TO EXAMINE FACTORS INFLUENCING DIVERSIFICATION OF INCOME GENERATING ACTIVITIES IN COMMERCIAL BANKS IN KENYA

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MAY 2010

Nyangweso, Evans
To examine factors influencing
DECLARATION

This research project is my original work and has never been presented for a degree in any other university.

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Banks, the world over, are transcending their normal business operations and diversifying their activities. The Kenyan banking Industry also has been steadily shifting away from concentrating on traditional activities such as loan – making, and diversifying into non– traditional activities that generate fee income, service charges or trading revenue, among others. Some of these non traditional activities of income generation that many banks have shifted to include installation of ATM services at various retail outlets, money transfer services, internet banking and partnerships for agency services. The purpose of this study was to examine the factors that influence diversification of income generating activities in commercial banks in Kenya. The study was carried out in fifteen commercial banks in Kenya which were randomly picked from three tiers which the banks were categorised, five from each tier. The target population was the staff working in areas of income diversification activities. The staff who participated in the study were therefore purposively sampled.

The study was descriptive and structured questionnaires consisting of both open and closed ended questions were used to collect data. Data collected was analysed using descriptive statistics such as mean and correlation. This analysis was carried out with the help of statistical package for social sciences (SPSS). Data presentation was in the form of tables, graphs and charts.

According to the findings of the study, majority of the respondents indicated that service offered, risk, competition and technology, greatly determined diversification of income generating activities in commercial banks in Kenya. The study also revealed significant statistical differences on how the variables studied influenced diversification of income generating activities in each tier.

The study concluded that diversification of income generating activities was greatly determined by service offered, risk appetite, competition and technology in use. However, the degree of influence of these variables on diversification differed among the three tiers of banks studied, pointing towards customer segmentation focus as an intervening variable. This is an indication that commercial banks are focused on deepening their relationship with customers and therefore there could be a move towards segment
targeting in diversification of income generating activities such that the segment of focus is what ultimately determines diversification of income generating activities.

In recommendation, the researcher suggested that any diversification into other income generation activities should take into consideration how such activities will be delivered to the customers to ensure that they remain loyal to the banks. Risks in the process of diversification of income generation activities should be identified, assessed and mitigated, while any diversification of income generation activity decision need to consider the level of competition in terms of ability to attract customers for a new income generation activity. Further, banks should embrace technology that will enhance their diversification of income generation activities. And given the role of intervening variables in income generation activities diversification decisions, the researcher recommends that while diversifying, the particular segment of focus of the bank should be considered.

Further research is recommended on the finding that there exist statistical differences on how much the factors studied affect decisions on income generation activities in all the tires. In particular, more research is recommended on segment focus and other intervening variables on how they influence decisions on diversification of income generation activities.

The findings of the study will benefit banks, policy makers, academia and the general public.
ACKNOWLEDGEMENT

I wish to express my appreciation to my supervisors, Mrs Esther Gitonga and Raphael Maganje for their insight, encouragement and invaluable scholarly suggestions which were vital from the start to the end of this project. I wish to also thank the management and staff of the institutions sampled for according me the support and cooperation that made the data collection exercise a success.

I also wish to acknowledge my loving mother, Aska, and my late father, Wilson who always encouraged learning. Further acknowledgement goes to my colleagues in school with whom I shared the MBA experience. Last but not least, to everyone who in any way directly or indirectly helped me in developing the project report.

Thank you and God bless you.
DEDICATION

To my dear loving wife, Gladys, my children, Elvis, Faith and Jonathan. I know you have always been there for me, physically, mentally, and even spiritually.
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<tr>
<td><strong>AFC:</strong> Agricultural Finance Corporation</td>
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<td><strong>ATMs:</strong> Automated Teller Machines</td>
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<td><strong>CBK:</strong> Central Bank of Kenya</td>
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<td><strong>EFTs:</strong> Electronic Fund Transfers</td>
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<td><strong>ICT:</strong> Information and Communication Technology</td>
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<td><strong>KEPSS:</strong> Electronic Payment and Settlement system</td>
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<td><strong>MPT:</strong> Modern Portfolio Theory</td>
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<td><strong>PWC:</strong> Price Water-house Coopers</td>
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<td><strong>RBT:</strong> Resource-Based Theory</td>
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<td><strong>RTGS:</strong> Real Time Gross and Settlement system</td>
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<td><strong>SMS:</strong> Short Message Services</td>
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<td><strong>SPSS:</strong> Statistical Package for Social Sciences</td>
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<td><strong>US:</strong> United States</td>
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<td><strong>YEF:</strong> Youth Enterprise Fund</td>
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DEFINITION OF TERMS

Bank: According to The Banking Act (Chapter 488 of The Laws of Kenya), 'Bank' means a company which carries on, or proposes to carry on, banking business in Kenya.

Banking business: Means the accepting from members of the public of money on deposit repayable on demand or at the expiry of a fixed period or after notice; the accepting from members of the public of money on current account and payment on and acceptance of cheques; and the employing of money held on deposit or on current account or any part of the money, by lending, investment or in any other manner for the account and the at risk of the person so employing the money.

Banking Risks: Danger that a certain unpredictable contingency can occur, which generates randomness in banks’ cashflows.

Banking Services: Any activities involved in accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to earn a profit.

Diversification: A portfolio strategy designed to reduce exposure to risk by combining a variety of investments, such as stocks, bonds, and real estate, which are unlikely to all move in the same direction. The goal of diversification is to reduce the risk in a portfolio.

Fee income: Income from fee charged by banks at the time of carrying out a transaction

Income generating activities: Are activities whose undertaking will lead to revenue

Industry Competition: The existence within a banking market for some services of a sufficient number of customers banks such that no single market participant has enough influence to determine the going price of the services.

Non Interest Income: Any income that banks earn from activities other than their core intermediation business (taking deposits and making loans) or from their investments

Service charge: Refers to monthly charge recovered by banks for maintaining and account
Trading revenue: Income made by trading in various currencies

Technology: The practical application of knowledge for the purpose of enhancing efficiency in service design and implementation.

Shariah: A banking system that complies to Islamic teachings
CHAPTER ONE
INTRODUCTION

1.1: Chapter Overview
This chapter discusses the research's background information and problem statement. Further, it outlines its key objectives, significance, scope, anticipated assumptions and limitations.

1.2: Background Information
This study was motivated mainly by two facts which include the rationale for any organization to diversify and the significant role that commercial banks play in Kenya today. By definition, diversification implies a means by which a firm expands from its core business into other product markets (Aaker, 2000). Within the banking industry, innovation and desire to penetrate into traditionally non-banking activities are today dominant with the sole purpose of internal sustainability and attainment of competitive edge. The proceeding two sub-sections give background to the study and the overall state of commercial banks in Kenya.

1.2.1: Background of the Study
During the second half of the 1980s, many banks adopted universal banking structures in different forms and degrees as a strategic response to increased environmental turbulence in both domestic and global market. Such diversification helped banks to eliminate the unevenness of geographical reach, product-process innovation, exploit economies of scale and scope, reap benefit of advanced technology and diversify risk along with mobilization of additional capital. Since then, diversification has opened the door for commercial banks to earn fee income from investment banking, merchant banking, insurance agency, securities brokerage, and other nontraditional financial services (Mohan, 2003).

Ali-Yrkko (2002) classifies the banks' motive to diversify as synergy (or economic) motive, managerial motive, value maximization motive, increased market power motive, capital strength and risk diversification motives. Further, he categorises determinants of diversification into two categories: external determinants such as economies of scale and scope, dynamics of bank competition, global presence of financial conglomerates and disintermediation in banking activities, while the internal determinants include risk
reduction motive, decline in interest margin, cost of production, low cost of capital and technology upgradation.

Berger et al. (1999) analysed the potential benefits and synergies from an expansion of banking business into non banking activities both from the cost perspective as a result of economies of scale and from the revenue perspective, due to the ability of banks to raise revenues from complementarities in financial services consumption. The result did not show that such synergies exist. However, De Young and Roland (2001) argue that banks may benefit from their operational expansion either in the form of lower costs of producing the current financial services or in the form of higher revenues from providing a new bundle of services to customers. Acharya (2006), on the contrary, finds that diversification is not guaranteed to produce superior performance.

According to Grenning and Bratanovic (2000), rapid innovations in financial markets and the internationalization of financial flows in the past decades have changed the face of traditional banking almost beyond recognition. Technological progress and deregulation have both provided new opportunities for and increased competitive pressures among banks and non banks alike. And while banking activities have become more profitable in general, evidence suggests that they have also become riskier. Moreover, they suggest that if the banking industry was to remain profitable in a deregulated environment, it must fundamentally change the way in which it makes money. Their study found that in order to offset expected declines in net interest margins due to post deregulation competition, fee income would have to be increased. Subsequently, many banking companies have heeded this recommendation by diversifying their fee based products and services.

Driven by advances in communications and information technologies, banks today have an edge to initiate new production processes for transactions and liquidity services such as ATMs and online bill pay, thus allowing banks to produce their traditional services more efficiently. This growth has already paid dividends based on the willingness of deposit customers to pay fees for these conveniences (Grenning and Bratanovic, 2000). Ennis (2001), supplements that these efficiencies have not only reduced per unit costs, enhanced service quality and increased customer convenience, but also represented a source of increased fee income for banks.
As far as Kenya is concerned, the wave of diversification became apparent in the banking sector in the 1990s. The reforms in this sector allowed the banks to undertake activities like investment banking, leasing, merchant banking, factoring, hire purchase and mutual funds, through separate subsidiaries. The industry too has been seen to be steadily shifting away from traditional sources of revenue like loan-making and leaning towards nontraditional activities that generate fee income, service charges, trading revenue, and other types of noninterest income (Mohan, 2003). It is not only the banks in the private sector that are making a headway into diversifying their operations, but also the public sector banks which are aggressively looking for expansions in advanced opportunities. Further, mergers, amalgamations and acquisitions have been undertaken on a large scale in order to gain size and to focus more sharply on competitive strengths. This consolidation has produced financial conglomerates that are expected to maximize economies of scale and scope by bundling the production of financial services (Jalan, 2008).

As a result of the growth in international financial markets and a greater diversity of financial instruments, banks now have a wider access to funds. At the same time, markets have expanded and opportunities to design new products and provide more services have arisen. While the pace of these changes appears to be quicker, commercial banks are generally becoming more involved in developing new instruments, products and services and techniques. This has consequently rendered the traditional banking practice — based on the receipt of deposits and the granting of loans — only one part of a typical bank’s business.

1.2.2: Commercial Banking Sector in Kenya

The banking sector in Kenya operates in a relatively deregulated environment. The dominance of foreign owned banks still account for substantial part of the banking system. According to CBK annual reports (2008), the banking sector comprises of 46 institutions out of which 34 are locally owned, 6 foreign-owned and 5 are locally incorporated. Despite the fact that locally-owned banks dominate the industry, they only account for 48.2% of the sector’s total assets, closely followed by the foreign owned banks with 43% of the sectors assets. However, the industry has continued to record impressive growth in the last few years. In the period ended December 2007, the overall profitability rose by 30 percent while the asset portfolio expanded by 26.1 percent over
the previous year. The performance indicators improved with a decline in the stock of non-performing loans and enhancement of capital adequacy ratios attributed mainly to fresh capital injections and retention of profits over the period (CBK Annual Report, 2008).

As recent as 1989, when the first ATMs were introduced in the Kenyan market, opening an account in a bank, especially personal current account, was a struggle, the conventional wisdom then being that retail customers were more of a bother due to their small deposits and inability to utilise some of the banks profitable channels. Since the turn of the last decade, however, there has been a rush for these retail customers who were even at one time exited by some banks in favour of high net worth customers and corporate clients. Thus as banks compete for business, the level of service, outlets and the range of products offered, have been either improved or innovated.

Despite all odds, the industry has been expanding in branch networking amid the introduction of branchless banking systems, which include the use of EFTs, ATM cards, SMS banking among others. The annual reports of CBK clearly indicate that, branch network has been slowly expanding since 2002. By the end of December 2006, Kenya had a total branch network of 575, as compared to 486 branches in the period ended December 2002. The slow growth of Branches can be attributed to the rapid rise of alternatives, which include electronic financial product through mobile phones and Personal computers (CBK Annual Report, 2008).

The banks have exponentially embraced the use of information and communication technologies in their service provision. They have invested huge amounts of money in implementing the self and virtual banking services with the objective of improving the quality of customer service. Some of the ICT-based products and services include the introduction of SMS banking, ATMs, Electronic clearing systems and direct debit among others. In mid 2005, Kenya’s banking Industry moved a milestone by introducing Real Time Gross and Settlement system (RTGS) which was renamed Kenya Electronic Payment and Settlement system (KEPSS). This was meant to facilitate the inter-bank financial data transfer. The development of e-banking services is expected to decongest banking halls and reduce the incidences of long queues in banking halls.
The industry has also over the years continued to introduce a wide range of new products, prompted by increased competition, embracing ICT and enhanced customer needs. As a marketing strategy, the new products offered in this segment of market, continue to assume local development brand names to suit the domestic environment and targeting the larger segment of local customer base. Among the products, include Islamic banking which was introduced in 2005, tailored in line with “Shariah” principles. Currently, Barclays Bank of Kenya, Kenya commercial Bank, K-Rep-Bank and Dubai Bank have so far introduced Islamic banking products in the market. All these indicate that Kenya’s banking industry has great developments like any other banking market in the world. As the banking fraternity continues to make forays into the retail segment of the market, it is becoming more paramount that customers be given value for their hard-earned deposits (CBK Annual Report, 2006).

Mwangi (2006) notes that the competition in the banking industry has forced Kenyan banks to move into previously uncharted waters like mortgage finance. And with banks having to contend with the emergence of institutions offering loans to customers like micro finance institutions, now supported by the microfinance bill 2008, government agencies like AFC, the Youth Enterprise Fund (YEF) and the Women Fund, banks are adopting a proactive strategy of putting huge investments in technology to be able to compete and reduce operation costs by diversifying the choice of services offered to their clients.

In addition, there has been intense market pressure for institutions to invest huge sums of money in new banking technology so as to enhance efficiency. The Central Bank of Kenya Annual Report for the financial year 2007/8 foresees that the banking institutions will need to cope with continuously changing business environment especially due to a robust ICT platform, to be enhanced by the commissioning of the submarine cable in June 2009. This aside, the world is undergoing a ‘knowledge revolution’ whose consequences will exceed even those of the industrial revolution, hence banks will be expected to continue aggressively designing new products that leverage on ICT to remain competitive in a quest to satisfy their clients (CBK Annual Report, 2008).

Further, the Basel Committee on banking supervision formulated and issued a revised capital framework referred to as Basel II in June 2004 which became available for
implementation among its member countries from end of 2006. Basel II consists of three pillars. Pillar I, which addresses capital requirements, requires banks to set aside adequate capital to cover the credit, market and operational risks they face. Locally, the Central Bank of Kenya has been keenly following developments leading up to the adoption of the new capital framework through surveys such as Basel II Implementation Survey for 2008, and participation in regional and international supervisory forums. Kenya banks are required to have a capital adequacy ratio of 12%. The implementation of the requirements poses a challenge to some of the existing banks in terms of cost, and hence the need for other sources of revenues (CBK Annual Report, 2008).

1.3: Statement of the Problem
For the last two decades, the world economies have witnessed a phenomenal transformation in the operations and objectives of financial sector and particularly regarding the banking industry. The deregulation, disintermediation, increased level of competition and emergence of advanced technologies, along with the consolidation wave in the banking sector have been instrumental in making banks to diversify their activities. As a result, the banks are transcending their normal business operation and are venturing into predominantly non-banking activities for the purpose of establishing financial sustainability. This is thought to be manifested in a relative increase in fee and other non-interest income vis-à-vis the net interest income. The general trend has been towards downstream universal banking where banks have undertaken traditionally non-banking activities such as investment banking, mortgage financing, securitization and insurance (Jalan, 2008).

In Kenya, commercial banks have embraced diversification into other products so as to increase income (CBK Annual Report, 2007). The drive has seen banks venture into traditionally non-banking activities as a means of stabilising turnovers. This motive, however, contrasts with researches such as by Dimsertz and Strahan (1997) on a sample of bank holding companies, where they found that even with diversification, average returns do not change. Also, Stiroh (2004) found that diversification into activities that generate noninterest income do not raise average market returns. In the same scope, Acharya (2006) found that diversification of loan products is not guaranteed to produce superior performance. Despite such findings, Kenyan banks have continued to embrace diversification outside the mainstream banking activities in terms of products and into
areas such as internet banking, mortgages, stock brokerage and agency services. These initiatives contrasting empirical exposition, thus, become critical and call for a well-structured investigation especially when there is a literature vacuum within the Kenyan contest backing the trends. The industry's unique case was inferred through individual bank's considered intent on determinants of diversification with the goal of bolstering the scope of income generation activities. Generalisations from the study were vital in injecting a new banking dimension, based on factual data, regarding strategic optimization and need for high-performance sustainability while expanding the industry's operations.

1.4: Objective of the Study
The general objective of this study was to investigate the factors that influence diversification of income generating activities in Commercial banks in Kenya.

Specifically, the study sought to:

(i) Establish how services offered by commercial banks influence diversification of income generating activities,
(ii) Examine the role risk plays in diversification of income generation activities in commercial banks in Kenya,
(iii) Determine the effects of competition on diversification of income generation activities in commercial banks in Kenya, and
(iv) Assess how technology affects diversification of income generation activities in commercial banks in Kenya

1.5: Research Questions
Towards attainment of the predesigned research objectives, the study sought to answer the following questions:

(i) How do services offered by commercial banks in Kenya determine diversification of income generation activities decisions?
(ii) What role does risk play in informing decision making for diversification of income generation activities?
(iii) To what extent does competition in the Kenyan banking industry influence diversification of income generation activities?
1.6: Scope of the Study
The study examined factors that affect diversification of income generating activities in commercial banks in Kenya. It covered all the 46 commercial banks operating in Kenya. The research data was sought from the head offices of the commercial banks, all of which are based in Nairobi. The study’s unit of analysis was the respective staff of bank in sections such as risk and compliance, marketing, finance, corporate planning, ICT and product research and development due to their close involvement in formulation and diversification decisions for products.

1.7: Significance of the Study
This study sought to bring out an understanding of the factors driving diversification of income generation activities in commercial banks in Kenya. Findings from the study were of use to a wide group of interests within and outside the banking industry. First, the banks management benefited from a comparative exposition between different industry players as a basis of establishing a diversification framework. Second, new entrants in the growing sector got first-hand details on the existing levels of performance prior to determining entry approaches and establishing pillars for sustainability. Third, the regulators and government agencies got updates on overall bank initiatives to venture into formerly hidden business opportunities and use the data as a critical tool for evaluating progress and determining weak points that need strengthening. In academic field, the study served as an update of the previous researches on diversification of income generating activities in commercial banks, besides adding to the literature on diversification of income activities and present opportunities for scholars and researchers who might have an interest in advancing findings further.

1.8: Study Assumptions
The study took the assumption that instruments adopted lead to valid and reliable generalisation of findings as determined by the objectives. Thus, responses from all the selected subjects were taken as true representations and basis for drawing inferences.
addition, it was assumed that all respondents were cooperative to provide adequate information as they were guided so that analysis was not delayed.

1.9: Limitations

The study anticipated the likelihood of respondents not giving information considered sensitive and internal to their institutions. However, as a mitigation strategy, the researcher first assured respondents on necessity for data confidentiality and this was demonstrated by not obliging them to provide company identity or their names on the questionnaire.
CHAPTER TWO
LITERATURE REVIEW

2.1: Chapter Overview
This chapter presents relevant literature review regarding the study area in order to give in-depth understanding of the problem under investigation. Predominantly, the reviews concentrate on diversification theories, empirical review, diversification in banking industry, study's conceptual framework and a critical review which reveals gaps to be filled by the study.

2.2: Theoretical Review
The theories of diversification have grown over time based on differing perspectives and researches that dwell on new economic and unfolding phenomena. Under the theoretical review, three main theories which are relevant to diversification are reviewed. They include Modern Portfolio Theory (MPT), the Theory of Growth of the Firm and the Resource-based theory.

2.2.1: Modern Portfolio Theory
Modern portfolio theory (MPT) holds that diversification of assets may increase returns at given risk levels, or alternatively, may provide the same returns at reduced risk levels. Applications of the theory use volatility of returns implied by market price fluctuations as the composite of risks. The returns are measured periodically by imputing sales of the assets at market prices. The evaluation of an imputed rate of return is made under unrealistic assumptions. It is not a realized rate of return - and, the realized rate of return is the realistic objective of the investment. MPT is certainly the dominant theory in modern portfolio strategy, which is at least consistent with its name, modern portfolio theory (Chandler, 2002).

Time horizons are critical to diversification strategy. Diversification serves to protect the investor from excessive concentration of risks. The major risks may be thought of as business risk (the chance of loss because of not getting the investment back), price level risk (the chance of loss of purchasing power even if the investment is recovered), and liquidity risk (the chance of loss from quickly or prematurely converting the asset to cash) (Athanassakos, 2009).
Rather than using diversification to maximize imputed rates of return (or minimize risk at some level of imputed return), with periodic measurements of volatile market prices, diversification may be used to maximize realized rates of return within given risk constraints over the relevant time horizon. The concept is to maximize the realized rate of return within the risk constraints that one is prepared to take. For example, one may set a time horizon of ten years for the purposes of portfolio construction. The idea is that one may determine the risk profile (considering business risk, price level risk, and liquidity risk) that is acceptable for the ten year period and construct the portfolio to maximize returns within the risk constraints determined. Thus, the purchase of a ten year treasury note at par while containing a liquidity risk has no realized gain or loss if held to maturity. The market fluctuations are irrelevant as long as the security is not sold (Chandler, 2002).

Athanassakos (2009), supplements that a fundamental tenet of modern portfolio theory is the notion of diversification. Rather than holding one or a few stocks, investors instead should hold a large basket of stocks. A strategy that attempts to outperform the market based on stock picking - in other words, selecting stocks that seem to be underpriced - will lead to a poorly diversified portfolio and risk for which there will be no reward. According to the theory, diversification helps investors minimize risk and, so doing, avoid losses.

The notion of diversification, however, assumes that risk can be measured. Events over the past two years have cast doubt on how risk should be measured and have forced many believers in modern portfolio theory to reassess their models and risk metrics. They have come to realize that risk depends on too many (known and unknown) variables to be accurately measured. However, this realization is not new. As early as 1930, Keynes had indicated that uncertainty and risk could not be quantified and measured. Unfortunately, for Keynes, Bayes had a different opinion of risk, that risk could be quantified and measured by a probability distribution, and his views prevailed over those of Keynes and dominated modern finance theory (Kor and Mahoney, 2004).

Adhering to this idea of measurable risk, investors over the years loaded up on risk, believing that risk is eliminated through diversification or diversification's derivatives, such as securitization and structured investment vehicles. The problem is that adherents to this idea of measurable risk did not count on the likelihood that something completely
unexpected would occur. Indeed, the past few years have shed doubt on the measurability of risk on which most finance models are based. Moreover, rapid innovation in financial markets made useless many of the tools and statistical models upon which risk managers relied. For diversification to work, one needs to find securities or assets that have low correlation with each other - correlation that is measured using historical data. And then one needs to expect that future correlations will be the same as they have been historically. If historical correlations prove to be an inaccurate measure of future relationships, then diversification that is based on this historical relationship will not work. Forecasting is difficult, especially when one deals with the future (Penrose, 1995).

While modern portfolio theory regards diversification as a substitute of due diligence, value investors beg to differ. While modern portfolio theory and diversification reject a case-by-case stock analysis, value investors think otherwise. While modern portfolio theory argues that diversification will save us all, recent events have proven otherwise. Valuing individual securities is not a wasted effort. Value investors have more concentrated portfolios, not because they reject diversification, but rather because they operate within the boundaries of their competence; they select only securities they understand; they prefer companies with stable cash flows and a history of steady earnings that can be reliably valued. They buy businesses cheap, based on their assets or future earnings. They never pay for growth - this is an additional way to protect their capital and limit risk. And then they apply a margin of safety, which provides downside protection and which is totally distinct from diversification. Additionally, to manage risk, value investors try to understand why they are buying and what they buying. They also like to look at investment opportunities intuitively; if something does not make intuitive sense, they are skeptical. Further, value investors choose to hold cash when they can't find underpriced stocks. A lack of new opportunities is a sign to value investors that the market as a whole may be overvalued. This is not a market timing call made based on a macroeconomic forecast. It is the result of a bottom-up search for good investments that, at the moment, comes up dry (Kor and Mahoney, 2004).
2.2.2: The Theory of Growth of the Firm

This theory was a brainchild of Penrose in 1959 who was more concerned with the growth of firms and only incidentally with the size of the firm (Dosi, Nelson and Winter, 2000). Penrose argued that the firm's operational activities are only a by-product of the process of growth and that there is no optimum or even most profitable size of the firm, thus making diversification an on-going process without limits. He emphasizes the internal resources of a firm on the productive services available to a firm from its own resources, particularly the productive services available from management with experience within the firm. The firm-specific experience of management affects the productive services that all its other resources are capable of rendering. As management tries to make the best use of the available resources, a dynamic interacting process occurs that encourages a continuous rate of growth of the firm. To focus attention on the crucial role of the firm's inherited resources, the environment is treated, in the first instance, as an image in the entrepreneur's mind of the possibilities and restrictions with which it is confronted (Dosi, Nelson and Winter, 2000).

According to Itami and Roehl (1997), in a private enterprise industrial economy, the business firm is the basic unit for the organization of production. Because of its complexity and diversity, a firm can be approached with many different types of analysis and from whatever point of view that seems appropriate to the business problem at hand. A firm is more than an administrative unit but a collection of productive resources, where the choice of different uses of these resources over time is determined by administrative decision. Chandler (2002), argues that, strictly speaking, it is never resources themselves, but only the services that the resource can render, that are the inputs in the production process and growth in size.

Dosi, Nelson and Winter (2000), submit that a versatile type of executive service is needed if expansion requires major efforts on the part of the firm to develop new markets or entails branching out into new lines of production. Here, the imaginative effort, the sense of timing, the instinctive recognition of what will catch on or how to make it catch on, become of overwhelming importance. These services are not likely to be equally available to all firms. Firms not only alter the environmental conditions necessary for the success of their actions, but, even more important, they also know that they can alter these conditions and that the environment is not independent of their own activities. Chandler
(2002), notes three classes of explanation for why there may be a limit to the growth of firms and they include managerial ability, product or factor markets, and uncertainty and risk. The first explanation refers to conditions within the firm, the second explanation refers to conditions outside the firm, and the third explanation is a combination of internal attitudes and external conditions. The capacities of the existing managerial personnel of the firm necessarily set a limit to the expansion of that firm in any given period of time, and such management possessing firm-specific abilities cannot be hired in the marketplace.

In the same scope, Itami and Roehl (1997), submit that if a firm diversifies its organization more rapidly than the individuals in the expanding organization can obtain the experience with each other they need for effective operation of the group, the efficiency of the firm will suffer. Because the services from current managerial resources control the amount of new managerial resources that can be absorbed, they create a fundamental limit to the amount of expansion a firm can undertake at any point in time. The amount of activity that can be planned at a given time period limits the amount of new personnel that can be profitably absorbed in the next period. Moreover, as plans are completed and put into operation, managerial services absorbed in the planning processes will be gradually released and become available for further planning.

Chandler (2002), argues that knowledge for diversification comes to people in two different ways: It can be formally taught, and it can be achieved via learning by-doing in the form of personal experience. Experience produces increased knowledge and contributes to objective knowledge insofar as its results can be transmitted to others. But experience itself can never be transmitted; experience produces a change - frequently a subtle change - in individuals and cannot be separated from them. Increasing experience shows itself in two ways - changes in knowledge acquired and changes in the ability to use knowledge. There is no sharp distinction between these two forms because to a considerable extent the ability to use old knowledge is dependent on the acquisition of new knowledge.

Itami and Roehl (1997), hasten to add that management not only is the source for expansion but also is a brake on expansion. A firm has a given amount of experienced managerial services available at any one time. Parts of these managerial services are
needed for ordinary operation, and the rest of these managerial services are available for planning and executing expansion programs. The effect of uncertainty is to require that some of these available services be used to gather information, process the information, and reach conclusions about the possibilities of action in which the management team has confidence. Further, Itami and Roehl (1997), maintain that the external inducements to expansion include growing demand for particular products, changes in technology that call for production on a larger scale than before, discoveries and inventions with particularly promising uses, and opportunities to obtain a better market position. Inducements to diversification also include backward integration to control sources of supply, diversification of final products to spread risk, or expansion of existing or allied products to preclude the entry of new competitors. External obstacles to expansion include keen competition in markets for particular products that makes profitable entry or expansion in those markets difficult.

Finally, Kor and Mahoney (2004), argue that whereas external inducements and obstacles have been widely discussed, little attention has been paid, in a systematic way at least, to the equally important internal influences on the direction of expansion. Internal obstacles arise when some of the important types of specialized services required for expansion in particular directions are not available in sufficient amounts within the firm. In particular, internal obstacles arise when not enough of the managerial capacity and the technical skills required for the planning, execution, and efficient operation of a new program can be obtained from among existing experienced personnel. Internal inducements to expansion arise largely from the existence of a pool of unused productive services, resources, and specialized knowledge, all of which will always be found within any firm. As long as resources are not used fully in current operations, there is an economic incentive for a firm to find a way of using them more fully.

2.2.3: Resource-Based Theory of Diversification

The resource-based theory (RBT) combines two different approaches, that is, a management perspective and an economics perspective (Peteraf and Barney, 2003). In RBT, the firm is defined as a collection of resources. These resources and the products of the firm are two sides of the same coin and most products require several resources (Penrose, 1995). Vice versa, most resources can be used in different ways, and a firm can seek new competitive advantages by using these resources in new ways, turning them to
borrowers and savers. Through these institutions, savings are mobilised hence providing a major source of finance required for social and economic development of a nation. Black and Donnie (1981), explain that banks accept funds from depositors and in return they issue claims upon themselves in the form of demand and time deposit liabilities. The funds acquired from their depositors are then converted into earning assets via the banks' lending and investing activities, which channel funds to borrowers in return for direct claims against the borrowers.

In the past decade, however, rapid innovations in financial markets and the internationalization of financial flows, have changed the face of traditional banking almost beyond recognition: Technological progress and deregulation have both provided new opportunities for and increased competitive pressures among banks and non banks alike. In the late 1980's, margins attained from the traditional business of banking began to diminish and capital adequacy requirements began to increase. Banks have responded to these new challenges with vigour and imagination by forging ahead into new areas (Grenning & Bratanovic, 2000).

The growth in international financial markets and a greater diversity of financial instruments have provided banks with wider access to funds. At the same time, markets have expanded and opportunities to design new products and provide more services have arisen. While the pace of these changes appears to be quicker in some countries than in others, banks everywhere are generally becoming more involved in developing new instruments, products and services and techniques. Traditional banking practice – based on the receipt of deposits and the granting of loans – is today only one part of a typical bank's business, and is often its least profitable. Diversification into new information-based activities, such as trading in financial markets and income generation through fees, are now the major sources of a bank's profitability. This diversification in the banking sector, mainly towards non interest income generation has been one of the most frequently researched topics in strategic management literature and to some extent in finance. Numerous studies have been conducted on determinants of this diversification and its financial implications, with most studies assessing the effect of diversification on revenue, stability, risk, profitability and revenue structure of banks. The risk – benefit analysis in decision theory compares the risks associated with the benefits expected of a
When the concept is applied on diversification, it means that the decision maker has to assess all the potential risks and benefits that may arise from diversification process. Perceived risk theory analyses the risk a person subjectively associates with the consequences of a decision and its impact on the intention to close a transaction (Bauer 1967). Pavlou (2001), noted that potential risk reduces individual intentions to conclude a deal. Thus as long as the perceived benefits outweigh the perceived risks, the person in charge will have a positive attitude towards a particular decision. Thus perception towards diversification could either be positive or negative.

2.4: Empirical Review

Stiroh (2004), who assesses the potential benefit of diversification for US banks engaging in non interest activities for the period 1984-2001, shows that net interest income and non-interest income (which is relatively more volatile) are increasingly correlated (lower diversification benefits). Stiroh and Rumble (2006), find similar results while considering the US financial holding companies over the period 1997 – 2002.

According to Lepetit et al (2005), banks which have expanded into non interest income activities present a higher level of risk than banks which principally supply traditional intermediation activities. Similarly Lepetit et al. (2005), while analysing the risk implications of the trend towards stronger product diversification in the European banking industry concludes that banks which have expanded into non interest income activities present a higher level of risk than banks which mainly perform traditional intermediation activities. A closer investigation shows that risk is mainly positively correlated with the share of fee-based activities but not with trading activities. Gallo et al (1996), find over the 1987-1994 period, that combining bank and mutual fund activities allows for some diversification benefits, increasing profitability for moderated risk levels.

De Young and Roland (2001), look at the impact of fee-based activities on bank profitability and volatility for large US commercial banks from 1988 to 1995. They conclude that fee based activities, which represent a growing share of banking activities, increase the volatility of bank revenue, hence risk. Landi and Ventureli (2002), observed an impressive growth in bank revenues, which they attributed to diversification to areas
such as security and insurance. They further noted that diversification is positively related to efficiency.

A general concern exists that financial innovation in banking, especially with regard to off-balance sheet instruments, may have the effect of concentrating risk and increasing volatility within the banking system as a whole. In a research on revenue from fee based service, De Young and Roland (1999), concluded that the banks earning grow more volatile as banks tilt their product mixes towards fee based activities and away from traditional intermediation activities. Jixin Xu (1996), in researching on the rate of return for banks, established that banks benefit from diversification through increasing the stability of their asset returns. It was revealed that international banking with diversification of the banks assets escapes systematic risk.

Ahmed and Hasan (2008), in a study to assess the value relevance of product diversification in US commercial banks, examined differences in the value relevance of commercial bank earnings components from interest and noninterest banking activities. Specifically, they studied market reaction to changes in bank earnings from non interest sources resulting from expansion into new financial services other than the traditional intermediation activities using sample of commercial banks between 1993 and 2002. Their findings show that annual abnormal returns have more significant positive relation with changes in the non interest component of bank earnings compared with changes in the interest component of earnings. These results are more obvious for small banks and after 1999, the year in which the Gramm-Leach-Bliley Act allowed banks to expand into more noninterest banking activities in the US.

A study of the banking sector in India carried out by Arora and Shubpreet (2009), between 2000 to 2007, concluded that risk reduction, cost of production, regulatory control and technological change were instrumental in bringing variations in the structure of income of the banks. Ennis (2001), researching on changes on assets for commercial banks in the U S, from 1993-2003, offered a possible explanation as including the fact that the 1990's was a period of continuous innovation in the banking industry, including ATM technology.
2.5: Conceptual Framework

In this research, four factors, namely, service, competition, risk and technology were considered as possible predictors of bank’s decision to diversify into other income generation activities. Thus, the study investigated on the functional relationship between the factors as independent variables and diversification of their income generating activities as demonstrated in fig. 2.1.

Fig 2.1: Schematic diagram showing dependent and independent variables

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Intervening Variable</th>
<th>Dependent variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking Services Offered</td>
<td></td>
<td>Diversification of Income Generating Activities</td>
</tr>
<tr>
<td>- Service</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Sustainability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Corporate Strategy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Customer Feedback</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Change of Consumer Needs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking Risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Forms of Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Spreading of Risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Opportunity Assessment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Level of Industry Competition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Entry of other Industries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Internal Stability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in Technology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Exposure to Risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Pace of Adoption</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Creation of Opportunities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Source: Researcher, 2010)
2.5.1: Banking Services

Service refers to the output of the whole process in delivering what the customer requires efficiently. For banking institutions worldwide, today’s business climate is increasingly complex and technology driven. To achieve success in this competitive environment, it is crucial to develop customer oriented business strategy aimed at reducing operational costs and maximising profitability. Retail banking organisations usually face problems such as multiple distribution channels which deliver inconsistent customer service, diverse and incoherent planning and management information systems providing for different targeting approaches across the channels based on different methodologies and techniques. Today, customers are no longer satisfied with traditional savings and current accounts but require banks to offer various financial products for them to choose, so as to attain value for their deposits. The new banking environment is about differentiating banking products, increased choices, security and accessibility. The ability of financial institutions to deliver products and services in the most efficient and effective manner will therefore be key to performance and relevance. In Kenya, majority of banks have introduced internet banking, mobile banking and other e-banking facilities, to enhance delivery channels to their customers. The objective on service will be measured using a set of indicators including service sustainability, corporate strategy, customer feedback, change of consumer needs, existing of opportunities and profitability.

2.5.2: Banking Risks

Risk is the balance between what commercial banks stand to gain or lose by undertaking certain income generating activities. Over the past decades, the combination of traditional and non traditional activities in banking has given rise to a substantial number of studies. Most of the existing literature is dedicated to potential diversification benefits for banks to engage in a broader scope of activities. In general, these studies, which essentially considered US data, provide mixed results. For instance, Boyd et al. (1980), who simulated portfolios of banking and non bank subsidiaries during the 1970’s, find a potential for risk reduction at relatively low levels of non-bank activities. The results obtained by Kwast (1989), to determine an optimal risk minimising combination of banking and non-bank activities for the period 1976-1985 show only a slight potential for risk reduction. Gallo et al. (1996), find, over the 1987-1994 period, that combining bank and mutual fund activities allows for some diversification benefits increasing profitability for moderated risk levels. In the study risk concentration, forms of risk, mitigation
efficiency, spreading of risks, opportunity assessment and incorporation of experts in risk mitigation will be used as parameters.

2.5.3: Industry Competition

Competition refers to attempts by different entities doing the same thing trying to outdo each other, that is, in the case of this study several banks in the banking business trying to get more customers to serve than the others. Competition has created a fast paced industry where firms must change in order to survive. According to Barth et al., (2004), nowhere is this force of change felt more strongly than in the financial sector. Once the sole domain of the bank, mutual funds, brokerage firms and other non bank competitors have continued to enter these markets due to deregulation. As a result, banks face fierce competition from non bank companies and other banks that enter their territory. With increased pressure, banks have a greater incentive to exploit new products. Measurement on how competition is influencing income generation activities decisions will be done using propensity for market penetration, entry of other industry players, regulatory efficiency, internal stability and product superiority.

2.5.4: Changes in Technology

Technology is the application of modern scientific information in industry, for example the use of modern computer applications in the banking industry. Over the last recent periods, there has been intense market pressure for institutions to invest huge sums of money in new banking technology so as to enhance efficiency. Commercial banks in Kenya have made greater efforts in their investment in technology and expedited their construction of computerised financial services, making it easier to offer products such as internet banking, mobile banking, electronic clearing systems and ATM services. The CBK Annual Report (2007/8) foresees that banks in Kenya institutions will need to cope with continuously changing business environment especially due to a robust ICT platform.

2.6: Summary and gaps to be filled by the study

Studies have been carried out on areas related to the study topic, but mainly in the US and Europe, for instance a PWC report (2003,) on a survey of retail banking fees noted that a decade ago non interest income accounted for approximately 35% of total bank revenues. In 2002 that figure had increased to 45%. Landi and Ventureli (2002), also observed an
impressive growth in bank revenues, which they attributed to diversification to areas such as security and insurance. They further noted that diversification is positively related to efficiency. Barth et al., (2004), find that diversification of income through non traditional activities is positively associated with bank stability. Beger et al., (1999), concluded that larger institutions that are diversified have lower insolvency risk; with the full impact of consolidation on risk of institutions depending on whether any diversification gains are off set by the institution’s pursuit of additional risks. Furthermore, Allen and Santomero (1998), argue that diversification enhances bank’s central role in risk management. According to them, diversification facilitates the redistribution of risk across market participants and thereby reduces risk associated with financial transactions.

A study of the banking sector in India carried out by Arora and Shubpreet (2009), between 2000 to 2007, concluded that risk reduction, cost of production, regulatory control and technological change were instrumental in bringing variations in the structure of income of the banks.

Although to the researcher’s knowledge there is no study that has been carried out on the factors determining diversification of income generation activities in commercial banks in Kenya, the Kenyan banks have continued to embrace diversification outside the mainstream banking activities in terms of products and into areas such as internet banking, mortgages, stock brokerage and agency services. These initiatives contrasting empirical exposition, thus, become critical and call for a well-structured investigation especially when there is a literature vacuum within the Kenyan contest backing the trends. The industry’s unique case will be inferred through individual bank’s considered intent on determinants of diversification with the goal of bolstering the scope of income generation activities. Generalisations from the study will be vital in injecting a new banking dimension, based on factual data, regarding strategic optimization and need for high-performance sustainability while expanding the industry’s operations.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1: Chapter Overview

This chapter highlights the research methodology that was applied in carrying out the study, including the research design, population and sample size. In addition, the data collection procedures and the data analysis methods which were used in order to achieve the objectives of the study are given.

3.2: Research Design

The research adopted descriptive research design for the purpose of accessing the study’s general intent. This design involved a set of methods and procedures that described the intended variables using statistical logic. It was the mainstay of research because it allowed the researcher to make comprehensive inferences about the investigated variables in the target populations. According to Mugenda et al., (2003), descriptive study can be used for explaining or exploring status of two or more variables at a given point in time. Kothari (2003) adds that the major purpose of the design is a description of the state of affairs as it exists at present.

3.3: Target population

The study’s target population constituted a total of 276 informants tasked with product research, development and market sustainability in the 46 commercial banks currently operating in Kenya. This population size was developed from six key sub-units of analysis in the three bank tiers which included product development, sales and marketing, finance, head of ICT departments, corporate planning, and risk and compliance departments. The tiers were used as a basis for stratification in order to facilitate a cross-sectional generalization of the findings. The Central Bank of Kenya (CBK) has categorized commercial banks in tiers based on their asset base (Appendix iii). Those institutions with a balance sheet of more than Sh.40 billion are categorized as tier I and there are 11 of such institutions in Kenya. Tier II constitutes banks with between Sh.10 billion and Sh.40 billion in assets, where there are 11 institutions under this tier while tier III are those with an asset base of less than Sh.10 billion where there are 24 institutions under this tier (The CBK Banking Survey, 2009).

Table 3.1 shows the sub-strata’s proportions in relation to the entire target population.
Table 3.1: Target Population

<table>
<thead>
<tr>
<th>Bank Category</th>
<th>No. of Banks</th>
<th>Population Size</th>
<th>Proportion (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier I (Balance sheet of more than 40 Billion Kenya Shillings)</td>
<td>11</td>
<td>66</td>
<td>24</td>
</tr>
<tr>
<td>Tier II (Balance sheet of less than 40, but more than 10 billion Kenya shillings)</td>
<td>11</td>
<td>66</td>
<td>24</td>
</tr>
<tr>
<td>Tier III (Balance sheet of less than 10 billion Kenya shillings)</td>
<td>24</td>
<td>144</td>
<td>52</td>
</tr>
<tr>
<td>Total</td>
<td>46</td>
<td>276</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: The Banking Survey, 2009

3.4: Sample Size and Sampling Design

The researcher first stratified all the banking institutions into three tiers on the basis of the size of their asset base as per CBK banking survey, 2009. From each tier, five member institutions were identified by simple random sampling provided that they had all the six key units of analysis. This resulted into an aggregate sample size of 90 respondents, which the researcher regarded as adequate since it represents all the critical extremes in the industry. Table 3.2 shows how the sample of 90 was attained.

Table 3.2: Sampling Design

<table>
<thead>
<tr>
<th>Bank Category</th>
<th>No. of Banks</th>
<th>Banks Selected</th>
<th>Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier I</td>
<td>11</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>Tier II</td>
<td>11</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>Tier III</td>
<td>24</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>46</td>
<td>15</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: The Banking Survey, 2009
3.5: Data types and data collection techniques

3.5.1: Data types and instruments

The study utilized primary data which was either qualitative or quantitative data. This data was collected through administration of questionnaires. A questionnaire was designed to capture the various variables of the study. The questionnaire had both open and closed ended questions covering issues on the factors affecting diversification of income in commercial banks in Kenya. Open-ended questions permitted free responses from the respondents, without providing or suggesting any structure for the replies. The closed questions enabled responses of the respondents to be limited to stated alternatives. The alternatives were simplified to enable ease of understanding and to facilitate accurate response. A questionnaire had been chosen as it enabled the researcher to collect large amount of information within a short period of time. The questionnaire was self administered.

3.5.2: Data collection techniques

The researcher collected primary data through field research. A self administered questionnaire was used to collect the data. This instrument allows each person to respond to the same set of questions in a predetermined order. The questionnaire was researcher-developed and was structured according to the specific objectives of the study. The researcher re-assured the respondents about the confidentiality of their feedback. This encouraged the respondents to be honest. Brief follow-up interviews were also held with the respondents in order to obtain more information or clarifications on data submitted in the questionnaire. This ensured the validity of the data collected.

3.6: Pilot testing

According to Mugenda and Mugenda (2003), pilot testing of questionnaires involves testing the actual instrument on a small sample taken from the population for whom the study is planned. It allows the evaluator to identify any difficulty with the materials and to investigate the accuracy and appropriateness on any instrument that has been developed. Delport et al (2002) also argues that it is essential for newly developed questionnaires to be thoroughly piloted before being utilized in the main investigation. Pilot testing of the questionnaire used in this study was conducted by administering them to a limited number of 10 respondents. The findings of the pilot questionnaire were used to improve
on the wording and formulation of the questions to ensure clarity, relevance and accuracy of the final questionnaire so as to obtain the richest data possible. The respondents who took part in the pilot testing were not included in the respondents who were sampled for the final data collection.

3.7: Data analysis

The data from the study was analysed using both qualitative and quantitative techniques. The raw data from the field was first validated, edited and coded. The questionnaires were then validated to determine whether an accurate or acceptable sample was obtained in terms of proportion of the issued questionnaires. They were also checked for completeness. The questionnaires were also scrutinized to see whether there were any errors or omissions, ambiguity or any irrelevant or illegible response, after which they were serialised for ease of reference. Uniform categories of questionnaires were then identified, classified and entered into the recommended computer software, statistical package for social science (SPSS) for analysis. Descriptive statistics such as percentages, frequencies and cross tabulations were used where necessary to analyse the data. The research findings were presented using frequency tables, percentages, pie charts and bar graphs.
CHAPTER FOUR
DATA PRESENTATION AND ANALYSIS

4.1: Introduction

This chapter presents the findings of the study. The research was conducted to examine the factors that influence diversification of income generating activities in commercial banks in Kenya. A study was conducted on a sample of 46 commercial banks operating in Kenya. Data was obtained from structured questionnaires administered to a sample size of 90 respondents. Out of this, 60 questionnaires were successfully filled and returned. This placed the response rate at 66.6%. The chapter is structured into sections namely: name of department where respondents work, banking services offered, banking risks, level of industry competition, changes in technology and a summary of how, overall, the variables investigated affect diversification of income generating activities in commercial banks.

The data has been analyzed corresponding to the specific objectives of the study. Analysis was done using statistical package for social sciences (SPSS) and chi square whereby banks were categorized according to their respective tier and the effects of each of the tiers to the dependent variable analyzed. Each variable is analyzed separately in order to bring out the extent to which each of them affects the independent variables (diversification of income generating activities) i.e. banking services offered, banking risks, level of industry competition and changes in technology.

Data is presented through pie charts, graphs and qualitative description using tables that are categorized and summarized according to common themes. Statistical analysis was conducted in two steps. First, a preliminary discriminate analysis was carried out to discover which factors contribute most to diversification of income generating activities. The factors were later ranked according to their importance. Second, further insights into discriminating factors of the same were comparatively analyzed using chi square.
4.2: Name of department

When respondents were asked to indicate the departments where they worked, 12 indicated that they worked in Product Development, Sales and Marketing and Corporate Planning departments had 10 each; Finance had 8, ICT had 9, while 11 respondents worked at Risk and Compliance department.

Table 4.2: Responses on departments where the respondents work

<table>
<thead>
<tr>
<th>Department</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product development</td>
<td>12</td>
<td>20</td>
</tr>
<tr>
<td>Sales and Marketing</td>
<td>10</td>
<td>16.7</td>
</tr>
<tr>
<td>Finance</td>
<td>8</td>
<td>13.3</td>
</tr>
<tr>
<td>ICT</td>
<td>9</td>
<td>15</td>
</tr>
<tr>
<td>Corporate Planning</td>
<td>10</td>
<td>16.7</td>
</tr>
<tr>
<td>Risk and Compliance</td>
<td>11</td>
<td>18.3</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.3: Banking services offered

The variables tested under this section included the effects corporate strategy, customer needs and customer feedback on determination of diversification of income generating activities in commercial banks in Kenya. The findings have been analysed below.

4.3.1: Extent to which customer needs have been changing

The respondents were asked to state to what extent the customers needs have changed; 2 respondents said to a very low extent, 3 said low extent, 9 said average extent, 28 said great extent, 18 said very great extent.
4.3.2: Turn around time on service delivery

Respondents were asked to what extent turnaround time on service delivery influences the income generation activities that they offer. 40% said great extent, 30% said very great extent, 20% said average extent, 10% said low extent. There were no responses on very low extent.

Fig 4.3.2: Turnaround time on service delivery
4.3.3: Convenience

Respondents were asked to what extent convenience influences the income generation activities that they offer. Out of the 60 respondents, 24 indicated to a very great extent, 26 to a great extent, 8 indicated an average extent and 2 indicated a low extent. There were no respondents on very low extent.

Table 4.3.3: Influence of convenience on service delivery

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low extent</td>
<td>2</td>
<td>3.3</td>
</tr>
<tr>
<td>Average extent</td>
<td>8</td>
<td>13.3</td>
</tr>
<tr>
<td>Great extent</td>
<td>26</td>
<td>43.3</td>
</tr>
<tr>
<td>Very great extent</td>
<td>24</td>
<td>40</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.3.4: Information gathered from the market

Respondents were asked to what extent information gathered from market influences the income generation activities that they offer. Of the responses received, 44% indicated great extent, 40% indicated very great extent, 13% average extent, while 3% indicated low extent.

Fig 4.3.4: Information gathered from the market
4.3.5: Customer feedback/Complaints
When respondents were asked to indicate the extent to which customer feedback/complaints influence the income generation activities that they offer, 30% indicated very great extent, 33% indicated great extent, 34% said average extent, while 3% said low extent.

Fig 4.3.5: Customer feedback/complaints

<table>
<thead>
<tr>
<th>Extent</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low extent</td>
<td>3%</td>
</tr>
<tr>
<td>Average extent</td>
<td>33%</td>
</tr>
<tr>
<td>Great extent</td>
<td>34%</td>
</tr>
<tr>
<td>Very great extent</td>
<td>30%</td>
</tr>
</tbody>
</table>

4.3.6: Company driven initiatives
Respondents were asked to what extent company driven initiative/strategy influence the income generation activities that they offer. 25 (41.7%) respondents indicated to a great extent, 15 (25%) average extent, 15 (25%) very great extent, 3 (5%) indicated low extent, while 2 (3.3%) indicated very low extent.
4.4: Banking Risks

In this section, the study attempted to establish role of risk in diversification of income generating activities in commercial banks in Kenya. The study sought data on strategic risks, reputational risks, compliance risks, operational risks, risks due to changes in customer desires, competition risk, credit risk and systems/technology risks.

4.4.1: Strategic risks

Respondents were asked to what extent strategic risks affect diversification decisions. 50% indicated to a very great extent, 46.7% a great extent, and 3.3% an average extent.

Table 4.4.1: Strategic risks

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average extent</td>
<td>2</td>
<td>3.3</td>
</tr>
<tr>
<td>Great extent</td>
<td>28</td>
<td>46.7</td>
</tr>
<tr>
<td>Very great extent</td>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>
4.4.2: Reputation risk

Respondents were asked to what extent does reputation risks affect diversification decisions; 42 (70%) indicated a very great extent, 15 (25%) indicated a great extent, 3 (5%) indicated an average extent.

Fig 4.4.2: Reputational risk

![Bar chart showing frequency of responses to the extent of reputation risk.]

4.4.3: Compliance risk

Respondents were asked to what extent compliance risk affects diversification decisions. 36% indicated a great extent, 33% average extent, 17% very great extent, while 7% indicated very low extent, as was the case in the low extent category.

Fig 4.4.3: Compliance risk

![Pie chart showing percentage of responses to the extent of compliance risk.]

34
4.4.4: Operational risk

When respondents were asked to indicate the extent to which operational risk affects income generating activities, 18 respondents indicated to a very great extent, 24 a great extent, 12 an average extent and 6 a low extent no respondent indicated a very low extent. There were no respondents on the very low extent.

Table 4.4.4: Operational risk

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low extent</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Average extent</td>
<td>12</td>
<td>20</td>
</tr>
<tr>
<td>Great extent</td>
<td>24</td>
<td>40</td>
</tr>
<tr>
<td>Very great extent</td>
<td>18</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.4.5: Risk of change in customer desires

Respondents were asked to what extent does change in customer desire risks affect diversification decisions, 13% indicated to an average extent, 44% a great extent, 40% a very great extent while 3% indicated a low extent. There were no responses on very low extent.

Fig 4.4.5: Risk of change in customer desires
4.4.5: Competition risk
Respondents were asked to what extent does competition risks affect diversification decisions. 47% said very great extent, 40% said great extent, 13% said average extent.

Fig 4.4.6: Competition risk

4.4.7: Credit risk
Respondents were asked to what extent credit risks affect diversification decisions; 70% said very great extent, 26.7% said great extent, while 3.3% said average extent. There were no responses on low extent and very low extent.

Table 4.4.7: Credit risk

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average extent</td>
<td>2</td>
<td>3.3</td>
</tr>
<tr>
<td>Great extent</td>
<td>16</td>
<td>26.7</td>
</tr>
<tr>
<td>Very great extent</td>
<td>42</td>
<td>70</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.4.8: System/technology risk
Respondents were asked to what extent do systems (technology) in use affect diversification decisions. 26 (43.3%) said great extent, 18 (30%) said to an average
extent, 8 (13.3%) said very great extent, 4 (6.7%) said low extent while 4 (6.7%) said very low extent.

**Fig 4.4.8: System/technology risk**

![System/technology risk bar chart]

<table>
<thead>
<tr>
<th>Extent</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low extent</td>
<td>8</td>
</tr>
<tr>
<td>Low extent</td>
<td>4</td>
</tr>
<tr>
<td>Average extent</td>
<td>13</td>
</tr>
<tr>
<td>Great extent</td>
<td>44</td>
</tr>
<tr>
<td>Very great extent</td>
<td>4</td>
</tr>
</tbody>
</table>

**4.4.9: Extent to which risks identified affect diversification decisions**

Respondents were asked to what Extent to which risk identified affect respondents decision to diversify income generating activities 44% said great extent, 40% said very great extent, 13% said average and 3% said low extent; there were no respondents on very low extent.

**Fig 4.4.9: Extent to which risks affect diversification decisions**

![Extent to which risks affect diversification decisions pie chart]
4.4.10: If diversification is considered as a way of spreading risk
Respondents were asked to whether their institution had considered diversification of income; 77% (46 respondents) said yes while 23% (14 respondents) said no.

Fig 4.4.10: Consideration of diversification as a form of spreading risk

4.5: Level of Industry Competition
This section investigated the role of competition in diversification decisions in commercial banks. Also examined was the possible impact of location, size of organisation, personnel and brand name on diversification of income generating activities decisions.

4.5.1: How competition affects decisions on income generation in banks
Respondents were asked the extent to which competition affects decisions that banks make in income generating activities. 16 respondents said very great extent, 20 said great, 20 average extent and 4 said low extent. There were no respondents on very low extent.
4.5.2: Location (urban/ rural)

Respondents were asked the extent to which Location (urban/ rural) affects banks decisions to diversify into other income generating activities. 28 said very great extent, 24 said great, 8 said average extent, 3 said low extent. There were no respondents on very low extent.

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average extent</td>
<td>8</td>
<td>13.3</td>
</tr>
<tr>
<td>Great extent</td>
<td>24</td>
<td>40</td>
</tr>
<tr>
<td>Very great extent</td>
<td>28</td>
<td>46.7</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.5.3: Size of organization

When the respondents were asked to indicate the extent to which size of the organization affects decision to diversify into other income generating activities, 27 respondents indicated to a great extent, 16 a very great extent, another 16, average extent, 2 respondents indicated to a low extent and there were no responses on the very low extent category.
4.5.4: Personnel

Respondents were also asked to indicate the extent to which personnel affects their decision to diversify into other income generating activities. 50% indicated to a very great extent, 47% indicated to a great extent, and 3% to an average extent.

Fig 4.5.4: How personnel affects diversification of income generating activities
4.5.5: Brand name

Respondents were also asked to indicate the extent to which the brand name affects their decision to diversify into other income generating activities, seventy percent indicated to a very great extent, 26.7% indicated to a great extent, and 3.3% to an average extent. There were no respondents who indicated low extent and very low extent.

Table 4.5.5: Whether a brand name affects diversification

<table>
<thead>
<tr>
<th>Extent</th>
<th>Number of Respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average extent</td>
<td>2</td>
<td>3.3</td>
</tr>
<tr>
<td>Great extent</td>
<td>16</td>
<td>26.7</td>
</tr>
<tr>
<td>Very great extent</td>
<td>42</td>
<td>70</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

4.5.6: Whether products have been introduced because of competition

When respondents were asked to indicate whether there are circumstances whereby respondents have introduced products because of competition, 40 respondents indicated yes whereas 20 said no.

Fig 4.5.6: If products have been introduced due to competition
4.6: Changes in Technology
Here the study sought to establish whether technological advances have any impact on diversification. Factors assessed included if those involved in diversification of income generating activities had a say in the type of technological system adopted and whether system upgradation considered diversification capability.

4.6.1: Computer system in use
Respondents were also asked to indicate the extent to which computer system in use affects their decision to diversify into other income generating activities, 47% indicated to a very great extent, 43% indicated to a great extent, and 10% to an average extent.

Fig 4.6.1: Computer system in use

4.6.2: Whether consultation is done during system change:
The respondents were asked whether their departments give input to the kind of system they wanted. 21 said great extent, 18 said average extent, 8 said very great extent, 4 said low extent and another 4 said, very great extent.
4.6.3: If system update has helped diversification of income generating activities

The respondents were asked to indicate whether the updates of systems have supported the respondent requirement to diversify their income generating activities. 77% said yes, 23% said no.

Fig 4.6.3: Whether update of system has supported diversification
4.7: Summary of effect of variables investigated on diversification

4.7.1: Service delivery to customers

The respondents were asked how service delivery to customers influences their decisions to diversify and to what extent. 45% said very great extent, 39% said great extent, 13% said average extent, while 3% said low extent.

Fig 4.7.1: Service delivery to customers

4.7.2: Risk associated with diversification

The respondents were asked how risk with diversification influences their decisions to diversify and to what extent. 51% said great extent, 43% said very great extent, 3% said average, another 3% said low extent.
Fig 4.7.2: Risk associated with diversification

4.7.3: Level of competition

The respondents were asked how level of competition influences their decisions to diversify and to what extent. 40% said great extent, 30% said very great extent, 20% said average, 10% said low extent.

Fig 4.7.3: Level of competition
4.7.4: Technology in use

The respondents when asked how technology in use influences their decisions to diversify and to what extent. 33% said great extent, 30% said very great extent, 34% said average extent, while 3% said low extent.

Fig 4.7.4: Technology in use

4.8: Chi square between different tiers

Chi square is generally used to assess whether two or more samples each consisting of frequency data differ significantly from each other. The table below displays the chi square values, degree of freedom and level of significance of each tier. The chi square values of each tier are 12.75 for tier 1, 10.36 for tier 2 and 12.993 for tier 3. The degrees of freedom are 8, 10 and 14 for each tier. The significance levels are 0.001, 0.007 and 0.027.

There was a significant difference in observations of the different tiers on the tested variables i.e. service offer, banking risks, level of industrial competition and changes in technology as per the parsons chi square values in the table below. Whereas diversification in Tier I banks was determined more by risk, competition and service delivery, Tier II banks’ diversification was determined by all the variables considered, while Tier III banks diversification was determined more by service delivery factors.
Table 4.8: Results of Chi Square Tests

<table>
<thead>
<tr>
<th>Tier</th>
<th>Value</th>
<th>df</th>
<th>Asymp. Sig. (2-sided)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pearson Chi-Square</td>
<td>15.750^a</td>
<td>8</td>
<td>.001</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>15.504</td>
<td>8</td>
<td>.130</td>
</tr>
<tr>
<td>Linear-by-Linear Association</td>
<td>1.355</td>
<td>1</td>
<td>.244</td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pearson Chi-Square</td>
<td>10.386^b</td>
<td>10</td>
<td>.007</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>10.226</td>
<td>10</td>
<td>.421</td>
</tr>
<tr>
<td>Linear-by-Linear Association</td>
<td>2.020</td>
<td>1</td>
<td>.155</td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pearson Chi-Square</td>
<td>9.993^c</td>
<td>14</td>
<td>.027</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>9.911</td>
<td>14</td>
<td>.534</td>
</tr>
<tr>
<td>Linear-by-Linear Association</td>
<td>.159</td>
<td>1</td>
<td>.690</td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>35</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 15 cells (100.0%) have expected count less than 5. The minimum expected count is .17.

b. 18 cells (100.0%) have expected count less than 5. The minimum expected count is .15.

c. 24 cells (100.0%) have expected count less than 5. The minimum expected count is .03.

4.9: Chapter Summary

This section summarises the findings of the extent to which the variables tested determined diversification of income generation activities in commercial banks in Kenya.

4.9.1: Banking services offered

Respondents were asked to what extent customer feedback/complaints influence the income generation activities that they offer. 43% said great extent, 40% said low extent, 17% said average extent, 0% said very low extent respectively, when the respondents were asked to select to what extent the customers needs have changed 2 indicated a very low extent, 2 indicated low extent, 9 indicated average extent, 28 said great extent, 18 indicated very great extent on issues of customer back Respondents were asked to indicate the extent to which customer feedback/complaints influence the income generation activities that they offer, 43% indicated to a great extent,40% indicated a low extent,17% an average extent and no respondent indicated a very low extent respectively.
CHAPTER FIVE
DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1: Introduction
In this chapter, the findings are discussed; conclusions are made from which recommendations are submitted.

5.2: Summary
The general objective of the study was to examine the factors that determine income generating activities in commercial banks in Kenya. The specific objectives were: to establish how services offered by commercial banks influence diversification of income generating activities, to examine the role risk plays in diversification of income generation activities in commercial banks in Kenya, to determine the effects of competition on diversification of income generation activities in commercial banks in Kenya, and assess how technology affects diversification of income generation activities in commercial banks in Kenya.

The research was a study of the 46 commercial banks operating in Kenya. The population size constituted a total of 276 employees tasked with product research, development and market sustainability in the these banks. This population size was developed from six key sub-units of analysis in the three bank tiers which included product development, sales and marketing, finance, head of ICT departments, corporate planning, and risk and compliance departments. Questionnaires were administered to a sample size of 90 respondents obtained from 15 banks, Standard Chartered, Equity, Barclays of Kenya, Cooperative, NIC, Family, I&M, Bank of Africa, Fina, Eco Bank, Credit Bank, Development Bank, Equatorial Bank, Southern Credit and Transanational Bank which were selected randomly, five each from Tier I, Tier II & Tier III as categorised by CBK according to asset base (Appendix iii). The tiers were used as a basis for stratification in order to facilitate a cross-sectional generalization of the findings.

The collected data was analysed using the Statistical Package for the Social Sciences (SPSS). Descriptive statistics used was for frequencies. The data was then presented in the form of tables, charts and graphs. The analyzed data was used for the findings, discussions and ultimately to draw conclusions and various recommendations on the study.
5.3: Discussion and Conclusions

The findings in the previous chapter are discussed according to the specific objectives below:

5.3.1: Role of service offer on diversification of income generating activities

Majority of the respondents observed that customer needs have been changing, and affirmed that turn around time for service delivery and convenience to customers determine very great extents the income generating activities that banks diversify into. For banking institutions worldwide, today’s business climate is increasingly complex and technology driven. To achieve success in this competitive environment, it is crucial to develop customer oriented business strategy aimed at reducing operational costs and maximising profitability. The current move in banks is to increase products per customer, hence the focus on customers as they diversify. Besides, CBK is keen on the treatment customers are experiencing in banks and have been in the forefront pushing for more and more customers to have access to bank products.

5.3.2: Effect of risk in diversification of income generation activities

Findings on the extent to which strategic risk, reputation risk, compliance risk, operational risk and a change in customers desires affect diversification of income generating activities indicated that a majority of the respondents were of the opinion that such risks greatly determine bank’s decisions on diversification of their income generating activities. While risks to do with failure to comply with statutory obligations can attract severe penalties from the regulators, other forms of risks such as reputation, strategic and operation can lead to either loss of customers or revenues, hence the emphasis by banks on addressing risk issues before diversification. On the other hand Allen et al., (1998) argue that diversification enhances bank’s central role in risk management. Further, that diversification facilitates the redistribution of risk across market participants and thereby reduces risk associated with financial transactions. Majority of respondents from Tier 1 banks also affirmed to this finding.

5.3.3: Competition and diversification of income generation activities

Competition was considered as key by a majority of the respondents as determining diversification of income generating activities in commercial banks in Kenya. Indeed
competition has created a fast paced industry where firms must change in order to survive. According to Barth et al., (2004), nowhere is this force of change felt more strongly than in the financial sector. Once the sole domain of the bank, mutual funds, brokerage firms and other non bank competitors have continued to enter these markets due to deregulation. As a result, banks face fierce competition from non bank companies and other banks that enter their territory. With increased pressure, banks have a greater incentive to exploit new products. All the major banks in Kenya, especially the leading Tier I banks, are involved in branch expansion with the aim of getting more retail customers, leading to an almost homogeneous product offer by these banks.

5.3.4: The role of technology on diversification of income generation activities

Majority of respondents considered technology in use as determining to a large extent their endeavours to diversify income generating activities. A study of the banking sector in India carried out by Arora et al., (2009), between 2000 to 2007, concluded that risk reduction, cost of production, regulatory control and technological change were instrumental in bringing variations in the structure of income of the banks. Ennis (2001), researching on changes on assets for commercial banks in the U S, from 1993-2003, offered a possible explanation as including the fact that the 1990’s was a period of continuous innovation in the banking industry, including ATM technology.

The respondents also indicated that when system upgrades are carried out, their input is sought and this has helped in the diversification. With system upgrades by a majority of the Kenyan banks, mobile banking and internet banking are now taking root and this could improve service in the long run as customers will no longer need to visit branches for services.

Although all respondents indicated that banks are putting emphasis on technology, the extent differs from one tier to another. Tier I banks have their systems inclined towards serving many clients as they deal with retail customers among other segments. Tier III banks on the other hand have embraced technology which serves their few clients but who have specific needs. Overall use of technology in banks has enabled a majority of banks to offer mobile banking, internet banking and money transfer services, besides bringing down the cost of such services.
5.4: Conclusion

Although the study revealed that all the variables considered: service offered, risk, competition and technology, do determine diversification of income generating activities in commercial banks in Kenya as indicated by the respondents, the following conclusions, were made following chi square test values that indicated that there exist statistical differences in the inter tier variables. There was a significant difference in observations of the different tiers on the tested variables i.e. service offer, banking risks, level of industrial competition and changes in technology as per the parsons chi square values. This is an indication that commercial banks are focused on deepening their relationship with customers and therefore there could be a move towards segment targeting in diversification of income generating activities. This also shows that banks in the three tiers have different emphasis on the segments they deal with. Whereas diversification in Tier I banks was determined more by risk, competition and service delivery, Tier II banks’ diversification was determined by all the variables considered, while Tier III banks diversification was determined more by service delivery factors. The conclusions correspond to the specific objectives of the study as discussed below:

5.4.1: How services offer influences diversification of income generating activities

Whereas the responses received indicated that the majority of the respondents considered service offered as determining diversification, this was not the case with the majority of the Tier III banks. This is because Tier III banks are specialised to serve certain clients, who in some cases are shareholders in these banks, hence service offer would not determine diversification of the income activities to a great extent.

5.4.2: Role of risk in diversification of income generation activities

Although majority of Tier I respondents considered the need to spread risk as a reason for diversification, majority of Tier III respondents did not consider spreading risk as important in making diversification of income generating activities decisions. There is however, need for such banks to address concentration risks by diversifying as failure to do so can adversely affect their operations in case the segment they have specialised in, for example farming or manufacturing, is affected by extraneous factors.
5.4.3: Effects of competition on diversification of income generation activities

Both Tier I and Tier II banks recognised competition as a determinant to the income diversification activities they would undertake. However, the majority of Tier III banks which have specialised segments in the market did not consider competition as determining their diversification decisions to a great extent. A bank like Equity with so many accolades due to taking up most customers in all sectors of the economy (retail, corporate, farming, mortgage, microfinance, small and micro enterprises, asset financing and brokerage services), appears to be downsizing due to inability to cope, hence the need to specialise. Thus with all the competition in the Tier I and Tier II banks, perhaps its time they also considered segmentation as this will enable them to effectively diversify into specific areas where there is less competition and where they can have a competitive edge.

5.4.4: How technology affects diversification of income generation activities

Although all respondents indicated that all banks are putting emphasis on technology, its mostly Tier I and Tier III banks who have embraced technology. Tier I banks have adopted technology which has enhanced their capacity to serve many clients, while tier III banks have their technology aligned to their clients specifications; such technology has enabled a majority of banks to offer mobile banking internet banking and money transfer services, hence bringing down the cost of such services.

5.5: Recommendations

In respect to the conclusions made in the study it is quite evident that service, competition, risk and technology play a major role in income diversification decisions in commercial banks in Kenya. Therefore the researcher made the following recommendations:

5.5.1: Recommendation on Service

The big banks today in Kenya are de-skilling their branches and converting staff from bankers into sales people. As these sales people bring in clients, maintaining them will require that the services they get are to their expectations. The researcher therefore
recommends that any diversification into other income generation activities should take into consideration how such activities will be delivered to the customers to ensure that they remain loyal to the banks.

5.5.2: Recommendation on Risks
Banking business is a sensitive business, which can be induced with maximum risk from operations, people, processes, systems, credit, market and even reputation, among others. Further, banks are always with the temptation to take big risks, as returns from such risks will usually be outstanding if successful, yet devastating if unsuccessful. The researcher recommends that risks in the process of diversification of income generation activities should be identified, assessed and mitigated.

5.5.3: Recommendation on Competition
The Kenyan banking industry has experienced increased competition over the last few years resulting from increased innovations among the players and new entrants into the market. It is the researcher’s recommendation that any diversification of income generation activity considers the level of competition in terms of ability to attract customers for a new income generation activity.

5.5.4: Recommendation on Technology
Technology has given banks enormous advantages in terms of quick access to information and ability to process data much faster. The ability to make decisions promptly has therefore been improved. Further, technology has simplified processes such as money transfers which appeared complex. And even the cost of processing transactions has reduced. The researcher recommends that banks should embrace technology that will enhance diversification of income generation activities.

5.5.5: Recommendation on Customer Segmentation focus
The role played by factors such as service, risk, competition and technology in diversification of income generating activities in banks cannot be overemphasised. However, the extent of application of such factors is greatly influenced by other intervening variables like the customer segmentation focus of the banks. A majority of banks have particular clientele to whom any shift in income generation activity lean towards. For instance Cooperative bank has more of Cooperatives, NIC is well known in
the circles of asset financing. CFC Stanbic has embraced more of the large scale
horticultural farmers, Fina Bank has inclined itself to the small and medium enterprises.
Citibank is a house hold name for the multinational corporates while K-Rep deals more
with the low income earners in the informal sector. The researcher recommends that
while diversifying into other income generation activities, the particular segment of focus
of the bank should be considered.

5.6: Recommendations for Further Research

First, further research should be carried on other financial institutions and mortgage
companies, other than commercial banks, to ascertain the factors that influence
diversification of income generating activities as they deal with similar clients.
Second, confirmations research should be done on the same subject, but in different banks
from those studied in this report, to ascertain the influence of diversification of income
generating activities in commercial banks in Kenya.
Third, much as banks have indeed embraced diversification of income generating
activities, Central Bank of Kenya could carry out further research to ascertain the extent
to which such diversification is improving the banks revenues and at what cost, to ensure
that such costs, if any, are not passed to the customers.
The finding that there exists statistical differences on how much the factors studied affect
decisions on income generating activities in all the tiers points to segment specialisation
and relationship deepening in the banking sector. More research therefore needs to be
done on segment focus and other intervening variables on how they influence decisions
on diversification of income generating activities.
REFERENCES


APPENDIX I
INTRODUCTION LETTER

Evans Nyangweso
Kenyatta University
P.O. Box 30003 - 00200
Nairobi

February 20, 2010

Dear Respondent,
I’m currently undertaking a research towards fulfilment of requirements for award of a Master of Business Administration degree, Kenyatta University. The research seeks to analyse the factors influencing diversification of income generation activities in commercial banks in Kenya. To achieve this objective, I have attached herewith a questionnaire that will assist to collect relevant data prior to deducing generalisations. Kindly complete the attached copy as accurately as possible. Any information given will strictly be confidential and used for academic purposes only.

Thank you for your co-operation.

Yours faithfully,

Evans Nyangweso
MBA Student- Kenyatta University
APPENDIX II
QUESTIONNAIRE

This questionnaire is divided into six sections with very brief questions which should take only a few moments of your time. Please place a tick (✓) or fill in your response in the blanks as and where appropriate.

1. Please indicate the department where you work within your organisation

2. To what extent do the following factors influence the income generation activities that you offer? (Where 1= Very low extent, 2= Low extent, 3= Average extent, 4= Great extent, 5= Very great extent)

<table>
<thead>
<tr>
<th>FACTOR</th>
<th>EXTENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnaround time for service delivery</td>
<td>1 2 3 4 5</td>
</tr>
<tr>
<td>Convenience</td>
<td></td>
</tr>
<tr>
<td>Information gathered from the markets</td>
<td></td>
</tr>
<tr>
<td>Customers feedback/complaints</td>
<td></td>
</tr>
<tr>
<td>Company driven initiative/strategy</td>
<td></td>
</tr>
</tbody>
</table>

3. What are some of the activities that you have diversified into in your endeavour to offer better service to your clients?

4. Do the following risks affect your diversification decisions? (Please tick appropriately)

<table>
<thead>
<tr>
<th>RISKS</th>
<th>Tick the risk that influences your income diversification decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic risks</td>
<td></td>
</tr>
<tr>
<td>Reputational risk</td>
<td></td>
</tr>
<tr>
<td>Compliance risk</td>
<td></td>
</tr>
<tr>
<td>Operational risk</td>
<td></td>
</tr>
<tr>
<td>Changes in customers desires</td>
<td></td>
</tr>
<tr>
<td>Competition</td>
<td></td>
</tr>
</tbody>
</table>
5. Are there any other risks that influence your decision to diversify your income generation activities?
   a) ..................................................................................................................
   b) ..................................................................................................................
   c) ..................................................................................................................
   d) ..................................................................................................................
   e) ..................................................................................................................

6. On a scale of 1-5, to what extent are the risks you have identified above affecting your decision to diversify your income generation activities?
   a) Very low extent [1]
   b) Low extent [2]
   c) Average extent [3]
   d) Great extent [4]
   e) Very great extent [5]


8. If yes, what are the income generation activities that you have diversified into?
   ..................................................................................................................
   ..................................................................................................................

9. How does competition in the banking sector affect decisions that you make in your organisation in terms of income generation activities? (Tick as appropriate)
   a) Very low extent [1]
   b) Low extent [2]
   c) Average extent [3]
   d) Great extent [4]
   e) Very great extent [5]
10. Please indicate how you consider the following situations as affecting your decisions to diversify into other income generation activities (Where 1= Very low extent, 2= Low extent, 3= Average extent 4= Great extent, 5= Very great extent)

<table>
<thead>
<tr>
<th>Situation</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location (Urban or rural)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of organisation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personnel</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Computer system in use</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brand name</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

11. Are there circumstances in which you have had to introduce products or other income generation activities because of competition? Yes [1] No [2]

12. If the answer to (12) is yes, mention these circumstances

13. What would you most likely do to overcome competitive threats and better position yourself for the future?

14. To what extent would the technology you use affect your ability to diversify income in your organisation?
   a) Very low extent [1]
   b) Low extent [2]
   c) Average extent [3]
   d) Great extent [4]
   e) Very great extent [5]

15. When was the current information technology system you are using updated?

16. Did you (or your department) give input on what kind of system you wanted?
17. If yes, has the update of technology system supported your requirements to diversify your income generation activities?

Yes [1]  No [2]

18. If yes, what are these activities you have diversified into?

19. How do you ensure success of the activities that you have diversified into?

a) ..............................................................

b) ..............................................................

c) ..............................................................

d) ..............................................................

20. a) Overall on a scale of 1 – 5, to what extent do the factors in the table below (discussed above) influence your decisions in diversification of income?, where

a) Very low extent [1]
b) Low extent [2]
c) Average extent [3]
d) Great extent [4]
e) Very great extent [5]

<table>
<thead>
<tr>
<th>Factors</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service delivery to customers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risks associated with diversification</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Level of competition in the banking industry</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technology in use</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

b). Other than the above factors, what else influences your decisions to diversify and to what extent?

<table>
<thead>
<tr>
<th>Factors</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
</table>
Thank you for your cooperation.
## APPENDIX III

### RANKING OF COMMERCIAL BANKS IN KENYA

<table>
<thead>
<tr>
<th>Bank Classification</th>
<th>Description</th>
<th>Commercial Banks</th>
</tr>
</thead>
</table>
| **Tier I**          | Comprises of banks with an asset base of more than Kes. 40 billion | 1. Citibank  
2. Equity Bank  
3. Standard Chartered Bank  
4. Commercial Bank of Africa  
5. Barclays Bank of Kenya  
6. NIC Bank  
7. Kenya Commercial Bank  
9. Diamond Trust Bank  
10. Co-operative Bank of Kenya  
11. CFC Stanbic Bank |
| **Tier II**         | Comprises of banks with an asset base of less than Kes. 40 billion but more than Kes. 10 billion | 1. I&M Bank  
2. Bank of India  
3. Bank of Baroda  
4. Family Bank  
5. Imperial Bank  
6. Prime Bank  
7. Bank of Africa  
8. Chase Bank  
9. Fina Bank  
10. EcoBank  
11. HFCK |
| **Tier III**        | Comprises of banks with an asset base of less than Kes. 10 billion | 1. Habib A.G. Zurich  
2. Victoria Commercial Bank  
3. Credit Bank  
4. Habib Bank (K) Ltd  
5. Oriental Commercial Bank  
6. K-Rep Bank  
7. ABC Bank  
8. Development Bank of Kenya  
9. Middle East Bank  
10. Equatorial Commercial Bank  
11. Trans-National Bank  
12. Dubai Bank  
13. Fidelity Commercial Bank  
14. City Finance Bank  
15. Paramount Universal Bank  
16. Giro Commercial Bank  
17. Consolidated Bank  
18. Guardian Bank  
19. Southern Credit Bank  
20. Gulf African Bank  
21. First Community Bank  
22. Eco Bank  
23. Chase Bank  
24. United Bank of Africa |

**Source:** The Banking Survey 2009
## APPENDIX IV
### WORK PLAN

<table>
<thead>
<tr>
<th>Period</th>
<th>MARCH 2010</th>
<th>APRIL 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Wk1</td>
<td>Wk2</td>
</tr>
<tr>
<td>Activity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pilot Testing</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Data Collection</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Data Editing</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Data Analysis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Report Writing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Submission</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## APPENDIX V
### THE BUDGET

<table>
<thead>
<tr>
<th>ITEM</th>
<th>COST(KSHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proposal Preparation</strong></td>
<td></td>
</tr>
<tr>
<td>1. Stationery</td>
<td>1500</td>
</tr>
<tr>
<td>2. Spiral binding</td>
<td>200</td>
</tr>
<tr>
<td>3. Miscellaneous</td>
<td>1000</td>
</tr>
<tr>
<td><strong>Sub total</strong></td>
<td>2700</td>
</tr>
<tr>
<td><strong>Data Collection/Analysis</strong></td>
<td></td>
</tr>
<tr>
<td>1. Stationery</td>
<td>1500</td>
</tr>
<tr>
<td>2. Incentives (during interviews)</td>
<td>2000</td>
</tr>
<tr>
<td>3. Allowance for research assistant</td>
<td>5000</td>
</tr>
<tr>
<td>4. Miscellaneous</td>
<td>1000</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>9500</td>
</tr>
<tr>
<td><strong>Final Report writing</strong></td>
<td></td>
</tr>
<tr>
<td>1. Stationery</td>
<td>1500</td>
</tr>
<tr>
<td>2. Binding</td>
<td>3000</td>
</tr>
<tr>
<td>3. Miscellaneous</td>
<td>2000</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>6500</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>18700</strong></td>
</tr>
</tbody>
</table>