DIVERSIFICATION STRATEGIES IN THE BANKING INDUSTRY IN KENYA

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DECLARATION

This management project is my original work and has not been presented for a degree in any other university.

Signed Date 13/11/2009

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D61/8458/2006

This project has been submitted for examination with my approval as university supervisor.

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DEDICATION

To my family and friends

ACKNOWLEDGEMENT

I would like to acknowledge the following persons whose contributions facilitated the completion of this project. First, I thank the Almighty God for the gift of life and for giving me the skills, acknowledge and energy to be able to complete this paper.

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TABLE OF CONTENTS

DECLARATION .... **i**

DEDICATION .... **ii**

ACKNOWLEDGEMENT .... **iii**

LIST OF TABLES .... **vi**

ABSTRACT .... **vii**

CHAPTER ONE: INTRODUCTION **1**

1.1 Background of the study 1

1.1.1 Diversification and performance 1

1.1.2 Banking Industry in Kenya 3

1.2 Statement of the problem 5

1.3 Objectives of the study 6

1.4 Importance of the study 6

CHAPTER TWO: LITERATURE REVIEW **7**

2.1 Application of Strategy in Commercial Banks 7

2.2 Benefits and Costs of Diversification 10

2.2.1 Benefits of Diversification 10

2.2.2 Costs of Diversification 13

2.3 Relationship between Diversification and Performance 15

CHAPTER THREE: RESEARCH METHODOLOGY **18**

3.1 Research Design 18

3.2 Population of the Study 18

3.3 Data Collection 18

3.4 Data Analysis 18

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS **19**

4.1 Introduction 19

4.2 Sample characteristics 19
4.3 Types of diversification strategies 20
4.4 Benefits of diversification 23
4.5 Costs of bank diversification 26

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS 28
5.1 Introduction 28
5.2 Summary of findings 28
5.3 Conclusions of the study 30
5.4 Recommendations 30
5.5 Suggestions for further research 31

REFERENCES 32

APPENDICES 36
Appendix 1: Institutions in Terms of Shareholding 36
Appendix 2: Questionnaire 38

LIST OF TABLES

Table 1: Age of respondents 19
Table 2: Gender 20
Table 3: Experience within the banks 20
Table 4: Vertical Diversification 21
Table 5: Horizontal Diversification 21
Table 6: Geographical Diversification 22
Table 7: Extent of use of various diversification strategies 22
Table 8: Greater Income Growth Potential 23
Table 9: Improvement of Distribution Channels 23
Table 10: Risk Control 24
Table 11: Improved Performance of Core Capabilities 24
Table 12: Need to Acquire New Technology 25
Table 13: Changing Business Focus 25
Table 14: Benefits of Bank Diversification 26
Table 15: Costs of bank diversification 27

ABSTRACT

The study sought to identify the types of bank diversification strategies in Kenya and to determine the benefits and costs of diversification on the commercial banks in Kenya. This was a cross-sectional survey of commercial banks in Kenya. The population of this study was all the commercial banks which had been operating in Kenya for at least five years. This study was a census of all the 43 commercial banks that had been operating in Kenya. Primary data was collected using questionnaires. The head of strategy or his/her appointee in each of the selected commercial banks filled in the questionnaires. The questionnaires were entered into the SPSS after being sorted and coded and analysed and interpreted using descriptive statistics and t-statistics. The results were summarised in terms of the objectives of the study and presented in form of tables.

The study revealed that three types of strategies (horizontal diversification, vertical diversification and geographical diversification) were prevalent within the banking industry in Kenya. But the most used strategy was the horizontal diversification followed by the geographical diversification. The study therefore concludes that the banks are using various diversification strategies in the industry in order to be competitive in the market. On the benefits of bank diversification, it was noted that benefits included greater income growth potential, improvement of the performance of distribution channels, risk control, acquisition of new technology, and change of business focus. The study concludes that there are a number of benefits of bank diversification available to commercial banks but improvement of core competencies/capabilities was not one of the significant benefits.

The study recommends that there is need for banks to diversify more in services so as to enjoy the enormous benefits of bank diversification. It is also recommended that commercial banks should consider more of customer segmentation and offer the products that can help improve the performance of such business segments. It may also be of interest for banks to offer more of self-service products such mobile and online banking given that the internet connectivity has been upgraded in Kenya with the introduction of

fibre optic cable. More studies need to be done in this area especially to unearth which type of diversification has a significant influence on bank performance.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

Since the late 1970s financial service organisations have observed regulatory changes, technological innovations as well as the emergence of new financial markets and forms of finance. At the same time, managers of banks raised fees for deposit services, reduced branch operating costs and shifted to higher earning assets. In other words, external innovations (and in particular, regulatory change and information technology applications) were instrumental in the changes banks made to their balance-sheet size, in increasing business-portfolio diversity and in restructuring their geographic scope. Changes in the size and diversity of banks followed external changes in bank markets but banks' strategic responses were still short of the competitive (or perfectly contestable market) benchmark. Documented evidence would thus suggest that some of the changes increased competition in bank markets while some others pursued strategies aiming to deter new participants entering the market (such as deterring insurance companies from supplying unsecured lending).

1.1.1 Diversification and performance

Diversification is a means by which a firm expands from its core business into other product markets (Gluck 1985). Research shows corporate management to be actively engaged in diversifying activities. Rumelt (1986) found that by 1974 only 14 percent of the Fortune 500 firms operated as single businesses and 86 percent operated as diversified businesses. Many researchers note a rise in diversified firms (Datta, Rajagopalan and Rasheed 1991). European corporate managers according to a survey, not only favour it but actively pursue diversification (Kerin, Mahajan and Varadarajan 1990).

Firms spend considerable sums acquiring other firms or bet heavily on internal R&D to diversify away from their core product/markets. Of late firms are beginning to moderate their zeal for diversification and are consolidating around their core businesses. But this trend has not affected large Asian corporations which continue to remain highly diversified. As in any economic activity there are costs and benefits associated with

diversification, and ultimately, a firm's performance must depend on how managers achieve a balance between costs and benefits in each concrete case.

Moreover, these benefits and costs may not fall equally on managers and investors. Management researchers argue that diversification prolongs the life of a firm. Researchers in finance argue diversification benefits managers because it buys them insurance, and shareholders usually bear all the costs of such insurance. Diversification can improve debt capacity, reduce the chances of bankruptcy by going into new product/ markets (Higgins and Schall 1975), and improve asset deployment and profitability (Teece 1982). Skills developed in one business transferred to other businesses, can increase labor and capital productivity.

Diversification in banking has been a topic of discussion in the literature for decades. The effects of diversification on performance, risk, efficiency and firm value has been examined extensively. With respect to diversification within the financial services industry, Delong (2001) examined U.S. bank mergers on the basis of both activity and geographical diversification and found that diversifying mergers fail to create value. More recently, Deng and Elyasiani (2005) reported that geographical diversification reduced systematic, unsystematic and total risk for U.S. bank holding companies with insignificant effects on bank value. Furthermore, DeYoung and Roland (2001) found that U.S. banks replacing traditional lending activities with fee-based activities was associated with higher revenue volatility implying higher earnings volatility (risk).

Empirical work on the relationship between performance and diversification has a long history in both the strategy literature (Montgomery, 1994) and in the finance literature (Martin and Sayrak, 2003). Work in finance, in particular, has cantered on a debate between two competing views of diversified firms. One view is that diversified firms are able to exploit superior information to make better resource allocation choices through their internal capital markets than could*financial markets (Myers and Majluf, 1984). A competing view is that diversified firms are plagued by inefficiencies due to agency problems and that resources would be better allocated between businesses by financial

markets (Schliefer and Vishney 1989). The observation that diversified firms trade at a discount to their more focused peers is taken as evidence of unresolved agency problems and poor corporate governance. Numerous studies have supported the existence of such a diversification discount (Berger and Ofek, 1995).

1.1.2 Banking Industry in Kenya

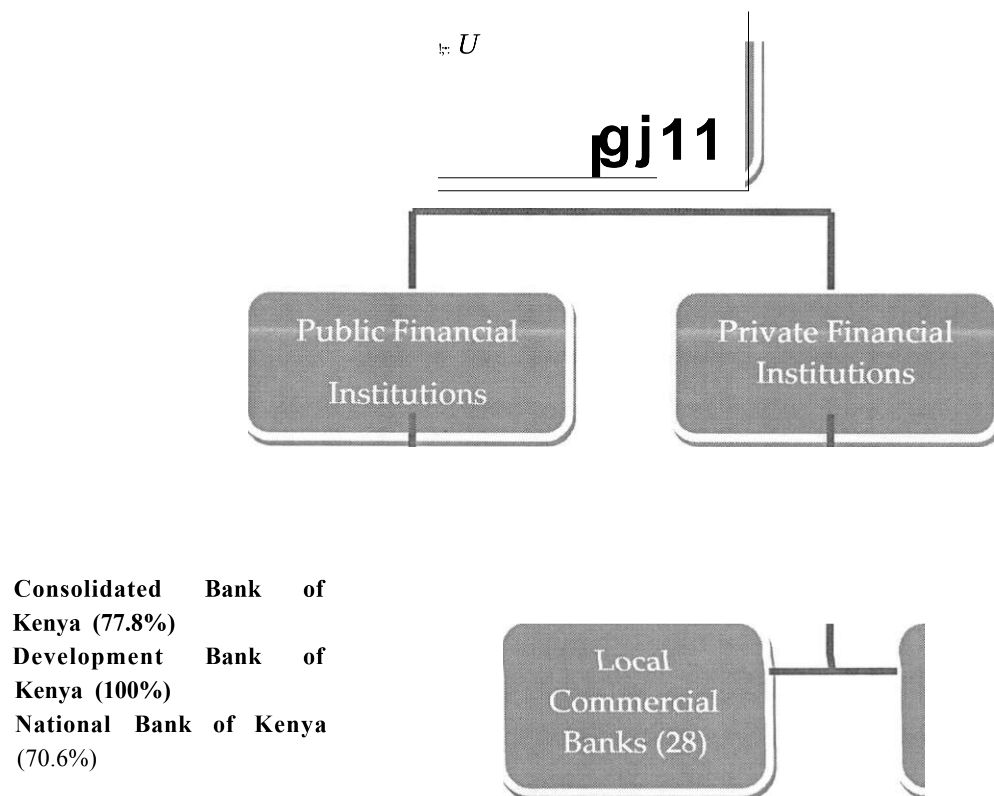
Commercial banks are licensed and regulated under the Banking Act, Cap 488 and Prudential Regulations issued there-under. There are currently 45 commercial banks in Kenya. Out of the 45 institutions, 33 are locally owned and 12 are foreign owned as shown in chart 1 below. The locally owned financial institutions comprise 3 banks with significant government shareholding and 28 privately owned commercial. The foreign owned financial institutions comprised 8 locally incorporated foreign banks and 4 branches of foreign incorporated banks. Of the 42 private banking institutions in the sector, 71% are locally owned and the remaining 29% are foreign owned (Bank Supervision Annual Report, 2008).

Kenya's banking sector in 2008 continued to be vibrant and dynamic in embracing changes amidst local and global turbulences. On the ICT front, banks continued to embrace new technology by upgrading and replacing their core banking systems. There was also an increased uptake in the use of mobile phone technology as a service delivery channel. Therefore, in this regard, a number of new products were introduced by financial institutions that leverage on ICT particularly mobile phone technology (Central Bank of Kenya, 2008).

On the consumer front, the Central Bank and the banking sector continued with initiatives to enhance the communication of bank charges and lending rates. The public continues to express its' concern on the perceived high level of bank charges and lending rates. Whereas there are legislative provisions on the approval of bank charges, the Central Bank also continues to lay emphasis on the promotion of competition in the banking sector through market discipline (Central Bank of Kenya, 2008).

Despite the challenging operating environment brought about by post election violence in the first quarter of 2008 and global financial crisis, the banking sector remained stable with all institutions remaining adequately capitalised during the period ending December 2008 (Bank Supervision Annual Report, 2009). Overall, institutions maintained capital adequacy ratios above the minimum requirement of 12.0 per cent. Total assets expanded by 24.4 per cent, customer deposits rose by 21.7 per cent while pre tax profits increased by 21.6 per cent compared to a similar period in 2007. However, return on equity declined from 27.5 per cent in December 2007 to 26.1 per cent in December 2008 mainly due to increase in equity at a proportionately higher rate than increase in income (Bank Supervision Annual Report, 2008).

Chart 1: Structure of Commercial Banks in Kenya



Source: Central Bank of Kenya (2008) Annual Bank Supervision Survey

1.2 Statement of the problem

For the past decade, financial institutions have been heading to a more diversified structure by providing one-stop-shopping service to their customers. This trend of diversification in financial institutions has been examined in different countries by many financial economists. A major issue raised by these studies is whether banks benefit or suffer from their diversification strategy. Earlier studies suggest that banks benefit from diversification due to factors such as risk reduction, more efficient financial services providing through information sharing, and the existence of internal capital market (Houston et al., 1997). On the contrary, recent studies provide evidence that banks suffer from diversification activities caused by lower market valuation, poorer risk-adjusted performance, and higher level of risk taking (Laeven and Levine, 2007; Stiroh and Rumble, 2006; Acharya et al., 2006). Hence, it is interesting to know whether banks suffer from diversification and whether there are mechanisms to help mitigate these negative diversification effects.

The relationship between diversification and firm performance has been the subject of abundant research in several fields. The main focus in the literature has been the relative performance of diversifiers versus specialised firms, typically analysing empirically large samples that include a broad number of industries. Despite the research accumulated in the last three decades, there is no widely accepted causal relationship between diversification and performance based on the empirical evidence of diversification discount, probably an inverted-U relationship, recent research shows that the diversification disappears when we control for the possibility of self-selection (Campa and Kedia, 2002; Villalonga, 2004).

Research in diversification has attracted a lot of researchers both in the field of finance and strategic management over the years (Maithulia, 1995; Mwindi, 2003; Njoroge, 2003; Mwau, 2005; Njoroge, 2006; Wakwoma, 2007; and Munene, 2008). Maithulia (1995) did an empirical investigation of portfolio diversification among commercial banks in Kenya. Mwindi (2003) did an analysis of the application of unrelated

diversification strategy by the major oil companies in Kenya. Njoroge (2003) did a study on diversification strategy and focused on Nation Media Group. Mwau (2005) also did a study of related diversification with EABS while Njoroge (2006) acknowledged that Kenol/Kobil uses diversification to build competitive advantage. Wakwoma (2007) on the other hand did a survey of product diversification strategies adopted by firms in the banking industry and Munene (2008) focused on diversification strategies among Christian Community Services of Mount Kenya East Region. The present study differs from the above studies on the focus and the depth of coverage of the concept of diversification strategy. The present study covers the commercial banks in Kenya and focuses on the types of diversification, effects and costs of diversification.

1.3 Objectives of the study

The objectives of this study were:

1. To identify the types of bank diversification strategies in Kenya.
2. To determine the benefits and costs of diversification on the commercial banks in Kenya.

1.4 Importance of the study

This study may be important to various groups of people. The policy makers can obtain knowledge of the financial sector dynamics as regards impact of foreign bank entry in Kenya on the domestic financial market. They can therefore obtain guidance from this study in designing appropriate policies that may regulate the sector.

The study can provide information to potential and current scholars on financial management among commercial banks in Kenya. This can expand their knowledge on strategic responses in financial institutions and also identify areas of further study.

CHAPTER TWO: LITERATURE REVIEW

2.1 Application of Strategy in Commercial Banks

Since the late 1970s, financial service organisations have observed reduced rates of financial return, raised fees for deposit services, reduced branch operating costs and a shift to higher earning assets. In other words, external innovations were instrumental in the changes banks made to their balance-sheet size, in increasing business-portfolio diversity and in restructuring their geographic scope (Gardener and Molyneux, 1990). Changes in the size and diversity of banks followed external changes in bank markets but banks' strategic responses were still short of the benchmark (de Bandt and Davis, 1999). Documented evidence would thus suggest that some of the changes increased competition in bank markets while some others pursued strategies aiming to deter new participants entering the market.

According to Canals (1998), the strategic response of commercial banks in Western Europe in light of changes in their growth opportunities during the late 1980s was to adopt two main generic strategies or types of organisational design. One set of banks adopted wide spread diversity in their geographic, product market and customer group portfolio whilst another set followed a rather focused strategy by specialising in one or all of those dimensions. According to Demsetz (1973, p. 3) and evidence documented in de Bandt and Davis (1999), banks of different sizes and operating in distinct markets reflected different levels of efficiency.

Two main explanations are possible. The first explanation is that of different degrees of competition a cross markets, that is, banks facing different barriers to entry and exit. Different degrees of competition would suggest the possibility of distinctive external growth opportunities based on geographical location. Location would then provide an explanation for bank size and relative efficiency because external growth opportunities are opened up by regulatory change, technical innovation, developments in the degree of market competition (market structure), and changes in customer preferences. The alternative explanation is that banks' generic strategies are based on an internal or

production-function perspective. Internal growth opportunities for commercial banks depend on the ease with which operating efficiencies, scale economies and scope economies can be exploited (Walter, 1997). In other words, bank managers decide on the scope of the banks' activities by weighing up the advantages of scale and scope against those of flexibility, simplicity and specialisation (Canals, 1998).

Among others Walter (1997) and Guillen and Tschoegl (2000) have documented empirical evidence suggesting that there is no inherent advantage built into generic organisational profiles for banks. Banks of the same size and with the same breadth of geographic, product market and customer group are known to observe different cost structures (Walter, 1997). Instead of generic strategies, differences in banks' market position or cost structures are thought to be based on bank managers anticipating the most attractive markets and capturing greater shares of growth opportunities by effective execution. Bank senior executives actively engaged in strategic planning could have forecasted the most profitable growth alternative for their banks and considered whether to enhance established capabilities to compete, create new capabilities or divest established capabilities (as market-based transactions or non-bank providers could be more efficient brokers of funds). Since the combination of anticipation and implementation is the source of sustainable competitive advantage, then differences in banks' cost structures or market positions emerge as anticipated advantage creates capabilities to compete. Unfortunately there is little systematic evidence that banks which engage in strategic planning outperform those that do not (Gardener, 1995 or Newkirk Moore, 1995), with the added result of having little empirical support to determine whether differences in planning approaches are responsible for distinct sets of capabilities to compete in bank markets.

In light of little systematic evidence on the effectiveness of banks' planning schemes, the present study proceeds based on the possibility that strategic and financial control of capabilities develops into a competit'we»-edge. This link between strategic intent and core capabilities was originally put forward by Penrose (1959) and successfully measured by Rumelt(1974). Surveys of the literature exploring Penrose's propositions for firm growth

are found in Conner (1991) and Schulze (1994). From the surveys it emerges that Penrose's main proposition was that strategic intent will rank resources, dedicated assets, intangible assets, skills and other inputs into the production process which determines the ability of a firm to compete. The purpose of the ranking is to establish which resources and which capabilities will allow the firm to capture the most promising growth opportunities. Strategic intent will also determine whether the firm must develop new capabilities or resources and whether the firm must change co-ordination and co-operation patterns between people, and between people and resources (Grant, 1991).

Strategic intent, therefore, establishes which resources and capabilities will be key for future profitability and these profit generating resources and capabilities are called "core capabilities". Furthermore, high strategic and financial control of core capabilities provides the organisational flexibility that visionary strategies require to deliver high sustainability of competitive advantage. Participants in bank markets are thus defined as banks, non-banks and non-finance intermediaries willing (and able) to develop a set of core capabilities closely related to brokering the financial needs of low-volume surplus- and deficit-spending agents as well as maintaining a national payment system. This set of distinctive capabilities represents the basis for competition in core markets for commercial banks.

Financial service organisations can also be defined from a consumer perspective. According to McKechnie (1992) and Lewis (1994), there are two service quality expectations that distinguish financial services, namely fiduciary responsibilities and two-way information flows between bank and customer. Firstly, fiduciary responsibilities refer to the responsibility that financial service organisations have regarding the management of their customers' funds and the nature of the fmancia\ advice supplied. Secondly, two-way information flows reflect individual customers repeatedly purchasing the same service from the same financial service organisation, sometimes over extended periods of time. Financial transactions and particularly those in retail bank markets require a great deal of information that reflects the latest changes in customers' private and confidential financial status (Lewis, 1994).

Empirical evidence documented in Geroski (1995), however, suggested that opportunities are captured by diversification (creating or relocating capabilities) rather than new establishments because capital building from scratch to effective competition threat is not, on average, very successful or even likely. Indeed, Caves and Porter (1977) was the first to suggest that greater competitive threats were distinguishable between the in-market and out-of market competitors. Moreover, these studies make an implicit claim that entry barriers affect the choice of diversification into bank markets.

2.2 Benefits and Costs of Diversification

Real or perceived, there are both cost and benefits to diversification. Indeed, despite suggestions that diversification destroys value and/or increases risk, diversification continues in practice. In an effort to understand why this is the case, the next sections illustrate some of the benefits and costs associated with diversification.

2.2.1 Benefits of Diversification

One of the most common benefits associated with respect to diversification is a lower cost of capital. With respect to banks, those with some level of global diversification have access to different capital markets which could lead to a lower cost of funds through a larger deposit base (Deng and Elyasiani, 2005).

Furthermore, the potential for more efficient internal capital markets is another often cited benefit to diversification. The logic states that a well diversified bank (either geographically, by activity or both) has an advantage over less diversified banks by possessing the ability to transfer internal cash flows from less efficient operations to areas where its use will be most beneficial to the organization. Since internal funds are less costly than external capital, those banks able to most effectively use such cash flows possess an advantage over those without such an opportunity (Stulz and Shin, 1998).

Internal capital markets possess other benefits as well. Myers and Majluf (1984) found that some firms might forego securing external funding for positive net present value

projects due to information asymmetries between the organization and the investors. However, the availability of internal funds can help to alleviate this underinvestment problem. Fluck and Lynch (1996) empirically showed some positive NPV projects were passed over at stand-alone, non-financial firms, but this same phenomenon was less prevalent in diversified firms. In addition, Stein (1997) modeled that liquidity-constrained firms who diversify can increase efficiency because management directs more funds to more efficient divisions. Gertner, Scharfstein and Stein (1994) also posit that internal capital markets increase the incentives to monitor relative to external capital markets.

From a resource-based perspective, diversifying firms can benefit from the ability to leverage managerial efficiency across products and/or geography. The best managers may be able to apply their skills and abilities to other products, or can transfer knowledge to other locations to improve performance across the organization. It may also be possible for banks to achieve economies of scale by diversifying geographically. Once an initial investment has been made and systems are in place, organizations can often expand the system elsewhere at a greatly reduced cost. For instance, once a bank has the tools and capabilities to evaluate loans to potential borrowers in one location, it is likely that this tool can be applied throughout the system at a lower cost. This remains true even if some modifications are necessary due to a different cultural or regulatory environment.

Another benefit associated with activity diversification is the ability to gain economies of scope for the organization (Deng and Elyasiani, 2005). An example might be a bank which collects information credit information on potential borrowers. With this information, the bank may be able to offer these potential clients insurance products or underwriting services at a lower cost because much of the information needed has already been collected when evaluating the loan application. Drucker and Puri (2005) empirically examined this issue with respect to underwriting and lending finding support for the existence of economies of scope. That is to say, banks with both lending and underwriting services are able to offer clients in need of both services lower underwriting spreads and lower yield spreads compared to clients without concurrent lending relationships.

It should be noted, however, that the ability to leverage resources is not necessarily positive and linear. It is argued that the benefits of economies of scale/scope exist only to a point (Iskandar-Datta and McLuaghlin, 2005). If an organization spreads its managers too thin, or overextends itself, these benefits may actually turn out to be a net cost to the organization. The costs associated with a firm's increased complexity may overshadow the benefits of diversification. As such, the benefits of diversification and performance would resemble an inverted-U in which there would be an optimal level of diversification beyond which benefits would begin to decline and may ultimately become negative.

Benefits associated with market power have also been advanced. The argument suggests that banks may diversify their activities or their operations geographically to gain or maintain market share. Consider a bank which uses resources from a profitable business loan operation to subsidize a struggling mortgage operation because the bank does not want to lose ground against a competitor. In another instance, a bank may divert resources from a lucrative geographical area to an area of expansion with the hopes of capturing market share and ultimately building a strong, profitable base in the new region. Of course, banks who consider diversification for this reason already must possess some power in their existing operations which is pointed out (Gribbin, 1976).

The potential for tax benefits is something that some researchers have also argued as a benefit for geographical diversification (Iskandar-Datta and McLaughlin, 2005). The existence of di fferent tax laws between communities, states or even countries could allow banks to reduce their overall tax liability by transferring resources from high tax areas to low tax areas. In addition, some municipalities might offer tax breaks to organizations to encourage them to begin operations in a particular location.

Finally, an important benefit that has been proposed by some is the ability for organizations to reduce earnings volatility by spreading operations across areas with different economic environments (Deng and Elyasiani, 2005; Boot and Schmeits, 2000). This is similar to portfolio theory which states that individual investors can greatly reduce firm-specific risk by diversifying the stocks in their portfolios.

2.2.2 **Costs of Diversification**

Of course, diversification is not without costs. Already mentioned are the costs associated with increased firm complexity. Adding products, or expanding operations geographically, makes it more difficult for top management to monitor the behavior of the other divisions/branches. Gertner, Scharfstein and Stein (1994) suggested that internal capital markets increased the incentive to monitor. That is to say, there may be more incentive to monitor diversified firms which could lead to improved operating performance and ultimately enhance value. However, increased monitoring is not costless.

While present in all firms, Jensen and Meckling's agency problems (1976) may be more severe in diversified firms compared to more focused organizations. In more diversified firms, there are more divisional, regional and product managers than would exist in a more focused firm. Each of these managers may have agendas which do not correspond to the objectives of top management or even the stakeholders of the organization. Indeed, diversification itself may be the pursuit of empire building in which managers try to protect their positions by enlarging their organization so they become more powerful, more indispensable and/or gain greater prestige. Managers may also try to expand operations in the pursuit of higher compensation packages for controlling larger organizations (Goforth, 1994; Shleifer and Vishny, 1989). Empirically, Lewellen and Huntsman (1970) found evidence linking firm size to compensation.

Managers might also seek to diversify their organizations as a way to reduce total firm risk and thereby reduce their personal risk (Amihud and Lev, 1981). This problem can exist with the organization's top management teams, or with the divisional and product managers in an already diversified firm. While diversification may help reduce the risk to the manager, it may not be in the best interest of stakeholders. And even if the organization's top management team is not subject to such agency risks, it is more difficult for them to monitor divisional fhanagers as the distance between managers at headquarters and those at satellite branches increases. This was the finding of Berger and DeYoung (2001) in their study of geographically diversified U.S. banks from 1993-1998.

Yet another potential cost stemming from agency problems is the potential for banks to take on riskier behaviour as a result of diversification. That is to say, managers who diversify by activity or related to geography, in order to reduce the volatility in their cash flows, might simultaneously increase their risk-taking behaviour which could ultimately increase the risk and/or adversely affect the organization's performance.

Although potentially significant, agency problems are not the only costs associated with diversification. Other disadvantages, such as increased exchange rate and political risk, exist (Fauver et al., 2004). This is especially true with banks which is one of the most heavily regulated industries in any economy. Political risk may be a consideration because it is currently unclear where responsibility would lie if a bank's foreign subsidiary were to fail. Would the parent bank take responsibility for the failure, or would it desire the government of the subsidiary country to bear the majority of the responsibility?

Other potential costs raised by Miller and Parke (2002) are those associated with dealing with different languages, laws and customs (also Deng and Elyasiani, 2005). Information may have to be presented in a number of languages which would increase costs. Furthermore, regulations in different regions/countries increase the cost of doing business, particularly if the same information had to be presented different ways to conform to various regional requirements. There may also be a cost to dealing with local politics which may give some advantages to domestic institutions simply because they are domestic.

It is difficult to believe that an organization diversified itself with the expectation of receiving some benefits without any increase in cost. Furthermore, no firm or organization would undertake such an action if the costs were expected to outweigh the benefits. While it is reasonable to assume that firms diversify because they believe the benefits of diversification will outweigh the costs, it is more difficult to determine which benefits a firm expects to achieve and which costs might be incurred as a result. While ultimately very beneficial, the ability to break down each of these potential benefits and

costs into their individual components is a monumental task. Indeed, it is not easy to explicitly quantify some of the concepts described above. What is possible, however, is to look at the overall impact of diversification. That is to say, it is possible to measure the amount of diversification (both activity and geography) a bank has undertaken? Their levels of risk and performance can then be compared to that of other banks with different levels of diversification, or no diversification to see the net impact of the diversification on the organization. If the benefits are greater than the costs, one would expect that performance has improved as diversification has increased, and/or that risk has declined. If the costs overshadow the benefits, highly diversified banks would be expected to under-perform more focused organizations or operate at higher risk levels.

2.3 Relationship between Diversification and Performance

Since the early work of Rumelt (1974, 1982), most strategy scholars believe diversification eventually begins having a negative impact on firm performance, based on the notion of relatedness among the businesses in which a corporation competes. A recent meta-analysis of the literature finds evidence of this idea, though several other functional relationships have been found in literature (Palich, Cardinal and Miller, 200). The main rationale is that the first few diversification steps are closely related to the core competences of the organisation, which allow for the transfer of competitive advantages and knowledge in particular. However, as the firm moves to other industries further away from the core, these possibilities disappear and performance should begin to suffer. This argument presumably applies across the board to all firms regardless of the initial industry in which they emerged.

DeLong (2001) examined U.S. bank mergers with respect to both activity and geographic location and found that banks focusing on both activity and geography were value increasing. Berger and DeYoung (2001) also studied the effect of geographic expansion on bank efficiency for U.S. banks, and found some support for increased efficiency for affiliate banks, but also discovered that this control dissipates with distance between the affiliate and the parent bank.

Conversely, Deng and Elyasiani (2005) found that geographical diversification reduced systematic and unsystematic risk for U.S. bank holding companies (BHCs), but such diversification had no significant effects on firm value. The authors did find evidence to suggest that an increase in distance between the parent and subsidiary led to an increase in both forms of risk lending support to agency theory.

Klien and Saidenberg (1997) discovered that diversified U.S. bank holding companies, defined as those banks operating in more than one state and having two or more commercial subsidiaries, held less capital and engaged in more lending than undiversified BHCs. However, this did not translate into higher profits which the authors suggest is evidence of organizational inefficiencies inherent to the structure of the holding company.

Mahajan , Rangan and Zardkoohi (1996) were able to conclude that the cost structure between domestic banks and multinational banks were different, and that multinational banks were able to fully exploit economies of scale, face lesser diseconomies of scale from joint production and had lower inefficiencies than domestic banks. However, their data was based on U.S. multinational and domestic banks from 1987-1990, a relatively short time period.

There is no clear consensus on the effects of geographical diversification on the performance of a bank. In addition, the majority of these studies focus on U.S. banks, and do not consider banks from abroad. A notable exception is Berger et al. (2000) who studied the efficiency of cross-border consolidations of financial institutions and found that domestic banks have a higher profit efficiency than do foreign banks. The paper incorporated banks from the U.S., France, Germany, Spain and the U.K.

There is also little consensus regarding activity-based diversification. Before such activities were permitted in the U.S., Boyd and Graham (1988) studied hypothetical mergers between banks and securities firms, real estate companies and insurance firms. Their findings indicated that banks merging with insurance companies might reduce the

risk of bankruptcy, while mergers with securities/real estate companies would increase the risk of bankruptcy. This study was updated in 2000 by Lown et al. with similar findings.

DeYong and Roland (2001) examined the changes in a bank's product mix for U.S. commercial banks between 1988 and 1995, and found that banks replacing traditional lending activities with fee-based activities (revenue diversification) experienced higher revenue volatility and total leverage3. Prior to this study, Rose (1989) suggested that banks moving into non-bank product lines could reduce cash flow risk. Templeton and Serveriens (1992) found that banks diversifying into other areas such as financial services would reduce unsystematic risk, but that there was no effect on systematic risk.

More recently, Stiroh (2004) found that non-interest diversification was negatively linked with performance. Furthermore, Laeven and Levine (2004) found a diversification discount comparing the activities of financial institutions. Financial conglomerates engaging in multiple lending activities have lower market values than they would if they were broken into separate financial institutions. This lack of consensus regarding diversification effects also exists with respect non-financial firms. Despite the lack of a clear consensus, it appears that the most recent data suggests that costs of diversification outweigh the benefits associated with diversification.

CHAPTER THREE:RESEARCH METHODOLOGY

3.1 Research Design

This is a cross-sectional survey of commercial banks in Kenya. Cross-sectional surveys are used when a large cross-section of data is collected from several firms at a time. Given that the present study sought to collect data on the effect of diversification on bank performance, a cross-sectional survey was deemed the most appropriate for the study.

3.2 Population of the Study

The population of this study was all the commercial banks which had been operating in Kenya for at least five years. According to the Central Bank of Kenya Supervision Report (2008) there were 43 commercial banks operating in Kenya at the end of the year. This study was a census of all the 43 commercial banks that had been operating in Kenya.

3.3 Data Collection

Primary data was collected. This was collected using questionnaires. The specific data collected here were on the types of diversification, the benefits and the costs of diversification strategy. One respondent, preferably the head of strategy or his/her appointee in each of the selected commercial banks, filled in the questionnaire.

3.4 Data Analysis

The questionnaires were entered into the SPSS after being sorted and coded. The questionnaires were analysed and interpreted using descriptive statistics and t-statistics. The descriptive statistics were the mean scores, standard deviations and percentages. The results were summarised in terms of the objectives of the study and presented in form of tables.

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents the results of the analysis. From the 43 questionnaires sent out to the various commercial banks, 38 were collected within the time period and used for analysis. This presents a response rate of 88.4%. The results are presented as follows. First, the characteristics of respondents are shown. This is followed by a presentation of results on types of diversification strategies used in the banking industry. These results are then followed by a discussion on the benefits of bank diversification. Lastly, a presentation on the costs and challenges of diversification in the banking industry is made.

4.2 Sample characteristics

The study found that 58% of the respondents were aged between 25 and 30 years, 21% were aged between 31 and 35 years while the remaining 21% were aged between 36 and 40 years. These results are summarised and presented in Table 1. The results imply that majority of the respondents were still young in the age bracket of 25 and 30 years.

Table 1: Age of respondents

	Frequency	Percent
25-30 years	22	57.9
31-35 years	8	21.1
36-40 years	8	21.1
Total	**38**	**100.0**

In terms of gender, the study found that 32% were male while the remaining 68% were female. This is presented in Table 2 and imply that majority of those who took part in the survey were female.

Table 2: Gender

	Frequency	Percent
Male	12	31.6
Female	26	68.4
Total	**38**	**100.0**

On the time the respondents had been working in the banks, the study found that 16% had been in the respective banks for a period less than 3 years, 63% had been in the banks for a period between 3 and 5 years while the remaining 21% had been working for their respective banks for a period between 6 and 10 years. These results are summarised and presented in Table 3. The results imply that majority of the respondents had been working in their respective banks for a period between 3 and 5 years. Thus, most of the employees are more experienced in terms of the operations of their respective banks hence their opinions are reliable.

Table 3: Experience within the banks

	Frequency	Percent
Less than 3 years	6	15.8
3-5 years	24	63.2
6-10 years	8	**21.1**
Total	**38**	**100.0**

4.3 Types of diversification strategies

The study revealed that 26% of the respondents moderately agreed that the banks had diversified services by providing a variety of services in the industry. Further, 74% of the respondents strongly agreed so. This is shown in Table 4. The results indicate therefore that the respondents agreed that the banks had diversified into other products and services. This confirms the use of vertical diversification as one type of bank diversification strategies in Kenya.

Table 4: Vertical Diversification

	Frequency	Percent
Moderately agree	10	26.3
Strongly agree	28	73.7
Total	**38**	**100.0**

The study found that 16% of the respondents were neutral on whether the bank was venturing into new industries. The study also found that 47% of the respondents moderately agreed that their banks were venturing into new industries while the remaining 37% strongly agreed. These results are shown in Table 5. The results imply therefore that the respondents agreed that the banks were focusing on venturing into new industries. This indicates that horizontal diversification is prevalent in the banking industry in Kenya.

Table 5: Horizontal Diversification

	Frequency	Percent
Neutral	6	15.8
Moderately agree	18	47.4
Strongly agree	14	36.8
Total	**38**	**100.0**

The study revealed that 63% of the respondents moderately agreed that the banks had opened up new markets in other regions. Further, 37% of the respondents strongly agreed so. These results are summarised and presented in Table 6. The results imply that the banks are opening up branches in other markets other than the local markets. This confirms the presence of geographical diversification strategy.

Table 6: Geographical Diversification

	Frequency	Percent
Moderately agree	24	63.2
Strongly agree	14	36.8
Total	**38**	**100.0**

The results shown in Table 7 indicate the types of diversification strategies used by various commercial banks in Kenya. As shown, the mean scores indicate whether the strategy is used or not. The responses were given on the extent of agreement from strongly disagree (-2.0) to strongly agree (+2.0). Thus, the mean score ranges from -2 to +2 with 0 being a neutral response. The t-values indicate the statistical difference of the responses on each of the strategies from 0 (neutral).

Table 7: Extent of use of various diversification strategies

	Mean score	Standard deviation	t-value
Vertical diversification	1.7368	.44626	23.992
Horizontal diversification	1.2105	.70358	17.256
Geographical diversification	1.3684	.4885	17.256

Thus, as shown in Table 7, the results indicate that the diversification strategy that was most prevalent was vertical integration (Mean = 1.7368). The t-value of 23.992 indicates that the mean response statistically differed from 0 (neutral). For this reason, it can be asserted that vertical integration was a major diversification strategy used in the banking industry. The same was the case for geographical diversification (Mean = 1.3684, t-value = 17.256) and horizontal diversification (Mean = 1.2105, t-value = 17.256).

On the ways in which the banks had diversified, the study found that such ways included adding new products to existing services (37%), customer segmentation (21%), targeting un-banked market (26%), branch expansion (26%), use of the existing technology for

other services (16%), mobile banking and ATM facilitation (16%),

4.4 Benefits of diversification

The study found that 21% of the respondents strongly disagreed that one of the benefits of diversification strategy was greater income growth potential while 79% of the respondents strongly agreed. These results are shown in Table 8. The results imply that majority of the respondents agreed that one of the benefits of diversification for commercial banks was greater income growth potential.

Table 8: Greater Income Growth Potential

	Frequency	Percent
Strongly disagree	8	21.1
Strongly agree	30	78.9
Total	**38**	**100.0**

The study found that 42% were neutral on whether diversification would help improve the performance of distribution channels. Another 37% moderately agreed while the remaining 21% strongly agreed. These results are shown in Table 9 and imply that majority of the respondents agree that diversification helps improve the performance of distribution channels.

Table 9: Improvement of Distribution Channels

	Frequency	Percent
~~ Neutral ~~	\6 ~	4
Moderately agree	14	36.8
Strongly agree	8	21.1
Total	**38**	**100.0**

The study further revealed that 16% of the respondents strongly disagreed that the reason for diversification is to control risks. Another 26% were neutral, 37% moderately agreed

while the remaining 21% strongly agreed. These results are summarised and presented in Table 10. The results imply that majority of the respondents believe that diversification helps in controlling costs.

Table 10: Risk Control

	Frequency	Percent
Strongly disagree	6	15.8
Neutral	10	26.3
Moderately agree	14	36.8
Strongly agree	8	21.1
Total	**38**	**100.0**

The study found that 21% of the respondents strongly disagreed that the need to improve performance of core capabilities of commercial banks was a reason for opting for a diversification strategy. Further, 16% of the respondents were neutral, 42% moderately agreed while the remaining 21% strongly agreed. These results are summarised and presented in Table 11. The results imply that majority of the respondents agreed that improvement of core capabilities is one of the benefits of diversification.

Table 11: Improved Performance of Core Capabilities

	Frequency	Percent
Strongly disagree	8	21.1
Neutral	6	15.8
Moderately agree	16	42.1
Strongly agree	8	21.1
Total	**38**	**100.0**

T7ie resu/ts in Tab/e /2 show responses on whether Che need to acquire new technology was one of the benefits of diversification. As shown, 47% of the respondents were neutral, 32% moderately agreed, while 21% strongly agreed. The results imply that

majority of the respondents agreed that the banks diversified because of the needed to acquire new technology.

Table 12: Need to Acquire New Technology

	Frequency	Percent
Neutral	~~18	47.4
Moderately agree	**12**	**31.6**
Strongly agree	8	21.1
Total	38	**100.0**

The study found that 37% of the respondents moderately agreed that the banks diversified in order to change their business focus. Further, 16% moderately agreed, while 47% strongly agreed. These results are presented in Table 13 and imply that majority of the respondents believe that banks diversified so as to change business focus.

Table 13: Changing Business Focus

	Frequency	Percent
Moderately disagree	14	36.8
Moderately agree	6	15.8
Strongly agree	18	47.4
Total	**38**	**100.0**

Other benefits of diversification were cited as improvement in service delivery, savings on staff salaries as some customers are able to bank via the mobile phones and improvement in customer relations. Other benefits also include increased income, increased job vacancies and maintenance of competitive edge.

Table 14 shows the results on extent to which the respondents agreed on the benefits of bank diversification strategy. From the mean scores, the study found that the benefits of bank diversification include grater income growth potential from diversification (1.1579). This was found to be statistically from zero (neutral response) as shown by the t-value of

4.319. It was also noted that another benefit include improvement in the performance of distribution channels (Mean = 0.7895). This was found to be statistically significant as t-value was 6.266. The study also found that diversification was done so as to control risks (mean = 0.4737). The t-value of 2.265 indicates that the mean response significantly differed from zero. It was further noted that another reason for diversification was to improve the performance of core capabilities (mean = 0.4737). This was found not to significantly differ from zero as shown by the t-value of 1.845. Another reason was to acquire new technology (mean = 0.7368). This was also found to statistically differ from zero (t = 5.715). Lastly, it was also revealed that banks diversify in order to change business focus (mean = 0.7368). The t-value of 3.270 also indicates that the mean response for this statistically differed from zero.

Table 14: Benefits of Bank Diversification

	Mean	Std. Deviation	t-value
There is greater income growth potential from diversification	1.1579	1.65262	4.319
There is need to improve the performance of distribution channels	.7895	.77661	6.266
The reason for diversification is to control risks	.4737	1.28897	2.265
The bank needs to improve performance of core capabilities	.4211	1.40716	1.845
The bank needed to acquire new technology	.7368	.79472	5.715
There is changing business focus	.7368	1.38884	3.270

4.5 Costs of bank diversification

On the costs of diversification, the -study found that 26% of the respondents cited increased costs spent on acquiring resources, 21% cited lowered profits and higher operating costs, 32% cited technological and marketing costs while the remaining 21%

cited training costs. These results are summarised and presented in Table 15.

Table 15: Costs of bank diversification

	Frequency	Percent
Increased cost spent on acquiring resources both human and physical resources	10	26.3
Lowered profits and higher operating costs	8	21.1
Technological and marketing costs	12	31.6
Training costs	8	21.1
Total	**38**	**100.0**

On the challenges of bank diversification, the study found that the challenges included customer resistance to change, low returns on investment before they pick up, higher costs, maintenance of high customer service standards in all segments, stiff competition, and increased costs on training.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This section presents the summary of findings, conclusions of the study and the recommendations for policy and practice. The section also presents the suggestions for further research.

5.2 Summary of findings

The study found that majority of the respondents were still young in the age bracket of 25 and 30 years. In terms of gender, the study found that majority of those who took part in the survey were female. On the time the respondents had been working in the banks, the study found that majority had been working in their respective banks for a period between 3 and 5 years. Thus, most of the employees are more experienced in terms of the operations of their respective banks hence their opinions are reliable.

The study revealed that the respondents agreed that the banks had diversified into other products and services. This confirms the use of vertical diversification as one type of bank diversification strategies in Kenya. The study found that the banks were focusing on venturing into new industries. This indicates that horizontal diversification is prevalent in the banking industry in Kenya. The study revealed that the banks are opening up branches in other markets other than the local markets. This confirms the presence of geographical diversification strategy. The results indicated that the diversification strategy that was most prevalent was vertical integration (Mean = 1.7368). The t-value of 23.992 indicates that the mean response statistically differed from 0 (neutral). For this reason, it can be asserted that vertical integration was a major diversification strategy used in the banking industry. The same was the case for geographical diversification (Mean = 1.3684, t-value = 17.256) and horizontal diversification (Mean = 1.2105, t-value = 17.256).

The study found that majority of the respondents agreed that one of the benefits of

diversification for commercial banks was greater income growth potential. It was also found that that diversification helps improve the performance of distribution channels. The study further revealed that majority of the respondents believe that diversification helps in controlling costs. The study found that majority of the respondents agreed that improvement of core capabilities is one of the benefits of diversification. It was also revealed that majority of the respondents agreed that the banks diversified because of the needed to acquire new technology. The study also found that banks diversified so as to change business focus. Other benefits of diversification were cited as improvement in service delivery, savings on staff salaries, increased income, increased job vacancies and maintenance of competitive edge. From the mean scores, the study found that the benefits of bank diversification include grater income growth potential from diversification (1.1579). This was found to be statistically from zero (neutral response) as shown by the t-value of 4.319. It was also noted that another benefit include improvement in the performance of distribution channels (Mean = 0.7895). This was found to be statistically significant as t-value was 6.266. The study also found that diversification was done so as to control risks (mean = 0.4737). The t-value of 2.265 indicates that the mean response significantly differed from zero. It was further noted that another reason for diversification was to improve the performance of core capabilities (mean = 0.4737). This was found not to significantly differ from zero as shown by the t-value of 1.845. Another reason was to acquire new technology (mean = 0.7368). This was also found to statistically differ from zero (t = 5.715). Lastly, it was also revealed that banks diversify in order to change business focus (mean = 0.7368). The t-value of 3.270 also indicates that the mean response for this statistically differed from zero.

On the costs of diversification, the study found that the costs included increased costs spent on acquiring resources, lowered profits and higher operating costs, technological and marketing costs and training costs. On the challenges of bank diversification, the study found that the challenges included customer resistance to change, low returns on investment before they pick up, higher costs, maintenance of high customer service standards in all segments, stiff competition, and increased costs on training.

5.3 Conclusions of the study

The study sought to identify the types of bank diversification strategies in Kenya and to determine the benefits and costs of diversification on the commercial banks in Kenya. As the study revealed, the three types of strategies (horizontal diversification, vertical diversification and geographical diversification) were prevalent within the banking industry in Kenya. But the most used strategy was the horizontal diversification followed by the geographical diversification. Horizontal diversification is exhibited in the banks adding onto their existing products services such as bill payments, ATM networks, mobile banking as well as interne banking. The geographical diversification is seen in banks venturing into new markets such as Southern Sudan, Uganda and Tanzania to open up new branches. This has been the case especially with Equity Bank and Kenya Commercial Bank. The study therefore concludes that the banks are using various diversification strategies in the industry in order to be competitive in the market.

On the benefits of bank diversification, it was noted that benefits included greater income growth potential, improvement of the performance of distribution channels, risk control, acquisition of new technology, and change of business focus. It is therefore concluded that there are a number of benefits of bank diversification available to commercial banks but improvement of core competencies/capabilities was not one of the significant benefits.

5.4 Recommendations

The study makes the following recommendations. First, there is need for banks to diversify more in services so as to enjoy the enormous benefits of bank diversification. More diversification options need to be explored in order to take advantage of these benefits.

Secondly, it is recommended that commercial banks should consider more of customer segmentation and offer the products that can help improve the performance of such business segments. It may also be of interest for banks to offer more of self-service

products such mobile and online banking given that the internet connectivity has been upgraded in Kenya with the introduction of fibre optic cable.

5.5 Suggestions for further research

More studies need to be done in this area especially to unearth which type of diversification has a significant influence on bank performance. This will help determine which diversification strategy commercial banks should follow for better performance.

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APPENDICES

Appendix 1: Institutions in Terms of Shareholding

a) Foreign owned institutions

i) Foreign owned not locally incorporated

1. Bank of Africa (K) Ltd.
2. Bank of India
3. Citibank N.A. Kenya
4. Habib Bank A.G. Zurich
5. Habib Bank Ltd.

ii) Foreign owned but locally incorporated institutions (Partly owned by locals)

1. Bank of Baroda (K) Ltd.
2. Barclays Bank of Kenya Ltd.
3. Diamond Trust Bank Kenya Ltd.
4. K-Rep Bank Ltd.
5. Standard Chartered Bank (K) Ltd.
6. Ecobank Ltd
7. Gulf Africa Bank (K) Ltd
8. First Community Bank

b) Institutions with Government participation

1. Consolidated Bank of Kenya Ltd.
2. Development Bank of Kenya Ltd.
3. Flousing Finance Ltd.
4. Kenya Commercial Bank Ltd.
5. National Bank of Kenya Ltd.
6. Savings & Loan Kenya Ltd.
7. CFC Stanbic Bank Ltd.

c) Institutions locally owned

1. African Banking Corporation Ltd.
2. City Finance Bank Ltd.
3. Commercial Bank of Africa Ltd.
4. Co-operative Bank of Kenya Ltd.
5. Credit Bank Ltd.
6. Charterhouse Bank Ltd.
7. Chase Bank (K) Ltd.
8. Dubai Bank Kenya Ltd
9. Equatorial Commercial Bank Ltd.
10. Equity Bank Ltd.
11. Family Bank Ltd.
12. Fidelity Commercial Bank Ltd.
13. Fina Bank Ltd.
14. Giro Commercial Bank Ltd.
15. Guardian Bank Ltd.
16. Imperial Bank Ltd.
17. Investment & Mortgages Bank Ltd.
18. Middle East Bank (K) Ltd.
19. NIC Bank Ltd.
20. Oriental Commercial Bank Ltd.
21. Paramount Universal Bank Ltd.
22. Prime Bank Ltd.
23. Southern Credit Banking Corporation Ltd.
24. Trans-National Bank Ltd.
25. Victoria Commercial Bank Ltd.

Source: Central Bank of Kenya (2009)

Appendix 2: Questionnaire

Section A: General Information

1. What is your age?

   Below 25 years ( )

   25-30 years ( )

   31-35 years ( )

   36-40 years ( )

   41-45 years ( )

   46 and above ( )

2. What is your gender?

   Male ( )

   Female ( )

3. How long have you been working with this bank?

   Less than 3 years ( )

   3-5 years ( )

   6-10 years ( )

   Over 10 years ( )

4. What is your position in the bank?

Section B: Types of Diversification Strategies

5. To what extent do you agree or disagree with the following statements regarding types of diversification strategy employed by the bank?

a) *The bank has diversified its services by providing a variety of services ir> the* industry.

   Strongly disagree ( )

   Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

b) The bank is venturing into new industries

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

c) The bank has opened up new markets in other regions.

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

6. In what way has the bank diversified its services?

Section C: Benefits of Diversification

7. To what extent do you agree or disagree with the following as the reasons for employing diversification strategy?

a) There is a grater income growth potential from diversification.

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

b) There is need to improve the performance of distribution channels.

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

c) The reason for diversification is to control risks

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

d) The bank needs to improve performance of core capabilities

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

e) The bank needed to acquire new technology

Strongly disagree ( )

Moderately disagree ( )

Neutral ( )

Moderately agree ( )

Strongly agree ( )

f) There is changing business focus

Strongly disagree

Moderately disagree

Neutral

Moderately agree

Strongly agree

8. What other benefits have you derived from diversification as a bank?

9. What were the costs of bank diversification?

10. What challenges did the bank face during diversification and after?

End of Questionnaire

i