings affirm the significant positive effect of retained earnings on SACCOs' financial intermediation, typically measured by the loan-to-deposit ratio (LDR). The regression analysis conducted by Muturi, Mwangi, and Kariuki (2023) revealed that retained earnings have a statistically significant and positive coefficient with the loan-to-deposit ratio, indicating that SACCOs reinvesting higher portions of their surplus earnings exhibit greater lending efficiency and asset expansion. Similarly, Komen, Mwangi, and Mutua (2024) found that the accumulation of retained

earnings enhances SACCOs' capital adequacy and liquidity, both of which are fundamental to sustaining effective intermediation. These findings corroborate the argument by Chege, Mwangi, and Otieno (2023) that profitability retention policies contribute to long-term solvency and lending capacity by providing a cushion against credit and liquidity risks.

Conceptually, retained earnings influence financial intermediation through three interrelated mechanisms. First, capital base strengthening, where reinvested surpluses augment SACCOs' equity base, improving their ability to extend credit without relying on costly external finance. Second, financial stability, as consistent profit retention improves liquidity reserves and reduces vulnerability to macroeconomic fluctuations. The SACCO Societies Regulatory Authority (SASRA, 2023) emphasizes that retained earnings form part of core capital, which underpins solvency and regulatory compliance. Third, growth and expansion, as surplus reinvestment facilitates portfolio diversification and infrastructural investment, enabling SACCOs to serve a broader membership base.

Despite the evident benefits, variations in profitability, dividend policies, and governance structures across SACCOs affect how efficiently retained earnings translate into enhanced intermediation. As Yuza, Ochieng, and Mumo (2023) noted, SACCOs that prioritize dividend payouts over reinvestment often experience slower growth in lending capacity and liquidity stability. This underscores the importance of strategic surplus management practices that balance member returns with institutional sustainability. From a policy perspective, encouraging SACCOs to strengthen capital accumulation through retained surpluses aligns with SASRA's prudential guidelines, which advocate for internal capitalization to promote resilience and reduce overreliance on debt. The positive association between retained earnings and intermediation efficiency demonstrates that sustainable profitability retention is central to the long-term development of SACCOs and the cooperative financial sector as a whole.

2.3 Empirical Review

Empirical research on financial structure and intermediation efficiency has increasingly highlighted the critical role of internally generated funds, particularly retained earnings, in shaping the performance of deposit-taking SACCOs. In Kenya, SACCOs serve as essential financial intermediaries, mobilizing member deposits and extending credit to low-income households and small enterprises underserved by commercial banks. While early studies, such as Mwangi (2016), explored the relationship between financial structure components including retained earnings and firm performance in listed companies, their applicability to SACCOs is limited due to differences in governance, ownership, and regulatory environments. Nevertheless, Mwangi's findings underscore the potential of internal financing to enhance equity-based outcomes, providing a theoretical foundation for examining retained earnings within cooperative financial institutions.

Subsequent studies in the Kenyan SACCO sector have provided more direct evidence on the importance of retained earnings. Mwatu (2018) demonstrated that equity financing, including retained surpluses, positively influences SACCO sustainability by strengthening internal capitalization. Complementing this, Komen, Mwangi, and Mutua (2024) established that SACCOs with higher retained earnings exhibited greater loan growth and more stable liquidity positions, indicating that internal funds not only support capitalization but also facilitate effective credit delivery. Similarly, Muturi, Mwangi, and Kariuki (2023) found that retained earnings, alongside long-term debt, significantly enhanced SACCOs' lending capacity, whereas reliance on short-term debt undermined liquidity and intermediation performance. Chege, Mwangi, and Otieno (2023) further confirmed that internally generated funds contribute more substantially to intermediation efficiency than short-term liabilities, highlighting the stabilizing role of retained earnings in sustaining lending operations.

More recent longitudinal analyses reinforce the centrality of retained earnings in cooperative financial management. Muriithi, Kimathi, and Kilonzo (2022) observed that retained earnings are essential for expanding asset bases and maintaining liquidity, while share capital primarily provides a regulatory buffer. Muriithi (2025), using panel data covering 2019–2024, quantified this effect, reporting that retained earnings significantly enhance SACCO intermediation efficiency, whereas short-term debt remains largely ineffective in supporting sustainable lending. Supporting these findings, Nyang'au, Otieno, and Gichohi (2023) demonstrated that internal financing strategies, particularly the accumulation and retention of surpluses, drive sustainable intermediation more than institutional size. Earlier studies by Kamau and Murigu (2017) and Karingi et al. (2017) similarly highlight the importance of member contributions and long-term internal funds in enabling SACCOs to grow their loan portfolios and maintain operational stability. Collectively, these studies underscore that retained earnings constitute a critical determinant of financial intermediation in Kenya's SACCO sector, providing both liquidity and lending capacity, while reducing reliance on costly external financing.

3.1 Research Methodology

This study employs a causal-explanatory longitudinal design using balanced panel data to examine the effect of retained earnings on the financial intermediation of deposit-taking SACCOs in Kenya. The sample comprises a census of all 174 licensed DT-SACCOs observed over the period 2019–2024, with secondary data sourced from SASRA annual supervision reports. Financial intermediation is proxied by the loan-to-deposit ratio, while the key explanatory variable is retained earnings. Short-term debt, long-term debt and share capital are included as control variables. The empirical analysis is conducted using panel regression techniques. Both Fixed Effects (FE) and Random Effects (RE) estimators are considered, with model selection guided by the Hausman specification test. Robustness is ensured through diagnostic tests for multicollinearity, heteroskedasticity, serial correlation, and stationarity.

The estimated econometric model is specified as:

$$W_{it} = \beta_0 + \beta_1 R_{it} + \beta_2 S_{it} + \beta_3 L_{it} + \beta_4 E_{it} + \epsilon_j \dots \dots \dots 3.1$$

Where:

W_{it} = loan to deposit ratio for each firm i at time t

S = Short term debt

L = Long term debt

R = Retained earnings

E = Share capital

4.1 Results and Interpretation

Results and interpretation are presented below.

4.1.1 Descriptive Statistics

Descriptive statistics were computed to provide an overview of the key variables used in the study and to summarize the general characteristics of the dataset covering 130 deposit-taking SACCOs in Kenya over the period 2019–2024. Table 4.1 below presents the summary results of the descriptive statistics, which form the foundation for subsequent correlation and regression analyses.

Table 4.1: Descriptive Statistics of Key Study Variables

	mean	std	min	max	skewness	kurtosis
Retained earnings	0.1839	0.3115	0.0000	4.0000	5.4193	52.5775
Financial intermediation	0.5629	0.5880	0.0050	6.1250	1.7044	10.5969

Source (SASRA, 2025)

Table 4.1 presents the descriptive statistics for the key variables used in the analysis, retained earnings and financial intermediation (loan-to-deposit ratio) for 130 deposit-taking SACCOs (DT-SACCOs) in Kenya between 2019 and 2024. The mean retained earnings ratio of 0.184 with a standard deviation of 0.312 implies limited but relatively consistent profit retention. The extreme values (0.000 – 4.000) and high skewness (5.419) indicate that while most SACCOs retain minimal earnings, a few have accumulated substantial internal reserves. This heterogeneity underscores the diverse profitability and capitalization strategies across the sector. Empirical evidence by Mureithi and Achoki (2018) supports this finding, asserting that retained earnings are a pivotal internal funding source that strengthens SACCOs' capital bases, reduces dependence on external debt, and enhances lending capacity. Similarly, Karingi et al. (2017) found that SACCOs with stronger retained earnings demonstrate improved loan-to-deposit ratios due to higher self-financing ability.

The mean loan-to-deposit ratio of 0.563 suggests that, on average, SACCOs lend about 56 percent of member deposits, reflecting moderate intermediation efficiency. The variation ($SD = 0.588$; $range = 0.005 - 6.125$) demonstrates that while most SACCOs maintain prudent lending levels, a few exhibits aggressive lending behavior, potentially increasing credit risk exposure. The positive skewness (1.704) and leptokurtic kurtosis (10.597) indicate concentration around moderate intermediation levels with a few extreme values. These findings align with Karingi et al. (2017), who emphasized that the loan-to-deposit ratio effectively captures SACCOs' intermediation capacity and is shaped by both liquidity management and capital adequacy. Similarly, Gichinga et al. (2024) observed that SACCOs' efficiency levels have improved over time but remain suboptimal due to uneven capital structures and inconsistent adherence to prudential limits on lending and liquidity.

4.1.2 Correlation Analysis

Retained earnings are positively correlated with financial intermediation ($r = 0.6218$). These results imply that SACCOs with greater internal surpluses reinvest more of their earnings, which in turn strengthens lending capacity. The positive relationship highlights the importance of self-financing in enhancing financial sustainability and reducing dependence on external borrowing. Empirical literature consistently confirms this relationship. Mureithi and Achoki (2018) established

that retained earnings are a key determinant of SACCO growth and financial resilience, allowing institutions to internally fund credit expansion. Ngeno and Omondi (2024) similarly observed that SACCOs that consistently reinvest profits exhibit higher operational efficiency and stronger liquidity positions. The present findings thus corroborate existing evidence that internally generated funds are critical for improving financial intermediation and ensuring long-term solvency.

4.1.3 Effect of Retained Earnings on Financial Intermediation of Deposit Taking SACCOs in Kenya

To examine the direct effect of retained earnings on financial intermediation among deposit-taking SACCOs in Kenya, the study estimated Equation 3.1 using the Random Effects Generalized Least Squares (RE-GLS) model. This estimation approach was selected based on the Hausman test results, which confirmed that the Random Effects model was both consistent and efficient. The model assessed the individual contributions of retained earnings to financial intermediation, measured by the loan-to-deposit ratio. Tables 4.2 and 4.3 present the initial RE-GLS coefficient estimates and model fit statistics.

Table 4.2: Random Effect Generalized Least Square Coefficient robustness

term	coef	std_err	p_value	ci_lower	ci_upper
const	0.361902	0.032623	0	0.297889	0.425915
Retained earnings	0.498845	0.215421	0.020769	0.076139	0.921552

Source (Author, 2025)

The regression constant ($\beta_0 = 0.3619$, $p < 0.05$) is positive and statistically significant, suggesting that, on average, SACCOs maintain a baseline intermediation efficiency of 36.19% even in the absence of changes in financial structure variables. This baseline intermediation reflects the inherent capacity of SACCOs to transform deposits into loans due to their cooperative nature and member-driven funding structures. The coefficient for retained earnings ($\beta_1 = 0.4988$, $p = 0.0208$) is positive and statistically significant at the 5% level, indicating that internal financing plays a key role in SACCOs' ability to lend. A one-unit increase in retained earnings raises intermediation efficiency by approximately 49.88%, demonstrating that accumulated surpluses and reserves enable SACCOs to fund loan portfolios without external borrowing. Retained earnings enhance liquidity and capital adequacy, thereby improving members' access to credit. Consequently, H_{03} is rejected, signifying that retained earnings have a significant positive effect on financial intermediation. The positive influence of retained earnings echoes findings by Kipkemai and Mwaura (2022), who observed that internally generated capital significantly enhances SACCO liquidity and operational sustainability by reducing reliance on costly external borrowing. Their study emphasized that SACCOs reinvesting profits achieve better intermediation efficiency due to increased lending flexibility.

4.1.4 Model Fit Robustness

To evaluate the overall performance and explanatory power of the Random Effects Generalized Least Squares (RE-GLS) model, key model fit statistics were examined. Table 4.3 presents the model fit robustness results for the RE-GLS estimation.

Table 4.3: Random Effect GLS Fit Robustness

nobs	rsq_overall	loglike
1050	0.36	-443.612

Source (Author, 2025)

The overall R^2 value of 0.36 indicates that approximately 36% of the total variation in financial intermediation (measured by the loan-to-deposit ratio) is jointly explained by retained earnings, long-term debt, short-term debt and share capital. This level of explanatory power is moderate yet robust for financial panel data, where numerous unobserved institutional and macroeconomic factors (such as interest rate movements, regulatory policy, and governance efficiency) typically influence outcomes. In panel models involving real financial institutions, R^2 values between 0.25 and 0.50 are considered satisfactory because they reflect meaningful but not overfitted relationships (Baltagi, 2021; Wooldridge, 2016). The log-likelihood statistic of -443.612 reflects the model's overall fit under the maximum likelihood estimation framework. While negative by construction, less negative values correspond to higher likelihoods and thus better-fitting models. The findings are consistent with existing empirical evidence on model fit and explanatory strength in SACCO financial studies. Muriithi, Kimathi, and Kilonzo (2022) reported an R^2 of 0.34 in their Random Effects model analyzing SACCO financial performance, concluding that moderate explanatory power is typical due to the influence of unobservable firm-specific characteristics such as governance practices and market competition. Similarly, Kipkemai and Mwaura (2022) found an R^2 of 0.38 when estimating the determinants of intermediation efficiency, emphasizing that while financial structure significantly influences outcomes, other non-financial drivers also contribute substantially.

5.1 Conclusion and Policy Recommendations

The study established that retained earnings play a pivotal role in enhancing the financial intermediation efficiency of deposit-taking SACCOs in Kenya. Empirical results indicate that SACCOs that reinvest a greater portion of their surpluses strengthen liquidity, expand credit capacity, and sustain financial stability. Retained earnings emerged as a more reliable and cost-effective source of funding than short-term debt, which was found to undermine lending efficiency due to refinancing pressures. Based on these findings, the study recommends that SACCO management prioritize internal capital formation by adopting surplus retention policies that balance member returns with institutional reinvestment. Regulators, particularly SASRA, should incentivize retained earnings accumulation through prudential guidelines that encourage minimum retention ratios, capital buffers and alignment of asset-liability structures. Policies promoting institutional growth, strategic mergers, and digital infrastructure investment are also encouraged to amplify the positive effects of retained earnings on intermediation.

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