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**DETERMINANTS OF HIGH PROFITABILITY TO COMMERCIAL BANKS IN  
KENYA UNDER TURBULENT ECONOMIC ENVIRONMENT.**

**(A survey of banks in Nyeri County)**

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**D53/OL/10572/2008**

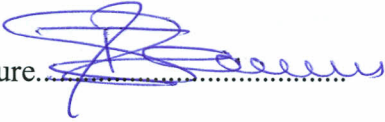
**A RESEARCH PAPER SUBMITTED TO KENYATTA UNIVERSITY SCHOOL OF  
BUSINESS, ACCOUNTING AND FINANCE DEPARTMENT IN PARTIAL  
FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTERS  
DEGREE IN BUSIESS ADMINISTRATION (FINANCE OPTION).**

**JUNE 2013**

## DECLARATION

I declare that this project is my original work and has not been submitted to any other college, institution or university for the award of a degree.

Signature.....



Date.....

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17/6/2013

## **DEDICATION**

A special tribute and dedication goes to all those who supported, encouraged me during the entire time of writing the project. My wife Becky, My daughter Britiny, Mother Veronica, my sisters Susan, Ruth, and my brothers for their support and understanding as I write this project. The employees of commercial banks in Nyeri County especially the management for allowing me to carry out the research within their busy organizations.

## **ACKNOWLEDGEMENT**

My sincere appreciation goes to the Almighty God for his protection and guidance as I undertake this research. My appreciation further goes to my supervisor Mr. J Mungai, of Kenyatta university school of business who gave me the direction and effort to make this project report successful. Not to forget my friends, colleagues and classmates for their support.

## LIST OF ABBREVIATIONS AND ACRONYMS

<b>KCB</b> -	Kenya Commercial bank
<b>CBK</b> -	Central Bank of Kenya
<b>GDP</b> -	Gross domestic product
<b>PBT</b> -	Profit Before Tax
<b>SACCO</b> -	Savings and Credit Cooperatives
<b>UK</b>	United Kingdom.
<b>SME</b>	Small and Medium Enterprises.
<b>DFI</b>	Development Finance Institutions
<b>KNBS</b>	Kenya National Bureau of statistics

## DEFINITION OF TERMS

<b>Risk</b>	Possibility of investment loss or speculation
<b>Financial deregulation</b>	Removing controls and rules that protected financial institutions
<b>Inflation</b>	A rise in the general level of prices of goods and services in an economy over a period of time.
<b>Portfolio</b>	Investments held by a company.
<b>Market share</b>	The portion of sales of a certain product controlled by a company.

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## ABSTRACT

The economic environment under which business organizations operate under was unstable and unpredictable characterized by constant changes in political, economic, technological and social cultural changes, these factors makes it difficult for organizations to put in place long term policies for effective and efficient operations, more to project returns and work towards the projected returns. The high inflation pressure attributed by high cost of basic goods and oil prices make most companies report little or no profit growth at all. The current economic expansion was also causing some problems; strong demand has raised inflation rates. Kenya like any other African state had further experienced a rapid growth in the household credit and increase in property prices. Financial institutions operating under this turbulent environment however seem to have become more resilient to shocks and banks performance has generally been good. Recent economic growth has however helped to boost banks profitability and improve asset quality. The main objective of this study therefore, was to investigate the factors that contribute to high profitability in financial institutions under the turbulent environment in Nyeri County. The study was carried out in major commercial banks. The target population for the study was the staff of these commercial banks which totals to three hundred and seventeen. For the purpose of collecting data the researcher used a questionnaire. Stratified sampling technique was used and a sample of 30% was used for the study. For the purpose of collecting primary data the researcher used the questionnaire. Data was collected from respondents which is both quantitative and qualitative in nature. Quantitative data was analyzed using descriptive statistics such as frequencies and mean scores. Qualitative data was analyzed using content analysis. The findings were then presented using tables, pie charts, and bar graphs for easier. The quantitative data was analyzed using Statistical Package for Social Sciences (SPSS). From the data collected, it is believed that bank profits are majorly drawn from bank charges and interest rates. In regard to data collected interest rates charged, commissions, fees levied, customer deposits, growth of Agriculture and SME all significantly contribute to banks profit levels.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background Information.

The banking industry is a key sector in any economy, and is the prime mover of economic life. Banks occupy a significant place in every nation (Soyibo and Adekaye, 1991). The banking sector in developing countries like Kenya are heterogeneous, in terms of number, size of institutions, ownership structure, profitability and competitiveness, use of IT and other structural features. A few of large commercial banks have the majority of the market share and co-exist with large number of small savings and co-operative banks. The foreign companies also have a remarkable share in the local banking industry, (Casu and Giraddone, 2006). The banking sector operates under varied environment characterized by financial liberalization, considered to increase efficiency by imposing competition as well minimize regulations that distort economic activities, financial regulation, which include control over interest rates, control over lending, high reserve requirement, restrictions on new entry. The general environment is also characterized by unpredictable changes which are both favorable and unfavorable and banks operate under this environment. Delis, (2006).

As profit seekers, commercial banks are inclined to formulate policies that aim at diversifying their portfolio and thus guaranteeing some minimum rate of return. To achieve the objective of profit maximization, banks make decisions to invest excess cash in a portfolio of securities with the aim of minimizing risk of loss. Banks generally consider costs and benefits of the different alternatives available when making investment decisions. Much analysis has been performed which indicates that portfolio asset allocation is by far the most important decision banks make, because these may account up to 90% of bank earnings, (Nafula, 2003).

Commercial banks, mutual savings banks, savings and loan associations, and credit unions comprise a group of financial services institutions, collectively called depository intermediaries (Mwega, 2009). The product and service offerings these institutions have in common bind them into an industry grouping that is subject to similar influences. Major regulatory influences on these institutions such as the banking act and Central bank have over the years eased entry, location, and activity restrictions within the general financial services industry (Brealey, 2001).

According to banking experts (Abdulla, 1994), these Acts are responsible for allowing increased competition from non bank suppliers of financial services (e.g, Mpesa and Airtel Money transfer services) as well as from contractual intermediaries (e.g., insurance companies). According to professor Njuguna Ndungu (CBK), Innovative solutions for strengthened regulatory framework for financial sector lie with the players. The regulators, the regulated and the market exist for each other and it is only through their acceptance to promote, advice and partner that a smarter regulatory framework in place will enable private sector to prosper.

Financial deregulation has taken place in the banking industry. This consists of removing controls and rules that in the past have protected financial institutions. This has led to improved performance of the industry (Koch, 1995). There is no doubt that the deregulation process has helped in the ending of repressed banking systems and is most likely one of the major contributors to single market programs. Furthermore, the wide liberalization and harmonization process have contributed in creating a business environment where operational efficiency and technology implementation play key roles in shaping banks' strategies, (Kamau, 2009), identifies three joint effects of deregulation and technology. First, the loosening of banking laws coupled with advantages of technology (in terms of potential economies of scale and other efficiencies) has encouraged the consolidation process. Second, the introduction of new technologies in a deregulated context has intensified competition and improved banks ability to adjust prices and terms of financial products, the barriers between bank and non-bank financial institutions has disappeared, allowing, for example, the rise of universal banking activity which however has not reduced other external factors which make the environment even more unpredictable.

According to market intelligence (2000), the structure of commercial banks portrays a cartel like feature. As at 2003 of the 48 commercial banks in the country, 10 own 75% of the total assets in the industry a clear indication that the industry is not competitive. In four of the top five banks, profitability followed an upward trend. Equity Bank was the top performer in the nine-month period ending September 2011 year when it hit Sh7.3 billion, up from Sh5.1 billion in the same period in the preceding year a 43 per cent increase. According to Geoffrey Irungu, Business Daily December 2011, During the nine months to September 2011, Kenya Commercial Bank saw a 42 per cent increase in post-tax profit to Sh6.4 billion while Cooperative Bank's profit rose 22 per cent to Sh4.5 billion compared to the same period in the year 2010. Standard Chartered

recorded a Sh3.86 billion post-tax profit in the nine-month period to September compared to Sh4.3 billion in the same period in the year 2010 a 10 per cent or Sh440 million reduction in earnings. Barclays Bank also had its after profit go up by Sh612 million to Sh6.1 billion in the first nine months of the year 2011.

According to Equity annual report and financial statement, 2009, the years 2008 and 2009 were characterized by the economy which was still recovering from the ravages of post election violence more so the beginning of the year 2008 which was marred by violence making it difficult for business organization to undertake their operations as most businesses remained shut especially at the beginning of the year. In the same year, global economic crisis and prolonged drought also explained the turbulent nature of economic environment. The post election violence negatively affected agriculture which is the main stay of the majority of Kenyans. The violence further destroyed business further affecting economic performance. The multiplier effect of the post election violence had greater negative impact than initially thought. According to Equity Bank Annual Report and Financial Statements, 2009, the economy had to bear an additional burden of higher energy costs and power rationing leading increased reliance of more expensive power supply. Inflation remained higher at 14.6% for the better part of the year before changing in a downward trend to 5.3%.

According to Equity bank Annual Report and Financial Statements, (2009), Commercial banks despite all this recorded an Asset growth by 11 % to 1.31 trillion at the end of September 2009 and the capital adequacy ratio stood at 20 percent and was above statutory minimum of 12%. Banks continued to expand their lending portfolio. Deposits increased to 1 trillion in October 2009 due to deposit mobilization and expansion of branch networks. According to peter K Munga, Chairman Equity bank, legislations such as regulations on SACCOs, Credit Information sharing was among the unexpected legislations that were introduced and which will affect the operations of financial sector.

According to KCB Rights Issue Memorandum, (2010), financial sector remained resilient with the leading banks recording improved performance in 2009. The sector notwithstanding local turbulences emerged unscathed from the effects of global financial crisis as it was not exposed to the toxic assets that fuelled the crisis. The impressive profits recorded by banks were as a result of proper management of various economic risks which include political risk, regulatory Risk,

credit risk, currency risk, operational risk, and liquidity risk interest rates risk and reputational risk. All this risks are turbulent and unpredictable. Any exposure to any of the risks will lead adverse effects on the profitability of the company and therefore require careful risk management controls and procedures.

## **1.2 Statement of the Problem**

According to Equity bank financial report 2010, every business from small to large must have an awareness of the environmental factors that affect it. Understanding these factors allows business to be more agile and to change based upon the needs of the customers. The economic environment in which Kenyan companies are operating under is characterized by low income earning population, unpredictable changes in economic conditions, political climate and legislations which affect the operations of a company, or otherwise known as the external environment characterized the dynamics of the environment (Meyer, 2009).

Financial institutions like any other company in addition to other inherent risks which otherwise do not affect operations of other companies such as liquidity risk, interest rates risk, operate under this turbulent environment. These institutions operate under the business environment consisting of the surrounding factors which are external and may not be under the control of the organization. They include; Economic, legal, technological, competitive and the global environment. Banks operate under these unpredictable environmental factors which directly affect their operations and performance. Commercial banks over the years have defied the trend in recording declined profits and slow or no growth in other areas of the economy to record an upward trend in terms of profits. According to a survey done by Kenya National Bureau of Statistics (2012), The Kenyan economy has been affected by Erratic weather conditions,, escalating oil prices weakening of the Kenya shilling and high inflation rates making the environment quite unpredictable and turbulent. According to KNBS the following is the trend in growth some key sectors on profit growth.

The trend in economic growth between the years 2010 to 2011 was on a downward trend with various sectors of the economy recording a negative growth. In the year 2010, Agriculture for example recorded growth of 1.5% as compared to the previous year growth of 6.4% in the previous year. Transport recorded a growth of 4.5% against 5.9% in the previous year. Banking industry unlike other industries recorded an improved growth of 9.0 % down from 7.5% in the previous year. Muthoka (2011).

According to KCB financial report 2011, the economy in general suffered from high inflationary pressure resulting in overall 12- month inflation rising from 4.51 per cent in December 2010 to 19.72 per cent November 2011, the average annual inflation rate grew consistently from 3.96 percent in December 2010 to 14.0 percent in December 2011. Despite the challenges and the declined growth in other sectors of the economy, KCB recorded a 54% growth in pre tax profit.

According to equity annual report (2009), the year 2009 was characterized by High inflation High oil prizes. The bank defied the odds to record a growth of 24% in PBT compared to the previous year. Banking industry as a whole defied the trend in the business industry where most companies are recording declined profits to record a continuous growth in profits. Consumers, the government and stakeholders are concerned about this trend in profitability of banks in Kenya. Consumers need assurance that the profits being made are normal profits and that they are not being exploited by the banks through bank charges. The government on the other side is concerned about the impact of this trend on the economy and therefore proper regulation of the financial sector. Stakeholders in the financial sector want the profitability trend to be sustainable and therefore knowledge of the factors underlying the continued profitability would assist the stakeholders in strategy formulation to ensure sustainable performance of the financial sector. The huge profitability enjoyed by the large banks vis-a-avis the other industries indicates that there are some significant factors that influence the profitability of commercial banks. Flamini *et al* (2009) and other several studies have shown that bank profitability is influenced by bank-specific factors and industry specific factors. A number of studies have been done on banks profitability under the changing environment (Shipho, 2011). However the researcher has not come across a study done on the factors contributing to high profitability of commercial banks in Nyeri County. Therefore this study look at the factors that contributes to high profitability of commercial banks in Nyeri County under the turbulent environment.

The researcher therefore sought investigate the factors that contribute to high profitability in banks more especially under turbulent economic environment where other players and industries in the economy ere recording negative growth.

### **1.3 Objectives**

The objectives of this study was:

#### **1.3.1 General objectives**

The general objective of the study was to investigate the factors that lead to high profitability of commercial banks under turbulent environment in Nyeri County.

#### **1.3.2 Specific objectives**

The objectives of the study were to;

- i. To determine the contribution of interest rates to banks profitability.
- ii. To investigate the relationship between deposits held by banks and profitability
- iii. To explore the relationship between banks charges and bank profitability
- iv. To analyze the contribution of other sectors of the economy to high profitability.

### **1.4 Research questions**

- i. To what extent do the interest rates contribute to high profits?
- ii. How do customer deposits contribute to high profitability in banks?
- iii. To what degree do you think bank charges contribute to high profits?
- iv. How do other sectors contribute to banks profitability?

### **1.5 Significance of the study**

The research was significant to a number of stakeholders which included banking industry to be able to understand the turbulent nature of the environment, and how they continued to work under the same environment with future focus on how the current performance was sustainable.

Customers attribute the high performance of banks to only interest rates and bank charges. The research was therefore enable the customers understand the various factors that contribute to high profits in commercial banks other than the bank charges and interest rates. Generally Kenyans have a perception that high interest rates charged by banks was the main the reason why they continue recording high profit margins while other industries record decline in profits due to high inflation. Therefore by understanding other factors that contribute to high profits, the public will know that there are other factors that contribute to banks profits.

The research provided valuable information regarding banks performance and the factors that contribute to high performance of financial institutions; specifically banks are able to understand the importance of looking into the future with regard to sustaining high profitability under the changing environment. Since no adequate study has been done in regard to the factors that contribute to high profits in commercial banks, it contributed to the general body of knowledge and form a basis for further research.

#### **1.6 Limitations of the study**

This research conducted in banks where information was regarded confidential and employees were not allowed to disclose it to anyone. This limitation was to overcome by the researcher having an introductory letter that would specifically state that the research was for academic purposes. The respondents, bank employees are very busy people, who may not have time to respond to the questionnaire. This was to overcome by structuring the questionnaire in a simple way that enabled the respondents to answer in a short time.

#### **1.7 Scope of the study**

This study was conducted in commercial banks Nyeri County branches. Nyeri County is one of the counties with all the major commercial banks having branches in the county. Nyeri County is also unique in that it was both favorable for agriculture as well as business and all commercial banks compete for the resources available. The international banks with branches in Nyeri County include Barclays and the Standard chartered banks, Major local banks include KCB, Equity and cooperative bank, Therefore the county had a variety of different banks both international and National banks, Nyeri County was appropriate for it had the major commercial banks represented in Kenya.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.1 Introduction.

The banking sector has experienced serious banking difficulties in the global market such as the United States where so many banking institutions failed in the 1930s and cost so much to be resolved. Indeed the cost of resolving banking problems have been particularly high in such countries as Finland Norway, Spain and Sweden as compared to the US. Other countries like Brazil Japan Mexico and Russia, banking problems have yet to be fully resolved. The troublesome situation for banks have been attributed to a mixture of bad luck bad policies and bad banking in addition to Volatility of the environment, an increase in bankers inclinations and incentives to take risk explains why banking no longer appears to be so safe. The banking industry in most countries has however continued to report impressive profits. (Caprio etal, 1996). This chapter therefore seeks to explore the theories of profits, Global Commercial banking, commercial banking in Kenya and Africa as a whole. The chapter also seek to examine the turbulent economic environment under which banks operate and how banks respond to unpredictable changes to the environment leading to growth in banks and high performance of the banking sector, as well as the empirical literature o the bank performance.

The banking industry had experienced marked changes in recent years as deregulation has allowed banking firms to diversify into broad financial service areas. The banking activities have diversified into different sectors prompting legislative and regulatory authorities in many countries to implement new laws and regulations in an attempt to promote greater confidence and stability in the banking industry. In this regard new bank standards for capitalization, risk exposure and information disclosure have been established. In addition modifications have been made on the pricing of bank products, the allowable activities of banks, the extent to which banks could be owned by, and owners of non bank firms, the restriction on geographical expansion of banks through branching merger and in the restrictions on geographical expansion

of banks through branching, merger and acquisition: the supervisory practices to contain bank risk-taking behavior and the insurance or guarantee schemes to protect depositors from bank failures. (Sponge, 1994). Commercial banks through this have become full service financial firms offering a range of nontraditional financial services including insurance, securities business as well as pensions. As banking systems open up, many institutions were also pursuing international strategies, so the traditional focus on banking as mainly domestic business was changing. This rapidly evolved poses both threats and opportunities to both bank managers and owners. The threats affected both domestic and international developments in the management process as well operations of the commercial banks. (Barbacasu, 1988).

Over the last generation, internationally active banks have shifted from international to global banking. Some banks, rather than taking deposits and offering consumer loans, mortgages and corporate loans have pursued a capital market strategy seeking to fund their portfolios of local securities locally as well by adopting a global consumer or global wholesale model where banks are looking to serve their customers through a local presence funded locally. Commercial banking and especially in Europe, UK's financial firms are among Europe's s best performing financial firms for over a decade. This is because UK banks have benefited from a buoyant domestic economy and have managed to maintain relatively high interest margins. Costs of the banks in Europe as well as provisioning have reduced this factors leading to the shift of banking to global which is reflected by changes in both banks' strategies and bank constraints in Europe. (Hawkins, 2001). According to Mckensey 2000, more than in any other major industries, it appears long term success in banking hangs on being in the right time over the last ten years for example, 88 percent of the growth in the revenues of Europe's 20 largest banks was attributable to market momentum, This is means competing in or entering territories and market segments that enriched everybody. However the banking industry do not always become successful with the new ways of doing business such as internet widely expected to compress margins, thus disintermediation or even commoditizing many parts of the business. (Mckensey, 2000).

In Africa, the primary role of the financial sector, is that of mobilizing financial resources from the savers and directing these resources into channels of desired development activities (Ajakaiye, 2005). Countries with better developed financial systems, i.e. financial markets and institutions that more effectively channel society's savings to its most productive use, experience

faster economic growth (Beck, 2007). They continue to add that financial sector development helps economic growth through more efficient resource allocation and productivity growth rather than through the scale of investment or saving mobilization. However, while remarkable growth has taken place in the continent ( Ndungu, 2010) of the Central Bank of Kenya in a speech delivered at the Mobile Policy Forum in Africa noted that expanding basic financial services has the potential to lift the majority of the population out of poverty and build better lives. The lack of accessible and effective banking and identity infrastructure coupled with predominantly cash based societies in much of the developing world has hampered the individual's ability to proactively and safely chart a path out of poverty into economic self-determination and growth (Landau, 2009), Access to finance refers to the availability of financial services – in the form of deposits, credit, payments, or insurance – to individuals or enterprises. The availability of such services can be constrained for instance by physical access, affordability or eligibility. According to the Finscope Ghana Report (2010), a significant majority of the population is unbanked: with a large proportion of the population being financially excluded.

According to Rights Issue, (2011), the banking system in Kenya is fairly well developed and compares favorably with the banking systems in the developed nations. The industry in Kenya is governed by 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). It is effectively regulated, comprising a central bank, a few large, financially stable banks and investment institutions, and a number of smaller banks including many foreign banks that have set up operations in Kenya. This large number of banks in the country has led to great changes in the banking environment leading to high performance and high profitability.

A key indicator of financial performance and efficiency in Kenya is the spread between lending and deposit rates. If this spread is large, it works as an impediment to the expansion of a development of financial intermediation. This is because it discourages potential savers due to low returns on deposits and thus limits financial feasible investment opportunities and thus limiting future growth potential. It can also be observed that developing countries like Kenya large spreads occur in developing countries due to high operating costs, financial taxation or

repression, lack of competitive financial banking sector and macroeconomic instability. (Njuguna and Ngugi, 2000).

The Financial institutions in Kenya constitute greater institutional diversity together with diversification of services offered. Commercial banks in the recent past have become new actors in the world of micro finance. Commercial banks have begun to invest in large number of potential clients for small loans many of which are microenterprise lending which in Kenya comprises of a bigger market with substantial income to banks (Almeyda, 1996). Banks have further in the recent experiences expanded financial technologies, organizational structure and regulation. According to Peter W Muthoka, the KCB bank performance in 2010 was attributed to the new core banking system (T24) Banking services continue to dominate this sector. Financial sector and banking in particular plays an important role in fostering economic development of a country (Levin,1993).

According to a write up by Peter K Munga (2009), Commercial banks have opened up to new markets outside the Kenya by injecting capital to these new markets. In 2010 KCB bank group injected additional capital to subsidiaries outside Kenya with the aim of increasing their market penetration (KCB bank group financial report, 2010).Equity bank limited started its operations in Uganda through the acquisition of the Uganda Micro Finance limited in 2008 converting it to a fully fledged commercial bank as well cross listing the bank's shares to Uganda Securities Exchange. In the same year the bank also rolled out its operations to South Sudan.

Due to the dominance of banking services in financial reform is highly recommended to promote competitiveness in the banking sector this however will require policy changes, for example on entry requirements tend to restrict entry. The dominance of the banking sector gives banks a competitive edge offer other financial institutions leading to high profit reporting (Njuguna and Ngugi, 2000). In the 1970s and 1980s, the development Finance institutions DFIs tripled from 1981 level while commercial banks experienced 50% growth. DFI failed to deliver as expected due to management problems and also failed to attain autonomy from government control in financing. The situation however changed with the introduction of banking act aimed at strengthening the sector's institutional framework. This however worked to strengthen the position of the banks in the financial system. Thus the observed structure of the financial sector has an historical as well as policy dimension, and in 1990s four banks continued to dominate the

sector. This period saw commercial banks dominating the financial sector with a total of 51 banks, 5 building societies, 39 Insurance companies 3 reinsurance companies 10 DFIs 13 forex bureau and 2670 savings and credit cooperative societies (Ngugi ad Kabubo, 1977), The high number of banks could not however last for long as the smaller banks collapsed.

According to Martin Oduor in in the KCB Rights issue (2011) “Nyeri County is one of the counties in central Kenya. The county has fertile land and agriculture is the main source of income for most residents of this county. The major agricultural activities in the county are tea, coffee and dairy farming. The county also consists of small and micro entrepreneurs with a good number having limited capital depending banking finance for their operations. The county is well banked with about twelve banks which have branches in all the major towns in this county. These are Nyeri town, Karatina, Mukurweini and Othaya. Other financial institutions in the county are Micro Finance institutions and Saccos.”

According to Peter Muthoka write up in in the KCB Rights Issue ( 2011), banks have diversified their focus to mass market by coming up with products that target them. This is after realizing that a large majority of the Kenyan market and especially Nyeri County comprise of middle and low income earners. In the recent years banks have introduced micro banking products that basically targets micro businesses by offering them short term loan facilities running up to one year. These have boosted the bank’s income as the interest charged on these loans is higher due to the risk level involved in them and the fact that they are unsecured. Banks have developed products and loan facilities for farmers that mainly target tea farmers, horticultural and coffee farmers. This has been very helpful to Nyeri county farmers since the county is mainly agricultural. This has led to farmer’s perception of the bank changing as it was now focusing more on low income segment of the market.

### **2.2.1 Theoretical literature.**

Profitability is measured with income and expenses. Income is money generated from the activities of the business both profitability for the past period or projecting profitability for the coming period, measuring profitability is the most important measure of the success of the business. A business that is not profitable cannot survive. Conversely, a business that is highly profitable has the ability to reward its owners with a large return on their investment. Increasing

profitability is one of the most important tasks of the banks like any other business organizations. Banks constantly look for ways to change the business to improve profitability. (Hofstrand, 2009) The suggestion that the future is not known, even probabilistically, in advance, and therefore that resource owners have no basis for knowing the future value of their resources, carries with an inevitable profit precipitate. Profits rate is usually taken as the ratio of profits to amount invested as capital. The implication is that profits result from and are a return to capital. (Dougherty, 2007).

According to Cover (2000), profit accrues because the society is dynamic by nature. Since the dynamic nature of society makes future uncertain and any act, the result of which has to come in future, involves risk. Thus profit is the price of risk taking and risk bearing. It arises only in a dynamic society which means in a society where changes does not occur i.e. it is static by nature the risk element disappears and hence the profit element does not exist there. A society is said to be dynamic when there is a change in its population, change in trends of the people, change in stock of the capital, change in the supply of entrepreneurs etc. when all these factors become constant, the future also becomes certain and the risk element disappears from the society.

Profit always equals to the marginal productivity of the entrepreneur. The marginal productivity of the entrepreneur cannot be evaluated in the case of the firm because there is only one entrepreneur in a firm. This however can be easily done in an industry where the number of the firms can be calculated and hence the marginal productivity of various entrepreneurs can be measured. Thus, profit depends upon the marginal production. The greater the marginal production the greater will be the profit. (Sco, 2011).

The services of the entrepreneur are also classified as labour though of a superior type. These entrepreneurs do a lot of work in organizing the business unit as well. The entrepreneurs in the shape of profit pay to themselves for service just as managers are paid for their services. It means that profit is a wage for the entrepreneur for the services rendered by them. According to Berger, (1995) Profit is the reward for uncertainty bearing and not the risk bearing .Berger has regarded uncertainty bearing as a factor of production, he classifies the position that profit arises because of the joint action of uncertainty bearing and capital.

According to (Hawley, 2003) Profit is reward for risk bearing which is the most important function of an entrepreneur. Hawley believes that risks are unpleasant and therefore no one likes to bear it, until and unless some reward is insured. Profit is a reward for bearing these risks. The profitability theories are dynamic and involve a number of factors that interact leading to profitability of the firm. Following the above theories, the researcher will put more emphasis on Prof. Knight and F.B. Hawley's theories. This is because the theories relate well with profit and risk and explain the interaction of a number of factors to achieve profitability of a firm.

## **2.3 Empirical literature**

The bank earnings or generally profits over a given period of time are a combination of a number of factors expressed as a function of profits. That is Profit (p)= f(loans and advances, certificate on deposits, government securities, deposits from other banks, other assets and investments in subsidiary companies) (Nafula, 2003). Various studies have been done on banking profitability under the changing environment. There has been a study done locally on banking performance, however the researcher has not come across a study done on the factors that lead to high performance of commercial banks in Nyeri County. In the study that was done in banking performance in Kenya. The research explored the general performance of banks. The study however did not look into bank performance under different economic conditions. The study will therefore explore the various factors contributing to banking profits under the changing environment.

### **2.3.1 Turbulence nature of Business Environment**

The year 2007 was characterized by unpredictable changes with hard economic times; financial institutions reduced lending by increasing interest rates, (Waweru, (2009) .Turbulent nature of environment is characterized by political climate, economic climate social climate, and technological environment this are the factors are uncontrollable or otherwise known as the external environment.

Macro environment is largely external to the business enterprise. Macro environment factors are uncontrollable factors and beyond the direct influence and control of the organization. Its factors are powerfully influence to its functions. External environment consists of individuals, groups, agencies, organizations, events, conditions and forces. These are frequently contacted by the

organization for its functions. It establishes good interaction and interdependent relations in form of conducts business transitions. Proper designing and administration of macro environment enable appropriate strategies and policies to cope with and make changes. The various external environments facing the business according to (Kotler, 2004) are such as; Demographics, Economics, Technology, Politics and Culture. In in this research and from the results collected, banks continue to grow in terms of profits due to the major income earning areas such as interest rates and other bankers charges.

The macroeconomic, systematic environment and other factors play a considerable role in determining the risk and returns of financial institutions, (Allen and Bali, 2004). The demographic environment itself is affected by changes in the mix of age groups in the population. If the population becomes older, this will lead to rising demand for products and services consumed by older people and a similar fall in demand for products consumed by younger people. The development of ethnic markets can also be relevant. In a number of countries, the ethnic mix of consumers is changing due to immigration and other factors. This will be reflected in changing demands for various goods, not only from the specific ethnic group but from other consumers whose tastes have been affected by them. Furthermore, as ethnic groups immigrate to other countries, their own tastes can affect those of consumers in the host nation. The demographic environment is also affected by the level of education in a country, since changes in education have an impact on the wealth of a nation and the tastes of its people (Kotler, 2004).

The lifestyles of a population also have an impact on the macro environment facing marketers. In Western countries there has been a growth in households made up of single people; and a large proportion of women now go out to work. This has resulted in an increase in the sales of convenience foods. There are also a greater proportion of couples whose children have grown up and left home. Such couples have more disposable income to spend on luxuries, holidays and home improvements (Kotler, 2004).

The economic environment is important to marketers because it affects the amount of money people have to spend on products and services. One of the components of the economic

environment is the distribution of income. Economies around the world not only vary in their absolute or total level of wealth but also in how their wealth is spread within the population. For example, poor countries may be classified either as those which have a highly unequal spread of wealth or those where it is more evenly shared. The former group of countries may be markets for luxury goods, despite the level of poverty. In contrast, the second type of country may be more attractive to marketers of inexpensive goods for the mass market (Kotler, 2004).

Consumers around the world differ in the extent to which they save money and the use they make of credit facilities. A high propensity to save will result in a lower propensity to consume. However, these patterns will also have a secondary effect on the overall macro economy of a nation. A country where people have a high propensity to save is likely to be characterized by low interest rates, which will affect industry's borrowing costs (Berry 1990).

Technological developments offer marketers both opportunities and threats. Although firms can offer customers a wider array of advanced products, changes in technology also mean that there may be more than one technical solution to a customer's needs. Where a market converges towards one technological standard, there can be problems for marketers who have promoted an alternative standard (Kotler, 2004).

Increased technological development accelerates the speed of obsolescence. Marketers have to consider how their product may need to be developed over time, if it is to remain competitive. Technological developments affect how people work and do business. For example, the falling cost of telecommunications coupled with their increased sophistication has meant that it is possible for individuals to work away from the office. In the future this could lead to lower usage of transportation systems. Furthermore, the falling cost of technology has meant that many more small firms can function in areas such as publishing and film production, which used to be the domain of large organizations. In a number of countries this has resulted in the establishment of small firms in these areas (Kotler, 2004). The risks from technological changes have meant that firms are increasingly entering into 'strategic alliances' with customers, suppliers and even competitors. Indeed, there has been an increasing emphasis on open, long term relationships, based on trust between customers and suppliers. This is expected to help in the development of products and the management of technological risks (Kotler, 2004).

Marketers are influenced by the regulatory environment. This has implications for their obligations to customers and the wider public. Customers are increasingly able to seek redress for faulty products, and those who live near manufacturing plants are able to claim compensation for pollution. The political environment around the world has recently favored the privatization of public companies. Such companies have also been able to compete more freely in the private sector. Political changes in Eastern Europe have also meant that these markets are now open to marketers from around the world (Kotler ,2004). People's opinions and tastes are shaped by the society in which they live. It should be noted that societies are not made up of homogeneous populations. They contain sub-cultures, which are beliefs and values shared by smaller groups of people. Such groups may arise out of a common race, religion, social activity or hobby. Sub-cultures are important to marketers insofar as they may have different consumption habits from the rest of the population. The following are some aspects of culture that influence people's consumption: the 'core' culture is that set of values handed down from generation to generation and which is reinforced by social institutions such as schools and places of worship. Core values are likely to be strongly held and it may be difficult for marketers to promote a message that runs counter to them. More susceptible to change are secondary values. People's opinions are influenced by the media, role models and changing tastes (Kotler, 2004). In summary kotler simplifies the environment as consisting Macro ad micro factors.

### **2.3.2 Banking Adaptation to Environmental Turbulence and Radical Institutional Change**

Adapting to environmental shocks is a capability all businesses have to develop in order to survive. Environmental shocks, or jolts, reshape the opportunities and threats the firm faces and are likely to render existing business strategies ineffective (Northcott, 2004). Different types of environmental shock can occur with which businesses have to cope; such shocks change the level of environmental munificence and consequently affect the performance of organizations. Recession, an environment of falling GDP, is one type of shock. Much profitability literature is concerned with strategic change in circumstances of environmental jolts, turbulence, radical institutional change, industry deregulation or hyper-competition. Although this literature does not always relate specifically to recession, certain themes may be relevant. (Grewal and Tansuhaj 2001), for instance, show that strategic flexibility, the ability to respond quickly to changing competitive conditions (Hitt, et al., 1998) has a positive influence on business performance

during and after a crisis. Others suggest that discontinuous change within an industry stimulates the formation of inter-organizational relationships, promotes experimentation with new organizational forms and precipitates affiliations spanning industry boundaries (Meyer, 1982). Inter-organizational networks absorb uncertainty arising from revolutionary change. (Dixon et al. 2000) discuss the dynamic capabilities required to survive and succeed in a transition economy – namely, the interactions between exploitation learning (learning to do things better) and deployment capabilities within the organization, and the interactions between exploration learning (creation, experimentation) and the search and selection capabilities required to manage innovation routines.

#### **2.4 The contribution of interest rates to bank profitability**

Commercial banks interest rates are determined by the central bank base rate to guide the commercial banks on the expected interest rates to be charged for a particular borrowing. (Beck and Fucks, 2004), observed that there are a number of factors that determine the interest spread in the commercial banks and thus based on the interest spread, different banks charge different interest rates based the type of the loan and the risk inherent for a particular group of customers.

According to CBK survey (2007), commercial banks in addition to interest rates charge other services which include account maintenance charges, loan processing fees, early repayment Fee. All this charges according to the survey add to the cost of borrowing and operating an account with commercial banks leading to an increased income and hence high profits for commercial banks.

Interest rate spread in Kenya remain high According to Infotrack survey on interest rate spread , (2012), commercial banks charge high interest rates on loans as opposed to the interest paid on customer deposits held by banks a factor that contributes to high profitability in banks. In 2011, the difference between interest paid by banks to customers and that charged to customers' was between 10% to 15 % a factor that contributes to high profits in banks.

The banking industry is the central player in all other sectors of the economy. The growth of this other economies means the growth of commercial banks profitability as a result of banking increases income from this other sectors. According to Bank of England report on finance for small businesses, (2000), growth of the SME increases in banking services toward the SMEs

leading to considerable income return for commercial banks. Agriculture is also a contributing factor towards the industry profitability.

#### **2.4.2 Summary of literature review.**

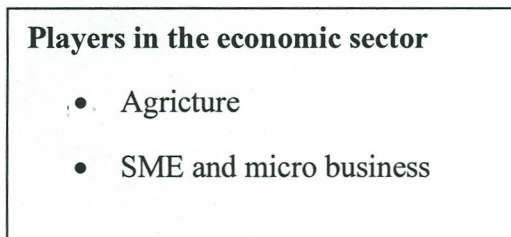
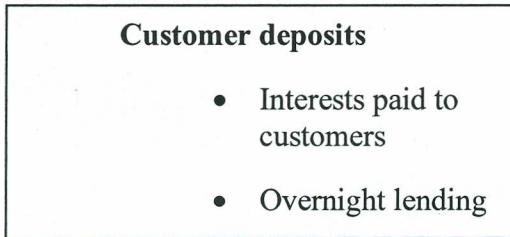
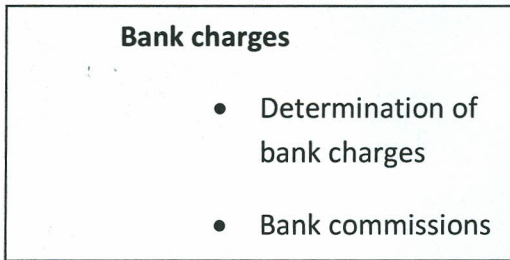
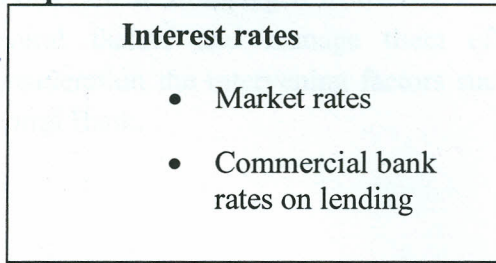
In order that commercial banks grow and profitability continues to advance in this global economy, economic growth is required. According to Goddard and his colleagues (2004), in spite of the growing body research into determinants of banking profitability, there remains a paucity of studies that have investigated the specific relationship between organizational size and its impact on profitability. (Cover, 1999) emphasizes the need for identifying determinants of profitability in the banking industry never been greater, As banks move into twenty first century, they must focus more than ever before on creating new streams of revenue in order to increase the shareholder value.

Previous studies of the determinants of concentration have proposed various explanations as to why some firms grow and attain large size. These include economies of scale or scope, efficiency, accumulated tacit knowledge and expertise as well as the resources needed to continue their expansions into foreign markets where barriers to entry may be prohibitive for smaller players in the market. Other studies have demonstrated the feasibility of using the feasibility of using bank level data to investigate profitability determinants. Berger, (2006

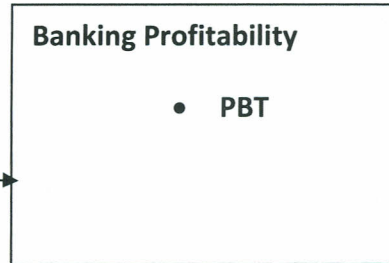
Moreover, macroeconomic stability and an enabling economic, environment must provide the conditions for the private sector to develop into a major engine of economic growth. The financial system and more specifically the banks have a major role in assisting to create this enabling environment. Putting up strategies that respond to the turbulences in the environment is vital for survival of any bank in Kenya today. Various studies that have been done in the past have not been able to exhaustively explain the factors that contribute high profitability in banks but rather explain the efficiency in the banking industry as the major contributor to high profitability in banks especially under turbulent economic environment. This research will therefore explore the factors that lead high profitability in banks under turbulent economic environment.

## 2.5 Conceptual framework

### Independent Variables



### Dependent Variable



### Intervening variables

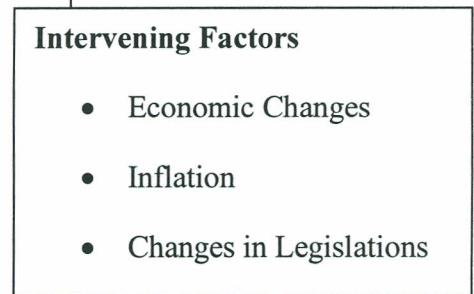


Figure 2.1

Source: (Researcher, 2012)

### 2.5.1 Explanation of Variables

Commercial banks are aware of the fact for high profits all factors that contribute to the banks income are well managed to overall lead to profitability. Banks will therefore need to employ several factors and manage them efficiently to contribute to profitability putting into consideration the intervening factors such as legislations and the regulatory body which is the central Bank.

#### 3.1 Research Purpose

The main objective of this study was to determine the effect of the economic environment on the profitability of banks in Nigeria. The study was carried out using panel research design to fulfill the above objective. The advantage of this panel data was that it controlled the individual heteroscedasticity and collinearity which are major weaknesses of cross-sectional data. The study was carried out using the following objectives:

#### 3.2 Target Population

The population of this study was composed of the seven major banks in Nigeria. These are KCB, Citibank, Fidelity Bank, First Bank, First City Monument Bank, GTBank and Zenith Bank.

#### 3.3 Sampling Technique

The sampling technique used in this study was purposive sampling. Purposive sampling is a non-probability sampling technique in which the researcher selects the sample based on their own judgement. In this study, the researcher selected the seven major banks in Nigeria as the sample. The researcher used purposive sampling to select the sample because the researcher was interested in the effect of the economic environment on the profitability of banks in Nigeria. The researcher used purposive sampling because the researcher was interested in the effect of the economic environment on the profitability of banks in Nigeria. The researcher used purposive sampling because the researcher was interested in the effect of the economic environment on the profitability of banks in Nigeria. The researcher used purposive sampling because the researcher was interested in the effect of the economic environment on the profitability of banks in Nigeria.

# CHAPTER THREE

## RESEARCH METHODOLOGY

### 3.0 Introduction

This chapter contains the design used in the research study, target population, sampling design (sample size determination, sampling procedure), data collection procedure, data collection instrument, validity and reliability of research instrument, administration of the instrument procedure and data analysis. The research process involved two steps: The sampling design which involved a step that described the approach that was used to select a sample and how adequate a sample size was. Secondly the procedures for obtaining population estimate from a sample data and for estimating the reliability of those estimates.

### 3.1 Research Design

The main objective of this study was to determine and evaluate the factors that affect bank profitability under turbulence economic environment. The study adopted an explanatory approach by using panel research design to fulfill the above objective. The advantage of using panel data was that it controlled for individual heterogeneity, less collinearity variables and tracks trends in the data something which simple time-series and cross sectional data cannot provide (Baltagi,2005).

### 3.2 Target Population

The population of this study was comprised staff of the seven major commercial banks in Nyeri County. These are KCB, Equity, Co-operative, Family, National bank, Barclays and Standard Chartered. They have a total population 355 employees.

### 3.3 Sampling Technique

The sampling technique that was adopted for this study was stratified random sampling. The employees were chosen depending on the organization (bank), the sample then further examined in terms of employment whether permanent or temporary, they were further examined into their position in the organization, clerical level, supervisory level and management. Homogeneous sample was used. (Salant & Dillman, 1994, p. 54). The respondents who participated the sample were selected at random; they had an equal (or known) chance of being selected. A sample size of 30% was used. According to (Mugenda and Mugenda, 2005). A sample size of 30% was appropriate in research study. Banks were sampled at random; employees from the sampled

banks in Nyeri County were also selected at random and this formed to form the respondents for the purpose of this research.

Below was the sampling frame:

**Table 3.1: Sampling Frame**

<b>Bank</b>	<b>Population in each bank.</b>	<b>Sample (30%)</b>
KCB	80	24
Equity	100	30
Co-operative	40	12
Family	50	15
National	25	8
Barclays	38	11
Standard Chartered	15	5
Financial managers	7	2
<b>Total</b>	<b>355</b>	<b>111</b>

**Source: (Researcher, 2012)**

### **3.4 Data collection Tools and Techniques**

Data was collected using a questionnaire. This was because questionnaire was used to collect large amounts of information at a low cost per respondent; respondents gave more honest answers to personal questions on a mail. The questionnaire had open and closed ended questions. The questionnaires were administered using drop and later pick method. The questionnaire was used because it was faster, less costly and it covered a wide perspective to the study, (Kothari, 2004).

### **3.5 Data Analysis**

Data collected were both qualitative and quantitative. Quantitative data was analyzed using descriptive statistics such as frequencies and mean scores. Individuals, offices, or entire firms were considered. Aggregating individual questionnaire responses across a team helps to lessen

the effects of idiosyncratic or individual attitudes. The model that was used was based on model of clustered data. A multiple linear regression model and t-statistic was used to determine the relative importance of each independent variable in influencing profitability. The linear regression models will be used as shown below.

$$PBT_{it} = \alpha C_{it} + \beta I_{it} + \gamma B_{it} + \delta C_{it} + \eta O_{it}; \text{ Where};$$

**PBT**                    profitability of the bank i at the time t

$C_{it}$                     Fixed effects for each bank

$I_{it}$                     Interest charged over time t

$B_{it}$                     Bank charges at the time t

$C_{it}$                     Customer deposits at the time t

$O_{it}$                     Other economic sectors at the time t

$\alpha$ - Bank specific factor coefficient,  $\eta$ - Market factor coefficients.

## **CHAPTER FOUR**

### **DATA ANALYSIS AND INTERPRETATION**

#### **4.1 INTRODUCTION**

The chapter presents the output of the research in terms of analysis responses from the respondents. The research results is explained both under quantitative and qualitative analysis. The first part of the results mentions the characteristics of the respondents in regard to their personal information. The rest of the analysis is in reference to the specific objectives of the study. A good number of staff were found be graduate trainees and graduate clerks who have degrees. This therefore means that banks employees are qualified and this leads to efficiency leading to high banks performance.

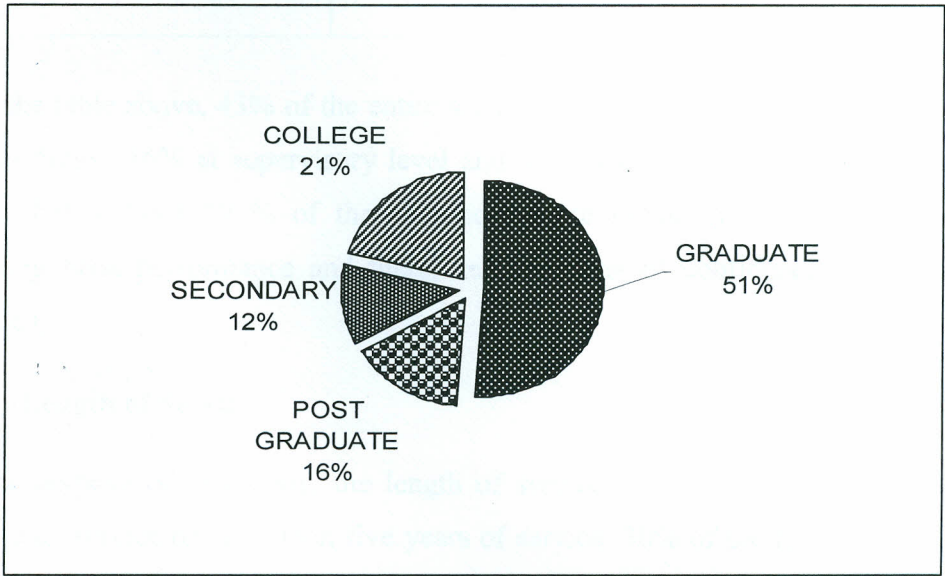
#### **4.2 QUANTITATIVE ANALYSIS AND RESULTS**

##### **4.2.1. Response Rate**

The response rate was computed by dividing the total sample size with the actual number of responses received through questionnaires. This means that out of 111 sample size, 100 duly completed questionnaires were received and processed. This translated into 90 % responses rate which was considered sufficient enough to proceed with the data analysis and interpretation.

##### **4.2.2. Education Level of Respondents**

The employee performance, productivity and output are a function of their level of education and training. This study sought to establish the breakdown of the staff level of education with the respective level of employment in their respective organizations. Staff deployment from the entry level or temporary employment to the senior management with respect of their education level was considered.



**Fig. 4.1 Education Level**

As observed, those who had secondary level of education were 12%, those with college level comprises of 21%, the graduates constituted 51% while those with postgraduate qualifications were 16% of the total population. The over 60% of the employees having at least a degree and above the response therefore will be more reliable in terms of information provided with regard to data collection.

**4.2.3 Categories of the Staff**

The staffs working in the banks under study were asked to classify themselves where the outcome of this aspect was illustrated below:-

**Table 4.1 categories of Staff.**

Category	Number	Percent
Sales	43	43
Clerical	32	32

Supervisory	16	16
Management	0	9
<b>Total</b>	<b>100</b>	<b>100</b>

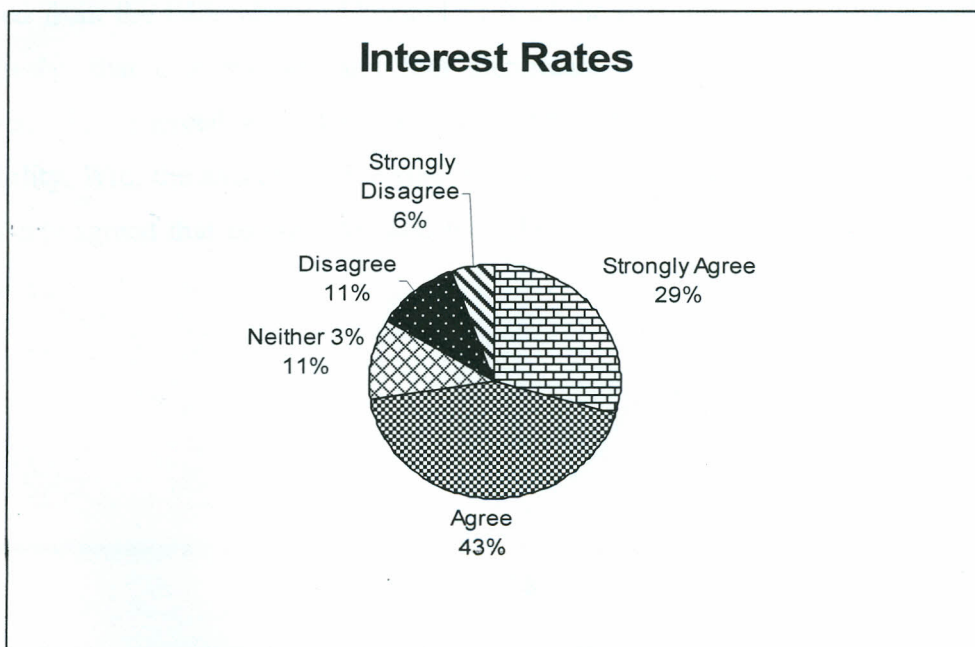
From the table above, 43% of the entire staff was engaged in sales that are on contract, 32% in clerical duties, 16% at supervisory level and 9% taking management positions. This therefore means that at least 59 % of the respondents are permanent with much more information regarding bank performance and therefore high level of confidence in terms of information collected,

#### 4.2.4. Length of Service

For the purpose of this study, the length of service was divided into less than five years of continuous service or more than five years of service. 30% of the respondents have worked for less than 5 years while more than 60% of the respondents have worked for more than 5 years. This implies a high confidence level with regard to information being provided.

#### 4.2.5. Banks Usage of Interest Rates to Improve its Profitability

Banks rely significantly on the interest income to meet their annual profits targets. The perception of the respondents was sought regarding whether they considered that banks relied on the interest rates to improve their profitability.



## Fig. 4.2 Interest rates

From the table above, 32% strongly agreed that interest rates were used by the banks to significantly improve their profitability. Another 47% agreed, 3% were not sure, 12% disagreed and 6% strongly disagreed. It is therefore evident that banks use interest as the major contributor to bank profits.

### 4.2.6. Commission and Fees in Profit Improvements

Services offered by the banks attract commission charges and fees. A common example is exchanging currencies or transferring funds to overseas banks. Respondents were asked whether they perceived use of commissions and fees as a factor that improved bank's profit.

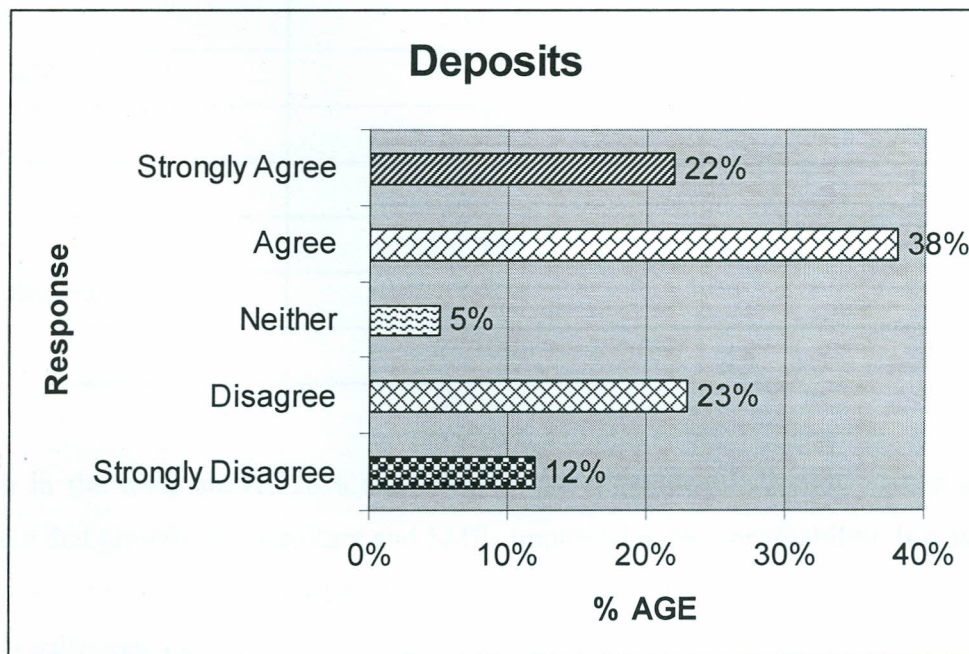
**Table 4.2** Extent of using Commissions to Improve Profitability

Comment	Number	Percentage
Strongly agree	43	43
Agree	51	51
Neither	0	0
Disagree	6	6
Strongly disagree	0	0
<b>Total</b>	<b>100</b>	<b>100</b>

As noted from the table above, 43% and 51% of the respondents strongly agreed and agreed respectively, that commissions and fees significantly improved bank's profitability levels. However, 6% disagreed with the proposition that banks used commissions to improve their profitability. With the analysis of the results therefore it will be noted that a good proportion of respondents agreed that commission and fees charged by banks are major contributors to bank profits.

#### 4.2.7. Use Customers Deposits to Improve Profitability

The study sought to find out whether the banks used customer deposits to either directly or indirectly improve their profitability. More customers' deposits mean more funds available for lending and for the banks utilization in inventing in securities. This aspect was examines in this study.



**Fig. 4.3 Customers Deposits**

From the table above, 22% of the respondents strongly agreed that banks relied on the customer's deposits to improve their profitability. In the same vein, 38% agreed although 5% were not sure. However, 23% and 12% disagree and strongly disagree respectively. The idea of customer deposit to bank profits is in relation to obtaining the deposit cheaply and using the same deposits in lending at higher interest rates, this therefore contributes to a factor contributing to high profits in banks.

#### 4.2.8. Impact of Growth in Agriculture and SME in Bank's Profitability

The entire economy is linked by multiple transactions and through multiplier effects. Agriculture and upcoming SME sectors contribute significantly to the flow of money transactions, most of

which goes through the banks. Growth of the agricultural sector and expansions of SME's were examined and their impact on bank's profitability pattern.

**Table 4.3 Growth of Agriculture and SME's impact Positively on Profitability**

<b>Response</b>	<b>Number</b>	<b>Percentage</b>
Strongly agree	28	28
Agree	39	39
Neither	4	4
Disagreed	21	21
Strongly disagree	8	8
<b>Total</b>	<b>100</b>	<b>100</b>

As shown in the table above, 28% and 39% of the respondents strongly agreed and agreed respectively that growth of agriculture and SMEs improved bank's profitability. It was noted that 4% were not sure while 21% disagree with 8% strongly disagreed. Irrespective of the different economic challenges, different players in the economic sector resort to bank borrowings leading to a boost in the bank performance.

#### **4.2.9. Use of Monthly Charges to Account Holders to Improve Banks Profitability**

The banks charges standing commission to all account holders for the services rendered. The study examined the perception of the respondents towards the contribution of monthly charges to all account holders by the banks with the aim of improving their annual profits. The study results were as shown below.

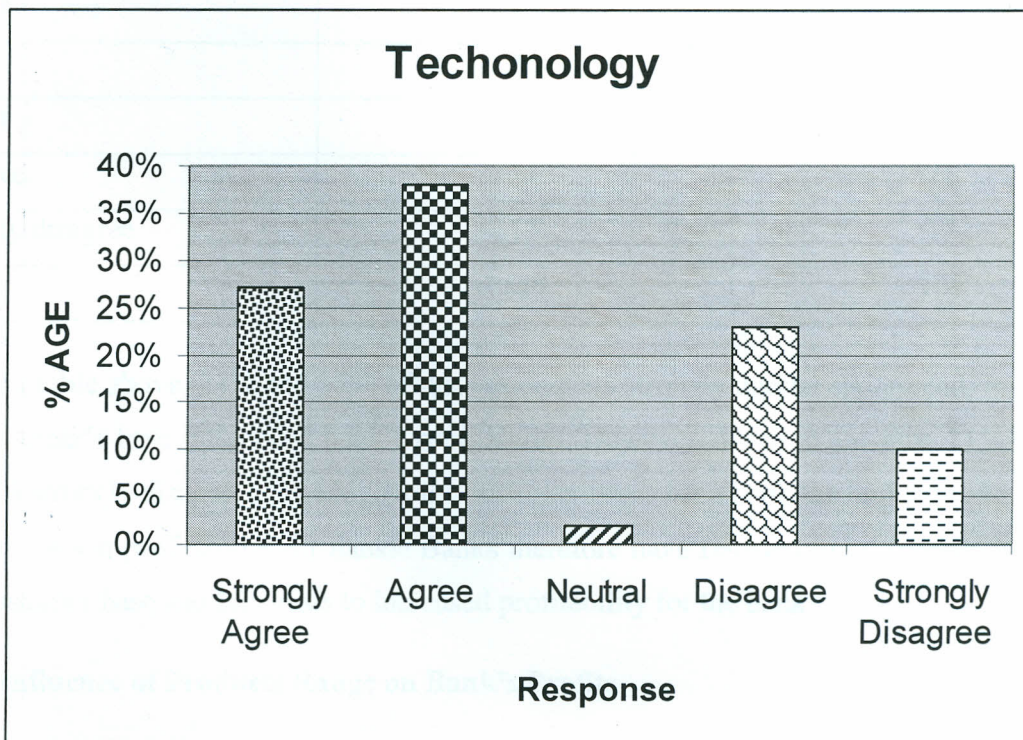
**Table 4.4 Monthly Charges to Account Holders Contributes to Bank's Profits Improvements.**

<b>Comment</b>	<b>Number</b>	<b>Percentage</b>
Strongly agree	36	36
Agree	41	41
Neither	1	1
Disagree	17	17
Strongly disagree	5	5
<b>Total</b>	<b>100</b>	<b>100</b>

From the table above, 36% of the respondents strongly agreed that monthly charges contributed significantly towards improving banks profitability. In addition, 41% agreed although 1% was not sure. On the contrary, 17% disagreed with another 5% strongly disagreeing. Monthly charges therefore can deductively be considered as one of the major contributors to bank performance.

#### **4.2.10 Use of technology to Improve Profitability**

The study sought to find out if, according to the opinion of the respondents, bank's use of modern technology was aimed at enhancing profitability. The use of information technology, such as computers, fax machines, scanners and other accessories transmit and stores a lot of data, even to overseas countries. This aspect was examined in this research.



**Fig. 4.4 Use of Techoonology**

As noted from the above figure, those who strongly agreed that new technology resulted into improved bank's profitability were 27%. Similarly, 38% agreed with 2% being neutral on this aspect. However, 23% disagreed with an additional 10% strongly disagreeing. Most banks have resorted to improved system most of which are geared towards encouraging efficiency in banks operations leading to increased performance and improved profitability.

**4.2.11 Effect of Customer Base on Profitability**

There is an assumed relationship, for the purpose of this research, between the number of customer base and revenue generation which is reflected in improved profitability. The higher the customer base, the higher the volume of the business and hence more profits. The perception of the respondents on this aspect was examined.

**Table 4.5 Extent to which Customer Base Influence on Bank's Profitability**

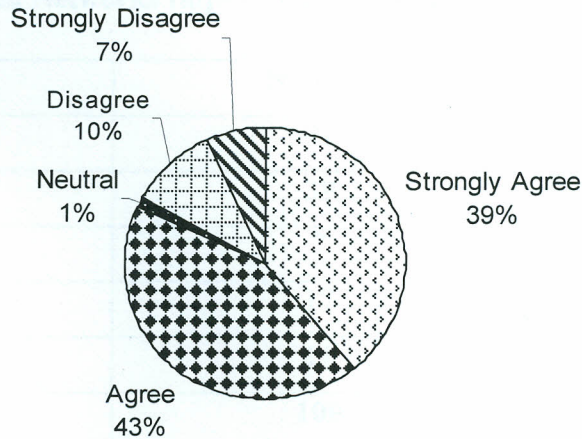
<b>Comment</b>	<b>Number</b>	<b>Percentage</b>
Strongly agree	23	23
Agree	35	35
Neither	4	4
Disagree	21	21
Strongly disagree	17	17
<b>Total</b>	<b>100</b>	<b>100</b>

From the table above, 23% and 35% of the respondents strongly agreed and agreed, respectively that customer's base influenced bank's profitability. However, 4% were not sure, 21% disagreed and 17% strongly disagreed. The higher the customer bases for a bank the higher the revenue and hence increased profitability for banks. Banks therefore have resorted to be focused in growing their customer base and this leads to increased profitability for the bank.

#### **4.2.12 Influence of Products Range on Bank's Profits**

Products range entails the different categories of products and services offered to the customers by the banks. This includes the different categories of accounts, investments and loan packages offered by the banks. This strategy was examined and it's a possible influence on the bank's profitability.

## Products Range



**Figure 4.4 Products Range**

From the figure above, 39% of the respondents strongly agreed that existence of multiple products and services by the bank's significantly levels. In addition, 43% agreed although 1% was not sure. On other hand, 10% disagreed as well as another 7% who strongly disagreed.

### 4.2.13 Influence of Branch Networks on Banks Profitability

Under business expansion strategy, banks systematically increase their branch networks to cover as many customers as possible. Indeed in large towns, one bank can operate several branches besides moving out to the upcountry market for example in Nyeri town some banks have more than one branch in the same town. More branch network means a wider clientele covered by a specific bank, this therefore means that banks are able to tab a high number of customer leading to profitability. This positively impacts on the banks revenues. This aspect was examined in this study.

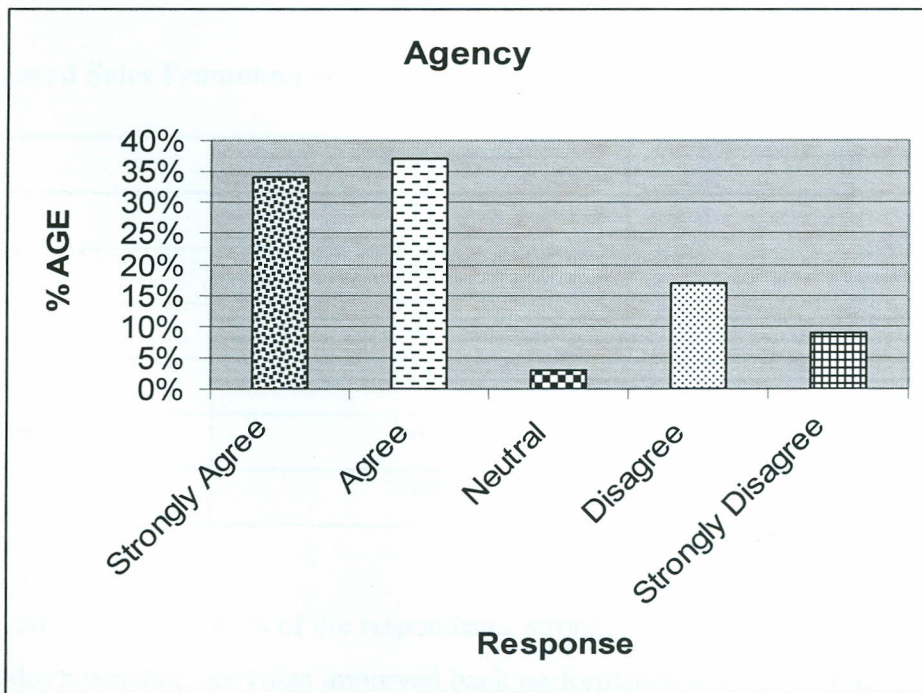
**Table 4.6 More Branch Networks Implies more Business Profits**

<b>Comment</b>	<b>Number</b>	<b>Percentage</b>
Strong Agree	31	31
Agree	39	39
Neither	2	2
Disagree	17	17
Strongly Disagree	11	11
<b>Total</b>	<b>100</b>	<b>100</b>

As observed from the table above, 31% and 39% of the respondents strongly agreed and agree respectively, that more networks translated to improved performance in terms of profitability. However, 2% were neutral, 17% disagree and 11% strongly disagreed. Branch network is a contributing factor to bank profitability as banks sought to tab as much revenue as possible leading to high branch network establishment and as a result increasing bank profitability.

#### **4.2.14 Utilization of Agency Banking and Bank's Profitability**

In this study, the use of agency banking as a business strategy to boost bank's performance was examined. Agency banking is a new concept in the banking industry and it means extending banking services to where customers are frequently available both in towns and in the rural canters. Agency banking has extended the banks services to many places reaching the unbanked. This aspect was subjected to the opinion of the respondents.



**Fig. 4.5 Agency banking**

From the table above, 34% strongly agreed that agency banking contributes significantly to bank profits. 37% agreed but 3% of the respondents were neutral. On the contrary, 17% disagreed and 9% strongly disagreed. Agency banking a new concept and banks appear to have embraced the cost due to initial cost involved in its establishment.

#### **4.2.15 Influence of Sales Promotion Activities on Banks Profits**

Sales promotion is undertaken by a business with the main intention by enlarging the customer base and increases the frequency of banking transactions. It also involves creating awareness to customers on the various products and services offered by banks. This study sought to find out the influence of sales promotion of banks profitability through the outcome of sales promotions.

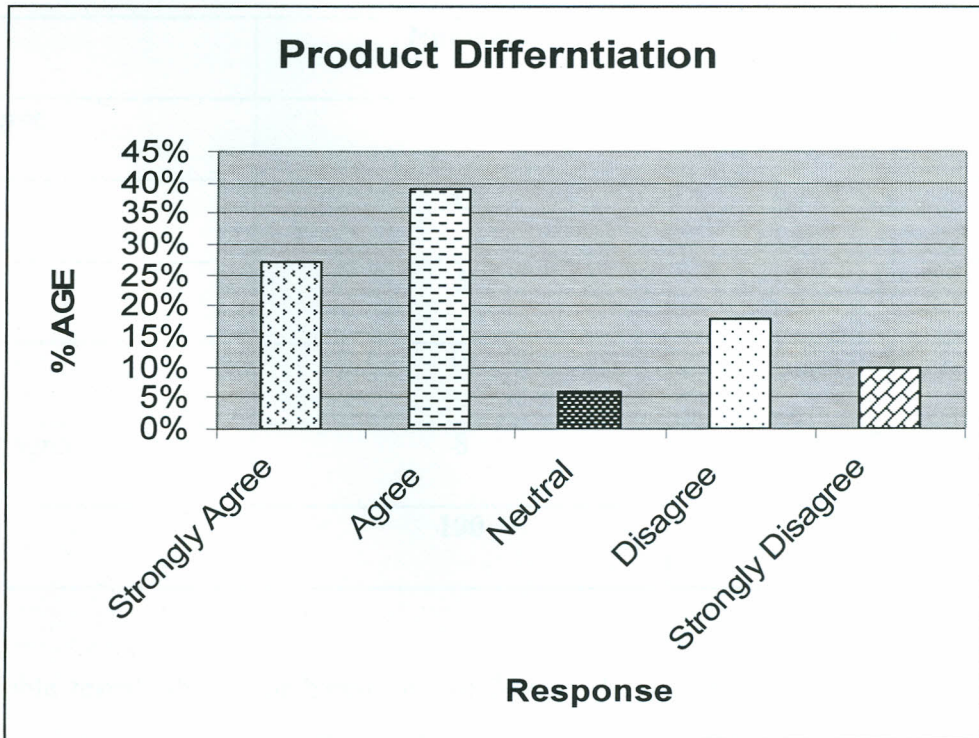
**Table 4.7 Enhanced Sales Promotion activities Improves profitability**

<b>Comment</b>	<b>Number</b>	<b>Percentage</b>
Strong Agree	37	37
Agree	41	41
Neither	2	2
Disagree	14	14
Strongly Disagree	6	6
<b>Total</b>	<b>100</b>	<b>100</b>

From the table above, 37% and 41% of the respondents, strongly agreed and agreed respectively that enhanced sales promotion activities improved bank performance through increased sales for the bank services and products. However, 2% were neutral. 14% disagreed with 6% strongly disagreeing. Banks have resorted to increasing sales staff for their organizations because of their importance in increasing bank income leading to increased bank profits.

#### **4.2. 16 Influence of Product Differentiation on Profitability**

From the strategic management point of view, product differentiation strategy is employed by firms to widen the market and cater for specific customers need under the mandate of market segmentation. More products and services mean expanded opportunities and more business transactions. Banks are therefore likely to earn more for the product range leading to high profitability in banks.



**Fig. 4.6 Product Differentiation**

From the figure above, 27% of the respondents strongly agreed that product differentiation was employed and they believed it improved bank's profits. Similarly, 39% agreed with 6% was not sure. However, 18% disagreed supported by another 10% who strongly disagreed. Banks have differentiated their products to suit different markets this has increased efficiency and thus leading to increased performance.

#### **4.2.17 SME demand for Capital and Bank's Profitability**

Small and medium enterprises support the economy in a big way with numerous banking transactions. The more the SME, the more the banking activities which translates into enhanced profits. The perception of the respondents on this aspect was examined, The research established that most respondents believed that bank performance is mostly influenced by demand of bank products at all times leading to banks high performance under turbulent economic environment.

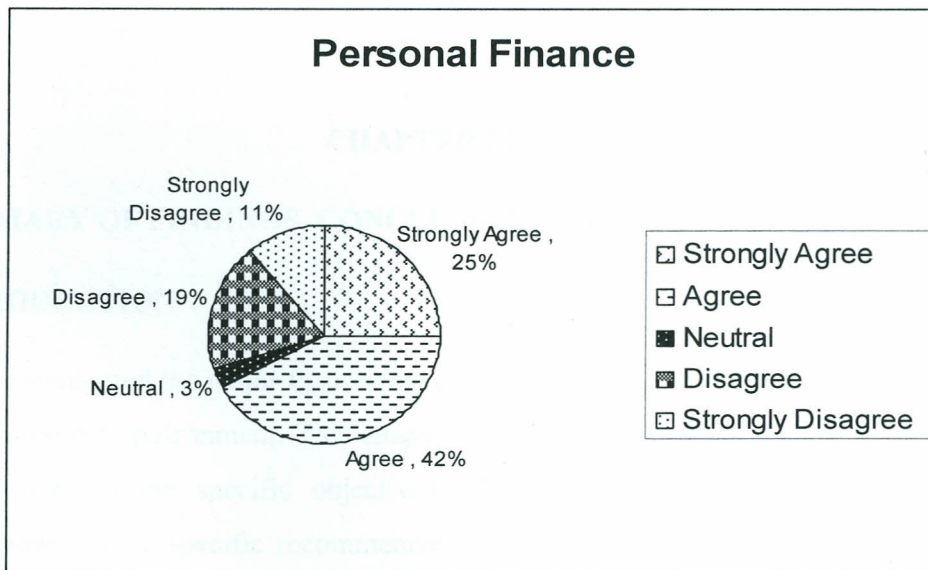
**Table 4.8 Increased SME Demand for Capital Impacts Positively on Profits**

<b>Comment</b>	<b>Number</b>	<b>Percentage</b>
Strongly Agree	31	31
Agree	43	43
Neither	5	5
Disagree	13	13
Strongly Disagree	8	8
<b>Total</b>	<b>100</b>	<b>100</b>

The above table reveals that a combined total of 74% of the respondents generally agreed that increased SME demand for capital influenced bank's profit levels. It was observed that 5% were not sure although 13% disagreed and 8% strongly disagreeing. This means that irrespective of different times in the economy small and medium enterprises will always be in demand for bank services and the result is constant customers leading to improved performance.

#### **4.2.18 Personal Financial Needs and banks Profitability**

Money is the central medium of exchange where almost all transactions involve money. As the population and business activities increase, so is the need for money. The introduction of agency banking and M-pesa system increased the velocity of money in the county. As personal financial engagements increase, banking transactions are likely to be positively correlated. This aspect was examined and indicated that most banks benefit as a result of need for financial needs for products offered by banks leading to high profitability in banks.



**Fig. 4.7 Influence of Personal Finance.**

The above results indicate that 25% of the respondents strongly agreed that increased personal financial needs influenced significantly on the banks profits. In the same vein, 42% agreed, 3% were not sure where as 19% disagreed and 11% strongly disagreeing.

#### 4.3 Summary of Equations and Correlation Analysis

Profit is a combination of several factors and not only one factor. From the data collected and analyzed banks do not only depend on one factor in terms of their profitability but a number of factors which are effectively and strategically employed leading to continuous growth in terms of profits. In summary therefore the profits taken as the a function of several factors of and summarized as below:

$$PBT_{it} = \alpha C_{it} + \alpha I_{it} + \alpha B_{it} + \alpha C_{it} + \square O_{it}; \text{ Where};$$

**PBT** profitability of the bank i at the time t before tax.

$C_{it}$  Fixed effects for each bank

$I_{it}$  Interest charged over time t

$B_{it}$  Bank charges at the time t

$C_{it}$  Customer deposits at the time t

$O_{it}$  Other economic sectors at the time t

$\alpha$ - Bank specific factor coefficient,  $\square$ - Market factor coefficients.

## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 INTRODUCTION**

The research investigated the major factors that contribute to high profitability of the commercial banks under turbulent environment. This chapter presents a summary of major findings and the conclusions based on the specific objectives of the study. From the study findings and conclusions drawn, some specific recommendations are drawn regarding the outcomes of this research. At the end of the chapter is a section on other areas of further research.

#### **5.2 Summary of Major Findings**

On the factor of the interest rates charged by the commercial banks, the study found that significant proportion of the bank's profits were believed to be generated by the interest rates income. The higher the lending, the higher the interest incomes and consequently the higher the banks profits.

The contribution of the revenues from commissions and fees was noted to be significant towards improving bank's profit levels. The study found that commissions and fees were believed to contribute in a big way towards profit generation by the banks. On the other hand, customers deposits determined the liquidity position of the banks and hence their ability and capacity to invest and to lend out. The study found that expanded customer deposits contributed significantly to the banks profits. In regard to the growth of agriculture and SME, the study established that sustained rates of growth directly enhanced banks profitability.

The study found that other service charge and internal re-engineering enhanced bank's profits. The monthly charges levied on the account holders were found to have a significant contribution towards the profits. In a similar way, investment and application of the information technology was found to be a major factor in contributing to improved banks profits. Expanding customer base meant more transactions through the banks and hence more profits product range offered by the banks significantly contributed to the levels of profits recorded by the commercial banks.

The driving forces behind enhanced customer deposits include expanding branch network, use of agency banking, effective application of sales promotion and differentiation strategy among others. The study found that operating more branch networks resulted into increased profits reported by the commercial banks. In addition, the study found that expanded agency banking contributed in a significant way towards improved profit levels by the banks. In the same vein, sustained sales promotion activities translated into noticeable increases in the profit levels, according to the study. In terms of product differentiation, this strategy was considered to have contributed to improved levels of profits largely because of catering for different market segments.

The study found that the agricultural sector as well as the SME contributed to enhanced business of the commercial banks. Increased agricultural activities and demand for capital by the SME's was found to have a positive impact on bank's profitability. Similarly, increased personal financial transactions and sustained growth in all sectors were found to have a significant influence on the amount of profits made by the banks.

### **5.3 Conclusion**

The study concludes on a number of issues based on the specific objectives of the study. In regard to the interest rates charged, commissions and fees levied amount of customer deposits and growth of agriculture and SME, the study concludes that they all significantly contributed banks high profitability levels. This supports the position that banks raises considerable amount of revenues from the above stated sources. The study further concludes that consistent utilization of monthly charges, application of modern information technology and sustained efforts to expand different product ranges of customers contributes significantly to the high profits registered by the commercial banks.

In regard to the customer enlargement activities, the study found that extensive branch networks, use of agency banking, increased sales promotion activities and application of product differentiation strategy similarly influenced positively on the bank's profits position. The other players of economic activities examined in this study were the agricultural sector and the SMEs. The study concludes that increased demand for capital by SMEs, increased agricultural activities, increased personal financial needs and needs for more finances to support the economy

translated into more business for the banks. It was, therefore, concluded that agriculture, the SME and the entire economy in general was growing and so were the banks profit levels.

The study summed up the issues examined and it concludes that all the four factors significantly improved bank's profitability. Specifically, interest rates charged, commission levied, amount of customer deposits and growth of agriculture contributed to bank's profit levels. The other services charged expansionist practices and other drivers of the economy like agriculture and SMEs equally contributed to the banks profit levels.

#### **5.4. RECOMMENDATIONS OF THE STUDY**

Based on the study findings and conclusions a number of recommendations have been drawn. There is a need for the banks to consider increasing the rate of interest for all the deposits held by the customers. A big different exist between the interest charge on loans given and the interest income earned by the account holders. As banks liquidity positions improve, there is a need to invest more in safe securities to increase the banks earning capacity.

It also recommended that innovative practices be embraced as an investment in the banking sector. Significant gains were evident in the banking sector after innovations were taken seriously by the management and the researchers. In addition, there is a need to increase the product range as more and more market segments occur.

Sustained efforts to improve on banks level of efficiency and effectiveness should be maintained. This includes exploring better opportunities by engaging employees in decision making and in problem solving. The momentum of employee's empowerment should be sustained. The feedback and issues raised by customers and other stakeholders should be evaluated and worked upon. In most cases, customer's complaints are useful in enhancing service delivery.

The study also recommends analysis be done to assess the contribution of agency banking to the banks profitability. The outcome would shed more light on whether they are contributing to revenue generation or simply enhancing customer satisfaction.

## 5.5 Suggestions for Further Studies

After investigating the major factors that lead to high profitability of the commercial banks under turbulent environment, other areas have been recommended to be studied. These include the following suggested topics:-

- (i) A correlation study between the amount of money banked by the hardware traders and their monthly sales volume in Nyeri town.
- (ii) Contribution of the agency banking services in enlarging the commercial bank's base.
- (iii) Evaluating the role of implementing cost-reduction measures on banks profitability.

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1. Name of respondent (print name)
2. Age of respondent
3. Marital status (check appropriate)
  - Married
  - Single
  - Other
4. Education (check all that apply)
  - Secondary or less
  - College diploma
  - Undergraduate degree
  - Master's degree
  - PhD or higher
5. Number of years of work experience (check all that apply)
  - 0-5
  - 6-10
  - 11-15
  - 16-20
  - 21-25
  - 26-30
  - 31-35
  - 36-40
  - 41-45
  - 46-50
  - 51-55
  - 56-60
  - 61-65
  - 66-70
  - 71-75
  - 76-80
  - 81-85
  - 86-90
  - 91-95
  - 96-100
6. What is your present job title?
  - Executive
  - Supervisory
  - Skilled
7. How long have you been with your present employer?
  - Less than 1 year
  - 1-5 years
  - More than 5 years

**Appendices**  
**Appendix I**  
**Questionnaire**

**SECTION A: Bio-Data**

1. Name of respondent (optional).....
2. Age of respondent.....
3. Marital Status (tick appropriately)  
Married                                    [    ]  
Single                                       [    ]  
Other                                        [    ]
4. Education level (tick appropriately)  
Secondary school                        [    ]  
College diploma                         [    ]  
Under graduate degree                 [    ]  
Masters degree                         [    ]
5. Bank/ Branch.....
6. Number of years of work experience in the bank.....
7. What is your position in your bank  
Sales                                       [    ]  
Clerical                                    [    ]  
Supervisory                               [    ]  
Management                              [    ]
8. How long have you worked with your organization?  
Less than five years                    [    ]  
More than five years                    [    ]

## SECTION B: INTEREST RATES

9. Is the interest rate in your bank variable?

YES [ ]

NO [ ]

BOTH

10. To what extent do you think your organization has used the following factors to improve profitability? Tick appropriately.

	Strongly agree	Agree	Not sure	disagree	Strongly disagree
(a) Interest rates					
(b) Commission and fees					
(c) Customer deposits					
(d) Growth of agriculture and SME					
(e) Competition					

## SECTION C: SERVICE CHARGES AND COMMISSION

11. Does your bank charge commission on services offered to customeres?

YES [ ]

NO [ ]

12. To what extent do you think your organization has used the following to increase bank income?

	Strongly agree	Agree	Not sure	Disagree	Strongly disagree
(a) Monthly charges and commission					
(b) New technology					
(c) Customer Base					
(d) Product range					

13. What method of commission collection is used? Tick appropriately

Automated                    [   ]

Manual                        [   ]

### SECTION D: CUSTOMER DEPOSITS

14. To what extent do you think your bank has used the following factors to attract more deposits? Tick appropriately.

	Strongly agree	Agree	Not sure	Disagree	Strongly disagree
(a) Branch network					
(b) Agent Banking					
(c) Accessibility of branches					
(d) Sales and sales promotion					
(e) Advertising					
(f) Attractive interest rates					
(g) Number of products					
(h) Newness of products					
(i) Differentiation of products from competitors					

### SECTION E: AGRICULTURE AND SME

15. To what extent do you think your organization has used the following sectors of the economy to increase profits?

	Strongly agree	Agree	Not sure	Disagree	Strongly disagree
(a) SME demand for capital					
(b) High population dependence on agriculture					
(c) Personal needs for development					
(d) Financial advice and literacy to customers					
(e) Need for growth in all sectors of the economy.					

### SECTION F: BANKING PROFITABILITY

16 To what extent do you think the following factors have contributed to high profitability?

	4	3	2	1
(a) Interest rates				
(b) Bank charges and commission				
(c) Other industry contribution				
(d) Customer Deposits				

Key: 1- Strongly Disagree 2- Disagree 3-Agree 4-Strongly Agree

**Appendix II**

**WORK PLAN**

<b>YEAR</b>	<b>2012</b>		
<b>ACTIVITYMONTH</b>	<b>OCTOBER</b>	<b>NOVEMBER</b>	<b>DECEMBER</b>
PROJECT PROPOSAL WRITING			
CORRECTIONS			
DATA COLLECTION			
DATA ANALYSIS			
REPORT WRITING			
FINALISATION OF REPORT			
SUBMISSION OF REPORT			

### Appendix III

### BUDGET

<b>BUDGET ITEM</b>	<b>TOTAL COST(Ksh)</b>
<b>MATERIALS</b>	
Literature Survey/Photocopying	3000
Internal Services	4500
<b>SUB TOTAL</b>	<b>7500</b>
<b>OTHER COSTS</b>	
Drafts Proposed Printing	2500
Binding	2000
Travel/ Accommodation	5000
Office Supplies	4000
Telephone/ Internet	3500
Report Publication & Photocopying	6500
<b>SUB TOTAL</b>	<b>23,500</b>
Other Costs	2500
<b>TOTAL COST</b>	<b><u>33, 500</u></b>