IMPACT OF STRATEGIC RESPONSE TO CHANGE ON FINANCIAL PERFORMANCE OF COMMERCIAL BANK IN KENYA

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ABSTRACT
The banking industry must continuously adapt its operations to the constantly changing environment in order to succeed in business. Several changes have taken place in the world economies particularly in the banking industry. In order to survive in this dynamic environment, banks need strategies that are focused on their activities and deal with emerging environmental and industry challenges accordingly. Bank Kenya Limited is a financial institution that is facing environments such as global and dynamic. Within a span of two years, financial institutions with a heritage of one hundred years have either ceased to exist or been acquired by more adapt players thanks to the current global financial crisis. This crisis is bringing unprecedented change to the financial services industry irrespective of organization size, focus or geography. This study is set up to establish the responses being utilized by banks in the face of increasing environmental changes and industry forces. The objective of the study were to evaluate the effect of technological advancement on profitability of Commercial Banks, to evaluate the effect expansive branch network on profitability of Commercial Banks, To establish effect competitive banking environment on profitability of Commercial Banks, and to find out the effect of product differentiation on profitability of Commercial Banks in Kenya. The study targeted target 309 employees in the head offices of five major banks in Kenya, namely: Kenya Commercial Banks, Barclays bank, standard chartered, cooperative bank of Kenya and Equity bank all located in Nairobi city. The study target mainly banks personnel involved in strategy formulation and implementation. The data was analysed through descriptive statistics such as mean, percentages and standard deviation. The data was presented in tables and graphs. The study found that technological innovation has a strong positive relationship with banks performance. This means that the better the technological innovation adopted by the bank the better the performance of the commercial banks. Similarly, there is a positive correlation between expansive branch network and the bank performance. This means that as the branches increase the more profitability the bank will be. However, there is associated cost related to
expansive branch network such as fixed cost and operation costs which were reported to effect bank performance. There are also chances of idle capacity that may result from poor planning of the branch network. There was a weak relationship between competitive banking environment and performance of commercial banks. Product differentiation also has a positive relationship with performance of commercial banks. The study recommends the banks to come up with product differentiation strategies by segmenting the customers based on their needs, size, type of business and designing products that meet the unique needs of these customer segments and also creating a pricing strategy for each segment. The study recommends that the banks consider more products and services which can appeal to the youth. The study further recommends that CBK needs to assist Kenyan banks with favourable operating environment.

**Key Words:** strategic response, financial performance, commercial bank, Kenya

**Introduction**

Strategy is depicted as a set of beliefs on how a firm can achieve success (Woods and Joyce, 2003). Arguably strategy is the main route to attain corporate goals and objectives, leading to enhanced long-term performance. That is to say, strategy is much more than beliefs and encompasses a deliberate search for a plan of action that will develop a business's competitive advantage and compound it (Henderson, 1999). Strategies are the set of decisions and actions that result in the formalization and implementation of plans designed to achieve a firm’s objectives (Pearce and Robinson, 2005). Therefore it is a reaction to what is happening in the economic environment of organizations. Porter (1980) views operational responses as part of a planning process that coordinates operational goals with those of the larger organization. Hence operational issues are mostly concerned with certain broad policies and policies for utilizing the resources of a firm to the best support of its long term competitive strategy.

According to Ross (1996) the firm has to learn, adopt and reorient themselves to the changing environment. Most importantly, when a discontinuity begins to affect a firm in a turbulent environment, faced with variety of pressures of new challenges brought about by globalization and trade liberalization, its impact, typically remains hidden within the normal fluctuations in performance. Firms therefore, should proactively engage themselves in strategies that will enable them to respond to the environmental challenges in order to gain competitive advantage over their competitors besides the firm’s success, and, indeed, even for its continued survival in the market. Ansoff and McDonnell (1990) noted that strategies involve changes in the firm’s strategic behaviors to assure success in transforming future environment.

The banking industry has experienced major changes in recent times due to the impact of deregulation, advances in information systems and technologies, globalization, and more recently the global financial crisis triggered by the subprime turmoil in the United States (Wignall & Atkinson, 2010). The speed and intensity with which the banking industry has
changed, has led to phenomenal growth in international transactions, expansion of banking operations across borders, and the restructuring and consolidation of banks. Such growth in turn has prompted banks to seek new sources of income, use complex tools for risk assessment and mitigation, and have greater awareness of their costs and the productivity gains to be realized from work reorganization and financial innovations (PriceWaterhouseCoopers, 2009). Accordingly, in addition to the traditional banking products, banks have become more involved in volatile investment activities and financial instruments such as junk bonds, leveraged buyouts, commercial papers, mutual funds, derivatives and assets securitization (World Bank, 2008).

Banks have increasingly become subject to immense pressure from their stakeholders to improve performance, forcing them to re-examine their traditional management control approaches and technologies, strengthen their capital base, reduce their non-performing and toxic assets, bring down operational costs, enhance corporate governance and sharpen their customer centric initiatives (Lapavitsas & Santos, 2008). Moreover, the recent financial crisis which started in mid-2007 has forced banking institutions worldwide to grapple with reduced public confidence, heightened shareholder scrutiny and increased regulatory insight (Wignall & Atkinson, 2010). As financial markets become more competitive, institutions feel increasing pressure to achieve and sustain growth. A crucial driver of success and sustainability, growth allows financial institutions to expand their portfolio by providing financial services to a larger number of clients while at the same time fulfilling their corporate social mission. Organizations can use a variety of organizational structures to facilitate expansion, including: growing existing operations, legal restructuring, franchising, strategic alliances, mergers and acquisitions. Recent trends indicate that various strategies and structures are being deployed in the banking industry (Brooks, 1995).

According to Lehman and Winer (2005) a major challenge facing many institutions is increased competition, which forces banks to focus on differentiation while maintaining low-cost products and services. Clients are also beginning to demand a greater variety of products and services, especially as markets mature. Various strategies, structures and alliances are available to financial institutions to help them expand outreach and provide offerings in an increasingly competitive landscape. However, It is essential to understand which type of expansion strategy is best for a given situation and marketplace because there is not a "one-size-fits-all" model for successful expansion (Bijapurkar, 2007).

**Banking sector globally and Kenya**

In the world’s top 1000 banks, there are many more large and medium-sized domestic banks from the developed countries than from the emerging economies. Illustratively, according to The Banker 2004, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan, over 80 in Germany, over 40 in Spain and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. India, on the other hand, had 20 banks within the top 1000 out of which only 6 were within the top 500 banks.
This is perhaps reflective of differences in size of economies and of the financial sectors. In most emerging markets, banking sector assets comprise well over 80 per cent of total financial sector assets, whereas these figures are much lower in the developed economies. Furthermore, deposits as a share of total bank liabilities have declined since 1990 in many developed countries, while in developing countries public deposits continue to be dominant in banks. In this regard, it is useful to emphasise the dominance of banks in the developing countries in promoting non-bank financial intermediaries and services including in development of debt-markets. Even where role of banks is apparently diminishing in emerging markets, substantively, they continue to play a leading role in non-banking financing activities, including the development of financial markets.

Banking sector in Kenya is playing a major role in the national development process. This role is increasing day by day. The banking sector is the backbone of the Kenyan economy and plays an important financial intermediary role. Therefore, its health is very critical to the health of the general economy at large. Banks play a central role in the money creation process and in the payment system. Moreover, bank credit is an important factor in the financing of investment and growth (Fayoumi & Abuzayed, 2009). The environments in which banks operate today are divergent. The banking sector has been facing unprecedented challenges with the wave of privatization and globalization in economy. Banks in are under intense pressure to perform in today’s volatile market place. And because of the main goal of management, to maximize the owner's wealth, managers especially in the banking sector are working under pressure from shareholders, international financial crisis, and the central Bank regulations to improve profitability (Zamil & others, 2010). The Kenyan Banking sector constitutes 43 commercial banks and one mortgage financial institution. The banking industry in Kenya is dominated by a few large banks most of which are foreign-owned, though some are partially locally owned. Six of the major commercial banks are listed on the Nairobi Stock Exchange. 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. The commercial banks and non-banking financial institutions offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services including investment banking (CBK Annual Report, 2009). The five most profitable banks in Kenya are KCB, Equity, Barclays, Standard Chartered bank and Co-operative Bank. The pretax profits for these banks in the financial year 2011 are as follows. 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).

Statement of the problem

All organizations exist and carry out their activities within the environment. The environment provides the organizations with inputs which they transform to outputs through internal processes and then the outputs are given back to the environment. Therefore in order to survive
in the environment, organizations have to pay attention to the environment and match their activities to the environmental conditions. The environment is dynamic and keeps changing. Since the external environment is uncontrollable, the firm has to match its operations to the external environment in order to survive and succeed.

In an attempt to support changes, many banks have adopted strategic responses to keep changing as the environment changes. Any firm that does not take actions to align itself with the environment cannot survive in the environment and is soon forced out of the market (Guerreiro et al., 2006). Several scholars have carried out extensive studies in the area of banking in Kenya and especially on competitive strategy. For instance, Warugu (2001) in his research, found out that focus and product differentiation are some of the major strategies that the banks have employed in their quest to outdo each other. Similarly Kiptugen (2003) looked at the strategic responses to a changing competitive environment in the case study of Kenya Commercial Bank, he established that proactive rather than reactive strategies such as research on changing customer needs and preferences forms the basis of its strategic planning. Mbwayo (2005) focused on the strategies applied by commercial banks in Kenya in anti money laundering compliance programs. He concluded that strict adherence procedures and standards have been implemented to ensure that money laundering is contained in Kenya. The researcher is not aware of any studies accounting a comprehensive analysis of these strategic responses and whether they were profitable in the long run. It is in this light therefore the study critically examine the impact of strategic responses adopted by commercial banks in Kenya on their performance.

**General Objective**

To establish the effectiveness of strategic response to change on performance of Commercial Banks in Kenya

**Specific Objective**

1. To evaluate the effect of technological advancement on profitability of Commercial Banks in Kenya
2. To evaluate the effect expansive branch network on profitability of Commercial Banks in Kenya
3. To establish effect competitive banking environment on profitability of Commercial Banks in Kenya.
4. To find out the effect of product differentiation on profitability of Commercial Banks in Kenya.
Theoretical review

Michael porter’s five forces model

Michael Porter (Harvard Business School Management Researcher) designed various vital frameworks for developing an organization’s strategy. One of the most renowned among managers making strategic decisions is the five competitive forces model that determines industry structure. According to Porter, the nature of competition in any industry is personified in the following five forces:

1. Threat of new potential entrants
2. Threat of substitute product/services
3. Bargaining power of suppliers
4. Bargaining power of buyers
5. Rivalry among current competitors

The five forces mentioned above are very significant from point of view of strategy formulation. The potential of these forces differs from industry to industry. These forces jointly determine the profitability of industry because they shape the prices which can be charged, the costs which can be borne, and the investment required to compete in the industry. Before making strategic decisions, the managers should use the five forces framework to determine the competitive structure of industry.

Figure 1: Porter’s Five Forces model
Institutional Theory

Institutional theory has evolved into a body of literature encompassing multiple levels of analysis concerning change in organizations. It deals with how organizations are affected by forces which lie beyond its control (Hoffman 1999) and is built on the notion that institutional environments are socially constructed (DiMaggio & Powell, 1983). Accordingly, the institutional environment and its participants play key roles in shaping organizational systems, structures and behaviors. Scott (1998, p12) explains that: every organization exists in a specific physical, technological, cultural and social environment to which it must adapt. No organization is self-sufficient, all depend for survival on types of relations they establish with larger systems of which they are a part.

From this perspective, an organization must comply with environmental changes if it is to receive legitimacy and continued societal support. Thus, the institutional environment is viewed as defining not only the appropriate organizational systems, structures and behaviors but also the manner in which they conform to institutionalised beliefs in society. While institutions are an integral part of organizational life, institutional theory treats institutions as largely exogenous to the organization. Institutional theorists suggest that institutional theory can be applied to a variety of different organisations and many different levels of analysis, stretching from a macro-system perspective to an organizational sub-system perspective (Scott, 2001). These levels are connected within an organizational field. DiMaggio & Powell (1983) introduced the concept of organizational fields to analyze the context of an organization which includes closely related suppliers, customers, regulators, competitors or other important inter-organizational links which are important determinants of institutional pressures. DiMaggio & Powell (1983) further emphasise that the impact of institutional pressure is dependent on the position of a particular organization within an organizational field. Over time, organizational fields are subject to change (Greenwood & Hinings 1996).

Organisations are forced to change their systems and procedures directly as a consequence of changing legislation. This adherence to pressure helps the organisation to secure economic resources and legitimacy (Meyer & Rowan, 1991). “Mimetic isomorphism” is the act of copying other organisations when organizations face uncertainty, and the way in which they “model themselves on other organisations” in order to overcome uncertainty (DiMaggio & Powell, 1983). In particular, ambiguous organisational goals and strategies or poorly understood technologies may cause organisations to model themselves on other organisations. Scapens (1994) argues that mimetic behaviour has a conformity element, wherein organisations adopt contemporary practices to legitimise their structures, systems and processes by appearing to be in control. “Normative isomorphism” is associated with professionalization (DiMaggio & Powell, 1983), and arises when professionals operating in organisations are subject to pressures to conform to a set of norms, values and rules developed by occupational and professional bodies (Abernethy & Chua, 1996). In this form of isomorphism, organisations feel obliged to adopt
structures, systems and processes that have been advocated by dominant occupational and professional groups (Burns 2000).

**Life Cycle Theory**

Van de Ven and Poole (1995) observe that many management scholars have adopted the metaphor of organic growth as a heuristic device to explain changes in an organizational entity from its initiation to its termination. Witness, for example, often-used references to the life cycle of organizations, products, and ventures, as well as stages in the development of individual careers, groups, and organizations: startup births, adolescent growth, maturity, and decline or death.

Life cycle theory assumes that change is immanent; that is, the developing entity has within it an underlying form, logic, program, or code that regulates the process of change and moves the entity from a given point of departure toward a subsequent end that is already prefigured in the present state. What lies latent, rudimentary, or homogeneous in the embryo or primitive state becomes progressively more realized, mature, and differentiated. External environmental events and processes can influence how the immanent form expresses itself, but they are always mediated by the immanent logic, rules, or programs that govern development.

**Teleological Theory**

Van de Ven and Poole (1995) describe a teleological theory as based on the assumption that change is guided by a goal or desired end state. It assumes that the organization is populated by purposeful and adaptive individuals. By themselves or in interaction with others they construct an envisioned end-state, take action to reach it, and monitor their progress. This approach underlies many organizational theories of change, including functionalism, decision making, adaptive learning, and most models of strategic choice and goal setting. Teleological theory views development as a cycle of goal formulation, implementation, evaluation, and modification of goals based on what was learned or intended. The theory can operate in a single individual or among a group of cooperating individuals or organizations who are sufficiently like-minded to act as a single collective entity. Since the individual or cooperating groups have the freedom to set whatever goals they like, teleological theory inherently accommodates creativity; there are no necessary constraints or forms that mandate reproduction of the current entity or state.

While teleology stresses the purposiveness of the individual as the generating force for change, it also recognizes limits on action. The organization’s environment and its resources of knowledge, time, money, etc. constrain what it can accomplish. Some of these constraints are embodied in the prerequisites, which are to some extent defined by institutions and other actors in the entity’s environment. Individuals do not override natural laws or environmental constraints but make use of them in accomplishing their purposes.
Conceptual framework

Technological innovation in banking

Technological innovations play a pivotal role in the performance of banks. Technology provides an opportunity for banks to improve service performance in addition to providing a broader range of financial products and services. The literature on banking reveals that over the last two decades there has been a phenomenal increase in the offer of e-banking or e-finance products and services by banks, such as internet banking, debit cards, e-bill payments, smart cards and stored value cards, in order to stay competitive. These advancements have allowed banks to innovate customer service and delivery channels, not only to fulfill the needs of customers, but also to achieve economies of scale and to increase competitiveness. Consequently, banks have increasingly started focusing on customer and product profitability analysis as key performance measures thereby requiring them to create existing and potential customers’ profiles which become important to the decisions to lend, mobilize deposits and track movement of customers’ accounts (Helliar et al. 2002).

As consumer and business world continues to evolve, innovation is becoming imperative for banks to move forward. One banking analyst comments: “we have to grind forward and grow our business, prove ourselves in this new environment”. Innovation is critical to help cut costs; respond to changing consumer and business expectations, particularly among different generations; and create the agility needed to compete. And, the industry couldn’t agree more: according to our recent Global CEO Survey, 87% of banking and capital markets CEOs surveyed believe that innovations will lead to operational efficiencies; and 64% also believe that their IT investments will help them tap into new marketing and transactional opportunities.

Banks are looking inwards at the costs of their networks to make sure they’re running as efficiently as possible while still delivering the best customer experience that exceeds expectations. New global centres of excellence focus on streamlining service, while creating a new reality in efficiency and effectiveness. Increasingly, such centres are popping up at those banks with broad geographic footprints to leverage time zone differences, skill and labour in critical markets to achieve scale-back benefits and efficiencies. The quick pace of new, emerging technologies is an imperative as banks approach innovation with an emphasis on customer experience. More and more clients are looking to interact through mobile and digital technologies, such as smart phones and tablets and expect their bank to be onboard. Banks today are investing in new digital technology and applications to improve the customer experience across all channels in a very integrated manner branch, web, call centres and mobile banking. For example, many banks are enabling their mobile workforce with sophisticated tools. Whether it’s an investment advisor or a commercial banker, providing on-site and on-demand advice using digital devices is becoming the new battlefield for many segments. Further, many banks have
launched innovative applications to help clients put banking at their fingertips, where we are really still in the early stages of this evolution.

Social media is spreading as a critical dimension to appeal to various segments of the banks’ client base, particularly Gen X and Gen Y customers. Many banks have tapped into the root of what social media means to the community, pursuing strategies (through such tools as Twitter, Facebook, YouTube and LinkedIn) to directly communicate with clients: to recruit; build product awareness and start dialogues; showcase philanthropy; run contests and promotions; and, most importantly, create loyalty among the individuals following them. It is also breaking new ground in how banks report their earnings. Traditional annual reports presented only in a PDF format may soon be a thing of the past, as new interactive reports that incorporate video from bank executives, allow visitors to share content and are compatible with mobile devices create a fresh, unique experience for users.

The evolving payments industry is also certainly top-of-mind, as customers and businesses alike demand more consumer-friendly payment options. For some this means opening up the doors to involve partnerships with other providers; others are looking inwards to upgrade their existing technology. Looking ahead, all banks will need to continuously reconsider how they can make these new technologies an integral part of their multi-channel strategy and if their legacy platforms can support innovation—or risk having their customers use alternative service providers.

**Branch network**

The study of Mendes & Reblo (2009) assesses a bank branch's operating and profit efficiency. The study also explore the impact of IT-based retail banking services on branch efficiency, and found that IT-based transactions at the branch level have a significant impact on profit efficiency, and therefore have a significant role to play in profit maximization improving bank branch technology to best support service delivery is also a practical way to achieve greater efficiency, which in turn, contributes to a commercial bank's overall profitability.

The most widely pursued corporate directional strategies are those designed to achieve growth in sales, assets and profits. Companies that do business in expanding industries must grow to survive. Continuing growth means increasing sales and a chance to take advantage of the experience curve to reduce the cost of product sold (Wheelen & Hunger, 2010). The motives behind the rapid growth of bank financial services are the stakeholders involved expect to increase their wealth (value per share of stock), and management expects to gain higher salaries and employee benefits.(Rose & Hudgins, 2008).The size of a bank is considered one of the main growth strategies based on the assumption that management of the bank is responsible for expanding their organization by acquiring additional assets and liabilities. The size of a bank is also associated with the concept of economies of scale. The studies of (Redmond & Bohnsack
2007) examined the effect of economies of scale and bank size on profitability. (Boyd & Runkle, 1993) showed that size of a bank is also associated with the concept of economies of scale.

Study suggests that if an industry is subject to economies of scale, larger institutions would be more efficient and could provide service at a lower cost. (Lawton & Harrington, 2006) examines how a bank from a small domestic market base diversified its revenue streams through international investment and acquisition but ultimately overstretched its resources and capabilities. (Paula, 2002) discusses whether there is some evidence in recent literature that banks do obtain economies of scale and scope when they expand their activities, mainly by mergers and acquisitions (M&As). The researcher concluded that expanded product array and potential for cross selling result from larger size and depth of product offering.

Emery (1991) studied the relationship between the status of the branch categories and found that there was a significant difference in terms of returns among these three categories of branches. (Scholterns, 2000) included location as one of the profitability determinants in his study and found that branch location had a significant relationship with profitability. He found that banks which operate in states in which branching was permitted were more profitable than those which operate in other environment.

**Competition in Banking**

(Athanasoglou, Delis, & Staikouras, 2008) indicated that as a result banks gain market share and an increase in earnings and an increase in profitability. Since large banks are assumed to enjoy economies of scale, they are able to produce their outputs or services more cheaply and efficiently than smaller banks. As a result, larger banks will earn higher rates of profit if entry is restricted. (Redmond & Bohnsack, 2007) examined the profitability of banks within different asset size categories. The hypothesis contends that there is a statistical difference in the profitability of these different sized banks.

Bennaceur & Goaied (2008) used two measures of performance are in their study: the net interest margin (NIM), and the return of assets (ROA). They examined the influence of bank regulations, concentration, financial and institutional development on Middle East and North Africa (MENA) countries commercial banks margin and profitability during the period 1989-2005. They find that bank specific characteristics, in particular bank capitalization and credit risk, have positive and significant impact on banks' net interest margin, cost efficiency and profitability. On the other hand, macroeconomic and financial development indicators have no significant impact on bank performance.

**Product differentiation**

Kotler (1998) elaborated on a concept of product differentiation in his book “The Theory of monopolistic Competition” as early as in 1933. He offered product differentiation as the
explanation for a downward falling demand curve of an individual product. He suggested that the demand is also dependent on the style of the product and selling activities in addition to pricing. He noticed the importance of non-price competition: reducing price competition is the primary aim of differentiating a product.

Today, many companies offer the same products and services. It may seem pointless to try to compete in an environment in which numerous other companies are already offering the same product or service. However, new companies often do come into the market place and successfully sell products and services that already existed in that market place. They are able to compete because they use product differentiation. Product differentiation is a specific kind of business and marketing strategy. It focuses on a target market in which competitors already offer similar products or services. A company that uses product differentiation tries to create the perception among certain target customers that the company’s version of this product or service is somehow different and thus has added value that is not available from competitors.

Product differentiation is extremely important to running any kind of business. This is due to economic principles that have been demonstrated time and time again in nearly every market place. If the public perceives no difference between two competing products, then the only possible means of competition is through pricing. In a situation such as this, products are viewed by customers as very easy substitutes for one another. If one product is more expensive than the other, the customer will simply purchase the cheaper product. She does this because she views no difference between them. To compete, the company with the higher price will lower its price to the same level as the competition. Eventually, another company may ignore the standard price in the market and offer the same product at an even lower price. The other competitors have no choice but to lower their prices as well. They have to or they will lose their business. Eventually, this leads to a situation in which the prices are lowered to the point where no business in the market can make a profit off of that product (Kilpi, 2003).

Situations such as these present themselves in markets where products are relatively similar. For example, people generally don’t consider one brand of peas inherently superior to another. Due to this fact, they are likely to just purchase the cheapest brand. Entering into a business such of this doesn’t seem like a lucrative proposition. Gaining market share and producing a sizable profit was very difficult (Jenkins et al, 1997).

**Internal determinants of profitability**

Internal determinants are factors that are mainly influenced by a bank's management decisions and policy objectives. Such as the level of liquidity, variation in loans loss provisions, capital adequacy, expense management, change in capital and asset risk, operational efficiency, and market interest rates. Internal determinants include financial statement variables and profit and loss account. The balance sheet management is directly related to asset and liabilities management. Asset management is concerned with the asset portfolio decisions which attempt to
maximize returns at an adequate level of liquidity. Furthermore, profit and loss statement management is directly related to income and expense management or returns and cost management. The main emphasis would be confined to areas such as managing interest rate sensitivity and margin, and allocation of expenses (Sufian & Chong, 2008).

Level of liquidity is one internal determinant of profitability; Liquidity is measured by the ratio of loans to total assets, which indicates the percentage of bank assets that are tied up in loans. To avoid insolvency problems, banks often hold liquid assets that can be easily converted into cash. Hence, the higher the liquid ratio, the less liquid a bank is, however, liquid assets are usually associated with lower rates of return and therefore higher liquidity would be associated with lower profitability (Bourke, 1989). Profit and loss statement management is directly related to income and expense management as well as to returns and cost management. The main emphasis would be confined to areas such as managing interest rate sensitivity and margin, and allocation of expenses, reducing expenses improves the efficiency and hence raises the profitability of a financial institution, implying a negative relationship between the operating expenses ratio and profitability (Bourke, 1989).

Guru, Staunton, & Balashanmugam (2002) revealed that efficient expenses management was one of the most significant in explaining high bank profitability. (Molyneux & Thornton, 1992) reported that higher salaries and benefits per employee was consistently associated with higher net charge offs to total assets. They suggested that banks with higher salaries and benefits would require higher net interest margins to maintain profitability. If banks are unable to arbitrarily reduce interest expense then it must raise the interest earned on loans by incorporating riskier loans in its loan portfolio. This may increase net charge offs and hence worsen the profitability prospects. This again would support the assumption of an inverse relationship between staff expenses and profitability of commercial banks.

Changes in capital and asset risk are related to commercial bank profitability. (Bourke1989), had reported that capital ratios are positively related to profitability. Bourke explained this by assuming that well capitalized banks may enjoy access to cheaper and less risky sources of funds and better quality asset markets. Alternatively the prudence implied by high capital ratios may also be maintained in their asset portfolio decisions with consequent improvement in loan loss provision and hence profitability.

**External determinants of bank profitability**

In addition to the internal factors the performance of banks is subject to the nation’s economy, the financial market structure, and the legal and political environment in which they operate so ,the external determinants of commercial bank profitability are those factors which are external to the commercial banks and hence outside the control of management. There are several specific factors suggested as impacting on profitability .Market concentration is one important factor affect profitability, the term concentration emerged from the structure-conduct-
Performance theory (SCP theory) which postulates that market concentration fosters collusion among firms in the market and earn monopoly profits. Concentration in the banking market, calculated by dividing the total assets of the five largest banks in the market with the total assets of all banks operating in the market. According to the structure-conduct-performance (SCP) hypothesis, banks in highly concentrated markets tend to collude and thus earn monopoly profits (Alfumi & Awad, 2003). On the one hand, concentration may act as a barrier to entry when entering markets where domestic banks are highly concentrated, implying a negative impact on profits. On the other hand, in a market dominated by foreign banks that have been found to be more efficient than domestic banks, such as in less developed countries, concentration may in fact be positively related to foreign banks’ profitability (Kosmidou, Pasiouras, & Tsaklanganos, 2007).

Market share is considered as one of the determinants of profitability since the bigger the market, the larger the firm’s potential for profits. Bigger market share also means more power to the bank in controlling the prices and services it offers to customers the bank’s market share expressed as a ratio of its deposits relative to the total deposits of the banking market in which it operates. An alternative to the SCP hypothesis is the Efficient-Structure hypothesis (EFS), which suggests that higher efficiency results with dominant market share, implying a positive association between market concentration and bank profitability. Market share influenced profitability and growth in the market created more opportunities for the bank, thus generating more profits (Spinlock, 1985). Athanasoglou, Delis & Staikouras (2008) indicated that as a result banks gain market share and an increase in earnings and an increase in profitability. Since large banks are assumed to enjoy economies of scale, they are able to produce their outputs or services more cheaply and efficiently than smaller banks. As a result, larger banks will earn higher rates of profit if entry is restricted.

Competition playing major role in affecting bank profitability, Traditional economic theory suggests that new entrants will increase rivalry in the market. Although competition is considered as one on the determinant of bank profitability ideally, an evaluation of competitive conditions and the degree of concentration in the banking industry should begin by rigorously defining the market under consideration, the relevant market consists of all suppliers of a particular banking service, including actual or potential competitors, and it has a product dimension and a geographical dimension. The product definition of a market is based on the equality of the products as regards their ability to fulfill specific consumer wants, the geographical boundaries of a market are determined by actual and potential contacts between actual and potential market participants. These boundaries depend on the products involved; for retail banking, the local dimension of a market is relevant while the regional or international dimension is relevant for corporate banking (Bikker & Haaf, 2002).

Capital adequacy playing major role in affecting bank profitability, to achieve an efficient intermediation process, and finally to provide desired levels of specific banks products or
services. To achieve these goals, regulations are imposed on both bank management and the banking system. Direct regulations on bank management basically cover the lending policy, deposit policy, interest rates, and liquidity requirements. Regulations on the banking system as a whole include regulation on the condition of entry, establishment of new branches, ventures, mergers and acquisitions. Financial regulators require commercial banks to sustain a minimum capital adequacy ratio to ensure that banks hold a sufficient amount of equity to absorb any shocks they might experience. Under the 1988 Accord of the Basel Committee on Banking Supervision, the minimum capital requirements specified as a percentage of the risk-weighted assets of the bank, measured by either Tier 1 or total capital ratio.

**Empirical review**

Several scholars have carried out extensive studies in the area of banking in Kenya. For instance, Warugu (2001) in his research, found out that focus and product differentiation are some of the major strategies that the banks have employed in their quest to outdo each other. Similarly Kiptugen (2003) looked at the strategic responses to a changing competitive environment in the case study of Kenya Commercial Bank, he established that proactive rather than reactive strategies such as research on changing customer needs and preferences forms the basis of its strategic planning. Mbwayo (2005) focused on the strategies applied by commercial banks in Kenya in anti money laundering compliance programs. He concluded that strict adherence procedures and standards have been implemented to ensure that money laundering is contained in Kenya. Athanasoglou, Delis & Staikouras (2008) indicated that as a result banks gain market share and an increase in earnings and an increase in profitability. Since large banks are assumed to enjoy economies of scale, they are able to produce their outputs or services more cheaply and efficiently than smaller banks. As a result, larger banks will earn higher rates of profit if entry is restricted.

The study of Mendes & Reblo (2009) assesses a bank branch's operating and profit efficiency. The study also explore the impact of IT-based retail banking services on branch efficiency, and found that IT-based transactions at the branch level have a significant impact on profit efficiency, and therefore have a significant role to play in profit maximization improving bank branch technology to best support service delivery is also a practical way to achieve greater efficiency, which in turn, contributes to a commercial bank's overall profitability. The studies of (Redmond & Bohnsack, 2007) examined the effect of economies of scale and bank size on profitability. Lawton & Harrington (2006) examines how a bank from a small domestic market base diversified its revenue streams through international investment and acquisition but ultimately overstretched its resources and capabilities. Scholterns (2000) included location as one of the profitability determinants in his study and found that branch location had a significant relationship with profitability. He found that banks which operate in states in which branching was permitted were more profitable than those which operate in other environment.
Bennaceur & Goaied (2008) used two measures of performance are in their study: the net interest margin (NIM), and the return of assets (ROA). They examined the influence of bank regulations, concentration, financial and institutional development on Middle East and North Africa (MENA) countries commercial banks margin and profitability during the period 1989-2005. They find that bank specific characteristics, in particular bank capitalization and credit risk, have positive and significant impact on banks' net interest margin, cost efficiency and profitability. On the other hand, macroeconomic and financial development indicators have no significant impact on bank performance.

Helliar et al., (2002) the literature on banking reveals that over the last two decades there has been a phenomenal increase in the offer of e-banking or e-finance products and services by banks, such as internet banking, debit cards, e-bill payments, smart cards and stored value cards, in order to stay competitive. Helliar et al.,(2002) asserts that technological advancements have allowed banks to innovate customer service and delivery channels, not only to fulfill the needs of customers, but also to achieve economies of scale and to increase competitiveness. Consequently, banks have increasingly started focusing on customer and product profitability analysis as key performance measures thereby requiring them to create existing and potential customers’ profiles which become important to the decisions to lend, mobilize deposits and track movement of customers’ accounts. Kotler (1998) elaborated on a concept of product differentiation in his book “The Theory of monopolistic Competition” as early as in 1933. He offered product differentiation as the explanation for a downward falling demand curve of an individual product. He suggested that the demand is also dependent on the style of the product and selling activities in addition to pricing. He noticed the importance of non-price competition: reducing price competition is the primary aim of differentiating a product.

According to Lehman and Winer (2005) a major challenge facing many institutions is increased competition, which forces banks to focus on differentiation while maintaining low-cost products and services. Clients are also beginning to demand a greater variety of products and services, especially as markets mature. Various strategies, structures and alliances are available to financial institutions to help them expand outreach and provide offerings in an increasingly competitive landscape. According to Ross (1996) the firm has to learn, adopt and reorient themselves to the changing environment. Most importantly, when a discontinuity begins to affect a firm in a turbulent environment, faced with variety of pressures of new challenges brought about by globalization and trade liberalization, its impact, typically remains hidden within the normal fluctuations in performance. Firms therefore, should proactively engage themselves in strategies that will enable them to respond to the environmental challenges in order to gain competitive advantage over their competitors besides the firm’s success, and, indeed, even for its continued survival in the market.
Research Methodology

Research Design

The research used descriptive survey approach. According to Ngechu (2004), descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions. It serves a variety of research objective such as descriptions of phenomenon or characteristics associated with a subject population, estimates of proportions of a population that have these characteristics and discovery of associations among different variables. For the purposes of obtaining adequate and relevant information in a short time, the study used survey approach. Best and Khan, 2009 agreed with other scholars argued that descriptive surveys describes and interprets phenomena and are concerned with conditions or relationships that exists, opinions that are held, processes that are going on, and effects that are evident or trend that are developing. Therefore the study used the design to be able to analyze the variables effectively.

Target population

Mugenda & Mugenda (2003) define a study population as consisting of the total collections of elements about which the study wants to make some inferences. According to the banks’ human resource department (2014) there are 309 employees working in the head offices, Nairobi.

Sample and Sampling Technique

Stratified sampling was used to select respondents from the entire department in the bank; the study was using a 30% of the target population. This comprises a sample size of 91 respondents who were used in data collection.

Instruments

The researcher will use well-structured self-scoring questionnaires with both open and closed ended questions to collect both quantitative and qualitative data from the sample population.

Data Collection procedure

The researcher used both primary and secondary data. Primary data was collected using self-administered questionnaire while secondary data was collected by reading through the banks’ published reports, brochures, journals and periodicals. The questionnaires consisted of open-ended and close ended questions. The close ended questions help the researcher to collect quantitative data while open-ended questions enabled the researcher to collect qualitative data. This was used to gain a better understanding and possibly enable a better and more insightful interpretation of the results from the study. The questionnaire comprised of two sections. The
first part included the demographic and operational characteristics designed to determine fundamental issues including the demographic characteristics of the respondents. The second part was devoted to the establishment strategic response to change and their effects on bank profitability.

**Pilot test**

Validity indicates the degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 2003). This study used content validity because it measure the degree to which the sample of the items represents the content that the test is designed to measure. Validity was ensured by discussing the instrument with an expert in the subject and with my supervisor. A pilot test was done using 3 banks which are not part of the sample population this is consistent with 1% to 10% rule of pilot test on the sample equivalent to actual sample size according to Saunders et al, (2007) and Mugenda & Mugenda, (1999). Reliability is the degree of consistency (Mugenda and Mugenda, 1999). A pilot study was conducted by the researcher by administering the questionnaires to the 3 banking institutions in Kenya. From this pilot study the researcher was able to detect questions that need editing and those with ambiguities. The final questionnaires were then be printed and dispatched to the field for data collection with the help of research assistants.

**Data Processing and analysis**

The data from the field was coded according to the themes researched in the study. A statistical package for social sciences (SPSS) package was used to aid in analysis. Quantitative data was analyzed through the use of a combination of descriptive statistics particularly frequency distributions tables, percentage and mean and also measure of dispersion such as variance and standard deviation.

**Research Results**

**Demographic information**

In regard to the demographic information about the respondents, the findings indicated that Majority of the respondents were men, most of the respondents were between 30 years while majority had between 6 to 10 years of experience. Majority of the respondents were working as senior, middle level or supervisor level of management in their bank. Majority had university level education.

**Technological innovation**

In regard to the technological innovation, majority of the respondents agreed that technological innovations have helped the bank in improving bank operations and growth. Infact, majority of
the respondents said to great extent technological innovations affect business growth in terms of customer growth, market share and bank profitability respectively.

**Branch network**

The study established that concerning the branch network, majority of the employees agreed that branch network increases customer base. They argued that expansive branch network bring financial services closer to the customers. They argued that branch network help bank’s to achieve the economy of scale as well as boosting product turnovers. However, the expansive branch network has challenges in that the operating premises are expensive as well as high need for employees to man the branch operation.

**Competitive edge**

On competitive banking environment majority of the respondents reported that their organization devoted resources to the massive advertisement and improving customer services. Majority, cited mobile money transfer and other commercial banks as posing the greatest competition to their organization. They asserted that competitive banking environment has greatly affected the bank operations in terms of cost of advertisement and reduced market share.

**Product differentiation**

Majority of the respondents reported that their organization had adopted product differentiation strategies ranging from creating brand names and improved product packaging. Majority reported that differentiation had helped in creating products that suit different clientele based on religion and different customer needs.

**Conclusion**

The first objective was to ascertain the influence of technological innovation in relation to the dependent variable performance of commercial banks. The findings show a strong positive relationship between the two variables with the coefficient of correlation of 0.818. This means that the better the technological innovation adopted by the bank the better the performance of the commercial banks. Similarly, there is a positive correlation of 0.670 between independent variable of expansive branch network and the bank performance. This means that as the branches increase the more profitability the bank will be. However, there is associated cost related to expansive branch network such as fixed cost and operation costs which were reported to effect bank performance. There are also chances of idle capacity that may result from poor planning of the branch network. There was a weak relationship with of 0.414 between competitive banking environment and performance of commercial banks. This shows that as the bank achieve competitive advantage the performance improves. Their strategies for managing competition in
the banking sectors vary from one institution to another and depend on the nature of competition. Product differentiation has a positive relationship with banks’ performance with the value of 0.662. This implies that organization product and service affect the performance of financial institution. The more the product or service appeal to the customer the more they are likely to buy and this translates to high customer base.

**Recommendations**

From the discussions and conclusions in this chapter, the researcher recommends the bank to employ modern growth strategies that would make it a bank of choice to bank customers. The banks need more public awareness on their products and services that can enable them to remain the market leaders. The study recommends the banks to come up with product differentiation strategies by segmenting the customers based on their needs, size, type of business and designing products that meet the unique needs of these customer segments and also creating a pricing strategy for each segment. The study recommends that the banks consider more products and services which can appeal to the youth. The youth comprises of 42% of the population in Kenya and have different tastes from the rest of the population. There is an upcoming niche of young generation who are economically stable and require a financial institution that can best meet their needs. Targeting such a niche therefore will enable the bank to broaden its customer base. The study further recommends that CBK needs to assist Kenyan banks with favourable operating environment. Prohibitive policies regarding international markets entry should be changed to encourage banks depending on the capital base to decide whether to enter international market or not.

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