

## INFLUENCE OF PRODUCT DIVERSIFICATION ON THE FINANCIAL PERFORMANCE OF SELECTED COMMERCIAL BANKS IN KENYA

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### ABSTRACT

Product diversification that includes new markets, technology, information flow and innovativeness have seen an unprecedented development and growth during the last few years and it is becoming a major catalyst for economic and social development in many countries. The main objective of this study was to determine the influence of product diversification on the financial performance of selected commercial banks in Kenya. The specific objectives were to establish how new markets, technology and information flow influence performance of commercial banks as well as to determine how innovativeness impacts on financial performance of commercial banks. The study adopted a descriptive research design. The study population was 40 top management, 200 middle level management and 360 junior staff working in 4 commercial banks in Kenya. The study used stratification sampling to collect data from the four selected banks. The study randomly sampled 10% of the junior staff. Random sampling was used to obtain a sample of the top management and middle level management respondents from the selected banks. Validity was ensured through discussion with the experts including supervisors and colleagues. Primary data was collected and analyzed using quantitative and qualitative techniques and then presented using narratives, tables and graphs. Secondary data was also obtained from books journals and commercial banks data base. Data collected was analyzed using SPSS (Statistical Package for Social Sciences) version 21. Descriptive statistics and inferential statistics such as multiple regression were used. This assisted in determining the level of influence the independent variables had on the dependent variable. The findings showed that that technology, information flow, new markets and innovativeness had effect on financial performance. Innovativeness was found to be a factor with the highest influence since it had the highest significant coefficient of 0.01 ( $<0.05$ ) compared to other which had .041, .033 and .021. The study recommends that though all banks are employing use of technology in rendering financial services in the country, they should ensure that those systems are of high and quality state ensuring that they are up to date. The study also recommends that all banks take care of

associated technologies which make clients susceptible by ensuring they inform the public of the possibilities of fraud and ensuring that they apply proper technology infrastructure backups.

**Keywords:** *Product Diversification on the Financial Performance.*

## Introduction

Recent divestitures by U.S. Financial Holding Companies (FHCs) are often interpreted as an indication that the lackluster financial performance of these conglomerates are due to the consolidation of commercial banking, investment banking and insurance business under the same umbrella (Stiroh & Rumble 2006; Yeager, 2007). More simply, it is suggested that the expansion of the banking enterprise into non-interest activities such as insurance services and investment banking is unrewarding. Examples of such divestitures include the dramatic spin-off by Citigroup of the Travelers property/casualty insurance unit to St. Paul Companies in 2003, and the spin-off of Travelers Life & Annuity business to MetLife in 2005.

Empirical studies documented on banking diversification to date is primarily based on U.S. market and other developed countries, with relatively much less insight and discussion on the diversification effects in the banking industry in emerging or transitional economies (Odesanmi & Wolfe, 2007). Acharya (2002) performed one of the first and important studies about diversification on banks' credit portfolio. They analysed Italian banks and found that both industrial and sectoral diversification reduces bank returns while producing riskier loans. However Hayden (2007) investigated German banks and found that diversification tends to be associated with reductions in bank returns, even after controlling for risk. Only in a few cases (high-risk banks and industrial diversification) did they reach statistically significant positive relationships between diversification and bank returns. Kamp (2004) analysed whether German banks diversify their loan portfolios or focus on certain industries and founded that a majority of banks significantly increased loan portfolio diversification. David & Dionne (2005) discussed how large banks in Sweden manage their loan portfolios and investigated the strategy behind loan portfolio diversification at banks. Schertler (2006) found that total domestic lending by savings banks and credit cooperatives (including their regional institutions), smaller banks, and banks that are highly specialized in specific sectors responds positively and, in relevant cases, more strongly to domestic sectorial growth.

## Statement of the Problem

Over the last three decades, market deregulation, technological progress, competition and reduced trade barriers across national borders have served as driving forces behind product diversification among financial institutions across the world (Parsons and Mutenga, 2009). While there are a lot of documented studies on influence of product diversification on performance of banks in the developed markets, scanty systematically documented information exists on the developing markets, Kenya included. For the quarter ended March 31st, 2013, the Kenyan banking sector comprised 43 commercial banks (CBK, 2013). According to Kenya Bankers Association (KBA), bank profitability can be affected by the level of product diversification (KBA, 2012). This view is also echoed by the central bank who confers that product diversification by banks improves their profitability (CBK, 2010). The profitability of Kenya's banking industry in the recent past has been a subject of public interest and debate. The industry posted KSh89.5 billion pre-tax profits in 2011, a 20.5 per cent increase from 2010's KSh74.3 billion (CBK, 2011). While the profit growth has also been helped by a steady growth in the customer base over the past four years from 4.7 million to 15.7 million, a report by the Central Bank of Kenya on 'Developments in the Kenyan Banking Sector for quarter ended March 31, 2012' indicates that this trend of profitability is equally largely attributed to product diversification by banks (KBA, 2012).

A key motivation for this research derives from the fact that there is no agreement on whether it is beneficial for banks to diversify or not, which suggests that there is still need for further research. The findings of this study helps shed light on some of these issues and provide motivation to examine Kenyan banks in the context of product diversification in boosting bank performance.

## Objectives of the Study

### General Objective

To analyze the influence of product diversification on the financial performance of selected commercial banks in Kenya.

## Specific Objectives

The specific objectives that the study sought to establish were as follows:

- i. To identify how new markets influence financial performance of commercial banks.
- ii. To establish the importance of technology on financial performance of commercial banks.
- iii. To examine the significance of information flow on financial performance of commercial banks.
- iv. To determine how innovativeness impacts on financial performance of commercial banks.

## Literature Review

### Innovation diffusion theory

Mahajan & Peterson (2000) defined an innovation as any idea, object or practice that is perceived as new by members of the social system and defined the diffusion of innovation as the process by which the innovation is communicated through certain channels over time among members of social systems. This can be related to innovation in product diversification. Diffusion of innovation theory attempts to explain and describe the mechanisms of how new inventions in this case internet and mobile banking is adopted and becomes successful. Sevcik (2004) stated that not all innovations are adopted even if they are good it may take a long time for an innovation to be adopted. He further stated that resistance to change may be a hindrance to diffusion of innovation although it might not stop the innovation it will slow it down.

Rogers (2001) identified five critical attributes that greatly influence the rate of adoption. These include relative advantage, compatibility, complexity, triability and observability. According to Rogers, the rate of adoption of new innovations will depend on how an organization perceives its relative advantage, compatibility, triability, observability and complexity. If an organization in Kenya observes the benefits of mobile and internet banking they will adopt these innovations given other factors such as the availability of the required tools. Adoption of such innovations will be faster in organizations that have internet access and information technology departments than in organizations without.

### Theory of information production and contemporary banking theory

Diamond (1984) suggested that economic agents may find it worthwhile to produce information about possible investment opportunities if this information is not free; for instance surplus units could incur substantial search costs if they were to seek out borrowers directly. There would be duplication of information production costs if there were no banks as surplus units would incur considerable expenses in seeking out the relevant information before they commit funds to a borrower. Banks enjoy economies of scale and have expertise in processing information related to deficit units (borrowers). They may obtain information upon first contact with borrowers but in real sense it's more likely to be learned over time through repeated dealings with the borrower. As they develop this information they develop a credit rating and become experts in processing information. As a result they have an information advantage and depositors are willing to place funds with a bank knowing that this will be directed to the appropriate borrowers without the former having to incur information costs.

Bhattacharya and Thakor (2003) contemporary banking theory suggests that banks, together with other financial intermediaries are essential in the allocation of capital in the economy. This theory is centered on information asymmetry, an assumption that "different economic agents possess different pieces of information on relevant economic variables, in that agents will use this information for their own profit" (Freixas & Rochet, 2002). Asymmetric information leads to adverse selection and moral hazard problems. Asymmetric information problem that occurs before the transaction occurs and is related to the lack of information about the lenders characteristics is known as adverse selection. Moral hazard takes place after the transaction occurs and is related with incentives by the lenders to behave opportunistically.

### Resource-based theory

The resource-based View illustrates that resources and capabilities can vary significantly across firms and that these differences can be stable (Barney & Hesterly, 1996). This can be related to different technologies that banks use in product diversification. If resources and capabilities of a firm are mixed and deployed in a proper way they can create competitive advantage for the firm, this can be related to cost of operation, time saving, quality of service operation and business agility.

The resource-based view in product diversification from a proposition that an organisation that lacks valuable, rare, inimitable and organized resources and capabilities, shall seek for an external provider in order to overcome that weakness. Therefore the most prominent use of the theory is in the Preparation phase of the out sourcing process for defining the decision making framework and in the vendor selection phase for selecting an appropriate vendor. The theory has also been used to explain some of the key issues of the managing relationship and reconsideration phases. This theory demonstrates that resources and capabilities should form the platform of strategy development.

### Agency Theory

Agency theory indicates that the nature of the agency relation is a contract between principal and agent which exists in all firms and cooperative activities. This can be the new markets that are yet to be exploited. This is an element in product diversification. The theory intends to solve conflicts resulting from interactions between principals and agent. Agency conflicts lead to agency cost which consists of agency cost of debt and agency cost of equity. Jensen and Meckling (2002) argue that the opportunity costs because of the impact of debt on investment decision, monitoring costs resulting from the incentive effects associated with highly leverage, bonding costs and the bankruptcy and reorganization costs are the components of agency costs of debt.

Jensen and Meckling (2002) also present that the tax deduction on the interest payments of debt and the incentive of obtaining additional capital for investment opportunities result in the incurrance of agency cost of debt. Bond holders employ covenants and monitoring devices to protect their claims on firms which is one part of the cost of debt. Webb (2005) concludes that superior performance in both environment and diversity issues results in lower agency cost of debt financing. Obviously the quality of information flow between the firms and its various agencies affects has a significant effect on the resolution of conflicts and then of the firm's success.

## Empirical Review

In the last decade, there has been an explosion of different forms of remote access financial services, i.e., beyond branches. These have been provided through a variety of different channels, including mobile phones, Automatic Teller Machines (ATMs), point-of-sale (POS) devices and banking correspondents. In many countries, these branchless channels have made an important contribution to enhancing financial inclusion by reaching people that traditional, branch-based structures would have been unable to reach.

Mobile banking is an innovation that has progressively rendered itself in pervasive ways cutting across several financial institutions and other sectors of the economy. During the 21st century mobile banking advanced from providing mere text messaging services to that of pseudo internet banking where customers could not only view their balances and set up multiple types of alerts but also transact activities such as fund transfers, redeem loyalty coupons, deposit cheques via the mobile phone and instruct payroll based transactions (Vaidya, 2011). The world has also become increasingly addicted to doing business in the cyber space, across the internet and World Wide Web. Internet commerce in its own respect has expanded in various innovative forms of money, and based on digital data issued by private market actors, has in one way or another substituted for state sanctioned bank notes and checking accounts as customary means of payments (Cohen, 2001).

According to Comptroller (1998) lending is the principal business for most commercial banks. Loan portfolio is therefore typically the largest asset and the largest source of revenue for banks. In view of the significant contribution of loans to the financial health of banks through interest income earnings, these assets are considered the most valuable assets of banks. Loan portfolio is typically the largest asset and the predominant source of income for banks. In spite of the huge income generated from their loan portfolio, available literature shows that huge portions of banks loans usually go bad and therefore affect the financial performance of these institutions (Comptroller, 1998).

## Data Analysis/Findings

### 4.8 Inferential Statistics

#### 4.8.1 Correlation Analysis

The correlation matrix indicates that financial performance is correlated with technology at 1 percent significance level (.367). Information flow is positively correlated to technology, innovativeness and new markets requirements at 5 percent significance level (.395), (.432) and (.512) respectively. The Table 4.24 also indicates that there is also correlation between technology and new markets.

**Table 4.24 Correlations**

	Technology	New markets	Information flow	Innovativeness	Financial performance
Technology	1				
New markets	.204	1			
Information flow	.493*	.412*	1		
Innovativeness	.395*	.432*	.512	1	
Financial performance	.367*	.590	.537	.598	1

\*. Correlation is significant at the 0.05 level (1-tailed).

Table 4.25 shows the results of the regression analysis based on the sign of the coefficient and the t-ratio. From the analysis the constant has a t-ratio of 4.13. This indicates that the other factors that influence financial performance and have not been included in the model are statistically significant in determining the financial performance. The constant is also positively related to the adoption implying that the impact of these factors which are not in the model impacted on financial performance by commercial banks in Kenya.

Table 4.25 Regression Coefficients

Model	Unstandardized		Standardized		
	Coefficients		Coefficients		
	B	Std. Error	Beta	T	Sig.
(Constant)	.483	.354		4.13	.012
Technology	0.837	.541	.072	2.438	.021
New markets	1.593	.368	.241	2.439	.033
Information flow	1.367	.471	.460	2.210	.041
Innovativeness	1.923	.531	.523	2.321	0.01

Dependent variable: Financial performance

The technology is positively related to the financial performance. This is shown by the coefficient which is statistically significant as indicated by a p- value of 0.021 (<0.05). New markets are positively related to financial performance and have the most statistically significant coefficient as indicated by a p – value of 0.033 (<0.05). This implies that a one unit change in new markets will change the financial performance by 1.593 units.

There is a positive relationship between information flow and the financial performance. Information flow also has a statistically significant coefficient as indicated by a p-value of 0.041 (<0.05). A one unit change in the information flow will change the financial performance by 1.367 units.

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