EFFECTS OF REVENUE DIVERSIFICATION INTO NON-INTEREST INCOME ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

(A Case of Five Most Profitable Banks in Kenya)

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This Research Project is submitted in Partial Fulfilment of the Requirement for Award of Degree of Masters of Business Administration (Finance Option) of Kenyatta University

2013
DECLARATION

I declare that this research project is my original work and that it has not been presented in any other university or institution for academic credit.

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DEDICATION

This research project is dedicated to my family for accepting and understanding my absences while undertaking my research project. Despite all this, they gave me the moral support, cooperation and understanding I needed during this period.

For this I say thank you all and God bless.
ACKNOWLEDGEMENT

I wish to thank the almighty for giving me wisdom to conduct this study. I also appreciate my supervisors for their guidance in conducting the research and the management of Kenyatta University for their understanding and support.
ABSTRACT

The growth of non-intermediation income activities suggests intermediation activities are becoming less important part of banking business strategies and strategically, banks have shifted their sales mix by diversifying in income sources. Banks exist to inter-mediate the transactions between demanders and suppliers of money at a given consideration. Earnings from these transactions form banks traditional income generating activities. This study set out to determine the effect of foreign exchange trading, fees and commissions on loans and advances, government securities and sale and lease of assets owned by the banks on the five most profitable commercial banks financial performance. This research adopted an exploratory design where the population of interest was drawn from the five most profitable commercial banks in Kenya; KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank. The study focused on the head offices of these commercial banks and particularly on staff that are directly dealing with the day to day management of the banks as well as senior management (directors and general managers) since they are the ones conversant with the effects of income source diversification into non-interest income sources on financial performance of these commercial banks. Stratified random sampling was used to select the sample, taking a sample of 30% from each stratum. The study used both primary data and secondary data. The questionnaires included structured and unstructured questions and was administered through drop and pick method to respondents who were the top, middle and low level managers in the organizations. Data was analysed using descriptive statistics. The Likert scale was used to analyse the mean score and standard deviation, this helped in determining the extent to which the bank uses various income diversification strategies to influence its performance. The researcher further employed a Herfindahl–Hirschman Index to measures the degree of diversification in a bank’s net operating revenue. The researcher further employed regression model to study the relationship between the bank financial performance and income diversification into non interest incomes by banks. The study established that all the banks in the study had diversified into noninterest income. It was also established that fees and commissions, foreign exchange, sale and lease of assets owned by commercial banks and government securities influenced financial performance of commercial banks in Kenya.
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DEFINITION OF TERMS

Agency Banking: Business carried out by an agent on behalf of an institution as permitted under CBK guideline.

Government Securities: Securities issued by a government to raise the funds necessary to pay for its expenses.

Foreign Exchange: Form of exchange for the global decentralized trading of international currencies.
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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

It is generally believed that diversification by a firm reduces risk, just as diversification of investments by an individual does. In both cases, however, whether the desired risk reduction effect is achieved does of course depend on the correlation between the different activities or lines of business (in the case of the firms), and on the correlation between the prices of the different investments (in the case of the investing individual). Banks, like other firms, generally seek to reduce their risks by diversifying across various lines of business, although there is usually some degree of specialisation. Traditionally banks have been thought of as firms which take deposits and make loans, and profit by the difference between the costs of the former and the earnings from the latter activities (Stiroh 2004). Banks can differ markedly in their sources of income. Some focus on business lending, some on household lending, and some on fee-earning activities. Increasingly, however, most banks are diversifying into fee-earning activities. Such diversification is either justified (by the bank) or welcomed (by commentators), or both, as reducing the bank’s exposure to risk. Diversification across various sources of earnings is welcomed for, it is claimed that diversification reduces risk (Bosch and Kick, 2009).

According to Angbazo (1997), implementation of reforms in the banking sector, desired results in their performance started to be realised. Banking was perhaps one sector that was more deeply touched by the process of liberalization, globalization and privatization accompanying with technology advancements. Result of these reforms like liberalization, deregulation of interest rates and free entry of private and foreign banks have made the banking sector more competitive in the domestic as well as world market. To meet this competition banking sector was required to be re-oriented to be tune with the international norms and practices.

In order to meet the challenges of global competition, banks have started to restructure their business. The banking sectors reforms especially deregulation of interest rates have totally changed the income structure of the banking sector. The banks have started to enter in the financial market with almost daily innovative products/services to capture maximum market share and then earn maximum profits. The banks have started to diversify their bank activities
into fee-based activities (non-interest income) that earn fee rather interest. In fact, findings from USA studies show that in 1990s non-interest income grew rapidly to be a large part of banks operating profits. Non-interest income accounts for 43% of U.S.A commercial banks net operating income (Stiroh 2004).

Financial liberalization of early 1990s in Kenya opened the banking industry to a number of players leading to stiff competition and weakening of financial performance of a number of commercial banks leading to collapse of some. In response, commercial banks have changed their behaviour of income sources by diversifying as a possible way of improving performance.

1.1.1 Revenue Diversification

As noted by Bosch and Kick (2009), in recent years, deregulation and technological innovation has permitted almost all financial institutions to capture an increasing share of their income stream from non-interest sources. By engaging in these non interest sources, banks have been able to diversify their income source. Shaped by structural forces of change, banking in emerging markets has recently experienced a decline in its traditional activities, leading banks to diversify into new business strategies. Generally, it is believed that diversification of income sources should reduce total risk, as diversification should stabilize operating income if income streams are negatively or imperfectly correlated.

According to Stiroh (2004), diversification is usually associated with a change in the characteristics of the company's product line and/or market, in contrast to market penetration, market development, and product development, which represent other types of change in product-market structure. Stiroh notes that there are four basic growth alternatives open to a business. It can grow through increased market penetration, through market development, through product development, or through diversification. A company which accepts diversification as a part of its planned approach to growth undertakes the task of continually weighing and comparing the advantages of these four alternatives, selecting first one combination and then another, depending on the particular circumstances in long-range development planning (Shawn, 2002).
1.1.2 Banking Industry in Kenya

The Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK), governs the Banking industry in Kenya. The banking sector was liberalised in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance’s docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The CBK publishes information on Kenya’s commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks’ interests and addresses issues affecting its members (Kenya Bankers Association annual Report, 2008).

The industry consists of forty-three commercial banks, fifteen micro finance institutions and forty-eight foreign exchange bureaus in Kenya as at December 2011 (www.centralbank.go.ke). The evolution of the banking industry has presented both challenges and opportunities for commercial banking institutions. The Banks face an increasingly competitive environment, replete with threats from non-bank institutions operating under different kinds of regulation. Over the last several years, financial modernization, deregulation, industry consolidation, the rise of new institutions, shifting trends in borrowing and lending, globalization, explosive growth in information technologies has changed the way many individuals interact with their banks hence influencing and affecting how commercial banks operate.

1.1.3 Commercial Banks in Kenya

There are forty three commercial banks in Kenya as at October 2012(www.centralbank.go.ke). Thirty of the banks, most of which are small to medium sized, are locally owned and twelve are foreign owned. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks’ interests and addresses issues affecting member institutions (www.pwc.com).

Driven by competition brought about by globalization, information technology and managerial innovation, the banks have attempted to fit their operations and systems to a customer focused strategy. The banking sector has embraced changes occurring in Information Technology with most banks having already achieved branchless banking as a
result of the adoption of communications options. According to The Central Bank Annual
Supervision report (2003), the increased utilization of modern information and
communications technology has for example led to several banks acquiring Automatic Teller
Machines (ATMs) as part of their branchless development strategy measures. When the
changes are on a larger scale and involve many individuals and subunits such as the ones
encountered by banks, it is a challenge to manage change simultaneously across functional
and managerial levels.

The five most profitable banks in Kenya are as follows. Barclays bank top in the list of the
most profitable banks with pre-tax profits of 9.002 billion, followed by Standard Chartered
Bank at Ksh 6.726 billion, Kenya Commercial Bank with Ksh 6.426 billion. Equity and Co-
operative Banks with Ksh 5.57 billion and Ksh 3.727 billion respectively in the year 2009,
(CBK, 2010). The pretax profits for these banks in the financial year 2011 is as follows.
Kenya Commercial Bank (KCB) 15.1 billion (a 54% increase from the previous year), Equity
bank pre-tax profit Ksh 12.83 billion (42% increase from the previous year), Barclays bank
rose to Ksh 12.01 billion (11% increase from the previous year), Standard Chartered Ksh 8.3
billion (8.7% increase) and cooperative bank 6.3 billion (10% increase) (CBK, 2012).

1.2 Problem Statement
Research findings from developed (USA and Europe) markets on impact of revenue
diversification into non-interest income on banks financial performance differs greatly. While
it worsens risk-return trade-off in USA it increases risk return trade-off in Europeans banks.
Stiroh (2004), De Young and Rice (2004), Stiroh and Rumble (2006) indicate a worse risk-
return trade-off for U.S.A commercial banks venturing into income source diversification.
According to Stiroh, (2004), diversification benefits banks from shifting into non-interest
income in U.S.A, banks increases bank revenue and reduces volatility of bank profits.
Diversification worsens the risk- return trade-off for USA banks (Rumble and Stiroh,2006)
and earnings gained from diversification caused by growth in non-interest income is
outweighed by the volatility increases, resulting in a non-commensurate increase in stock
returns. The results obtained are thus conflicting. It is against this background that this study
seeks to establish whether banks revenue diversification into non-interest income has an
influence on bank financial performance.
Further, in Kenya, while vast research has been done to determine factors that affect financial performance of banks in Kenya, none has been done to determine the effect of non-interest income on banks' financial performance in Kenya. For example, Birya (2009) conducted a study to investigate the effect of privatization on financial performance of commercial banks listed at the NSE. The study established that the performance of these banks improved after privatization. Further, Auka (2006) conducted a study to determine factors influencing the practice of corporate social responsibility of financial institutions in Kenya. The study indicated that the financial institutions sampled were influenced by the need to be market leaders to participate in corporate citizenship.

While most previous work on bank diversification was dedicated to U.S. and European banks there are no studies that analyse the relationship between the changing structure of bank income and performance in Kenyan banking industry. To researcher knowledge, no study exists that explicitly analyses the effect of non-interest income activities on Kenyan banks. In order to contribute to this area of banking literature, the researcher analysed the effect of banks' non-interest activities on their financial performance, with a special emphasis on banks' interest margins. The study therefore seeks to investigate how foreign exchange trading income, commissions and brokerage, government securities and sale and lease of assets owned by the banks affects financial performance of banks in Kenya.

1.3 Objectives of the study
The study aimed at establishing the effects of revenue diversification into non-interest income on financial performance of commercial banks in Kenya.

1.3.1 Specific Objectives
The study was guided by the following specific objectives.

i. To investigate how foreign exchange trading income affects financial performance of commercial banks in Kenya

ii. To determine the extent to which fees and commissions on loans and advances affects financial performance of commercial banks in Kenya

iii. To assess how government securities affects financial performance of commercial banks in Kenya
iv. To determine the effect of sale and lease of assets owned by the banks on financial performance of commercial banks in Kenya

1.3.2 Research Hypothesis

H1: Commercial banks in Kenya have diversified into non-interest source of income.

H2: Diversification into non-interest source of income improves financial performance of commercial banks.

1.4 Significance of the study

The study is important not only to the management of cited commercial banks (KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank) but all the commercial banks in Kenya as it would provide an insight on the diversifications into non interest income that can be made to improve the performance of the organisation. The results of this study would provide information to policymakers and other stakeholders in the financial sector (especially the banks) as they do analysis of banks performance in order to set guidelines to be followed by banks wishing to diversify into non-interest income. It is also believed that the study would make recommendations that are of importance to banks relating to diversification strategies into non-interest income.

The research results would also be important to scholars and researchers as it would add to the existing pool of knowledge. Further, this study is also significant in that, academically it would add to the existing knowledge on income diversification strategies that can be used to maintain and improve organisation financial performance thus forming part of academic reference.

1.5 Scope of the study

The study targeted employees in the headquarters of the five most profitable commercial banks in Kenya banks (KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank) who are in top, middle and lower level management. Therefore, the data was collected from these employees who are considered to be knowledgeable on the subject matter. These are considered as major respondents of the study since they were the target group of this study. The study was determined to collect data from the respondents with a goal of investigating the effects diversification into non-interest incomes on financial performance of commercial banks in Kenya.
1.6 Limitations of the study

The study was limited to an analysis of effects diversification into non-interest income on financial performance of commercial banks in Kenya. The study was limited to KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank targeting the headquarters. Further, the study was limited to 12 weeks, within this period the researcher did the proposal, data collection and analysis for final compilation of project report.

1.7 Assumptions of the study

In the study, it was assumed that the respondents would cooperative enough to give the required information. This assumption disregarded the fact that most of them usually have busy schedules and time to fill the questionnaire might be regarded as wasted. The researcher also assumed that selected respondents would be willing to give information as sought by the study. The researcher assumed that there would be adequacy of resources intended to facilitate data collection, and that the information collected would be a representation of the whole for inference. Finally, the researcher also assumed that the data collected from the respondents would be credible and reliable to be analysed.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction
This chapter presents a review of related literature on the subject under study presented by various researchers, scholars, analyst and authors. The research has drawn materials from several sources which are closely related to the theme and the objectives of the study.

2.2 Financial Performances
Financial performance is described by La Porta et al, (2002) as the level of performance of a business over a specified period of time, expressed in terms of overall profits and losses during that time. It is therefore measuring the results of a firm's policies and operations in monetary terms. Profit making is the fundamental dimension for an enterprise to sustain, perform and grow to maximize wealth. Social responsibility is the fundamental accountability of the state that focuses on social enlistment in its totality (La Porta et al, 2002). The performance of a company is the result of its overall strategy, innovation, quality, market position and long term view. Hence organizations are constantly seeking new and improved products, processes, and organizational structures that will reduce their costs of production, better satisfaction of the customer demands, and greater profits. Finance is the life blood of any organization; improvements in the financial sector will have positive direct ramifications throughout the economy. The capability of a firm to create and sustain organizational wealth depends on the competitive effectiveness of its value chain that in turn, is determined by the firm’s relationships with clients, shareholders, employees and other stakeholders (Kotter and Heskett, 1999). Therefore, financial performance of an organisation is of utmost importance in determining it success

According to Helen and Keasey (1999), periodic measurement of firm performance is conducted for several reasons: it helps investors to formulate their expectations concerning the future earning potential of firms; it supplies a plausible feedback on how well the company has achieved its goals; it furnishes the basis of an adequate bonus plan that gives incentives to achieve the firm’s goals and rewards the results of proper decisions.

Financial performances measurements have been described by many authors. Stewart (1991) did a review of the main value-based measures: the economic value added (EVA) the cash flow return on investment (CFROI) and the shareholder value approach (SVA) described by
Alfred Rappaport (1986). It has been said that you must measure what you expect to manage and accomplish to create a reference to work with. One way of establishing references and managing the financial affairs of an organization is to use ratios. Ratios are simply relationships between two financial balances or financial calculations. These relationships establish references to understand financial performance. The main application of these ratios is return on equity, liquidity ratios, asset management ratios, profitability ratios, leverage ratios and market value ratios.

By using this monetary link it has been possible to decide whether investment could be justified, a product was made obsolete, or return on capital was acceptable. In fairness financial performance measurement is historically a recording system which is now being used more often to support competitive improvement and guide investment. This study seeks to investigate effects of revenue diversification into non-interest income on financial performance of commercial banks in Kenya. It is therefore going to investigate how diversification into foreign exchange trading, fees and commissions on loans and advances, government securities and sale and lease of assets owned by the banks influences banks financial performance.

2.3 Revenue Diversification and Performance

Empirical literature on financial firms has produced mixed evidence as to whether and how increased diversification affects performance. In an early survey, Saunders and Walters (1994) review 18 studies that examine whether non-bank activities reduce bank holding company (BHC) risk and indicate no consensus: 9 answer yes, 6 answer no, and 3 are mixed. These, and more recent studies, approach the risk question from a variety of perspectives: creation of synthetic or counterfactual mergers of banks with non-banks, analysis of actual operating results, and analysis of market reactions to diversification.

The most relevant comparisons for this study are the papers that examine the actual performance of banks with varying degrees of concentration and diversification. The general conclusion is that bank expansion into less traditional financial activities is associated with increased risk and lower returns. DeYoung and Roland (2001) found that a shift toward fee-based activities is associated with increased revenue volatility and a higher degree of total leverage, both of which imply greater earnings volatility for commercial banks. Stiroh (2004b) concludes that a greater reliance on non-interest income, particularly trading
revenue, is associated with higher risk and lower risk-adjusted profits across commercial banks. A study of loan portfolio diversity by Acharya et al. (2002) reports that diversification of loans does not typically improve performance or reduce risk in Italian banks. Morgan and Samolyk (2003) examine geographic diversification and find similarly negative results: diversification is not associated with greater returns (ROE or ROA) or reduced risk. Finally, Stiroh (2005) shows that increased exposure to non-interest income increases the volatility of equity market returns, but not the mean.

A few studies find some potential for gains from expansion into specific activities. Templeton and Severiens (1992) examine 54 bank holding companies from 1979 to 1986 and find that diversification (as measured by the share of market value not attributed to bank assets) is associated with lower variance of shareholder returns. Kwan (1998) examines the returns of banks. Section 20 subsidiaries and their commercial bank affiliates and finds that Section 20 subsidiaries are typically more risky and not necessarily more profitable than their commercial bank affiliates. Nonetheless, Kwan concludes that some diversification benefits may exist for commercial banks because of the low return correlation between securities and bank subsidiaries. Cornett et al. (2002) also report that evidence of gains from Section 20 subsidiaries as the industry-adjusted operating cash flow return on assets rises, while risks do not change significantly.

2.4 Theoretical Orientation

2.4.1 Resource-Based View Theory

The theoretical perspective that has come to be known as the resource-based view of the firm suggests that sustainable competitive advantage often originates inside the firm, and that strategy at the firm level is therefore driven by firm-specific resources and capabilities. The resource-based view of the firm suggests that diversification arises as firms attempt to leverage non-tradable firm-specific resources, among them human resources. Studies of diversification have long been a mainstay of economics as well as strategic management research (Hoskisson and Hitt, 1990).

Resource-based view theory generally assumes that firms are organized with a single product focus and face a homogeneous factor market. Based on those assumptions, a market power view (Edwards, 1955) of diversification emphasizes the benefits a firm may reap at the
expense of its competitors and customers. More skeptical views offered by agency theorists emphasize the benefits that diversification offers to firm managers themselves, often at the expense of its shareholders.

The effectiveness of firm strategies depends on the utilization and exploitation of existing resources. To the extent that firms have pools of underused resources, these create unique, firm-specific opportunities for exploitation (Montgomery, 1994). Diversification is one such strategy for exploiting existing firm-specific resources: firm diversification can be understood as a process through which managers first identify resources that are unique to their firm, and then decide in which markets those resources can earn the highest rents. Some firm resources are 'indivisible' and therefore 'sticky', and, particularly if they are intangible, difficult or impossible to trade in the market.

2.4.2 Financial Intermediation Theory
Financial intermediation is a process which involves surplus units depositing funds with financial institutions who then lend to deficit units. Stiroh (2004) identify that financial intermediaries can be distinguished by four criteria: first their main categories of liabilities (deposits) are specified for a fixed sum which is not related to the performance of a portfolio. Second the deposits are typically short-term and of a much shorter term than their assets. Third a high proportion of their liabilities are chequeable (can be withdrawn on demand). And fourth their liabilities and assets are largely not transferable. The most important contribution of intermediaries is a steady flow of funds from surplus to deficit units.

According to Scholtens and van Wensveen (2003), the role of the financial intermediary is essentially seen as that of creating specialized financial commodities. These are created whenever an intermediary finds that it can sell them for prices which are expected to cover all costs of their production, both direct costs and opportunity costs. Financial intermediaries exist due to market imperfections. As such, in a 'perfect' market situation, with no transaction or information costs, financial intermediaries would not exist. Numerous markets are characterized by informational differences between buyers and sellers. In financial markets, information asymmetries are particularly pronounced. Borrowers typically know their collateral, industriousness, and moral integrity better than do lenders. On the other hand, entrepreneurs possess inside information about their own projects for which they seek
financing. Moral hazard hampers the transfer of information between market participants, which is an important factor for projects of good quality to be financed.

2.4.3 Uncovered Interest Parity Theory
While the purchasing power parity condition applies to the cross border pricing of goods and services, uncovered interest rate parity theory looks into the cross border pricing of financial investments. According to Reid and Joshua (2004), this theory states that, lacking frictions in financial markets, the price of otherwise risk less financial investments or the rate of return received on them, should be identical across borders. The frictions present in the international financial markets are slightly different from those in goods markets. While there are likely to be few frictions in the form of costs to transferring capital across borders, markets for investment capital still include the frictions, causing the imperfect capital mobility such as multiple currencies. Uncovered interest parity requires that overseas returns be expected to equal domestic returns when converted at spot exchange rates. The theory established that in international financial markets, when looking at the domestic currency return on an investment that pays interest in a foreign currency, exchange rate changes must be added to the own currency return.

2.4.4 Theoretical Framework

<table>
<thead>
<tr>
<th>Theories</th>
<th>Dependent Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resource-Based View Theory</td>
<td></td>
</tr>
<tr>
<td>Financial Intermediation Theory</td>
<td></td>
</tr>
<tr>
<td>Uncovered Interest Parity Theory</td>
<td></td>
</tr>
</tbody>
</table>

Financial performance

Figure 2.1: Theoretical framework

2.5 Empirical Review
Generally, it is believed that diversification of income sources should reduce total risk, as diversification should stabilize operating income if income streams are negatively or imperfectly correlated. While this argument is clear from a traditional point of view, DeYoung and Roland (2001) provide three reasons why non-interest income may increase volatility. First, revenues from fee-based activities might be more volatile than interest income because the customer-bank relationship is stronger in the traditional lending business,
i.e. for many of the new fee-based activities it is easier for customers to switch to another bank. Second, expanding into fee-based services can considerably increase fixed costs (e.g. by investments in technology and human resources) whereas, if a lending relationship is already established, the only cost of an additional loan are the bank’s interest expenses. Third, in contrast to the lending business, fee-based activities require less regulatory capital, which suggests a higher degree of financial leverage and therefore leads to a higher earnings volatility. Indeed, DeYoung and Roland (2001) and Stiroh (2004a) find empirical evidence that reliance on non-interest activities increases the volatility of large U.S. banks.

Stiroh (2004a) analyzes the potential benefit of income diversification for U.S. banks. Since the growth of net interest and net non-interest income in the period 1984-2001 is increasingly correlated, he concludes that the diversification benefits decreased during the period in question. Furthermore, he shows that at the bank level risk-adjusted returns are negatively associated with non-interest income shares. De Young and Rice (2004) suggest that there are differences between the European and the U.S. banking sector. They argue that universal banking has been the historic norm in many European banking systems, possibly based on experience as European banks are better informed as to how to exploit the diversification benefit of fee-based activities. Smith et al. (2003) likewise empirically confirm that European banks are able to seek diversification benefits through combining interest and non-interest income activities. In the case of European banks, the authors find that non-interest income is indeed more volatile than interest income but, in contrast to U.S. studies, there are negative correlations between these two income streams. Hence, they conclude that non-interest activities potentially stabilize bank earnings, a result that is also confirmed by Davis and Tuori (2000) for a number of European banks, including some in Germany.

Gischer and Jüttner (2003) find a weak negative relationship between ROA and the fee income to interest income ratio for 19 OECD countries. The results for the Australian banking sector are similar. Esho et al. (2005) show that for a sample of Australian Credit Unions the return on assets (ROA) is negatively associated with the increment of transaction fees. Against expectations, risk rises in line with a higher revenue share of this income source. Conversely, revenue shares of fees received for off-balance sheet facilities and fiduciary activities do not seem to have any influence on risk and return, possibly on account of the relatively small share of this income category. Lepetit et al. (2008) find that in the case
of 602 European banks during the period 1996-2002 there was a negative correlation between interest margin and non-interest income. The authors assume that banks use loans as a loss leader to expand their non-interest income via cross-selling.

Stiroh and Rumble (2006), Stiroh (2004b), Mercieca et al. (2007) and Chiorazzo et al. (2008) differentiate between a “direct exposure” effect (a greater reliance on non-interest activity) and an “indirect diversification effect” (change of concentration between the two income streams), whereby the latter is measured by the Herfindahl Hirschmann Index (HHI). Indeed, Stiroh and Rumble (2006), Stiroh (2004a) and Mercieca et al. (2007) show that for small European banks, small U.S. community banks and U.S. financial holding companies higher concentration is accompanied by a lower degree of income volatility, while shifting into non-interest income creates an inefficient trade-off between risk and return. Furthermore, all three studies conclude that the banks’ financial stability, measured through z-score, is negatively affected by reliance on non-interest income. In contrast to these papers, Chiorazzo et al. (2008) identify a positive relation between diversification and non-interest income activity and risk-adjusted performance for Italian banks between 1993 and 2003. Split samples, grouped by size classes, reveal that large banks, in particular, benefit from non-interest income activities while within the group of small banks only institutions with a low non-interest income share are able to benefit from expanding their non-interest business.

If, indeed, there are only two income streams the question remains, however, as to whether the “direct exposure effect” can be separated from the “diversification effect”. In this context, Petersen (2004) complains that in the binary case, where the bank chooses between lending and non-interest activities, the HHI is merely a non-linear form of the non-interest income share. In particular, if the bank’s noninterest income share is less than 50%, which is true for most of the small banks, the correlation between HHI and non-interest income share is extremely large and, hence, empirically separating these two effects might be impossible.

Until now academic literature has paid only little attention to the fact that noninterest activity and banks’ performance are interrelated. On the one hand, there is the suspicion that banks suffering from declining or highly volatile profitability are inclined to expand their engagement in non-interest activities in order to earn a higher or more stable return. On the other hand, shifting banks’ business towards non-interest income also has an impact on profitability. In econometric analysis it is necessary to pay attention to the possible
endogeneity of non-interest income activities, as otherwise the endogeneity of independent variables leads to inconsistent estimators. Endogeneity in the modeling of noninterest income is, for example, considered in De Young and Rice (2004), Laeven and Levine (2005) and Campa and Kedia (2002), whereas all studies use an instrumental variable approach to derive consistent estimators.

De Young and Rice (2004) demonstrate the empirical links between banks’ non-interest income, business strategies, market conditions, technological change and financial performance for U.S. commercial banks between 1989 and 2001. They show that well managed banks, measured by a relative ROE measure, are less engaged in non-interest income while large banks and banks that focus more on relationship banking are more reliant on non-interest income. They also find that marginal increases in non-interest income engender higher, but more volatile profits, and a decline in risk-adjusted profits. Craigwell and Maxwell (2006) also find a positive impact of non-interest income on ROA and its volatility for Barbados banks between 1985 and 2001. In contrast to other studies, however, they find no evidence that relative performance helps to explain non-interest income. Surprisingly, in the Barbados study non-interest income - in relative terms - plays a larger role for smaller banks.

2.5.1 Foreign Exchange

The foreign exchange market is a form of exchange for the global decentralized trading of international currencies. Financial centres around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies.

An important part of this market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate.

Exchange rate is a vital microeconomic variable and backbone of Trade. A variation of exchange rate plays an important role in determination of balance of trade. Volatile exchange
rate slows down the process of trade, destabilizes the capital movements, and shatters the investor's confidence to invest in a country with high exchange rate volatility which in turn slows the process of growth.

Although high and sustained economic growth is one of the key economic goals in many countries, attaining it is likely to be influenced by appropriate macroeconomic policies aimed at general macroeconomic stability. Among the instruments that are crucial in economic management and stability of basic prices is the exchange rate. As a relative price the exchange rate is important in making spending and investment decision (Logue, 2007). This brings the exchange rate into focus.

2.5.2 Fees and Commissions Loans and Advances

Lending is the principal business activity for most commercial banks. The loan portfolio is typically the largest asset and the predominate source of revenue. As such, it is one of the greatest sources of risk to a bank's safety and soundness. Whether due to lax credit standards, poor portfolio risk management, or weakness in the economy, loan portfolio problems have historically been the major cause of bank losses and failures. Effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness. Lending has been, and still is, the mainstay of banks' business, and this is more true to emerging economies like Kenya where capital markets are not yet well developed. To most of the transition economies, however, and Kenya in particular, lending activities have been controversial and a difficult matter (Richard, 2006).

For decades, good loan portfolio managers have concentrated most of their effort on prudently approving loans and carefully monitoring loan performance. Although these activities continue to be mainstays of loan portfolio management, analysis of past credit problems, such as those associated with oil and gas lending, agricultural lending, and commercial real estate lending in the 1980s, has made it clear that portfolio managers should do more (Von Stauffenberg, 2002). Traditional practices rely too much on trailing indicators of credit quality such as delinquency, nonaccrual, and risk rating trends. Banks have found that these indicators do not provide sufficient lead time for corrective action when there is a systemic increase in risk.
2.5.3 Government Securities

The banks also invest in government securities including treasury bills and bonds. More often than not, the money the government receives from taxes is not enough to cover spending. In such circumstances, the government has to borrow money to be able to finance its spending. To do this, it issues Treasury Bonds and Treasury Bills (both are collectively known as government securities) through the Central Bank of Kenya (CBK), which is the banker to the government. The CBK is the government’s agent when it comes to borrowing through Treasury Bills and Treasury Bonds.

In essence, the government takes a loan from everyone who purchases government securities, and like with any other loan, there is a repayment period and an interest rate specific to that loan. Buying government securities in simple terms is the same as lending money to the government. A government bond is a bond issued by a national government, generally promising to pay a certain amount (the face value) on a certain date, as well as periodic interest payments. Bonds are debt investments whereby an investor loans a certain amount of money, for a certain amount of time, with a certain interest rate, to a company or country. Government bonds are usually denominated in the country's own currency.

2.5.4 Sale and lease of assets owned by the banks

To this day, national banks, bank holding companies, and many state-chartered banks are prohibited from owning real estate directly, except when obtained through foreclosure or if used for bank premises. In addition, savings and loan institutions generally have had authority to make commercial real estate loans and to invest in real estate directly for only a little more than a decade.

Rosen et al. (1989) focus on 319 banks involved in real estate activities from 1980-1985 and conclude that shifts toward high-levels of real estate investment will likely increase risk. Templeton and Severiens (1992) examine market data for 54 bank holding companies from 1979 to 1986 and conclude that diversification (measured as the share of market value not attributed to bank assets) is associated with lower variance of shareholder returns. This suggests some diversification benefits, although their measure of diversification is a rough proxy at best. Similarly, Kwan (1998) reports that bank Section 20 subsidiaries typically posted more volatile accounting returns, although not necessarily higher returns. DeYoung and Roland (2001) examines the link between bank profitability, volatility, and different
revenue shares for 472 large commercial banks from 1988 to 1995. They conclude that increased involvement in real assets owned by the banks increases the volatility of bank revenue and bank earnings.

2.6 Conceptual Framework

**Independent Variables**

**Source:** Researcher, 2013

**Figure 2.2: Conceptual Framework**

2.7 Operationalization of variables
3.1 Introduction
This chapter presents the methodology that was used to conduct the study. It covers the research design, the target population, data collection instruments and procedures and the method of data analysis.

3.2 Research Design
This research adopted an exploratory design where the population of interest was drawn from the five most profitable commercial banks in Kenya; KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank. The design was deemed appropriate because the main interest is to explore the viable relationship and describe how the factors support matters under investigation in one organization. An exploratory method provides qualitative data from cross section of the chosen population.

3.3 Target Population
The target population of this study was the management staff working in KCB, Equity Bank, Barclays, Standard Chartered and Cooperative Bank. The study focused on the head offices of these commercial banks and particularly on staffs that are directly dealing with the day to day management of the bank as well as senior management (directors and general managers) since they are the ones conversant with the effects of income source diversification into non-interest income sources on financial performance of the commercial banks. The population characteristic was as summarized in the table below. Mugenda and Mugenda, (2003), explain that the target population should have some observable characteristics, to which the researcher intends to generalize the results of the study.

Table 3.1: Target Population

<table>
<thead>
<tr>
<th>Sections</th>
<th>Population (Frequency)</th>
<th>Percentage %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top management</td>
<td>23</td>
<td>10.4</td>
</tr>
<tr>
<td>Middle level management</td>
<td>75</td>
<td>33.9</td>
</tr>
<tr>
<td>Lower level management</td>
<td>123</td>
<td>55.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>221</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Respective Banks HR Department, 2012
3.4 Sample Design and Procedure
From the above population of 221, a sample of 30% from within each group in proportions that each group bear to the population as a whole then adjusted to the nearest five was taken using stratified random sample which gave each item in the population an equal probability of being selected. According to Kothari (2000) a representative sample is one which is at least 10% of the population thus the choice of 30% is considered as representative. Stratified random sampling technique is used when population of interest is not homogeneous and can be subdivided into groups or strata to obtain a representative sample. The selection was as follows.

Table 3.2: Sample Size

<table>
<thead>
<tr>
<th>Sections</th>
<th>Population (Frequency)</th>
<th>Sample Ratio</th>
<th>Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top management</td>
<td>23</td>
<td>0.3</td>
<td>5</td>
</tr>
<tr>
<td>Middle level management</td>
<td>75</td>
<td>0.3</td>
<td>20</td>
</tr>
<tr>
<td>Lower level management</td>
<td>123</td>
<td>0.3</td>
<td>40</td>
</tr>
<tr>
<td>Total</td>
<td>221</td>
<td>0.3</td>
<td>65</td>
</tr>
</tbody>
</table>

Source: Researcher, 2012

3.5 Data Collection and Instruments
The study used both primary data and secondary data. While primary data was collected using questionnaire, secondary data was collected using audited financial statements of commercial banks included in the study. Close-ended Questionnaires were used for the five Commercial banks respondents. The financial statements (secondary data) were obtained from individual banks websites, CBK supervisory data bank and/or National daily newspapers (Nation and Standard). These sources are authentic thus reliable, suitable and valid. The study used longitudinal approach to study the 5 years trends of income source diversification.

3.6 Data Analysis and Reporting
Both descriptive and inferential statistics were used with the aid of SPSS programme at 95% confidence level. The descriptive statistical tools helped the researcher to describe the data and determine the extent to be used. The Likert scale was used to analyze the mean score and
standard deviation, this helped in determining the extent to which the bank uses various income diversification strategies to influence its performance. Data analysis used Statistical Package for Social Science (SPSS) version 20 and Microsoft Excel software. Tables were used to summarize responses for further analysis and facilitated comparison. This generated quantitative reports through tabulations, percentages, and measure of central tendency.

To measure the diversification of the 5 commercial banks, the researcher followed the basic Herfindahl–Hirschman Index (HHI) used in Morgan and Samolyk (2003); Stiroh (2004a) and Thomas (2002). The primary measure of evidence of revenue diversification, DIV, accounts for variation in the breakdown of net operating revenue into two broad categories: net interest income, NET, and non-interest income, NON. Using this breakdown, the researcher measured revenue diversification of the banks as:

\[
DIV = 1 - (SH_{NET}^2 + SH_{NON}^2)
\]

Where: \(SH_{NET}\) is the share of net operating revenue from net interest sources and \(SH_{NON}\) is the share of net operating revenue from non-interest sources defined as;

\[
SH_{NON} = \frac{NON}{NON + NET}
\]

\[
SH_{NET} = \frac{NET}{NON + NET}
\]

DIV measures the degree of diversification in a bank’s net operating revenue. A higher value indicates a more diversified mix: 0.0 means that all revenue comes from a single source (complete concentration), while 0.5 is an even split between net interest income and non-interest income (complete diversification). These measures are then averaged over a period of 5 years to get a measure of average revenue diversification, DIV, average net interest income shares, \(SH_{NET}\), and average non-interest income shares, \(SH_{NON}\).

The researcher further employed regression model to study the relationship between the bank financial performance and income diversification into non-interest incomes by banks. The study hypothesis was tested using Chi-square.

The relationship of the equation was a linear equation as shown below;

\[
Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \epsilon
\]

Where;
Y = Financial Performance; \( \beta_0 \) = constant term; \( \beta_1 - \beta_4 \) = Beta coefficients (intercepts for independent variables); X\(_1\) = Foreign Exchange; X\(_2\) = Fees and Commission on Loan and Advances; X\(_3\) = Government Securities; X\(_4\) = sales and lease of assets and \( \varepsilon \) = Error term.
CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

4.1 Introduction
This chapter presents analysis and findings of the study as set out in the research methodology. The results were presented on effects of revenue diversification into non-interest income on financial performance of commercial banks in Kenya taking a case of five most profitable banks in Kenya. The study targeted a total of 65 respondents out of which 62 responded and returned their questionnaires contributing to 95.4% response rate. This response rate was adequate conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. This response rate was due to extra efforts were made via personal calls and visits to remind the respondent to fill-in and return the questionnaires.

4.2 Demographic Information of the Respondents
The study required that the respondents indicate their gender. The data findings are presented in Table 4.1 below.

Table 4.1: Gender of the respondents

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>33</td>
<td>53.3</td>
</tr>
<tr>
<td>Female</td>
<td>29</td>
<td>46.7</td>
</tr>
<tr>
<td>Total</td>
<td>92</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Research, 2013

On the gender of the respondents, the study established that the majority of respondents were males as shown by 53.3%, while females were 46.7%. It therefore implies that in the five most profitable banks in Kenya there is equal representation of both genders in the workforce.

Further, the respondents were asked to indicate the category their age fell in. The Figure 4.1 below presents the data findings.
On the age of the respondents, the figure 4.1 above indicates that majority of the respondents (52%) were aged between 26 and 35 years of age, 26% were aged between 36 and 45 years while those with 46 years and above and between 18 and 25 years were 14% and 8% respectively.

The researcher also sought to establish the respondents’ highest level of education. The results are shown on Table 4.2 below.

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificate/Diploma</td>
<td>29</td>
</tr>
<tr>
<td>Degree</td>
<td>21</td>
</tr>
<tr>
<td>Post graduate</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>62</strong></td>
</tr>
</tbody>
</table>

According to the table above, most of the respondents (46.8%) indicated that they had Certificate/Diploma as their highest education qualification, 33.9% had a degree, 19.4% were post graduates education qualifications. It therefore indicates that all the respondents had at least a Certificate/Diploma depicting that the workforce in the five most profitable banks in Kenya has high academic credentials and therefore could give relevant information as sought by the study.
The study required that the respondents indicate the number of years they had worked in their respective banks. The data findings are presented on Figure 4.2 below.

![Years worked in the banks](image)

**Figure 4.2: Years worked in the banks**

**Source: Research, 2013**

The study sought to establish from the respondents the duration they had worked in the banks. Most of the respondents (30.6%) indicated that they had worked in the banks for less than 5 years, 29.0% for between 5 and 10 years, 21% for between 10 and 15 years while 11.3% and 8.1% of them said they had worked in the banks for between 15 to 20 years and more than 20 years respectively. It therefore illustrates that majority of the respondents had worked in the banks for more than 5 years and therefore eligible to give relevant information as sought by this study.

### 4.3 Effects of Revenue Diversification on Financial Performance

The study sought to establish respondents' level of agreement with below statement related to income source diversification and performance. Table 4.3 below presents the findings.

**Table 4.3: Revenue Source Diversification and Performance**

<table>
<thead>
<tr>
<th>Description</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expansion into less traditional financial activities is associated with increased risk.</td>
<td>3.3529</td>
<td>.99632</td>
</tr>
<tr>
<td>Revenues source diversification implies greater earnings</td>
<td>3.8235</td>
<td>.95101</td>
</tr>
</tbody>
</table>
Majority of the respondents strongly agreed that revenue source diversification for the bank is associated with greater returns as shown by a mean score of 4.2824. Further, the respondents were in agreement with statements that revenues source diversification implies greater earnings volatility for commercial banks as shown by a mean score of 3.8235 and that expansion into less traditional financial activities is associated with increased risk as shown by a mean score of 3.3529.

4.3.1 Foreign Exchange
The study aimed at establishing from the respondents, the extent diversification into foreign exchange influences financial performance. The findings are as presented on Figure 4.3 below.

According to the figure above, most of the respondents (43.5%) indicated that it influenced to a great extent, 30.6% to a very great extent, 21% said that it influenced to a moderate extent while 3.2% and 1.6% indicated that income from foreign exchange influences financial performance to a low extent and to no extent respectively.
The study sought to establish the respondents' level of agreement with the statements below regarding foreign exchange and financial performance. The results are presented on the Table 4.4 below

Table 4.4: Foreign exchange and financial performance

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange rate is important in making spending and investment decision for the bank</td>
<td>3.2658</td>
<td>1.27443</td>
</tr>
<tr>
<td>Foreign exchange is a vital income source and backbone of trade and influences financial performance of a bank</td>
<td>3.2763</td>
<td>1.44733</td>
</tr>
<tr>
<td>Foreign exchange plays an important role in determination of balance of trade</td>
<td>3.2778</td>
<td>1.31978</td>
</tr>
<tr>
<td>Attractive exchange rate encourages the process of trade.</td>
<td>3.6111</td>
<td>1.09216</td>
</tr>
<tr>
<td>Unwavering exchange rates stabilises capital movements and also improves the investor's confidence to invest</td>
<td>3.7222</td>
<td>1.17851</td>
</tr>
</tbody>
</table>

Source: Research, (2013)

On the respondents' level of agreement with above statements, majority of them were in agreement with the statement that unwavering exchange rates stabilises capital movements and also improves the investor's confidence to invest as indicated by a mean score of 3.7222, that attractive exchange rate encourages the process of trade as indicated by a mean score of 3.6111 and that foreign exchange plays an important role in determination of balance of trade as indicated by a mean score of 3.2778. They were however in neutral on the statement that foreign exchange is a vital income source and backbone of trade and influences financial performance of a bank as indicated by a mean score of 3.2763 and that foreign exchange rate is important in making spending and investment decision for the bank as indicated by a mean score of 3.2658
The study required the respondents to indicate the extent fees and commissions on loans and advances influences financial performance of commercial banks. The data findings are as presented on the Figure 4.4 below.

### 4.3.2 Fees and Commissions on Loans and Advances

![Figure 4.4: Extent fees and commissions on loans and advances influences financial performance](image)

Source: Research, 2013

On the extent fees and commissions on loans and advances influences financial performance of commercial banks, majority of the respondents (61.1%) indicated that it affected financial performance of the banks to a great extent, 22.2% said that it influenced to a moderate extent while 11.1% and 5.6% said that it influenced to a low extent and not at all respectively. This therefore illustrates that fees and commissions on loans and advances influences financial performance of commercial banks to a great extent.

The study sought to establish the respondents' level of agreement with above statements on effects fees and commissions on loans and advances on financial performance. Findings are presented on the Table 4.5 below.

### Table 4.5: Fees and Commissions on Loans and Advances and Financial Performance

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks largely depends on loan portfolio as an asset and the predominate source of revenue</td>
<td>3.9444</td>
<td>.53823</td>
</tr>
</tbody>
</table>
Effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness | 3.8327 | .82465
Lending is the mainstay of banks’ business and therefore influences financial performance | 3.5056 | .93760

Source: Research, (2013)

The study established that majority of the respondents were in agreement with the statements that banks largely depends on loan portfolio as an asset and the predominate source of revenue as indicated by a mean score of 3.9444, effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness as indicated by a mean score of 3.8327 and that lending is the mainstay of banks’ business and therefore influences financial performance as indicated by a mean score of 3.5056.

4.3.3 Government Securities

The study further sought to establish the extent government securities influences financial performance. The results are presented on Figure 4.5 below.

Figure 4.5: Extent Government Securities Influences Financial Performance

Source: Research, (2013)

According to the Figure 4.5 above, most of the respondents (34%) indicated that it influenced to a great extent, 27% said that it influenced to a moderate extent while 24% said that government securities influences financial performance of the commercial banks to a very great extent. Further, 10% of the respondents indicated that it influenced to a low extent while 5% said that government securities does not influences financial performance at all.
The respondents indicated that the banks benefited from government securities in that, government security have low risk involved. In fact, they indicated that mostly banks would prefer to invest in government bond and Treasury bill as their returns are guaranteed and unlike loans where some of it turns to be non-performing.

4.3.4 Incomes from Assets
The figure 4.6 below presents results obtained from the respondents on the extent income from asset influences financial performance.

![Figure 4.6: Extent Income from asset influences Financial Performance](image)

**Figure 4.6: Extent Income from asset influences Financial Performance**

**Source: Research, (2013)**

Most of the respondents (33.3%) said that it affected to a great extent, 27.8% said either to a very great extent or to a moderate extent while 11.1% indicated to a low extent. This has shown that diversification into sale and lease of assets influences financial performance of the banks to a great extent.

This study sought to establish the extent the banks studied relied on the below as a form of income. The data finding are presented on the table 4.6 below.

**Table 4. 6: Income from assets and financial performance**

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease of assets</td>
<td>3.3981</td>
<td>1.09813</td>
</tr>
<tr>
<td>Sale of assets</td>
<td>3.3529</td>
<td>1.27187</td>
</tr>
</tbody>
</table>

**Source: Research, (2013)**

30
According to the respondents, the bank relied to a moderate extent on lease of assets as illustrated by a mean score of 3.3981 and sale of assets as illustrated by a mean score of 3.3529.

4.4 Herfindahl–Hirschman Index

To measure the diversification of the 5 commercial banks, the study used the basic Herfindahl–Hirschman Index (HHI) which is also used in Morgan and Samolyk (2003); Stiroh (2004a) and Thomas (2002). The study measured revenue diversification of the banks using the following formula.

\[ DIV = 1 - (SH_{NET}^2 + SH_{NON}^2) \]

**Where:** \( SH_{NET} \) is the share of net operating revenue from net interest sources and \( SH_{NON} \) is the share of net operating revenue from non-interest sources calculated as shown below.

\[ SH_{NON} = \frac{NON}{NON + NET} \]
\[ SH_{NET} = \frac{NET}{NON + NET} \]

DIV measures the degree of diversification in a bank’s net operating revenue. A higher value indicates a more diversified mix: 0.0 means that all revenue comes from a single source (complete concentration), while 0.5 is an even split between net interest income and non-interest income (complete diversification). These measures are then averaged over a the period of 5 years to get a measure of average revenue diversification, DIV, average net interest income shares, \( SH_{NET} \), and average non-interest income shares, \( SH_{NON} \). The NET and NON figure used in this analysis are in millions (KShs’000,000)

**Table 4.7: Standard Chartered Bank, Kenya**

Table 4.7 and Figure 4.7 present DIV for Chartered Bank. The period covered is 5 years

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>4,965</td>
<td>5,877</td>
<td>7,337</td>
<td>8,116</td>
<td>9,851</td>
</tr>
<tr>
<td>NON</td>
<td>3744</td>
<td>4,585</td>
<td>5,614</td>
<td>6,052</td>
<td>3,814</td>
</tr>
<tr>
<td>Total</td>
<td>8,709</td>
<td>10,462</td>
<td>12,951</td>
<td>14,168</td>
<td>13,665</td>
</tr>
<tr>
<td>( SH_{NET} )</td>
<td>0.57</td>
<td>0.56</td>
<td>0.57</td>
<td>0.57</td>
<td>0.72</td>
</tr>
</tbody>
</table>
The table and figure above indicates DIV of 0.49 for four years from 2007 to 2010 which then fall to 0.40 in 2011. This indicates that in Standard Chartered bank in Kenya has a high degree of diversification in net operating revenue. However, the bank is biased toward interest income as opposed to non-interest income. It worth noting that in 2011, the DIY falls from 0.49 previous year to 0.40, this implies that the bank shifted its focus to interest income and the contribution of non-interest income fell in that year.

Table 4.8 and Figure 4.8 present DIV for Kenya Commercial Bank. The period covered is 5 years.

Table 4.8: Kenya Commercial Bank

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>8,452</td>
<td>11,775</td>
<td>14,469</td>
<td>19,645</td>
<td>23,286</td>
</tr>
<tr>
<td>NON</td>
<td>5,683</td>
<td>7,652</td>
<td>8,053</td>
<td>9,303</td>
<td>11,175</td>
</tr>
<tr>
<td>Total</td>
<td>14,135</td>
<td>19,427</td>
<td>22,522</td>
<td>28,948</td>
<td>34,461</td>
</tr>
<tr>
<td>( SH_{NET}^2 )</td>
<td>0.60</td>
<td>0.61</td>
<td>0.64</td>
<td>0.68</td>
<td>0.68</td>
</tr>
</tbody>
</table>
Figure 4.8: Kenya Commercial Bank DIV

Source: Research, (2013)

The table and figure above indicates DIV fluctuation in Kenya Commercial Bank. DIV in KCB falls gradually from 0.48 to 0.44 from 2007 to 2011. This fall in DIV indicates that KCB degree of diversification in net operating revenue is also falling and is now focusing on its core businesses. In other words, KCB is shifting its focus from non-interest income and concentrating with interest income.

Table 4.9 and Figure 4.9 present DIV for Equity Bank Limited. The period covered is 5 years

Table 4.9: Equity Bank Limited

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>2,660</td>
<td>5,952</td>
<td>8,278</td>
<td>11,056</td>
<td>15,561</td>
</tr>
<tr>
<td>NON</td>
<td>3,163</td>
<td>8,444</td>
<td>11,241</td>
<td>18,396</td>
<td>33,726</td>
</tr>
<tr>
<td>Total</td>
<td>5,823</td>
<td>14,396</td>
<td>19,519</td>
<td>29,452</td>
<td>49,287</td>
</tr>
<tr>
<td>$SH_{NET}^2$</td>
<td>0.46</td>
<td>0.41</td>
<td>0.42</td>
<td>0.38</td>
<td>0.32</td>
</tr>
<tr>
<td>$SH_{NON}^2$</td>
<td>0.21</td>
<td>0.17</td>
<td>0.18</td>
<td>0.14</td>
<td>0.10</td>
</tr>
</tbody>
</table>
Further, the study sought to establish the degree of diversification in net operating revenue in Equity Bank. The table and figure above indicates a fall in DIV in Equity Bank gradually from 0.50 to 0.43 from 2007 to 2011. This fall in DIV indicates that Equity Bank degree of diversification in net operating revenue is also falling and is now focusing on its interest income more as compared to non-interest income. However, it should be noted that DIV is still high almost at even split between net interest income and non-interest income (complete diversification).

Table 4.10 and Figure 4.10 present DIV for Co-operative Bank of Kenya. The period covered is 5 years.

Table 4.10: Co-operative Bank of Kenya

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>4,850</td>
<td>5,696</td>
<td>7,054</td>
<td>9,503</td>
<td>12,370</td>
</tr>
<tr>
<td>NON</td>
<td>3,426</td>
<td>3,954</td>
<td>4,664</td>
<td>6,168</td>
<td>5,966</td>
</tr>
<tr>
<td>Total</td>
<td>8,276</td>
<td>9,650</td>
<td>11,718</td>
<td>15,671</td>
<td>18,336</td>
</tr>
</tbody>
</table>

Source: Research, (2013)
The figure and table above presents income diversification data for Cooperative Bank. The data indicates a constant DIV value. In 2007, cooperative bank had a DIV value of 0.49, a DIV value of 0.48 in 2008, 2009 and 2010 and a DIV value of 0.44 in 2011. This decline in DIV indicates a slight change in banks focus on income sources. It therefore shows that non-interest income in Cooperative Banks has fallen in 2011.

Table 4.11 and Figure 4.11 present DIV for Barclays Bank of Kenya. The period covered is 5 years.

**Table 4.11: Barclays Bank of Kenya**

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>11,381</td>
<td>14,010</td>
<td>14,770</td>
<td>15,674</td>
<td>16,336</td>
</tr>
<tr>
<td>NON</td>
<td>7,500</td>
<td>9,623</td>
<td>9,004</td>
<td>10,742</td>
<td>10,003</td>
</tr>
<tr>
<td>Total</td>
<td>18,881</td>
<td>23,633</td>
<td>23,774</td>
<td>26,416</td>
<td>26,339</td>
</tr>
<tr>
<td>$SH_{NET}$</td>
<td>0.60</td>
<td>0.59</td>
<td>0.62</td>
<td>0.59</td>
<td>0.62</td>
</tr>
<tr>
<td>$SII_{NET}^3$</td>
<td>0.36</td>
<td>0.35</td>
<td>0.39</td>
<td>0.35</td>
<td>0.38</td>
</tr>
<tr>
<td>$SH_{NON}^3$</td>
<td>0.40</td>
<td>0.41</td>
<td>0.38</td>
<td>0.41</td>
<td>0.38</td>
</tr>
<tr>
<td>$SH_{NON}^2$</td>
<td>0.16</td>
<td>0.17</td>
<td>0.14</td>
<td>0.17</td>
<td>0.14</td>
</tr>
<tr>
<td>DIV</td>
<td>0.48</td>
<td>0.48</td>
<td>0.47</td>
<td>0.48</td>
<td>0.47</td>
</tr>
</tbody>
</table>

Source: Research, (2013)

Figure 4. 11: Barclays Bank of Kenya DIV

Source: Research, (2013)

Finally, the study sought to establish income source diversification in Barclays Bank. The data findings are as presented on table and figure above. Barclays Bank of Kenya has maintained it DIV between 0.48 and 0.47 in the five year period studied. It therefore shows that the bank has diversified to a constant extent. However, interest income precedes non-interest income.

4.5 Regression Analysis

In addition, the researcher conducted a multiple regression analysis so as to test relationship among variables (independent) on the financial performance of five most profitable commercial banks in Kenya. The researcher applied the statistical package for social sciences (SPSS V 2.0) to code, enter and compute the measurements of the multiple regressions for the study.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (financial performance) that is explained by all the four independent...
variables (foreign exchange, fees and commission, government securities and income from lease and sale of assets).

4.5.1 Model Summary

Table 4.12: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.925</td>
<td>0.856</td>
<td>0.793</td>
<td>0.6527</td>
</tr>
</tbody>
</table>

Source: Research, 2013

The four independent variables that were studied, explain only 85.6% of the effects of non-interest income source on financial performance as represented by the R². This therefore means that other factors not studied in this research contribute 14.4% of the effect. Therefore, further research should be conducted to investigate the other non-interest income source (14.4%) that affects financial performance of commercial banks in Kenya.

4.5.2 ANOVA Results

Table 4.13: ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>2</td>
<td>1.267</td>
<td>9.513</td>
<td>.0181</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>60</td>
<td>2.327</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>62</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research, (2013)

The significance value is 0.0181 which is less that 0.05 thus the model is statistically significance in predicting how foreign exchange, fees and commission, government securities and income from sale and lease of assets influence financial performance of commercial banks in Kenya. The F critical at 5% level of significance was 3.23. Since F calculated is greater than the F critical (value = 9. 513), this shows that the overall model was significant.
4.5.3 Coefficient of determination

Table 4. 14: Coefficient of determination

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td>t</td>
</tr>
<tr>
<td>(Constant)</td>
<td>1.144</td>
<td>1.2187</td>
<td>1.615</td>
<td>0.216</td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td>0.765</td>
<td>0.3114</td>
<td>0.051</td>
<td>3.697</td>
</tr>
<tr>
<td>Fees and commissions</td>
<td>0.603</td>
<td>0.1897</td>
<td>0.277</td>
<td>3.231</td>
</tr>
<tr>
<td>Government Securities</td>
<td>0.603</td>
<td>0.1897</td>
<td>0.277</td>
<td>3.231</td>
</tr>
<tr>
<td>Income from sale and</td>
<td>0.663</td>
<td>0.1897</td>
<td>0.277</td>
<td>3.231</td>
</tr>
<tr>
<td>lease of assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research, (2013)

Multiple regression analysis was conducted to determine the relationship between financial performance and the four variables. As per the SPSS generated table above, the equation \( Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \epsilon \) becomes:

\[ Y = 1.144 + 0.708X_1 + 0.765X_2 + 0.603X_3 + 0.663X_4 \]

According to the regression equation established, taking all factors into account (foreign exchange, fees and commission, government securities and income from lease and sale of assets) constant at zero, bank financial performance will be 1.144. The data findings analysed also shows that taking all other independent variables at zero, a unit increase in foreign exchange income will lead to a 0.708 increase in financial performance; a unit increase in fees and commission income will lead to a 0.765 increase in financial performance; a unit increase in government security income will lead to a 0.603 increase in financial performance.
of the banks and a unit increase in income from sales and lease of assets owned by the banks will lead to a 0.663 increase in financial performance. This infers that fees and commissions contribute most to the financial performance followed by foreign exchange. At 5% level of significance and 95% level of confidence, fees and commissions had a 0.0097 level of significance, foreign exchange showed a 0.0248 level of significance, government securities showed a 0.0248 level of significance, and sale and lease of assets owned by the bank showed a 0.0212 level of significance hence the most significant non interest source of income is fees and commission.
CHAPTER FIVE

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter presents discussion, conclusion drawn from the findings and recommendations made therefore.

5.2 Discussion
The results show that five most profitable banks in Kenya have an equal representation of both genders in the workforce. Majority of the respondents are 26 years and above. The study has also established that all the respondents had at least a Certificate/Diploma depicting that the workforce in the five most profitable banks in Kenya has high academic attainment. Most of the respondents indicated that they had worked for their respective banks for more than 5 years.

The study illustrates that revenue source diversification for the bank is associated with greater returns and it implies greater earnings volatility for commercial banks. Further, it is indicated that expansion into less traditional financial activities is associated with increased risk.

Foreign exchange was found to influences financial performance to a great extent. Further, the study indicated that unwavering exchange rates stabilises capital movements and also improves the investor’s confidence to invest, that attractive exchange rate encourages the process of trade and that foreign exchange plays an important role in determination of balance of trade.

According to the results, fees and commissions on loans and advances influence financial performance of the five most profitable banks in Kenya to a great extent. Also, it was established that banks largely depends on loan portfolio as an asset and the predominate source of revenue, that effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness and that lending is the mainstay of banks’ business and therefore influences financial performance.

On government securities, the study has illustrated that they influence financial performance of the banks to a great extent. It was also established that banks prefers government securities (Government bonds and Treasury bills) since they have low involved risk. Further, it was
established that unlike loans which might turn to be non-performing, government securities' returns are guaranteed. Finally, the study indicates that income from assets also influences financial performance of the five banks studied. It also indicated that the banks relied on income from lease and sale of assets owned by the bank. From the regression analysis the following regression equation was formulated: \[ Y = 1.144 + 0.708X_1 + 0.765X_2 + 0.603X_3 + 0.663X_4 \]

5.3 Conclusion
The study aimed at investigating how foreign exchange trading income affects financial performance of commercial banks in Kenya. The study concludes that foreign exchange influences financial performance to a great extent. This is based on the fact that unwavering exchange rates stabilises capital movements and also improves the investor’s confidence to invest and that attractive exchange rate encourages the process of trade.

On extent to which fees and commissions on loans and advances affects financial performance of commercial banks in Kenya, it was concluded that they affect to a great extent. Further, it was shown that banks largely depends on loan portfolio as an asset and as a predominate source of revenue and that lending is the mainstay of banks’ business and therefore influences financial performance.

The study also concludes that government securities affect financial performance of commercial banks in Kenya to a great extent. The study indicates that banks would prefer government securities to leading as government securities offered more security compared to loans. Finally the study concluded that sale and lease of assets owned by the banks influences financial performance of commercial banks in Kenya to a great extent.

5.4 Recommendations
On foreign exchange, the study recommends that the government through the Central bank should put in place measures to ensure that exchange rates are stable. With stability in the exchange rates, the banks are able to plan on their income as predictions can be made easily. Further, the study recommends that CBK should offer an environment where the banks operations are not interfered with. For example, CBK should ensure stability of interest rates so as to encourage lending. Through improved lending, banks are able to earn commissions and fees. Fees and commissions form a significant portion of banks income.
The study also recommends that banks should embrace opportunities to invest in government securities. This is because, government securities are less risky compared to other avenues that banks might chose to invest in.

Also, it is recommended that banks should invest on other assets such as building that they would use as their premises and lease out the rest to gain an income. Further the study recommends that the bank also invests in assets that they could sell at a profit to boost their income.

5.5 Suggestion for Further Research

The study established that it had not exhaustively researched on non-interest income that banks diversified into that influenced financial performance of the bank. The study therefore recommends that another study be done to establish the other non-interest incomes that the banks diversified into that influenced financial performance of the commercial banks in Kenya. Also, the study recommends that another study should be done in augment the study findings on the sustainability of each of the non-interest income source.
REFERENCES


KENYATTA UNIVERSITY
SCHOOL OF BUSINESS
DOCTORAL & MBA COORDINATION OFFICE

P. O. Box 43844
NAROBI
KENYA
Tel: 8710901 -19 Ext. 57500

26th February, 2013

TO WHOM IT MAY CONCERN:

RE: JAMES GITONGA MURIITHI – D53/OL/14713/2009

This is to confirm that the above named is a Master of Business Administration MBA (Finance Option) student in the School of Business, Kenyatta University.

He is through with course work and has successfully defended his Masters Degree proposal (Effects of Revenue Diversification into Non-Interest Income on Financial Performance of Commercial Banks in Kenya: A Case of Five most Profitable Banks in Kenya). I confirm that he has done all the corrections that were pointed out by the examiners during the defense and he is now embarking on data collection.

Any assistance accorded him will be much appreciated by this office.

Thank you.

DAVID NZUKI (PhD)
DOCTORAL AND MBA PROGRAMME COORDINATOR

DN/nt
Appendix II: Letter of Introduction

James Gitonga Murithi
P O Box 400
Meru.

Dear Respondent,

REQUEST FOR RESEARCH DATA

My name is James Gitonga Murithi and I am currently studying for my Master of Business Administration (Finance Option) of Kenyatta University and as part of my course work; I need to conduct a research based on my area of study. I will therefore study effects of revenue diversification into non-interest income on financial performance of commercial banks in Kenya.

You have been identified as one of the people that could be of assistance with the research and I thus request your participation in the research. Essentially, you would be required to complete a questionnaire. Your will be treated anonymously and your responses will be treated with utmost confidentiality. The information you provide will be used only for academic purposes.

Thank you in advance.

James Gitonga Murithi
Appendix III: Questionnaire

SECTION A: BACKGROUND INFORMATION
You are requested to fill out your personal information in the spaces below. Please tick only one response.

1) Please indicate your position in the bank

2) Gender
   Male: [ ]   Female: [ ]

3) In what category does your age fall?
   18-25 [ ]   26-35 [ ]
   36-45 [ ]   46 and above [ ]

4) Highest Level of education
   O-Level [ ]   Certificate/Diploma [ ]
   Degree [ ]   Postgraduate [ ]

5) How long have you worked in this organization?
   Less than 5 years [ ]   Between 5 and 10 years [ ]
   Between 10 and 15 years [ ]   Between 15 and 20 years [ ]
   More than 20 years [ ]

SECTION B: EFFECTS OF REVENUE DIVERSIFICATION ON FINANCIAL PERFORMANCE

6) On a scale of 1 to 5, please indicate your level of agreement with statements below that shows the relationship between revenue source diversification and performance. Where 1 = strongly disagree; 2 = disagree; 3 = Neutral; 4 = Agree and 5 = Strongly Agree

<table>
<thead>
<tr>
<th>Statement</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expansion into less traditional financial activities is associated with increased risk.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Revenues source diversification implies greater earnings volatility for commercial banks

Revenue source diversification for the banks is associated with greater returns

Foreign Exchange

7) To what extent do you think diversification into foreign exchange influences financial performance of commercial banks?

<table>
<thead>
<tr>
<th></th>
<th>Not at all</th>
<th>Low extent</th>
<th>Moderate extent</th>
<th>Great extent</th>
<th>Very great extent</th>
</tr>
</thead>
</table>

8) Please indicate your level of agreement with statements below that shows the relationship between foreign exchange and financial performance. On a scale of 1 to 5, where 1 = strongly disagree; 2 = disagree; 3 = Neutral; 4 = Agree and 5 = Strongly Agree.

<table>
<thead>
<tr>
<th>Statements</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange rate is important in making spending and investment decision for the bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange is a vital income source and backbone of trade and influences financial performance of a bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange plays an important role in determination of balance of trade</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Attractive exchange rate encourages the process of trade.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unwavering exchange rates stabilises capital movements and also improves the investor's confidence to invest</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Loans and Advances Commissions

9) To what extent do you think loans and advances commissions influence financial performance of commercial banks?

- Not at all [ ]
- Moderate extent [ ]
- Very great extent [ ]

10) Please indicate your level of agreement with statements below on loans and advances commissions and financial performance. On a scale of 1 to 5, where 1 = strongly disagree; 2 = disagree; 3 = Neutral; 4 = Agree and 5 = Strongly Agree.

<table>
<thead>
<tr>
<th>Statements</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks largely depend on loan portfolio as an asset and the predominate source of revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lending is the mainstay of banks’ business and therefore influences financial performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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Government Securities

11) To what extent do you think government securities influence financial performance of commercial banks?

- Not at all [ ]
- Moderate extent [ ]
- Very great extent [ ]

12) In your own opinion, how does the bank benefit from the government security purchased?

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13) Are there any challenges that the banks encounter in government security that threatens their financial performance.

Yes [ ]  No [ ]

14) If yes, what are these challenges?


Incomes from Assets

15) To what extent do you think income from asset owned by the bank influences financial performance of commercial banks?

Not at all [ ]  Low extent [ ]

Moderate extent [ ]  Great extent [ ]

Very great extent [ ]

16) Indicate the extent to which your bank relies on the following form of income from assets as a form of income? Use a scale of 1 to 5 where; 1 = not at all and 5 = to a very great extent.

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<td>Lease of assets</td>
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<td>Sale of assets</td>
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Thank You for Participating