RESPONSE STRATEGIES TO CHANGES IN THE ECONOMIC ENV IRONMENT BY THE CO-OPERATIVE BANK OF KENYA LIMITED

BY

PIUS KIPTOO CHEBOI

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DECLARATION

This research project is my original work and has not been presented for examination in any other institution or examination body.

Name: PIUS KIPTOO CHEBOI

SIGNATURE……………………………

DATE.

REGNO: D61/60071/2010

This research project is presented for examination with my approval as the University supervisor.

Name: DR. JAMES GATHUNGU

SIGNATURE……………………………

DATE 12/11/2012

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DEDICATION

To my dear wife Margaret and daughter Eileen May Chemutai glory be to God.

ABSTRACT

Much of previous research into response strategies by firms to changes in the environment has concentrated mainly on the external environment as a whole. However no known local study has specifically focused on the economic environment and how it affects the strategies of the firm. This study therefore sought to fill the existing research gap by carrying out a case study on response strategies by the Co-operative Bank of Kenya Limited to changes in the economic environment. The main purpose of the study was to investigate how changes in economic factors like interest rates, inflation rates, exchange rates, international trade and CBK regulations affected the bank and how the bank amended its strategies to deal with the threats and opportunities in the economic environment.

This research was conducted through a case study with the target population of this study being the Divisional Directors of Co-operative Bank of Kenya Limited. This paper utilized an interview guide administered personally by the researcher across heads of functional Divisions in the bank. From the findings, the study established from the majority of respondents that the bank had indeed been greatly affected by changes in the economic environment.

The study further established from respondents that the bank had responded by increasing rates, concentrating more on non-funded income streams, external borrowing, restructuring loans, slowing down on lending, diversifying through subsidiaries and globalization of its business. This study therefore recommends that in order to avoid negative effects of the economic environment. The Co-operative Bank of Kenya Limited should diversify its source of funds for lending to cushion long-term borrowers from erratic interest rates and CBK should stop over reliance on the CBR.

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ACRONYMNS AND ABBREV IATIONS

CBK - Central Bank of Kenya

CRR - Cash Reserve Ratio

CBR - Central Bank Rate

CTS - Cheque Truncation System

GDP - Gross Domestic Product

KBA - Kenya Bankers Association

ICT - Information Communication Technology

MPC- Monetary Policy Committee

RTGS - Real Time Gross Settlement

EIB - European Investment Bank

IFC - International Finance Corporation

KES - Kenyan Shilling

GBP - Great Britain Pound

LTD - Limited Company

CHAPTER ONE: INTRODUCTION

1.1. Background of the study

The financial services industry has been severely affected by a high interest regime, elevated inflationary trends, declining business environment, changing econ-political patterns, narrowing profit margins and unstable local currency in the last quarter of 2011 and throughout 2012. Hunger and Wheeler (1995) argued that organisations do not operate in a vacuum but within an external environment which consists of variables that form the context within which firms exist. Organizations face a new era today as a result of several major changes over the last decade. They have to meet a complex set of new challenges from the environment. Strategists are faced with the need to understand the effects of the environment, Johnson and Scholes (1988).

Organizations are environment dependent and environment serving and they are in a constant two-way interaction with the environment. They receive inputs from the environment, transform or add value to them, and return the outputs in form of goods and services back to the environment. They therefore affect and are affected by what happens in the external environment, which is beyond the organization's control. Environmental changes create pressure for change in the organization and this means that they have to respond to relevant change to ensure that they survive according to Ansoff and McDonnell (1990).

Banks in Kenya have experienced tremendous growth in terms of; profitability, service delivery channels, technological application and customer base over the last decade due to improvements in the economy and a relatively stable political environment conducive for investment. However, today the industry is facing challenges from a continuously changing economic environment and a restrictive regulatory framework. The Economic environment will undoubtedly continue to be a more significant factor in future.

1.1.1. Response strategies and the Economic Environment

Response strategies can either be; operational, strategic, tactical, corporate or business originated. Strategic responses can be defined as the set of decisions and actions that result in the formalization and implementation of plans designed to achieve a firm's objective. Grant (1998) refers to them as situations where companies seek to actively fit their strategies to the existing environment: the environment is perceived as being given, while the strategy can be adopted. Johnson and Scholes (2002) argue that strategic responses are mainly concerned with decisions and actions meant to achieve business objectives and purpose. Operational strategies are concerned with how the component part of an organisation delivers effectively the corporate and business level strategies in terms of resources, processes and people as discussed by Johnson and Scholes (2006)

All businesses operate as open systems they constantly interact with their environment to survive. Organizations require effective strategy to achieve its planned goals. Whether private or public a firm has to develop a strategy to manage the environment it operates in, Pearce and Robinson (2002)

Economic environment refers to all the economic activities in a country such as inflation rates, bank lending rates, balance of payments, level and growth of GDP, the growth of population and factors affecting that growth like HIV. These factors aflFect the operations of the firm but the firm can barely influence their direction according to Yabs (2007). Economic environment includes system, policies and nature of an economy, trade cycles, economic resources, level of income, distribution of income and wealth (GDP). Economic environment is very dynamic and complex in nature. It does not remain the same. It keeps on changing from time to time with the changes in an economy like change in government policies and political situations. It has five main components namely, Condition. System, Policies, International economic environment and Legislation/Regulation (www.theganinigeek.com/business-finance/ Retrieved 08/06/2012 at 1800hrs)

Economic Policies of a business unit are largely affected by the economic conditions of an economy. Any improvement in the economic conditions such as standard of living, purchasing power of public, demand and supply and distribution of income largely affects the size of the market. Business cycle is another economic condition that is very important for a business unit it has 5 different stages; Prosperity, Boom, Decline, Depression and Recovery. An Economic System of a nation is a framework of rules, goals and incentives that controls economic relations among people in a society. Different countries of a world have different economic systems and the prevailing economic system in a country affect the business units to a large extent. Economic conditions of a nation can be of any one of the following types; - Capitalism, Socialism and Mixed economy. Economic policies affect different business units in different ways; the Monetary policy controls the supply and cost of money (interest rates), Fiscal policy controls government expenditure and taxation. Foreign trade policy regulates foreign trade, (www.thegeminigeek.com/business-finance/ Retrieved 08/06/2012 1800hn>)

1.1.2. The Banking Industry in Kenya

The banking industry in Kenya comprises 43 commercial banks, 1 mortgage finance company. 6 deposit taking microfinance institutions, 4 representative offices of foreign banks, 112 foreign exchange bureaus and 2 credit reference bureaus. The Sector recorded improved performance with the size of assets standing at Kes. 2.1 trillion, loans & advances worth Kes. 1.2 trillion, while the deposit base was Kes. 1.6 trillion at the beginning of year 2012, CBK (2011). The industry has grown tremendously in the last decade with banks leveraging on robust ICT platforms known as Core banking systems rather than recruiting a corresponding number of employees to serve the increasing number of customers.

The industry has restructured and evolved from the traditional banking approach to new ways of doing business facilitated by major amendments to the Banking act and spurred by increased innovation in the delivery of financial products and services throughout the country. These developments have been a catalyst to fulfilling the goals of building an all-inclusive and efficient financial system. Key challenges facing the banking industry are; exchange rate instability, inflationary pressures, and restrictive monetary policy that is driving up the CBR (rate) and CBK reserve ratios resulting in tight liquidity and a depressed business environment.

Some of the specific developments include; expansion of banks through branches and other places of business across Kenya and larger East African region, growth of the deposit-taking microfinance sub-sector, increased permeation of mobile financial services with an increased number of banks entering into partnership with mobile service providers to provide financial services through the mobile phone platform. Increased usage of the

agency banking model, which was rolled out in May 2010, to allow commercial banks engage third parties to offer specified banking services on their behalf, use of the internet as a remote delivery channel for banking services and development of the CTS (Cheque Truncation System) and RTGS (Real Time Gross Settlement System) in conjunction with KBA to speed up the clearing and payment channels, CBK (2011)

1.1 J. Co-operative Bank of Kenya Ltd

The Co-operative Bank of Kenya Limited is incorporated in Kenya under the Company's Act and is also licensed to do the business of banking under the Banking Act. The Bank was initially registered under the Co-operative Societies Act at the point of founding in 1965.This status was retained up to and until June 27th 2008 when the Bank's Special General Meeting resolved to incorporate under the Companies Act with a view to complying with the requirements for listing on the Nairobi Stock Exchange (NSE). The Bank went public and was listed on December 22 2008. Shares previously held by the 3,805 co-operatives societies and unions were ring-fenced under Coop Holdings Co-operative Society Limited which became the strategic investor in the Bank with a 64.56% stake.

The Bank runs three subsidiary companies, namely: Kingdom Securities Limited, a stock broking firm with the bank holding a controlling 60% stake, Co-opTrust Investment Services Limited a fund management subsidiary wholly-owned by the bank and Co-op Consultancy & Insurance Agency Limited (CCLA), the corporate finance, financial advisory and capacity-building subsidiary wholly-owned by the bank.

The bank's vision is to be the leading and dominant Kenyan bank with a strong countrywide presence, playing a central role in the co-operative movement and providing relevant and innovative financial services to our customers for the optimum benefit of all our stakeholders. Its mission is to offer value-added financial services to our chosen market segments with special emphasis on the co-operative movement through a highly effective network of service points, excellent customer service and a highly motivated team of qualified personnel.

The Co-operative Bank of Kenya Limited is owned by over 154.942 shareholders (as at 2011 close). Out of this. Coop Holdings Co-operative Society Limited owns 64.56%. with the rest held by other investors. The Bank has an Authorised share capital of Kes 5.000,000,000 made up of 5,000,000,000 shares of Kes 1.00 each, and an Issued and fully paid capital of Kes 3.492,370,900 made up of 3,492,370,900 shares of Kes 1.00 each. As at the close of 2011, Co-op Bank had a staff establishment of 3,193 employees (www.co-opbank.co.ke/ Retrieved 04/06/12 1340hrs)

Co-operative Bank of Kenya Ltd reported a Profit Before Tax of Kshs.6.36 billion for the year ended December 31, 2011 which was underpinned by growth in the loan book to 168 billion and growth in customer base by 44% to stand at 2.3 million account holders that grew income from commissions tremendously. In line with the new constitution the bank performed a strategic positioning of its outlets and mapped out an additional 42 branches 30% of which are already operational, (www.co-opbank.co.ke/ Retrieved 04/06/12 1340hrs)

1.2. Research Problem

The environment is what gives organisations their means of survival. However it is also the source of threats and environmental change can be fatal for an organisation. An organisation is faced with three layers of business environment; the macro-environment, industry and competitor as discussed in Johnson, Scholes and Whittington (2008). Thompson Strickland and Gamble (2007) argued that all companies operate in a 'macro-environment' shaped by influences emanating from the economy at large; population demographics; social values and lifestyles; government regulation; technological factors; and closer to home, the industry in which it operates

Co-operative Bank of Kenya Ltd a major player in the banking industry has been affected by changes in the economic environment and is grappling with a financial crisis that has affected performance with regards to deposits mobilization, reduction in trade volumes and volatile Kenyan shilling. CBK through its Monetary Policy Committee raised its base lending rate to banks to 18% forcing the bank to lend at 24% making it almost impossible to do lending business in Kenya and jeopardizing quality of loans already booked. High inflation rates have eroded disposable income for Kenyans who are unable to save forcing the bank to turn to CBK and other banks for deposits at exorbitant rates. On the backdrop of these challenges Co-opbank has responded by re-engineering the way it does business by turning its focus including its human resources to focus on liability campaigns to open more accounts and raise cheap customer deposits as opposed to concentrating on lending.

In Kenya a number of studies have been carried out to document strategic responses by various organisations to changing external environment. Some of them include; Gacheri (2010) did strategic responses by Tuskys supermarket to its changing competitive environment and found out that the most significant factor was competition. Machau (2009) did strategic responses to changes in the external environment by commercial banks in Kenya and found that banks targeted new customer segments and additional distribution channels. Muchelule (2010) did strategic responses adopted by the Kenya Ports Authority to changing external environment and found out that the organisation reacted by introducing low-cost but high quality services.

Further research by Mureithi (2010) concentrated on strategic responses by NIC bank to changes in the external environment and found that the bank responded with re-branding, strong customer service and hiring competent staff. Kiptugen (2003) researched on strategic responses by Kenya Commercial Bank to its changing competitive environment through restructuring, marketing, embracing information technology and culture change.

However no known study has been done to explore the response strategies by Co-operative bank of Kenya Ltd to changes in the economic environment. The economic environment is the most crucial factor in any business as it links directly with the objective of profit making which is the fundamental endeavour of any business. How did Co-operative bank of Kenya Ltd respond to changes in the economic environment?

13. Objective of the study

The objective of this study was to determine the response strategies adopted by The Co-operative Bank of Kenya Ltd to changes in the economic environment.

1.4. Value of the study

This study will contribute to practice by the regulator CBK, Top management of Commercial Banks, Ministry of Finance and other stakeholders in the financial services industry in formulating sound policies and strategies to manage trends in the changing economic environment that can provide numerous opportunities or prove to be catastrophic to organisations in the economic system. Policy makers would infer on the need for proper and informed regulation of the banking industry

The study is intended to add to the body of knowledge, specifically with regard to strategic responses in the banking industry and hopefully ignite the need for further research especially looking into factors in the economic environment and how it affects business. It would be a fundamental base to researchers willing to isolate factors in the external environment to deal with the economic factor exclusively.

CHAPTER TWO: LITERATURE REV IEW

2.1. Introduction

This chapter reviews literature from other researchers who have carried out studies in the same field. The specific areas covered are; concept of strategy, response strategies, economic environment and the economic environment. A review of the literature will guide the study in determining if a research gap on the area exists.

2.2. Concept of Strategy

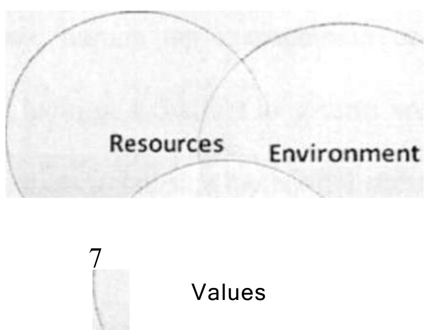
Strategy is the direction and scope of an organization over the long term which achieves advantages for the organization through its configuration of resources within a changing environment and fulfills stakeholder's expectation as defined by Johnson and Scholes (2002). Strategy is all about competition and trying to gain competitive advantage. It can also be defined as the pattern or plan that integrates organizations major goals, policies and action sequences into a cohesive whole. A well formulated strategy helps to marshal and allocate an organisations resources in a unique viable posture based on its relative internal competencies and shortcomings, anticipated changes in the environment and contingent moves by intelligent opponents, Quinn and Mintzberg (2003).

Strategy acts as a bridge between the firms' resources, opportunities and risks the firm faces in the environment. It incorporates the competitive moves and approaches to deliver the best performance and satisfaction to all stakeholders. On the other hand, operational responses are concerned with how the component parts of the firm deliver effectively the corporate or business level strategies in terms of resources, processes and people as discussed by Johnson and Scholes (2002)

It is all about understanding of the external environment and the resources available to compete in the external environment. The understanding , management and leadership of stakeholders (internal and external), organisational culture and change are usually key in determining the type of place an organisation is to work in or interact with an external stakeholder. Developing strategy is often concerned with markets, competition and growth both domestically and internationally which necessitates changes to structure and culture. Organisations which are concerned with their progress will seek to control and evaluate their success or identify areas of actual or potential failure. Capon (2008).

An alternative view of strategy is the interaction of the external environment, the resources and values of the organisation, as illustrated below

Figure 2.1 The EVR Diagram



Source: Thompson. J.L. (2001) *Strategic Management* (4th Ed), Thomson Learning

23. Response strategies

They are a set of decisions and actions that result in the formulization and implementation of plans designed to achieve a firms' objectives, Pearce and Robinson (1997). The management system adopted by an organisation is a determining component of the firms responsiveness to the environmental changes as discussed by Ansoff and McDonnel (1990). According to Ansoff (1999) for an organization to implement a strategic response three components are essential these are; the right climate (will to respond), competence (ability to respond) and capacity (volume of response). Strategic responses are mainly concerned with decisions and actions meant to achieve business objectives and purpose, Johnson and Scholes (2002).

Strategic responses require organisations to change their strategy to match the environment and also to transform or re-design their internal capabilities to match their strategy according to Ansoff (1998). Firms must adopt new strategies to new environmental conditions. The change in competition will require strategies, which will in turn call for reformed organizational capabilities. Byars (1991) argues that operational responses are concerned with efficiency of operations while strategic responses on the other hand affects several areas of operations, require top management decisions and huge financial commitments, are forward looking and affect long term prosperity of the firm and most critical are dependent on the environment. Operational strategies are concerned with how the component part of an organisation delivers effectively the corporate and business level strategies in terms of resources, processes and people as discussed by Johnson and Scholes (2006)

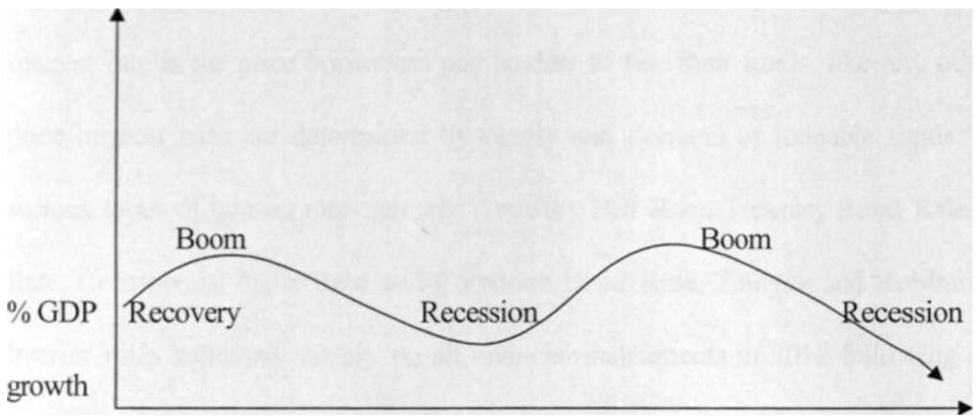
It is necessary for organisations to utilise environmental scanning techniques so as to predict environmental changes. Such scanning involves studying and interpreting social, political, economic and technological events so as to identify trends that could eventually affect the organisation as advanced by Thompson and Strickland (1993). The concern in real time responses is to minimize the sum to total losses and restore profitability to ensure organizations success in a turbulent and surprising environment according to Burnes (1998).

2.4. Economic Environment

Economic environment includes all the economic activities in a country such as inflation rates, bank lending rates, balance of payments, level and growth of GDP, the growth of population and factors affecting that growth like HIV. These factors affect the operations of the firm but the firm can barely influence their direction. Economic cycles are alternating periods of doom, recession, depression and recovery, Yabs (2007). The economic environment faced by organizations is shaped and influenced by the political environment as well as by the economic bodies that are constituents of the external environment according to Capon (2008). Political decisions which have an economic impact include taxation and other economic decisions outlined in the annual budget.

The world economy grew by 3.8 percent in 2011 compared to 5.0 percent in 2010. The slow down reflected the escalating strains in the Euro Area and fragilities in the financial and economic conditions of the major developed economies. The unprecedented policy measures taken by Governments during the early stage of the crisis did not help much to stabilize financial markets and jump-start recovery. Kenya's economy has been on recovery which is attributed to several factors including: favourable weather conditions that supported the dominant agricultural sector; increased credit to the private sector, enhanced public investment in infrastructure and a relatively stable domestic macroeconomic environment all of which supported private consumption and investment demand. The growth enabling environment in 2010 reversed in 2011 due to high oil and food prices and instability in the foreign exchange market, CBK (2011)

Figure 2.2 The Business Cycle



Time

Source; Yabs, J. (2007) *Strategic Management Practices in Kenya*, Nairobi: Lelax Global Ltd

2.5. Determinants of Economic Environment

Several factors directly impact on the economic environment Blanchard (2009) defines inflation rate as the rate at which the average price of the goods in the economy is increasing over time. Inflationary pressure in 2011 reflected steep increases in food and fuel prices and tight liquidity in the economy by reducing the purchasing power of business customers. Exchange rate is another key determinant The Kenya shilling weakened against the US dollar, the Sterling Pound and the Euro, but strengthened against the Japanese Yen in 2011 due to the Euro sovereign debt crisis that led to increased demand for US Dollars. This triggered the aggressive monetary policy actions with the Monetary Policy Committee (MPC) raising the Central Bank Rate (CBR) by 1,100 basis points from 7 percent in September 2011 to 18 percent in December 2011, and the cash reserve ratio (CRR) by 50 basis points to a monthly average of 5.25 percent effective 15^{lll} December 2011. CBK also reduced commercial banks' foreign exchange exposure limit from 20 percent of core capital to 10 percent. CBK (2012)

Interest rate is the price borrowers pay lenders to use their funds, like any other market price interest rates are determined by supply and demand of loanable funds. There are various types of interest rates namely; Treasury Bill Rate, Treasury Bond Rate, Discount Rate, Commercial Paper Rate and Corporate Bond Rate, Pindyck and Rubinfeld (2009). Interest rates increased sharply on all financial instruments in 2012 following aggressive monetary policy tightening adopted by the Bank to address inflationary pressures and stabilize the exchange rate, CBK (2012).

Balance of Payments refers to a summary record of a country's international economic transactions in a given period of time, Schiller (1997). A country's balance of payment records all the flows of money between residents of that country and the rest of the world. When all the components of the balance of payments account are taken together, the balance of payments should exactly balance: credits should equal debits. If they are not equal, the rate of exchange would have to adjust until they were, or the government would have to intervene to make them equal according to Sloman and Hinde (2007). Business cycle is another key determinant of the Economic environment actual growth tends to fluctuate in some years there is a high rate of economic growth: the country experiences a boom. In other years, economic growth is low or even negative: the country experiences a recession. This cycle of booms and recessions is known as the business cycle Sloman and Hinde (2007).

2.6. Summary

This chapter explains the review of literature which comprised the secondary data that is available concerning the area of study. This acts as the guiding principle in defining the concepts under which the area of study revolves and helps in identifying the knowledge gap that the researcher studied. The economic environment facing a firm includes factors like inflation rates, bank lending rates, balance of payments, level of GDP and business cycles which have a direct impact on the profitability and operations of an organisation. Strategic responses require organisations to change their strategy to match the environment and also to transform or re-design their internal capabilities to match their strategy in order to survive. Most of the studies conducted have concentrated on the external environment without giving proper attention to the individual factors in the environment like economic factors.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1. Introduction

This chapter sets out the various stages followed in completing the study and the blueprint for collection, measurement and analysis of data. It is an overall scheme on how the research objective was fulfilled. In this chapter most of the decisions about how the research was executed are addressed. This section involves identification of procedures and techniques that were used in the collection, processing and analysis of data.

3.2. Research Design

The study was conducted through a case study, Mugcnda and Mugenda (2003) described a case study as an in-depth investigation of an individual institution or phenomenon. Case studies place more emphasis on a full contextual analysis of fewer events or conditions. The research studied Co-operative Bank of Kenya Limited to identity the response strategies to changes in the economic environment. From the foregoing a case study was the best suited way to fulfill the objective of the study.

3 J. Data Collection

Primary data was collected from the sampled employees of Co-opbank who were all based at Head office in Nairobi. It was done through personal interviews with an interview guide to the open ended questions to Divisional heads of; Finance Division, Credit Management Division. Human Resources Division, Retail Banking Division, Corporate and Institutional Banking Division. The choice of the above interviewees was informed by their leadership positions in bank that involves strategy formulation and direct link to business operations of the bank which is important to strategy implementation. Secondary data was sourced from various publications of Co-operative Bank of Kenya Limited, CBK publications and other relevant industry publications to supplement the primary data collected.

3.4. Data analysis

Data analysis was through content analysis methodology, Mugenda and Mugenda (2003) stressed that the main purpose of content analysis is to study existing information in order to determine factors that explain a specific phenomenon. Data was first be evaluated for usefulness, consistency, credibility and adequacy. The study used a set of categorizations to make valid and replicable inferences from data to their context. The data collected was broken down into different aspects of response strategies, arranged into logical groups and analyzed to provide a systematic and qualitative description of the objectives of the study.

Statistical analysis was used in graphic representation of the secondary quantitative data collected through use of bar charts and line graphs. The qualitative data was presented in continuous prose as a qualitative report of the strategic responses adopted by Co-operative Bank of Kenya Limited.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1. Introduction

This chapter presents the analysis and interpretations of data from the field as set out in the research methodology on the response strategies adapted by Co-operative Bank of Kenya Limited to changes in the economic environment. To enhance data quality of the information obtained unstructured questions were used whereby interviewees indicated their views and opinions about the response strategies. According to the data found; of the Divisional Directors projected in the research methodology only four were interviewed which makes a response rate of 80% that was achieved after tireless scheduling and re-scheduling of appointments through polite reminders and the kind assistance of the respective personal assistants.

4.2. Respondents profile

This section presents the findings on the respondent's profiles. The interview was successfully administered to four directors namely; Director of Finance, Director of Retail Banking, Director of Credit Management Division and the Director of Corporate and Institutional Banking. The information gathered from the respondents indicates that majority of the Directors have vast experience and knowledge in the management of Co-operative Bank of Kenya Limited having served the bank for more than ten years thus it can be safely assumed that majority of the respondents are well versed with the challenges of the economic environment and the response strategies by Co-operative Bank of Kenya Limited given their practical experience and exposure.

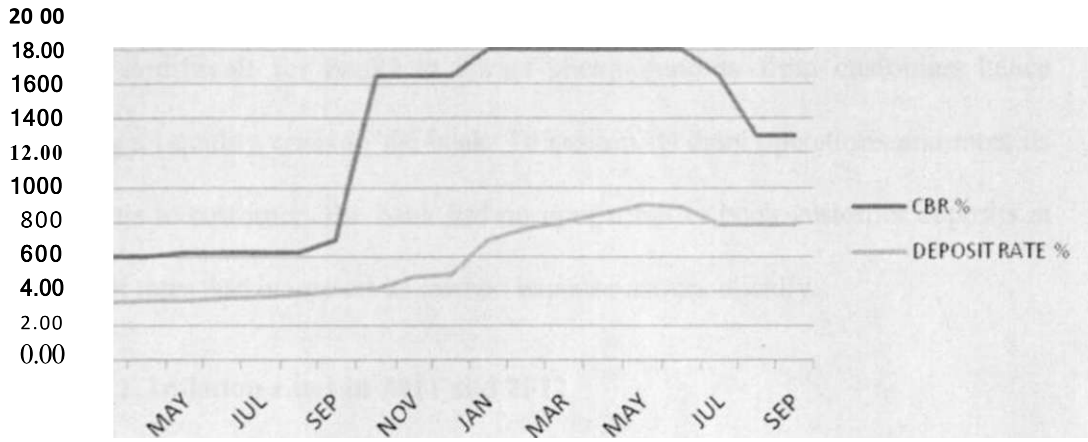
According to the respondents they are charged with different responsibilities; the Retail banking director directs and coordinates, through subordinate managerial personnel all activities of retail consumer products and service channels. He oversees new accounts acquisition, branch operations, customer service, marketing, personal banking, business banking and tellers. The Director of Corporate and Institutional Banking manages banking services for large corporations designed to deal with major financial transactions, cash management, and other banking services custom-tailored for large firms. It involves one stop banking to clients covering all the lines credit in the bank, account relationship management and negotiated pricings and tariffs.

The Director of Credit Management is responsible for credit risk analysis, credit administration, portfolio management and collateral management. Finally the Director of Finance handles budget preparation, control and planning, financial accounting and reporting, revenue assurance and cost management for the bank.

4.3. Factors in the Economic Environment influencing the bank.

The study concentrated on five factors in the economic environment that have had a major impact on the banks strategies namely; interest rates, inflation rates, exchange rates, international trade and CBK regulations. The data from the respondents was analyzed using content analysis which showed that the Board of Directors of Co-operative Bank Limited are facing a turbulent economic environment due to changes in the factors as discussed by them below.

Graph 4.1. Movements of CBR and the Deposit rate in 2011 and 2012

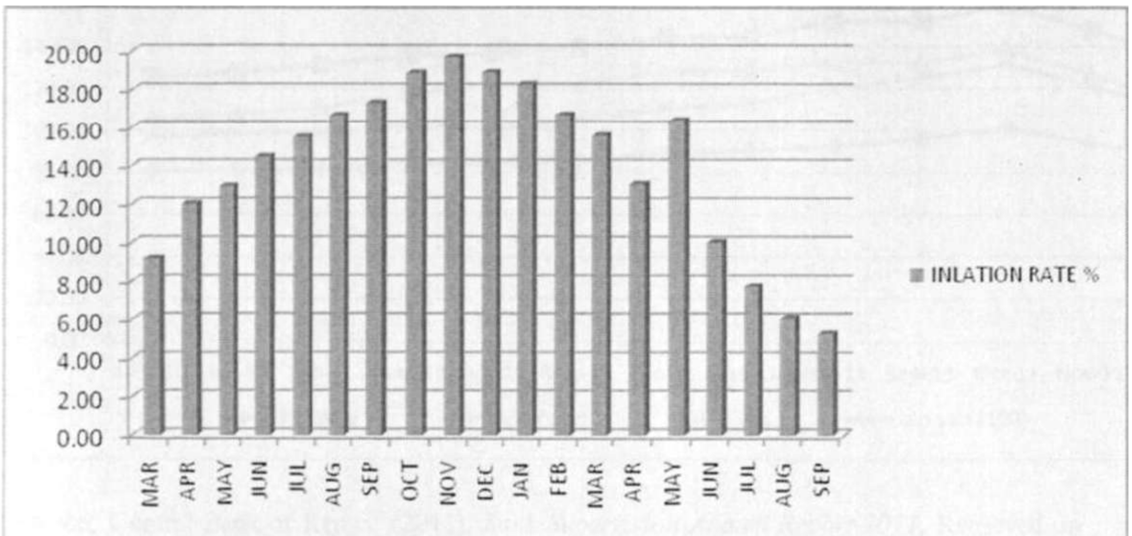


Source: Central Bank of Kenya, (2012), *Consolidating Monetary Policy Decisions,* on Retrieved 30/09/12 1311 hrs from http://www.centralbank.go.ke/downloads/mpc/

The study revealed that the year 2011 was characterized by a difficult macro-economic environment especially second half of the year and first half of 2012 with Kenya's economic growth declining to an estimated 4.3% compared to 5.6% in 2010. The reaction by the regulator was thus to increase the Central Bank Rate (CBR) from 6% in March 2011 to 18% in November 2011 as can be seen from the graph above to control inflation and weakening of the Kenya Shilling. Owing to the high interest rate regime the interest rates on loan products subsequently went up across the banking industry. It was established from the interviewees that interest income is earned from the spread between customer deposit rates and interest charged on advances which was severely eroded resulting in massive defaults on loans that translated to increased provisioning for bad loans and reduced profit margins for the bank.

The movement in the CBR also affected the Central bank borrowing discount window which made it prohibitive for banks to borrow from Central Bank. Further the study found out from the interviewees that the increase in interest rates reduced loan uptake by customers and a steep increase in the deposit rate from an industry average of 3.41% in March 2011 to 7.85% in September 2012 as reflected in graph 4.1 above that made it difficult for banks to attract cheap deposits from customers hence occasioning a liquidity crisis in the bank. To sustain its daily operations and meet its commitments to customers the bank had no option but to book customer deposits at high deposit rates that increased its interest expense astronomically.

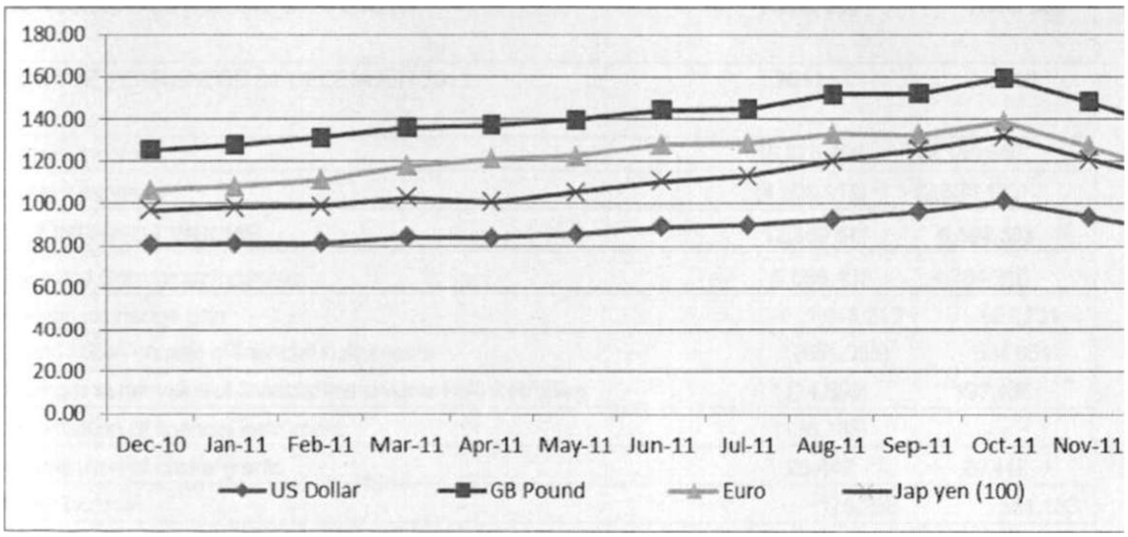
Graph 4.1.1. Inflation rates in 2011 and 2012



Source ; Central Bank of Kenya, (2012), *Consolidating Monetary Policy Decisions,* Retrieved on 30/09/12 1311 hrs from http://www.centralbank.go.ke/downloads/mpc/

On the second factor of inflation rate the interviewees unanimously agreed that the country faced a period of hyper inflation from mid 2011 to the first half of 2012 from a low of 9.19% in March 2011 to a peak of 19.72% in November 2011 from the graph above. The high inflation rates inflated the cost of living for customers and eroded their disposable income thus reducing their marginal propensity to save denying the bank deposits for onward lending. The interviewees further reiterated that the sustained high inflation levels led to contraction of the economy and business slowed down drastically affecting appetite for loans, reducing interest income and increasing default rate in existing customers with loans as priorities changed for customers who were keener on fulfilling basic needs. Finally the operating costs for the bank were impacted as it was forced to negotiate new salaries for its unionisable staff members and pay more in interest expense to book customer deposits.

Graph 4.1.2. Values of Kenyan shilling against major world currencies



Source; Central Bank of Kenya, (2011), *Bank Supervision Annual Report 2011,* Retrieved on 07/09/12 1620 hrs http://www.centralbank.go.ke/downloads//annualreports/bsd/

The study required respondents to assess the effect of exchange rates on the bank and the interviewees had mixed reactions from the fact that ultimately the bank benefited from the volatile exchange rate. The Kenyan shilling was severely weakened in 2011 and the first two quarters of 2011 against the major world currencies as displayed in graph 4.3 above emanating from excess demand for the dollar due to the country's greater imports than exports. The bank through its Treasury department buys and sells foreign currencies for a margin and facilitates international trade of imports and exports through a dedicated trade finance department that has tailored products for customers at a fee. The bank positioned itself strategically and was able to make good returns through dealings in foreign currencies as the margins were attractive as demonstrated by the from the increase in foreign exchange gains in the extract from its annual books of 2011 below.

Table 4.1.3.Gro\vth in foreign exchange gain and loss on sale of financial instruments

CONSOLIDATED INCOME STATEMENT	KShs'000	KShs'000
FOR THE YEAR ENDED 31 DECEMBER 2011	**2011**	**2010**
Interest income	16,875,486	12,140,640
Interest expense	(4,505,915)	(2,638,132)
NET INTEREST INCOME	**12,369,571**	**9,502,508**
Fees and Commission income	5,569,407	4,384,518
Foreign exchange gain	1,013,213	621,201
(Loss) / Gain on sale of financial instruments	(651,085)	594,651
Changes in fair value of financial instruments held for trading	(24,853)	197,406
Amortisation of financial instrument	(136,135)	-
Amortisation of capital grants	20,447	20,447
Other income	175,286	351,183
OPERATING INCOME	**18,335,851**	**15,671,914**

Source: The Co-operative Bank of Kenya Ltd (2011), *Annual Report & Financial Statements*

From the study, all respondents attest to the major impact international trade has had on the bank with increased competition from newly registered foreign banks like; UBA, EcoBank, HSBC and Bank China who have strong financial muscle from their parent companies enabling them to offer more competitive pricing. The internationalization of banking business also exposed the bank to the financial crisis in the United States and the Euro zone debt crisis affected foreign markets of our agro- based economy that resulted to a dip in our foreign earnings and reduced diaspora remittances that denied the bank income through commissions and trade in foreign currencies.

The interviewees cited Central Bank Regulations as the single most important factor impacting on its operations directly. Through its open market operations; CBK buys and sells securities in the secondary market in order to achieve a desired level of Bank reserves. Alternatively, it injects money into the economy through buying securities in exchange for money stock. CBK in the recent past has floated competitively priced securities to mop up liquidity in the market which has complicated matters for the bank. CBK, as a lender of last resort provides secured short-term loans to commercial banks on overnight basis at punitive rates, thus restricting the bank to seek funding in the market at prohibitive rates. CBK is also empowered by the law to retain a certain proportion of commercial banks' deposits to be held as non-interest bearing reserves at the Central Bank. It increased its Cash Reserve Ratio (CRR) from October 201 land the new reserve requirements restricted Co-operative Bank of Kenya Limited's ability to expand credit to its customers.

4.4. Response strategies to changes in the Economic environment.

The interviewees indicated that to counter the changes in the economic environment the bank embarked on strategies to mitigate on threats posed by changes in the economic environment and exploited opportunities presented by the same changes. The study revealed that Co-operative Bank of Kenya Limited diversified its investment strategy as a response to changes in the economic environment by strengthening its business model to offer a 'one-stop-shop' financial services supermarket. Services offered include securities management, trust services, custody services, stock brokerage, financial, investment in addition to management consultancy and much more will be offered to customers as the regulatory framework is set up.

The interviewees cited shift of focus from lending to deposit mobilization by redeploying staff from lending roles to liability acquisition through campaigns in the media by the bank as a strategic intervention to save on interest expenses and maintain the minimum cash reserves in a difficult environment. During the year 2011, the customer deposits grew from Kshs. 123 billion to Kshs. 142.6 billion, a 15% growth as a result of an increase in the number of accounts to over 2.3 million as the bank confined focus on increasing financial access to the majority of Kenyans. Given the constrained economic activity due to inflation, the bank continued to enforce strict credit risk management policies and also made adequate provisions for bad and doubtful debts.

The study further established that the bank had invested heavily on non-funded commission based income streams as opposed to traditional lending due to lack of cheap deposits and poor appetite for loans. To grow its transaction based income, it launched an agency banking platform "Co-op Kwa Jirani". Its aim is to ensure banking services are taken closer to the people. It entails cash deposit taking, cash withdrawals, school fees payments, utility payments, balance enquiry, mini statements and other banking services. Co-op Kwa Jirani agents can be used by all Co-op bank customers and Sacco Link members. Its mobile phone services product M-banking which also facilitates seamless two-way funds transfer between bank accounts and money transfer solutions offered by mobile telecommunication firms. The bank's internet-banking solution CoopNet has contributed to growth in customer base especially for Kenyans in the diaspora

From the study its evident that Co-operative Bank of Kenya Limited had prepared itself well to benefit from opportunities presented by international trade with its regional expansion on course with the establishment of the Co-operative Bank of Southern Sudan as a joint venture with the Southern Sudan Co-operative movement already approved by the Government. The bank established a dedicated Diaspora Banking Department to tap into business from overseas through foreign currency denominated loans and special remittance accounts. The bank runs franchises for Moneygram and Western union to reap from commissions on diaspora remittances. The interviewees further explained that the bank had an advanced Trade Finance Department with corresponding banks across the globe to offer competitive products like letters of credit and guarantees for clients dealing in imports and exports.

To lock in its customer base mainly comprising of Co-operatives and Sacco's in the country and shield itself from rapidly changing economic conditions the bank offers enhanced access to innovative and value-adding financial services to them. The bank offers retail banking and related products through front office service points (FOSAs) located at Sacco premises and to date over 418 have been enlisted. Through Co-op Consultancy Services Ltd, the group assists Saccos in the establishment and management of FOSAs. The Sacco Link Switch has integrated the bank's and SACCOs' financial systems, providing a solution through which ATMs, mobile banking, point of sale (POS) channels and internet banking is facilitated.

Table 4.1.4. Growth in interest income versus interest expense

CONSOLIDATED INCOME STATEMENT		
FOR THE YEAR ENDED 31 DECEMBER 2011	**2011**	**2010**
	KShs'000	**KShs'000**
Interest income	16,875,486	12,140,640
Interest expense	(4,505,915)	(2,638,132)

Source: The Co-operative Bank of Kenya Ltd (2011), *Annual Report & Financial Statements*

To offset the effects of a high CBR that results in a smaller interest spread margin which erodes interest income significantly the interviewees indicated that the bank uses a margin of 6% above the CBR to price its loans and the margin is applied throughout the variation of the CBR which contributed to increase in interest income in tandem with increase in interest expense as demonstrated by excerpts from books of the bank in Table 4.4. The interviewees credit the good performance of the bank in 2011 in a difficult economic environment to this strategy which saw interest income rise due to the banks peak base rate of 24% that applied to July 2012 when the CBR was at 18%.

The interviewees further discussed mitigation against non- performing loans occasioned by the high interest regime through an Early Alert Committee chaired by Director of Credit Management that meets monthly to review the entire portfolio of the bank. It rehabilitates struggling customers through; loan restructures, extension of moratoriums for projects, capitalization of arrears, interest rate reduction, extension of loan term, limit reviews and waiver of arrears penalties.

The study observed that with the liquidity tightening policy aggressively pursued by CBK it was prohibitive for the bank to borrow from CBK or the other commercial banks thus it turned to international finance partners for long term funds to sustain its operations and maintain its growth trajectory. The bank approached European Investment Bank (EIB) for a loan of 40 million pounds that was successfully disbursed in 2012 and has signed a loan contract with IFC for 2013. Co-operative Bank of Kenya Limited invested heavily on Government bonds during the low interest regime and liquidating them during the high interest regime occasioned massive losses as evidenced by loss on sale of financial instruments in Table **4.4** thus it was a well calculated ploy to borrow from international financiers as the situation improves on the domestic front.

4.5. Discussions

Strategic responses require organisations to change their strategy to match the environment and also to transform or re-design their internal capabilities to match their strategy according to Ansoff (1998). Firms must adopt new strategies to new environmental conditions. The change in competition will require strategies, which will in turn call for reformed organizational capabilities. The Co-operative Bank of Kenya Limited was faced with a restrictive CBK policy, high interest regime, elevated inflationary levels, volatile exchange rates and a CBR. that increased from 6.00% to 18% within a span of eight months. Such environmental shocks can shut down an entire industry if organisations don't amend their strategy to match the environment and also re- design their internal capabilities.

The management of the bank responded aptly by changing tact and moving away from traditional lending business to concentrate on non-funded income streams and reaching out to financial partners for funds at cheaper rates. Operational responses are concerned with efficiency of operations while strategic responses on the other hand affects several areas of operations, require top management decisions and huge financial commitments, are forward looking and affect long term prosperity of the firm and most critical are dependent on the environment as argued by Byars (1991).

It is important to note that the response strategies from Co-operative Bank of Kenya Limited had both strategic and operational responses in the sense the short term operational issues like restructuring of the portfolio, aggressive campaigns to mobilize deposits, robust credit risk analysis were operational in nature while the big long term decisions like regional expansion, seeking loans from external financiers and diversifying its investment portfolio were strategic.

The economic environment faced by organizations is shaped and influenced by the political environment as well as by the economic bodies that are constituents of the external environment according to Capon (2008). The Central Bank of Kenya though a purely regulatory body was formed by an act of parliament and thus a political creature, however its decisions have far reaching economic ramifications to banks. The CBR also known as signalling rate is the basis of pricing of financial instruments throughout the economy like; interest rates, deposit rates, interbank rates, T - Bonds rates, CBK discount window and T-Bills.

Such overdependence on the CBR only has major reverberations across the economy and banking industry any time it changes and it exposes the banking industry to massive losses and realignments if the management of commercial banks don't move with speed to mitigate the risk like Co-operative Bank of Kenya Ltd did. Kenya's economy has been on recovery which is attributed to several factors including: favourable weather conditions that supported the dominant agricultural sector; increased credit to the private sector, enhanced public investment in infrastructure and a relatively stable domestic macroeconomic environment all of which supported private consumption and investment demand.

The growth enabling environment in 2010 reversed in 2011 due to high oil and food prices and instability in the foreign exchange market. To control the hyper inflation and a volatile Kenyan shilling CBK increased its CBR by 200% that immediately stifled credit to the private sector and led to a slump in the economy. It is important to note the direct link between economic factors, CBK regulation and actions of banks to the performance of the economy they are all intertwined and prudent management of banks and moderation of CBK regulations will ensure a stable economy.

CHAPTER FIVE:

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Introduction

This chapter summarizes the study and gives its overall view. It also discusses the relevance of the study to decision makers of the organization and stakeholders; gives recommendations of issues the researcher feels should be done in light of the study findings to enable the organization respond more effectively to changes in the economic environment.

5.2. Summary of findings

The study inquired on response strategies by Co-operative Bank of Kenya Limited to changes in the economic environment with emphasis on five factors namely; interest rates, inflation rates, exchange rates, international trade and CBK regulations. The study further investigated how changes in the factors had affected the bank and how the bank amended its strategy to deal with threats and opportunities arising from such changes. From the study change in interest rates affected the bank greatly as non-performing loans increased, demand for loans fell drastically and the deposit rate went up forcing the bank to pay higher rates to book deposits reducing its interest income due to reduced interest spreads.

As a result the bank responded by going slow on lending and concentrating on opening new accounts to raise cheap deposits. The bank aggressively pursued non-funded transaction based income streams like internet banking, M banking, Agency banking and growth of its ATM network to sustain revenues. Inflation levels in the country reduced disposable income of customers of the bank and they could save but spend more to survive which slowed down the economy as funds could not flow from savers to producers. Majority of the respondents reiterated that expansion and retention of Co-operatives and Sacco's through offering of value added services like Sacco link proved instrumental in shielding the bank from effects of inflation due to a broad customer base. On exchange rates the respondents pointed to a weak Kenyan shilling that allowed the bank to make good returns from foreign currency trade by realigning its resources to meet the increased demand for the dollar.

The good performance of the bank is attributed to its creative pricing model whereby its products are priced at a premium of 6% above the CBR and prices change in tandem with the CBR to shield the bank from reduced margins. Respondents cited the move as contributing negatively to customers through high interest and default in loans. The growth in international trade is a major factor in the economic environment as it introduced stiff competition from foreign banks and presented numerous investment opportunities to C-operative Bank of Kenya Limited. Through a dedicated Diaspora banking department and Trade finance department the bank maximized revenue from international trade and diaspora remittances through franchises of Moneygram and Western Union.

Central Bank of Kenya through its Monetary Policy Committee embarked on a liquidity tightening policy from mid 2011 to mid 2012 by raising its CRR and the discount window to make it prohibitive for the bank to borrow from CBK. Co-operative Bank of Kenya Limited approached EIB and IFC for long-term loans at lower pricing to sustain its operations and grow its loan book. The interviewees also indicated that the bank diversified its investment strategy to be a 'one-stop-shop' financial services supermarket offering securities management, trust services, custody services, stock brokerage, financial, investment and management consultancy. This strategy is aimed at spreading risks associated with a turbulent economic environment and increases its revenue generating streams.

5.3. Conclusion

The goal of this research was to study response strategies by Co-operative Bank of Kenya Limited to changes in the economic environment. From the research findings top management of the bank need to be able to continuously study the economic environment for changes to determine the appropriate strategies to counter the changes and take advantage of opportunities presented by them, no single strategy is able to confront all the changes in economic factors but it requires a blend of operational responses that are implemented at short notice to mitigate on the erratic factors and long term strategic moves to sustain the bank in the long term. The Co-operative Bank of Kenya Limited managed to survive the difficult period in late 2011 and early 2012 and post good results. This therefore indicates that banks can survive in the long term if they scan the economic environment continuously and amend their capabilities to match the environment.

5.4. Recommendations

The study recommends that Co-operative Bank of Kenya Limited should diversify its deposits base as source of funds to finance lending by approaching more foreign lenders on negotiated pricing to shield long term borrowers like mortgage holders from vagaries of inflation and erratic interest rates. This would ensure a better performing portfolio and guaranteed returns to the bank unlike the current scenario where the bank is forced to provision for bad debts against its profits.

The study further recommends that CBK should stop over reliance on the CBR to control inflation and protect the Kenyan shilling. More effective tools are available under fiscal policy like taxation and government expenditure to control inflation which is responsible for pushing up the other economic factors. CBK should also initiate controls on maximum loans per sector in the industry to control consumerism where almost 80% of lending in Kenya is for consumption and not production. The culture of consumerism puts pressure on the Kenyan shilling with imports exceeding exports by far initiating a vicious circle to cushion it against the major world currencies.

5.5. **Limitations of the study**

Being a case study, research findings cannot be generalized to other firms in the industry due to the unique model of Co-operative Bank Limited as the sole banker of Co-operatives and Sacco's in the industry guaranteeing it loyal customers and huge deposits. The study was carried out within a limited time and resources that constrained the scope as well as the depth of the research. Additionally the Directors of the bank did not have sufficient time to explain all the issues in detail hence some response strategies were derived from the bank's internal publications to clearly explain the trends

5.6. **Suggestions for further research**

The study only concentrated on response strategies by the Co-operative Bank of Kenya Limited to changes in the economic environment. The researcher however suggests that further research is still required on the entire financial services industry to determine how a change in the economic environment affects the industry. Such studies could unearth more information and still contribute to theory development and knowledge advancement. The Co-operative Bank of Kenya Limited in its mission wants to be the leading and dominant Kenyan bank with a strong countrywide presence. Therefore, further studies on effect of changes in the economic environment on performance of the bank are necessary to establish the competitive strategies the bank is employing to achieve its vision.

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APPENDIX 1: INTERVIEW GUIDE

RE: INTERVIEW QUESTIONS ON RESPONSE STRATEGIES TO CHANGES IN THE ECONOMIC ENVIRONMENT BY THE CO-OPERATIVE BANK OF KENYA LIMITED

TO: SELECTED DIVISIONAL HEADS OF CO-OPERATIVE BANK OF KENYA LTD

FROM: PIUS KIPTOO CHEBOI

C/O SCHOOL OF BUSINESS UNIVERSITY OF NAIROBI

INTERVIEW QUESTIONS

1. Interviewee's position in the Bank:

2. Years with the Bank:

3. Years in the current position:

4. What are your duties in the Bank?

5. How has changes in the following Economic factors influenced the Bank? Explain.

a). Interest rates

b). Inflation rates

c). Exchange rates

d). International trade

e). CBK regulations

6. What has been the implication of changes in the Economic factors above on the Bank's strategies?

7. How has the bank been able to amend its strategies as per the factors explained in (5.) above?

APPENDIX 2: KEY FINANCIAL INDICATORS

KEY FINANCIAL INDICATORS				
YEAR	MONTH	INLATION RATE %	CBR %	DEPOSIT RATE %
2011	MAR	9.19	6.00	3.41
	APR	12.05	6.00	3.47
	MAY	12.95	6.25	3.47
	JUN	14.49	6.25	3.57
	JUL	15.53	6.25	3.68
	AUG	16.67	6.25	3.85
	SEP	17.32	7.00	4.07
	OCT	18.91	16.50	4.21
	NOV	19.72	16.50	4.83
	DEC	18.93	16.50	5.02
2012	JAN	18.31	18.00	6.99
	FEB	16.69	18.00	7.66
	MAR	15.61	18.00	8.01
	APR	13.06	18.00	8.53
	MAY	16.40	18.00	9.04
	JUN	10.05	18.00	8.91
	JUL	7.74	16.50	7.88
	AUG	6.09	13.00	7.86
	SEP	5.32	13.00	7.85