

**ASSESSMENT OF DETERMINANTS OF FOREIGN BANKS  
INVESTMENTS IN EMERGING ECONOMIES: A SURVEY OF  
COMMERCIAL BANKS IN KENYA**

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## **DECLARATION**

This management research project is my original work and has not been presented for a degree at the University of Nairobi or any other university.

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Signed \_\_\_\_\_

Date \_\_\_\_\_

This management research project has been submitted for examination with my approval as the University Supervisor.

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Signed \_\_\_\_\_

Date \_\_\_\_\_

## **DEDICATION**

This research project is dedicated to my family and all commercial banks that have interest abroad or are intending to invest in Kenya as an emerging economy.

## **ACKNOWLEDGEMENT**

First, I thank the Almighty God for His hand in seeing me through this project.

I most sincerely appreciate the contribution and encouragement from my dear loving husband Hudson and my two children Jasper & Justus who encouraged throughout to the completion of the project.

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## **ABSTRACT**

Greater foreign participation in the banking industry raises a number of important analytical issues such as; the factors determining a bank's decision to expand its activities abroad, its choice of countries to invest in, and the form of participation (branch, subsidiary, ownership of local banks), differences in the business focus of foreign and domestic banks; and the impact of foreign-entry on the performance of the domestic banking industry.

This study therefore was set with an objective of assessing the factors that influence commercial banks investments in Kenya as an emerging economy. The study used descriptive survey as the research design on the population of 12 foreign commercial banks operating in Kenya. The data was collected by means of questionnaires consisting of both open and close ended questions. The data was analyzed using descriptive statistics. Qualitative data was analyzed using content analysis.

The study identified profitability and credit expansion as the top most factors considered by foreign banks when investing in Kenya. International competition, technological innovation and advancement in foreign countries, favorable credit/cash ratio requirements, political stability in the foreign country, are the other factors that were viewed as critical in bank investment. However, tax consideration was viewed to have little though considerable influence in determining the foreign banks investment in Kenya.

It was also established that foreign commercial banks have been operating in Kenya for a considerably long period. The oldest banks have been operating for over thirty years while the new entrants are less than five years old. Foreign banks in Kenya like domestic banks have enjoyed considerable branch networks mainly due to high profitability, relatively easy gain of market shares, and high level of skilled labour besides the relatively stable economy. Like most businesses, the foreign commercial banks face various risks that they need to handle in order to remain afloat on top being the exchange rate risk.

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## **LIST OF ABBREVIATIONS AND ACRONYMS**

|           |   |
|-----------|---|
| BSD       | Bank Supervision Department                           |
| CBK       | Central Bank of Kenya                                 |
| E-banking | Electronic Banking                                    |
| EBRD      | European Bank for Reconstruction and Development      |
| E-Mail    | Electronic Mail                                       |
| EMEs      | Emerging Market Economies                             |
| FBI       | Foreign Banks Investment                              |
| FDI       | Foreign Direct Investment                             |
| GDP       | Gross Domestic Product                                |
| IT        | Information Technology                                |
| NAFTA     | Northern American Free Trade Agreement                |
| NIC       | National Industrial Credit                            |
| OECD      | Organization for Economic Cooperation and Development |
| R & D     | Research Development                                  |
| WTO       | World Trade Organization                              |

# **CHAPTER ONE: INTRODUCTION**

## **1.1 Background to the Study**

The importance of industrial policy, institutions and foreign direct investment (FDI) in industrialization, for economic growth and development, is one of the most widely debated issues in the economic discourse (Busse and Hefeker, 2007). FDI in emerging economies has increased significantly over the last 3 decades. In Kenya, total FDI rose from some US \$4 billion in 1980, to US \$182 billion in 1999, before falling back to US \$152 billion in 2003 (Central Bank of Kenya 2009).

In emerging markets banking systems, foreign ownership has increased dramatically during the second half of the 1990's, and further increases are already occurring in many countries. The increased activities of foreign banks in emerging markets can be measured either in terms of foreign bank participation in domestic banking markets or in terms of how effectively foreign banks control banking activities (Mathieson and Roldos, 2001).

Emerging economies are low-income, rapid-growth countries using economic liberalization as their primary engine of growth. In emerging economies, local competitors may have developed capabilities for relationship-based management in their environment that substitute for the lack of institutional infrastructure. These assets may be used domestically or in transferring abroad to other emerging economies where such assets would otherwise be useful (Hoskisson et al, 2000).

The increase in foreign ownership of banks in emerging markets is one facet of the ongoing consolidation of banking systems in both mature and emerging markets. An increasing share of the banking sector is controlled by foreign capital in the majority of transition countries. To analyze the effects of this trend on the performance of the banking sector is quite a crucial phenomenon (Allen and Rai, 1996)

Governments all over the world offer significant inducements to attract investment, motivated by the expectation of spillover benefits to augment the primary benefits of a boost to national

income from new investments. There are several possible sources of induced spillovers from foreign direct investment (Gorg and Greenaway, 2004).

Acquiring domestic banks and establishing subsidiaries was the natural method of entry in the context of the privatization or recapitalization of the banking system. Furthermore, investing institutions sought to make investments that were sufficiently large to obtain a critical mass, and exploit economies of scale when entering retail markets. Typically, subsidiaries posed the branch network necessary to enter these markets. The legal form of a subsidiary has apparently proved sufficiently flexible to implement a variety of business strategies and different degrees of centralization (Cardenas et al, 2003).

Greater foreign participation in the banking industry raises a number of important analytical issues such as; the factors determining a bank's decision to expand its activities abroad, its choice of countries to invest in, and the form of participation (branch, subsidiary, ownership of local banks), differences in the business focus of foreign and domestic banks; and the impact of foreign-entry on the performance of the domestic banking industry. The policy issues include how much and what sort of foreign participation to permit and what key supervisory issues arises as a result of greater foreign participation (Hawkins and Mihaljek, 2001).

### **1.1.1 Need for Banks Investment in Emerging Economies**

Foreign investors entering emerging markets have to take strategic decisions on where and how to set up operations. These decisions have to accommodate institutional conditions that vary not only between countries, but also within the host economy. Investors adapt their strategies to formal and informal institutions prevailing at the host location, especially when entering emerging markets (Li, 1995).

Foreign bank participation in emerging economies is a relatively recent phenomenon that in most cases goes back to the mid 1990s reflecting global trends of consolidation and integration of the banking industry, as well as privatizations and liberalization in emerging economies. To the extent that foreign banks are less financially constrained than domestic especially during periods

of tight monetary conditions, comparing the relative responses of loan growth to monetary conditions across domestic and foreign banks provides alternative to solve the identification problem. Foreign banks have to be less financially constrained than domestic, either because they can resort to internal funds, or because they face a more stable deposit base. Second, the loan demand facing domestic banks cannot be systematically different from the loan demand of foreign banks (Arena, 2004).

Recent international business and strategy explores the relationship between countries institutional framework and business strategies (Oliver, 1977; Peng, 2000), and has developed an institutional based view of strategy. The institutional perspective may not be a theory that in itself, would explain corporate strategies. Host economy institutions moderate traditional determinants of entry strategies. Especially in emerging economies, empirical research finds that institutions influence the strategies of both domestic banks and foreign direct investment (Meyer, 2001).

Financial sector foreign direct investment in emerging market economies has surged over the past decade. While the benefits of heightened financial sector efficiency and better risk management are widely acknowledged, foreign ownership poses changes for host countries due to the migration of decision-making and the congruence of the organizational structures of foreign-owned banks and host country legal and regulatory systems. Many of these challenges will be best met by global coordination on the part of supervisors and central banks (Domanski, 2007).

There is widespread agreement on the benefits of foreign banks participation for the emerging economies. Foreign banks usually bring state of the art technology and training for domestic bankers. Moreover, they are familiar with sophisticated financial instrument and techniques, and have faster and cheaper access to international capital markets and liquid funds (Li, 1995).

The entry of foreign banks reflects the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems, as well as to help reduce the cost of recapitalizing weak domestic banks.

Adopting a liberal approach to foreign banks entry has been laid down by international trade agreements (WTO, NAFTA) or has been a condition of membership of the OECD or the European Union, or is part of reciprocity requirements for domestic banks to expand into foreign markets (Peng, 2000).

### **1.1.2 Overview of Foreign Banking in Kenya**

Kenya's economy is reasonably diversified, though most employment is dependent on agriculture, which contributes approximately 24% of GDP. As compared to investments, foreign investment banks appears to be holding up better than local commercial banks amid the turmoil that has beset banking industry since the middle of 2007 (Kenya Economic Survey, 2008).

The banking industry in Kenya is governed by the companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of financial system. The CBK publishes information of Kenya's Commercial Banks and non-banking institutions, interest rates and other publications and guidelines (CBK, 2009).

A foreign bank is a financial institution engaged in provision of routine banking services in a country other than the one it was originally chartered. Business historians tell us that foreign banks have been around for almost two centuries now. Banks in Kenya started foreign operations mainly following the commerce of the parent country but also because they perceived business opportunities in the form of risk-diversification (Joydeep, 1994).

Foreign owned banks play a key role of intermediation in the economy, which is the smooth and efficient functioning of the economy. The banking sector comprised the Central Bank of Kenya, as the regulatory authority, Commercial Banks, Non-Bank Financial Institutions, Forex Bureaus and Deposit Taking Microfinance Institutions as the regulated entities. As at 31st December 2009, the banking sector was composed of 46 institutions, 44 of which were commercial banks

and 2 mortgage finance companies, 1 licensed deposit taking microfinance institution and 130 foreign exchange bureaus. Out of the 46 institutions, 33 were locally owned and 12 were foreign owned. The foreign owned financial institutions comprised 9 locally incorporated foreign banks and 4 branches of foreign incorporated banks. These foreign banks are; Bank of Africa (K) Limited, Bank of Baroda (K) Limited, Bank of India, Barclays Bank of Kenya Limited, CFC Stanbic Bank, Citibank N.A. Kenya, Diamond Trust Bank, EcoBank, Habib Bank Limited, Habib Bank A.G Zurich, Standard Chartered Bank (k) Limited and UBA Bank Limited Kenya (CBK, 2009).

Foreign owned banks in Kenya offer a wide range of products ranging personal banking, SME banking and wholesale banking. In terms of the differences in function between local and foreign banks the Central Bank Kenya; Supervision Department confirms that there is no material difference between local and international banks as they both handle retail and corporate clients. However, the international banks have more corporate international clients and have the lion's share in forex business. Since the legal requirements are the same for both local and international banks in terms of capital base, the international banks are generally stronger due to high performance standards set by the parent banks, especially in credit appraisal procedures (CBK, 2009).

While the strength and level of development of Kenya's economy relative to its neighbours attracted market-seeking foreign investment until the early 1980s, rising levels of corruption, low growth and increasing operation costs have discouraged foreign investment in the past two decades. The challenges that face banks in Kenya cut across the local and foreign owned banks. These may include among others; competition with the non-bank financial institutions for household savings and corporate finance mandates e.g. mutual funds, insurance companies. These institutions are better able to diversify risks for their clients and usually take advantage of economies of scale. This has forced commercial banks in Kenya across the board to seek innovative ways to expand and diversify their operations in order to maintain their competitiveness and profitability. In this regard, commercial banks are increasingly diversifying into non-traditional financial activities such as leasing and insurance services, fee-based

businesses, investment banking and asset management. As a consequence, distinctions between Kenyan commercial banks and other financial institutions are blurring (CBK, 2009).

Wallner (1998) shows theoretically that especially in the emerging countries, characterized by soft budget constraints, foreign investment is welcomed to achieve such strategic restructuring as the presence of foreign investors gives governments incentives to reduce subsidies to firms because otherwise a part of the subsidy may disappear in ‘foreign pockets’. Hence, the hardening of budget constraints increases effort by managers to restructure more.

A second important reason why foreign direct investors venture into emerging countries rests on the belief that they generate positive externalities to the domestic firms through a transfer of know-how and technology. Introduction by foreign banks may benefit domestic banks through the accelerated diffusion of new technology. This could occur through labour turnover or through imitation or other channels (Konings, 2000).

## **1.2 Statement of the Problem**

In recent times, developing countries, especially in Africa see the role of foreign direct investment as crucial to their development. Foreign investment is seen as an engine of growth as it provides the much needed capital for investment, increases competition in the host country industries, and aids local firms to become more productive by adopting more efficient technology or by investing in human and/or physical capital. Foreign direct investment contributes to growth in a substantial manner because it is more stable than other forms of capital flows. Investment services are being established worldwide and increasingly business investments are becoming globalized in much the same way that manufacturing is outsourcing overseas. The investment bankers in the banking organization can no longer ignore international competition in investment services, especially the globalization of investments in the emerging economies as compared to the mature economies (Terpstra and Chwo-Ming, 1988).

The foreign banks operating in Kenya have been largely affected by factors such as relative cost advantage, which could be due to for example, different operating strategies, different

investment products, differences in regulatory requirements and/or support from home governments. Foreign banks arise from Foreign Direct Investment (FDI) of capital in a foreign country pursuing the foundation or the acquisitions of an enterprise abroad or having the majority influence on foreign abroad or having the majority influence on foreign enterprise.

Foreign Bank Investment (FBI) in the financial sectors of emerging markets economies have expanded dramatically over the past 10 years. Growing foreign involvement is deemed instrumental in aligning the financial systems of emerging market economies (EMEs) (Mathieson and Roldos, 2001). There is a substantial body of literature on the motivations driving foreign banking investments, although much of this does not specifically address investments in Africa. There is adequate literature covering various aspects of investment banking.

Mwamba, (2003) undertook a study on challenges facing investment banking in Kenya and identified information costs and the home country regulations as the most prevalent challenges. Iseme, (2006) studied on the topic an empirical study of location determinants of foreign direct investment in Kenya. Matundura (2008) undertook a study on investigation into factors hindering development of foreign direct investment in Kenya. Major factors identified in his study were the financial crisis, liberalization of foreign entry as well as the growth opportunities which were found to be inadequate in most African countries.

Chombo (2009) researched on the influence of the global credit crunch of foreign direct investment inflows in Kenya. Dinga (2009) undertook a study of the impact of foreign direct investments on economic growth in Kenya and Njuguna (2009) researched on the factors that influence in the growth of telecommunications sector in Kenya. Chombo (2009), Dinga (2009) and Njuguna (2009) had a common finding that, foreign direct investment in emerging countries are affected by considerations regarding regulatory environment, the degree with which the host country is economically integrated with the home country, the information costs present involved in operating in the host country, and the profit opportunities available in the host country.

Despite the mentioned and enormous amount of research that has been undertaken on investment in banking, most of these studies have not narrowed down on motivations behind FBI in

emerging economies such as Kenya. Moreover, probably due to relatively low level of Foreign Banking Investment in Africa, when compared with other regions, the researcher is not aware of any study on motivations behind FBIs in Kenya. This study fills the existing puzzle by answering the question: What are the determinants of Foreign Banks Investments in emerging economies? The study focused on selected foreign banks in Kenya.

### **1.3 Objective of the Study**

The objective of this study was to determine the factors that influence foreign banks investments in Kenya.

### **1.4 Significance of the Study**

This study will be useful in a number of ways. In particular the study;

Will assist commercial banks investment managers and policy makers in understanding the factors that determine the choice of banks investments in emerging economies. This will help them in identifying factors that are unique from the ones of mature economies.

Shall also assist researchers and students of banking in gaining an understanding of the factors determining or influencing foreign banks expansion to emerging economies.

Will benefit the business people and investors who like stocks market buyers will be able to evaluate those investments that generate gainful returns.

Will finally assist the government in the formulation of its fiscal, monetary and investment policies, through its principle banking arm which is the Central Bank of Kenya.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter reviews the existing literature on factors that determine foreign banks investment in emerging economies. Particularly, the chapter entails a review on the concept of FBI, theoretical review, empirical review, strategies in an emerging economy, as well as determinants of foreign banks investments.

### **2.2 Concept of Foreign Bank Investments**

An emerging economy can be defined as a country that satisfies two criteria; a rapid pace of economic development, and government policies favoring economic liberalization and the adoption of a free-market system. Many emerging market economies have major shortcomings which create a need for foreign bank participation; the lack of capital, the lack of commercial banking skills and an inefficient banking structure. The first two factors have been important in Kenya transition economies, while the lack of capital and inefficient market structures have played a major role in opening up the banking system in Kenya's crises economies (Arnold and Quelch, 1998).

The expansion of international banks into emerging economies has resulted into a renewal interest in the causes and consequences of financial FBI. A good post of the existing literature was developed in the 1970's and early 1980's, with the objective of explaining the so-called "Second wave" of financial institutions international expansion.

Foreign direct investment in the financial sectors of Emerging Market Economies (EMEs) has expanded dramatically over the past 10 years. Growing foreign involvement has been instrumental in aligning the financial systems of emerging market economies more closely with international standards. In terms of capital allocation, risk management and corporate governance. At the same time, there have been significant changes in the way in which foreign

banks organize and conduct business in EMEs. The transformation of host country banks through foreign bank entry has generally improved the efficiency and stability of domestic financial systems. But it has also given rise to new challenges for host country authorities (Domanski, 2007).

### **2.3 Theoretical Review**

In a world of perfectly competitive markets and full information, foreign bank entry in poor countries should undoubtedly be welfare improving. With access to better technology, more opportunities to diversify risk, and, possibly, better corporate governance, these banks should be able to offer more attractive interest rates and increase the volume of credit. When information about borrower quality is imperfect, on the other hand, banks have to screen and monitor prospective borrowers. If foreign banks have an advantage only in lending to the less opaque customers, the effects of foreign bank entry on credit availability, efficiency, and welfare are not clear cut. Towards this end, there is extensive theoretical literature examining the determinants of FBIs towards emerging countries. A convenient categorization of these reasons is between “pull” and “push” factors.

“Push” factors are originated in the home country of the parent bank and generally respond to the question “why” the financial FDI originates. “Pull” factors answer to the question “where” and are related to the economic, financial and regulatory developments in the host country. “Push” factors might be related to the economic situation in the home country. Slow growth and profitability in the home country is the most common factor among those. Also, especially as developed countries banking sectors become more and more concentrated, foreign banks, through the opening of new markets, open up new growth opportunities, escaping home country antitrust policies. Some institution specific factors also might be behind the decision to invest abroad. Banks that are willing to improve their cost efficiency might see in the increase in the tapped markets by the bank as a way to achieve economies of scale, scope and product mix. Also, starting activity abroad might be for a bank an opportunity for improved geographical diversification.

“Pull” factors are specific to the country receiving the foreign bank. The most well known and studied of these is the so-called “follow the client” motive. According to this theory, the foreign bank has the aim of providing banking and other similar services either to outposts of domestic parent companies or to importers of the home countries produced goods. Strong non-financial FDIs or bilateral flows would be behind the decision of a bank to start operation in an emerging economy.

A country’s open-door policy and relatively stable political conditions are also found to be important determinants of foreign bank investment in emerging economies. Many emerging economies create favorable business environment for foreign investment and facilitate the functioning of the market mechanism .This may include among others tax-free zones, and export processing zones. Countries which exhibit strong GDP or income growth can in theory attract more foreign investment because of the potentially higher expected profitability of the banking activity than in countries characterized by weak and volatile growth. High profitability and relatively easy gain of market shares can be expected by foreign banks when they entry a country in which banks enjoy high margins or very weak competition. Cultural and linguistic factors might also be the base of the choice in the location of the investment by developed countries’ banks.

Virtually all existing theoretical paradigms focus on the comparison of benefits and costs of the investment decision. As with any kind of investment, the bank will face uncertainty about the expected profits of such decision, and even expected costs. On the cost side, Hymer (1969) introduces the widely accepted notion that foreign banks face significant cost disadvantages when compared with local competition. These additional costs can arise as a consequence of cultural differences, legal barriers or increased control problems, just to cite a few examples. Therefore, in order to operate profitably in a foreign market, international banks must be able to realize gains that are unavailable to local competitors.

## **2.4 Strategy in Emerging Economies**

Emerging economies are low-income, rapid-growth countries using economic liberalization as

their primary engine of growth emerging market present differences in structural characteristics, yet exhibit commonalities of melancholy evidence of varying degrees of economic and political under development. There is a greater consensus in the finance literature on what the characteristics of emerging markets are than there is on their meaning (Herbert, 1996) Among the various development policies and strategies those having to do with foreign trade and foreign direct investment tend to have a momentous impact on the access to resources achieved by entrepreneurs and firms in emerging economies. The reason is that some of the resources for new industry entry are domestic (labour, home market access), and others are situated, at least in past, beyond the home country's border (raw materials, capital, technology, know-how, access to foreign markets). If foreign trade and investment policies are such that only certain local entrepreneurs and firms can combine the required domestic and foreign resources, they will be able to accumulate the capability to repeatedly enter new industries and build diversified business groups (Meyer, 2000).

Foreign investors entering markets have to make strategic decisions on where and how to set up operations. These decisions have to accommodate institutional conditions that vary not only between countries, but also within the host economy. Foreign banks have to decide where and how to set up their operations. These strategic decisions have to accommodate institutional conditions that vary not only between countries, but also within the host economy. Investors adapt their strategies to formal and informal institutions prevailing at the location, especially when entering markets (Herbert, 1996). Acquiring domestic banks and establishing subsidiaries was the natural method of entry in the context of the privatization or recapitalization of the banking system. Furthermore, investing institutions sought to make investments that were sufficiently large to make investments that were sufficiently large to obtain a critical mass, and exploit large to obtain a critical mass, and exploit economies of scale when entering retail markets. Typically, subsidiaries possess the branch network necessary to enter these markets. The legal form of a subsidiary has apparently proved sufficiently flexible to implement a variety of business strategies and different degrees of centralization (Domanski, 2007). Banks initially extended their services abroad in order to assist their home-country customers with international transactions, with a growing understanding of foreign markets and a more developed network of

relationships with local financial institutions, some banks subsequently increased the range of their operations by adding local customers. Following this pattern foreign bank would first establish representative offices. At a later stage, they would open branches and, eventually, establish subsidiaries (Song, 2004).

## **2.5 Determinants of Foreign Banks Investments**

Recent years have seen an increased importance to international trade in goods and financial services. To facilitate such trade, many banking institutions have also become international. Banks expand internationally by establishing foreign banks. The internationalization of the banking sector is facilitated by the liberalization of financial markets worldwide. Developed and developing countries alike now increasingly allow banks to be foreign-owned (Claessens, et al, 2001). Studies of FDI in emerging market economies have put particular stress on indicators of economic and political risk (Jun and Singh, 1996). This comprises three main elements; macroeconomic stability, e.g. growth, inflation, exchange rate risk; institutional stability, such as policies towards FDI, tax regimes, the transparency of legal regulations and the scale of corruption; and political stability ranging from indicators of political freedom to measures of surveillance and revolutions (Culem, 1998).

The banking systems of many emerging economies are fragmented in terms of the number and size of institutions, ownership patterns, profitability and competitiveness of banks, use of modern technology, and other structural features very often, three or four large commercial banks coexist with a large number of smaller urban and rural banks, many of the family-owned (especially in Asia) or under the influence of the public sector (as in Latin America and Central Europe). In general, few commercial banks, even larger ones, are listed on a stock exchange. Profitability varies widely, with some banks earning high returns but operating very inefficiently, and other banks competing fiercely for a narrow segment of the market. Likewise while some commercial banks in the emerging economies are at the cutting edge of technology and financial innovation, many are still struggling with the basic operations such as credit risk assessment and liquidity management (Hawkins and Mihaljek, 2001).

### **2.5.1 Profitability**

The literature available indicates that the key locational factors determining FBI are host country market size, cost-notably of natural resources and labour, and the riskiness of investment, both in terms of the economic and the political environment (Jun and Singh (1996); Culem (1998)). Market size, typically measured by host country Gross Domestic Product (GDP) captures potential economies of large-scale production. Expected profitability according to EBRD (2000) will also be higher in host economies if inputs costs, most notably labour, energy and raw materials, are lower than in the donor economy. For most of the transition economies, the key resources is labour, which is regarded as having relatively high levels of skills and training (in comparison for example to regions with comparable per capita income levels in South East Asia or Latin America), and a strong scientific base This indicates the inclusion of labour costs. However, banks only prefer low wage locations if the reduced labour costs is not compensated by lower labour productivity, or an overvalued currency. Hence the appropriate measure is unit labour costs denominated in a foreign currency (Bevan and Estrin, 2000).

The entry of foreign banks reflects the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems as well as to help reduce the cost of recapitalizing weak domestic banks. Adopting a liberal approach to foreign banks entry has been laid down by international trade agreements or has been a condition of membership of the OECD or the European Union, or is part of reciprocity requirements for domestic banks to expand into foreign markets (Mathieson and Roldos, 2001).

### **2.5.2 Credit Expansion**

The rapid credit expansion by foreign banks also raises financial stability issues for host country authorities. Some of this growth is the result of the aggressive expansion by foreign banks due to much higher spreads. To be sure household credit growth is occurring from a low base and in rapidly growing economies, so the debt burden is still relatively low it is also not clear how much slower. This credit growth would have been in the absence of foreign bank participation. Still,

the development underscores the need for host country authorities to have adequate information to assess the activities of all financial institutional in their markets (Domanski, 2007). The benefits foreign banks can offer are now much more widely recognized. But it would be irrational to pretend that there are no drawbacks or no difficult choices for local supervisory authorities. The supervisory response to the rapid rise of foreign banks is still being refined, and in some countries, remains an important task. Foreign banks have become well established as key vehicles in the international integration of the financial systems of emerging market economies.

There has been a strategic shift by foreign banks away from pursuing internationally active corporate clients towards the exploration of business opportunities in the domestic market (Moreno and Villar, 2005). A development of great importance has been that lending by big local affiliates has progressively displaced direct dollar-denominated lending by the head offices of international banks. This is potentially a positive development as it can mean greater borrowing in local currency and thus smaller currency mismatches. In addition, the deeper local presence of international banks may contribute to greater efficiency and resilience of the financial sector (Song, 2004).

### **2.5.3 International Competition and Exchange Rate**

The banking industry worldwide is being transformed. The global forces of change include technological innovation, the deregulation of financial services at the national level and opening up to international competition; and equally important, changes in corporate behaviour is, such as growing disintermediation and increased emphasis on shareholder value At the same time, to exploit the benefits of foreign bank involvement, more scope remains to develop the institutional infrastructure. This includes the improvement of legal and accounting frameworks as well as bankruptcy procedures in EMEs, and their harmonization at the global level (Hawkins and Mihaljek, 2001). An exchange rate peg may collapse because; if and when a bank crisis comes, stabilizing the banks and keeping the exchange rate peg become mutually incompatible objectives. A central bank may attempt to fight a bank crisis by keeping interest rates from rising (which would further wreck the banks) or by providing lender-of last-resort funds. But then

agents will use the additional domestic currency to buy reserves, eventually forcing the abandonment of the fixed exchange rate. It is in this sense that we observe “twin crises” a financial crisis and a balance of payment crisis (Chang and Velasco, 1998).

Banking in the emerging economies was traditionally a highly protected industry, living off good spreads achieved on regulated deposit and lending rates and pervasive restrictions on domestic and foreign entry. One of the main catalysts for increased competition at the domestic level has been the removal of ceilings on deposit rates and the lifting of prohibitions on interest payments on current accounts. These deregulation measures have reduced sources of cheap funding for many banks and put pressure on their profits. Intensified competition has made it harder for banks to subsidize different activities and has forced them to price risks more realistically and to charge explicitly “free” services (Hawkins and Mihaljek, 2001).

#### **2.5.4 Technological Innovations and Advancement**

According to conventional wisdom, new Information Technology (IT) is not at present likely to impinge much on the development of the banking industry in the emerging economies, which remain technologically behind the industrial countries. For example, the low level of penetration in most emerging economies means that the internet is not seen as a threat to traditional banks. Given the signs of a possible bursting of the e-banking “bubble”, some have also argued that the issue of electronic banking (e-banking) may go away before the emerging markets need to worry about it(Hawkins and Mihaljek, 2001).

As in advanced economies, new technology is affecting the structure and performance of the banking industry in the emerging markets mainly through its impact on the costs and the determination of optimal scale. Branch-based transactions are much more expensive than alternative delivery channels. This cost advantage would seem to favour smaller institutions, as investments needed to attract deposits or provide banking services via the internet are in principle lower than the cost of setting up a traditional branch network. At the same time, investment needed to develop adequate back office and risk assessment systems are very high, creating considerable cost advantages for larger institutions. Moreover, branch networks are not

expected to shrink as a result of the more fundamentally, banks are increasingly losing their privileged access to information about investment opportunities, and are thus under pressure to merge or build alliances with domestic or foreign-owned banks (Bevan et. al., 2004).

## **2.5.5 Tax Credit Considerations**

Tax consequences are central to investment decision. The performance of any investment strategy is measured by how much it yields after taxes even so for household and institutional investors who face significant tax rates. Tax sheltering and deferral of tax obligations may be pivotal in their investment strategy (Bodie et al., 2008). The required net profits of foreign banks may be influenced by the tax regime of the bank's parent country. A foreign bank that will benefit from a foreign tax credit for instance may accept a relatively low net-of-host country- tax profitability. At the same time, domestic and foreign banks may accept different net profits to the extent that their cost of capital differs. Foreign banks, specifically, may be able to raise equity capital internationally, and therefore accept lower net profits in most developed countries, whereas they generally have higher net profits in developing countries. De Young and Nolle (1996) have argued that foreign banks in the United States have been relatively less profitable, because they valued growth above profitability.

In developing countries, foreign banks may be able to realize high interest margins because they are frequently exempt from credit allocation regulations and other such restrictions. Especially in countries where domestic banking markets are dominated by state banks, institutions frequently use non-commercial criteria to allocate their credit. Furthermore pervasive market inefficiencies and outmoded banking practices that exist in developing countries should also lead to high interest margins for foreign banks, outweighing the information disadvantages they face (Claessens et al., 2001). According to Herrero and Simon (2003) growing foreign bank participation has exposed EMEs to three underlying trends in the global financial system: consolidation, capital allocation based on risk-adjusted profitability and corporate governance based on widely dispersed ownership by private shareholders at the parent level. The benefits of this of financial globalization in the form of heightened financial sector efficiency, improved

pricing and better risk management are widely acknowledged.

## 2.6 Empirical Review

Empirical studies relating to aspects of foreign bank investments have been scarcely examined. However, Eller *et al.* (2006) used a measure of financial sector foreign investments to examine its impact on economic growth in the transition economies of Central and Eastern Europe. They emphasized on the crucial role of the efficiency channel whereby the inflow of foreign investments induces microstructure changes in the banking industry, which spillover into overall efficiency gains for the financial sector, with appropriate consequences for economic growth.

The researchers used performance variables (e.g. profitability, efficiency etc) and also some measure of foreign presence, such as the proportion of foreign-owned assets in the domestic banking industry or, in some cases, simply a dummy variable for foreign ownership. However, they precluded broader investigation of foreign investments “spillovers”, which characterize the extent of technology transfer or knowledge diffusion that might occur between industrial and financial sectors of the economy for instance the inflows that affect economic growth in the banking industry, thus, highlighting a source of environmental change affecting the banking sector. Chowdhury and Mavrotas (2006) examined the determinant of FBI in third world countries by using time-series data covering the period 1969-2000 for three developing countries, namely Chile, Malaysia and Thailand. They followed the Toda and Yamamoto causality test approach. Their empirical findings clearly suggest that GDP causes FBI in the case of Chile and not vice versa, while for both Malaysia and Thailand, there is strong evidence of a bi-directional causality between the two variables.

Empirical studies on mergers and acquisitions in foreign banking have concentrated on the banking market. Bevan and Estrin observed that as foreign banks have historically followed their home-country customers to the emerging markets, they are often seen as specializing in service large corporate customers, either multinational banks or “cherry-picked” hosts country banks. This has led to concerns that in banking systems with a large foreign participation some segments of the market-rural customers, small and medium-sized firms would be left unattended.

As a result, domestic banks could be left with the less creditworthy customers, increasing the overall riskiness of domestic banks' portfolios, and credit markets could become segmented.

Locally, the empiricism is based on the concept of FBI within non-banking institutions. Iseme, (2006) undertook an empirical study of location determinants of foreign direct investment in Kenya. His discussion is based on authentic case of the airlines in Kenya. The paper finds that there are some successes of management knowledge transfer from such investment, although foreign strategic investment is limited as a minority share in local airlines. Culture shock came at the first stage and syncretism later on. In addition, some observers are concerned that foreign investors will be reluctant to transfer their expertise to local partners, and few skills will be acquired by local investors. There is widespread agreement on the benefits of foreign bank participation for the emerging economies. Foreign bank usually bring state of the art technology and training for domestic bankers. Moreover, they are familiar with sophisticated financial instruments and techniques, and have faster and cheaper access to international capital markets and liquid funds. Their presence may also encourage other foreign firms to invest in the domestic economy. They may add to the stability of the financial system "by allowing domestic residents to do their capital flight at home".

An empirical study by Matundura (2008) into factors hindering development of foreign direct investment in Kenya revealed that even though FBI is particularly important for its package of tangible and intangible assets there are inherent challenges facing local investors and the country as whole through repatriation of profits. The study also indicated considerable evidence that FBI can affect growth and development by complementing domestic investment and by undertaking trade and transfer of knowledge and technology. The study was undertaken on the management of Telkom Kenya. Empirical studies have also found that foreign bank entry improves the functioning of national banking markets, both by increasing the degree of competition and by introducing a variety of new financial products and better risk management techniques. The efficiency effects of foreign banks appear to occur on entry, and do not depend on gaining a substantial market share. Foreign banks have higher interest rate margins, profitability and tax payments than domestic banks in emerging markets, and significant foreign bank entry is

associated with a reduction in both operating expenses and the profitability of domestic banks (Pomerleano and Vojta, 2001).

Furthermore, in Hansen and Rand (2006), the causal relationship between foreign investments and GDP is analyzed in a sample of 31 developing countries covering the period 1970-2000. Their conclusions regarding the direction of causation between the two variables seem to vary significantly depending on the econometric approach adopted and the sample used. In addition, looking at time series on 11 countries, Zhang (2001) evidences strong Granger-causal relationship between FDI and GDP growth. Based on cross-country studies, foreign-owned banks have been found to have lower operating costs and higher profitability than private domestic banks, while state-owned banks have higher costs and lower profitability than the other two categories.. Foreign bank entry in developing countries also appears to lower interest margins and profitability, suggesting an increase in competition (Claessens et al, 2001)). A recent study of eight Latin American countries, however, finds the opposite to be true (Levy-Yeyati et al, 2003)).

Drawing on an exceptionally rich data set of 80,000 business loans in Pakistan, Mian (2006) finds that private domestic banks lend more to informationally opaque businesses than foreign banks, and are more successful at recovering defaulted debt. The interpretation of these results is that distance constraints (both cultural and geographic) between top management and loan officers force foreign banks to curtail discretion in lending decisions, resulting in less lending to informational opaque smaller businesses. Distance also appears to impair the recovery of defaulted loans. In a third country study on India, Enrica et al, (2006) compares borrowing behavior of firms located in districts with and without foreign bank entry. He concludes that the 10% most profitable firms benefited from foreign bank entry through an increase in loan size, while other firms experienced a 7.6% reduction in their likelihood of having a loan. This result is driven by a decrease in domestic bank loans to group-affiliated firms. The result holds after instrumentation of foreign bank location.

## **2.7 Capital and Liquidity in Banks**

Economists typically view banks as intermediaries that serve to channel funds from individual investors to firms with productive investment opportunities. This commonly held view, however, is difficult to reconcile with the assumption of frictionless capital markets; in frictionless markets, firms would raise capital directly from individual investors and avoid the cost of intermediation (Hoshi and Scharfstein, 1990). The defining characteristics of banks are that most of their investments are loans to businesses and consumers and most of their liabilities are accounts of depositors. As investors, the objective of banks is to try to match the risk of assets to liabilities while earning a profitable spread between the lending and borrowing rates (Gitman and Joehnk, 2001). According to Corrado and Jordan (2002) liquidity is the ease (and speed) with which an asset can be sold and still fetch a fair price. It is a relationship between the time dimension (how long will it take to dispose) and the prices dimension (any discount from fair market price) of an investment asset. Some countries apply a stringent capital requirement for foreign banks branches. The concerns are twofold. There may be some reluctance to rely on the home country regulations in some case, and in the event of a failure of a parent bank, there is concern that any resolution might favour depositors and creditors in the home country at the expense of host country. Therefore, some host country supervisors want to rely on foreign bank branches having capital and assets in the host country to match the liabilities in the host country (Song, 2004).

The home bank will need to take account of the fact that capital cannot always easily be moved from one part of a banking group to another across international borders. Host country supervisors are primarily responsible for the liquidity of foreign establishment, since they are better equipped to assess liquidity as a function of local market conditions and practices, although the home country supervisor is responsible for group liquidity. In some counties, liquidity is increasingly outsourced by the most authorities to home authorities if the ban is operating its liquidity on a global consolidated basis (Mian, 2003). While illiquid banks exits in emerging and mature economies alike, our approach may be most relevant for emerging markets for two reasons. First, banks play a much larger role in emerging than in mature economies; this

observation justifies a focus on banks to the detriment of other credit mechanisms such as debt or equity. Second, focusing on illiquidity is natural for emerging market because their access to world capital markets is limited. If banks in mature economies face a liquidity problem (as opposed to a solvency one), they are likely to get emergency funds from the world capital markets (Chang and Velasco, 1998).

## **2.8 Foreign Investment Location**

Each host country determines the types of foreign bank operations it will permit. Desired forms of entry may vary from bank to bank and from country to country, depending upon business-strategy considerations and host country-laws and banking structures .According to Narula and Dunning (2000); and United Nations (2002) institutions are widely regarded as crucial locational advantage to host countries aiming to attract investors. However, there is little agreement on which institutions matter, and why. Foreign direct investors view institutions as an important aspect of the locational advantages of a potential host country. They form part of a potential host country. They form part of the created assets of countries, and have arguably become increasingly significant relative to more conventional ‘natural assets’ have raw materials or cheap labour.

Financial liberalization of this kind proceeds on the premise that the gains to domestic market participants from foreign entry outweigh any losses to domestic banking institutions. Several authors have addressed the potential benefits of foreign bank entry to the domestic economy in terms of better resource allocation and higher efficiency. Levine (1996); Walter and Gray (1983); and Gelb and Sagari (1990), specifically mentions that foreign banks may (i) improve the quality and availability of financial services in the domestic financial market by increasing bank competition, and enabling the application of more modern banking skills and technology, (ii) serve to stimulate the development of the underlying bank supervisory and legal framework, and (iii) enhance a country’s access to international capital.

## **2.9 Summary, Research Gap and Conclusion**

This chapter reviewed literature on determinants of foreign banks investments. Major factors identified included profitability, credit expansion, international competition and exchange rate, technological innovation and advancement as well as tax credit considerations. The review concludes that, in order to operate profitably in a foreign market; international banks must be able to realize gains that are unavailable to local competitors. This review was guided by the theories of “push” and “pull” factors and empirical studies by various authors. While there is sufficient literature on determinants of foreign bank investments, the testing or assessment of the theoretical and empirical factors has not been carried out in Kenya. The current study therefore differs from the reviewed studies in that the survey of foreign banks will specifically be carried out in Kenya as an emerging economy in Africa.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter presents a discussion of the research methodology that was employed to address the research questions. The study is a survey of the foreign banks operating in Kenya.

### **3.2 Research Design**

This was a descriptive survey study that applied both quantitative and qualitative approaches. This design was chosen because it enables the researcher to have an in-depth understanding of the behavior pattern of the industry under survey. The importance of descriptive survey design is emphasized by Kothari (2004) who acknowledges that a survey is a powerful form of qualitative analysis that involves a careful and complete observation of a social unit, irrespective of what type of unit is under study. The study was set to assess the motivations by banks when investing abroad.

### **3.3 Population of Study**

The population of study composed of 12 foreign banks operating in Kenya as per the list in Appendix I. Due to the small number of such banks in Kenya, a census study was carried out hence no sampling was done.

### **3.4 Data Collection Method**

Data was collected by means of a questionnaire, which consisted of open-ended and closed-ended questions. The questionnaires were administered to the respondents using hard copies sent by hand (or where possible, digital copies sent via e-mail). For those sent by hand, the drop and pick later method was used. The questionnaires were divided into two parts. Part A; capturing general information about the respondent organization/bank; and part B addressing the objectives

of the research. The target respondents were senior managers designated as being responsible for planning, decision-making and monitoring of the bank's investment products. Measurement used a five point Likert scale.

### **3.5 Data Analysis Technique**

Data analysis was conducted using descriptive statistics, which included measures of central tendency, measures of variability and measures of frequency among others. According to Mugenda and Mugenda (2003) descriptive statistics enable meaningful description of a distribution of scores or measurements using a few indices or statistics. Measures of central tendency give us the expected score or measure from a group of scores in a study. Measures of variability, such as standard deviation, inform the analyst about the distribution of scores around the mean of the distribution. Frequency distribution shows a record of the number of times a score of record appears. The Statistical Package for Social Scientists (SPSS) program-Version 13.0 was used to analyze the data. Qualitative data was analyzed using content analysis. Analyzed data was presented in form of tables and charts.

## **CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION**

### **4.1 Introduction**

The aim of this analysis is to bring out the relationship between the results and the hypothesis of the study i.e. factors that influence foreign banks investments in Kenya.

Survey questionnaires were administered to the entire population of twelve (12) foreign banks operating here in Kenya in September 2010. Their participation in the research was completely voluntary, and the respondent's confidentiality was protected by answering the questionnaire anonymously. Ten responses were returned a return rate of eighty-three percent (83%).

### **4.2 Measures of Data Analysis**

The questionnaires were used to collect data from the population. The questionnaires were divided into two parts, A and B.

The questionnaire included seventeen items that measured different attitudes toward research. Part A; captured the general information about the respondent organization/bank; and part B addressed the objectives of the research. Respondents rated these items using a 5-point Likert scale with the following scale values: 1.Not at all, 2.Little extent, 3.Moderate extent, 4.Great extent, and 5.Very great extent.

In addition, the questionnaire included both closed and open ended items, where respondents marked their preferences and expectations when conducting research.

The corrected data was analyzed scientifically by classifying and tabulating the information along with their groupings. Means and standard deviations were calculated to get some significant differences. Analyzed data was presented in form of tables and charts.

### **4.3 Data Analysis and Findings**

The analysis has both the bio data and those areas addressing the main objective of the study as indicated below:

#### **4.3.1 Country where the head office is based**

This area of study sought to enquire the country of origin or head offices of the various foreign commercial banks with investments in Kenya. The study indicated that some of the banks according to the respondents had their roots in Africa, while others had their head offices outside the continent of Africa.

CFC Stanbic Bank LTD, Eco Bank Kenya LTD, UBA Kenya Bank LTD and Diamond Trust Bank Kenya have their head offices in South Africa, Togo, Nigeria and Kenya respectively. Bank of India and Bank of Baroda have their head offices in India, while both Barclays Bank of Kenya and Standard Chartered Bank of Kenya have their head offices in United Kingdom. Habib Bank LTD and Habib Bank AG Zurich have their head offices in Pakistan and Switzerland respectively.

#### **4.3.2 Length of time the bank has been operating in Kenya**

The study required to establish the length of time the various banks have been operational in Kenya. From the findings as indicated in Appendix II, 50% had been operational for 30 years and above, 20% had either been operational for less than 5 years or over 25 years while only 10% have been operational for between over 5 years. This depicts that most foreign commercial banks have been operational in Kenya for a considerably long time while new entrants (less than 5 years) portrays a characteristic that Kenya is an emerging economy.

#### **4.3.3 Countries of Operation**

The respondents were required to state the number of countries their respective banks are operating in; 50% of the respondents' banks were operating in 10-29 countries, 30% in 100 and above countries while 10% was either operating in less than 10 countries or 50-99 countries as

illustrated in Appendix III.

#### **4.3.4 Factors That Influence Foreign Commercial Banks Investment in Kenya**

This was the most critical area of the research study as it sought out to identify the extent to which the various factors hypothesized have influenced the respondent's bank in investing in Kenya as an emerging economy.

**Table 1: Factors That Influence Foreign Bank Investment in Kenya**

| Factor  | Not at All | Little Extent | Moderate | Great Extent | Very Great Extent | Mean | STDEV |
|---|------------|---------------|----------|--------------|-------------------|------|-------|
| Profitability   | 0          | 0             | 3        | 4            | 3                 | 4.0  | 0.77  |
| Credit expansion by foreign banks                             | 0          | 1             | 0        | 7            | 2                 | 4.0  | 0.77  |
| International competition and exchange rate                   | 0          | 1             | 4        | 4            | 1                 | 3.5  | 0.81  |
| Technological innovation and advancement in foreign countries | 0          | 0             | 4        | 5            | 1                 | 3.7  | 0.64  |
| Tax considerations  | 1          | 2             | 4        | 2            | 1                 | 3.0  | 1.09  |
| Favorable credit/cash ratio requirements                      | 0          | 0             | 6        | 1            | 3                 | 3.7  | 0.90  |
| Political stability in the foreign country                    | 1          | 1             | 2        | 4            | 2                 | 3.5  | 1.20  |

According to table 1 above, in general, profitability and credit expansion by foreign banks are the top most factors considered by most of the foreign commercial banks while investing in Kenya as demonstrated through a high mean score of 4 and a relatively low standard deviation of 0.77.

Technological innovation and advancement, and favorable credit/cash ratio requirements were also considered to a great extent as influencing the foreign commercial banks while investing in Kenya each with a mean score of 3.7. However, favorable credit/cash ratio requirements had a higher standard deviation of 0.9 revealing that most banks did not consider that as a major factor. International competition and exchange rate, and political stability in the foreign country are

other factors that were identified to have greatly influenced the foreign banks investing in Kenya each with mean score of 3.5. On the other hand, some banks did not consider political stability as a critical factor as shown through the higher standard deviation of 1.2. By and large, tax considerations, was viewed to have little though considerable influence in determining the foreign banks investment in Kenya.

#### **4.3.5 Status of Financial Performance**

Financial performance of most foreign commercial banks in Kenya in comparison with other branches in other countries is relatively stable and excellently performing at 40% response as illustrated in Appendix IV. 30% of the respondent banks expressed that their organization in Kenya was stable but fairly performing while a small percentage of 10% indicated that the organization performance was declining but still profitable. Generally, foreign commercial banks in Kenya are financially stable albeit a very small number with declining performance.

All the respondent foreign commercial banks confirmed that they had policies on foreign bank investments and agreed that the policies influenced the choice of countries to invest.

#### **4.3.6 Risk Factors to Foreign Banks Survival**

Studies of Foreign Bank Investment in emerging market economies has put particular emphasis on indicators of economic and political risk as threats to survival. Kenya as an emerging economy is not in isolation as the cited factors and many more affect the survival of foreign banks.

As indicated in table 2 below and represented by Appendix V, several factors do, to a very great extent pose threat to foreign banks survival.

**Table 2: Factors That Threaten Foreign Bank's Survival**

| Factor                                  | Not at All | Little Extent | Moderate Extent | Great Extent | Very Great Extent | Mean | ST DEV |
|---|------------|---------------|-----------------|--------------|-------------------|------|--------|
| Inflation                               | 0          | 0             | 2               | 4            | 4                 | 4.2  | 0.74   |
| Exchange rate risks                     | 0          | 0             | 0               | 7            | 3                 | 4.3  | 0.45   |
| Financial instability                   | 0          | 2             | 1               | 3            | 4                 | 3.9  | 1.13   |
| Profound tax regimes                    | 0          | 1             | 4               | 4            | 1                 | 3.5  | 0.80   |
| Unfavorable regulations                 | 0          | 1             | 1               | 4            | 4                 | 4.1  | 0.94   |
| High scale of corruption                | 0          | 3             | 2               | 2            | 3                 | 3.5  | 1.20   |
| High competition                        | 0          | 0             | 2               | 6            | 2                 | 4    | 0.63   |
| Political stability                     | 0          | 1             | 2               | 2            | 5                 | 4.1  | 1.04   |
| Emerging economic policies and treaties | 1          | 1             | 3               | 3            | 2                 | 3.4  | 1.20   |

Exchange rate risks were identified as the greatest threat to foreign banks operating in Kenya. This can be illustrated through the highest mean of 4.3 and the lowest standard deviation of 0.45. Inflation, unfavorable legal/state regulations, political stability, high competition from local organizations are the other threats highly considered as threats according to the respondents as exhibited through their mean scores of 4.2, 4.1, 4.1 and 4.0 respectively. However political stability and unfavorable legal/state regulations had high standard deviations of close to 1.0 which means that some banks felt that they both have very little influence on their survival. Financial instability within the institutional, profound tax regimes, high scale of corruption and emerging economic policies and treaties are rarely perceived as threats to respondent's bank survival as these had lower but considerable mean scores of 3.9, 3.5, 3.5, and 3.4 respectively.

#### **4.4 Summary of Findings and Interpretations**

The objective study was to determine the factors that influence foreign banks investments in Kenya. The analysis of the important findings in line with this objective as has been presented in chapter four can be summarized as follows:

- a) Banks that had their head office in the Africa continent portray some similarities

in terms of factors that motivated their investment in Kenya. Technological innovation was singled out as the most preferred factor that influenced these banks to invest in Kenya. Profitability and credit expansion were also regarded as critical factors while tax considerations attracted varied reactions.

- b) The banks that had their head office outside Africa also depicted some similarities in terms of factors that influencing their decision to invest abroad. Credit expansion came on top as the most considered factor when investing across continents. Other factors that had considerable influence include profitability, international competition, technological innovation and political stability illustrating that, Kenya is a relatively politically stable country. It therefore clearly comes out that, whether the origin of the bank was within or outside the Africa continent, profitability and credit expansion are the most influential factors when investing in a foreign country. It can also be deduced that the international trade between Kenya and the origin of these banks is a key component in determining the foreign investments.
- c) As illustrated in 4.3.2 above, 50% of the respondent banks have been operating in Kenya for 30 years and above. However, eighty three percent of banks that have their head office outside Africa have been operating in Kenya for a relatively long period of over 30 years. In terms of priority of influential factors, credit expansion and international competition were identified as key in keeping these banks in business abroad. Profitability was also identified to be of substance although some banks, about 40%, indicated that the same moderately influenced their decision to hold on the Kenyan banking sector. Tax considerations were viewed to have least influence for these banks with head office outside Africa and have been in business in Kenya for long. The banks which have their head office outside Africa and have been operating in Kenya for a relatively short period, cited credit expansion and international competition as critical factors which attracted their investment in Kenya. International competition and credit expansion therefore came out as being unique to those banks with head office outside Africa irrespective of how long they had been operational in Kenya. It is therefore clear that foreign banks have been operating

in Kenya for a relatively long period and in actual sense they have been profitable and have a rich experience in international business.

- d) Having branches across the globe is a clear indication that an institution has a strong capital base and is ready to deal with the various risks it is likely to face. Most banks that have their head office/origin in Africa are operating in over ten countries. Credit expansion, profitability and technological innovation have been pointed out as the most influential factors while maintaining branch networks in various countries and Kenya sustainably. Generally, tax consideration was cited to have minimal impact on their decisions to invest abroad. A point to note is that while expanding to various countries, political stability was recognized as a key factor which most of these banks took into consideration. The other banks with their head office in Africa and are operating in less than 10 countries, regarded profitability , favourable cash/ credit ratio and political stability as being the factors that mostly influence their investments. These banks therefore seem to be risk averse and hence would want to maximize returns probably through product differentiation.
- e) Operations in over hundred countries was identified by 50% of those banks with their origin or head office outside the Africa continent, 33 % operating in over ten countries while 17% operating in over fifty countries. This implies that this category of foreign commercial banks have a wide network of investments across the globe an indication of strong capital base and experience in international business. Generally, these banks demonstrated similarities in motivating factors as credit expansion and international competition came on the top. Profitability and technological innovation have also driven these banks to operate in many countries including the emerging economies like Kenya.
- f) A Majority of foreign commercial bank are financially stable. However, the few which indicated declining performance can be attributed to aggressive competition from local/domestic banks in the last decade like Equity Bank.
- g) Exchange rate risks, inflation, unfavorable legal/state regulations, political stability, high competition from local organizations are highly considered as threats to the survival of

foreign banks in Kenya. However financial instability within the institution, profound tax regimes, high scale of corruption and emerging economic policies and treaties are rarely perceived as threats to the foreign banks survival in Kenya. The risks that are faced by the banks therefore are the common business risks faced by international businesses. Political risk and exchange rate risks seem to have weight because the two go hand in hand. Unfavorable state regulations are also country specific and avenues can be sought to handle the same while competition is inevitable.

## **CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter presents the conclusions and recommendations based on the findings in Chapter Four. The limitations of the study and suggestions for further research are also presented in this chapter.

### **5.2 Conclusions**

Foreign commercial banks operating in Kenya portrayed major similarities on the factors influencing their investment in Kenya.

The Kenyan economy proved profitable and politically stable for most of the respondent banks an indication that there could be more opportunities unexploited. Credit expansion was also cited as a crucial factor indicates that the banking sector in Kenya is still not saturated hence there exist room for more entrants. Technological advancement emerged as an area of consideration while investing abroad by a number of foreign banks. At a glance, Kenya was considered to be technologically compliant a characteristic of an emerging economy.

International competition was more critical to those banks with origins/head office outside Africa than those with head office within Africa. Hence, it is clear that, in whereas there is domestic competition, foreign banks are likely to hold tight to their head office strategies for long with slow response to local competition. This situation has resulted to some banks experiencing declining financial performance as depicted in 4.5 above.

A point to specifically note is that issues of tax minimally influenced the decision of a foreign bank to invest abroad. This is because a foreign bank will benefit from a foreign tax credit therefore accepting a relatively low net-of-host country- tax profitability. At the same time, foreign banks may accept different net profits to the extent that their cost of capital differs. Foreign banks may therefore, be able to raise equity capital internationally, and therefore accept

lower net profits in most emerging economies like Kenya, whereas they generally have higher net profits in developed countries.

The respondent's bank also highlighted that when opening branches in Kenya, the size of the market, good commercial activity, skilled labour, political stability, economic growth, infrastructure, competition, technology growth, good international relations, and customer satisfaction were some of the factors they took into consideration.

In conclusion, push and pull factors were seen to be playing a key role on the decisions by foreign banks to invest in Kenya. Push factors included profitability in the home country/Kenya and the foreign bank's opportunity for improved geographical diversification/international competition among others. Pull factors also included Kenya's open-door policy to international trade and relatively stable political conditions. With the presence of foreign commercial banks in Kenya, the benefits of this of financial globalization in the form of heightened financial sector efficiency, improved pricing and better risk management are widely acknowledged.

### **5.3 Recommendations**

The conclusion of the study is that Kenya is a relatively economically and politically stable country with the necessary regulatory framework to attract internal businesses and particularly in the banking sector.

It is therefore recommended that the government should reevaluate its fiscal and monetary policies and other regulatory measures to be able to attract more investment especially from the continent which only had 40% of the respondent banks. This should be carried out in a way that tax issues will not come out as an impediment to carry out business in Kenya.

In as much as international business is very healthy for the country's economic growth, caution should be taken by the government to ensure that the domestic banks are not overshadowed by powerful foreign banks with strong capital bases. Since a significant number of banks indicated that their financial performance is stable and excellently performing, there is a general assumption that they have deliberately taken measures to reduce costs and embraced

technology. However, the government should be keen on labour laws and policies to ensure that the skilled labour provided by Kenyans is not unnecessary exploited through poor perks and long working hours in the guise of reducing costs.

Despite the good financial performance of the foreign commercial banks operating in Kenya, the risks that cited cannot be overlooked. The Kenyan government should make deliberate efforts to address the unfavorable state regulations and issues on governance as a step towards political stability. This then will ensure that foreign exchange risks and inflation are managed and contained within acceptable limits.

#### **5.4 Limitations of the Study**

There is a drawback in that the study was exploratory in nature. Accordingly, it will not be able to prove or disprove the theories on foreign banks investment. The study also makes use means as an analytical generalization tool. For most accurate results, case studies should have been more appropriate on each of the foreign banks in Kenya. Such a situation may be very costly and time consuming. Moreover, questionnaires seemed to be the easiest and cost effective means of collecting data, yet the structured interviews could be more appropriate as more accurate information could be provided once the objectives of the study are well understood by the respondents.

Finally, a census study was carried out. However, due to the low investment of foreign banks in Kenya, the number is relatively small to enable the conclusions of the study to be applied generally to all emerging market economies.

#### **5.5 Areas for Further Studies**

The study has led to the establishment of further areas of studies from observations in chapter four. Tax considerations were viewed to have minimal influence by foreign banks when investing abroad. An investigation should be carried out to establish the reason and how the tax issues can be an opportunity for the host country in terms of revenue generation.

The respondent banks unanimously agreed that they had investment policies in place on the choice of country to invest. A study should be carried out to establish the extent to which these policies differ from those employed by domestic banks when opening branches within Kenya.

Finally, an in depth investigation of perception challenges faced by foreign banks when penetrating into the Kenyan market on what is viewed as foreign against home grown/domestic should be carried to establish its effect on the nature/category of customers.

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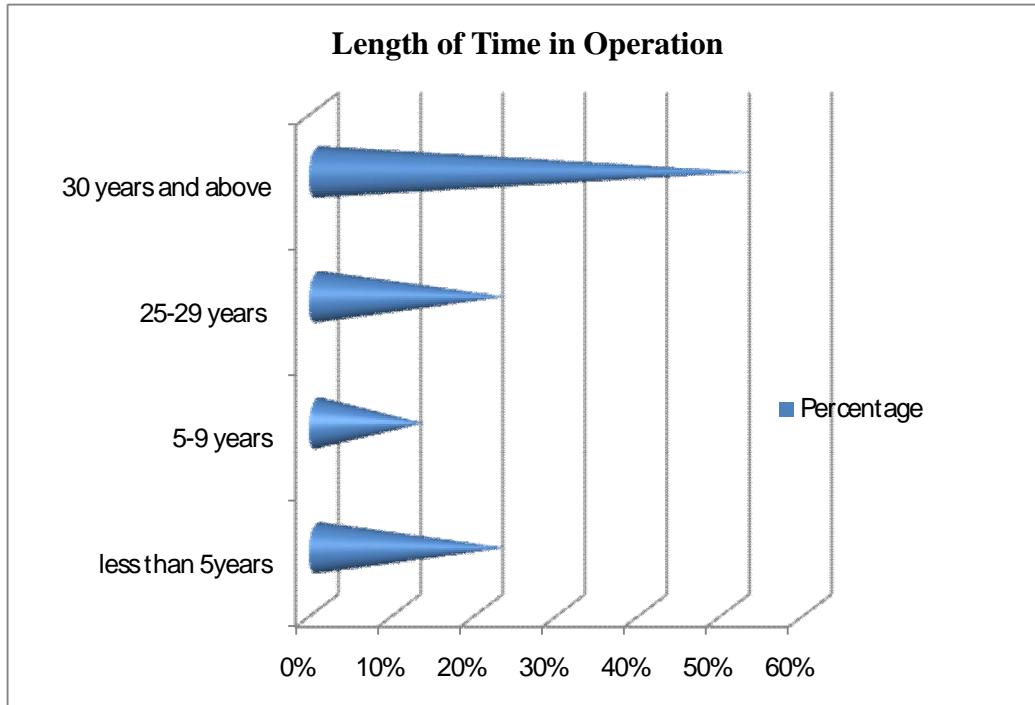
## **APPENDICES**

### **Appendix I: List of Foreign Banks Operating in Kenya**

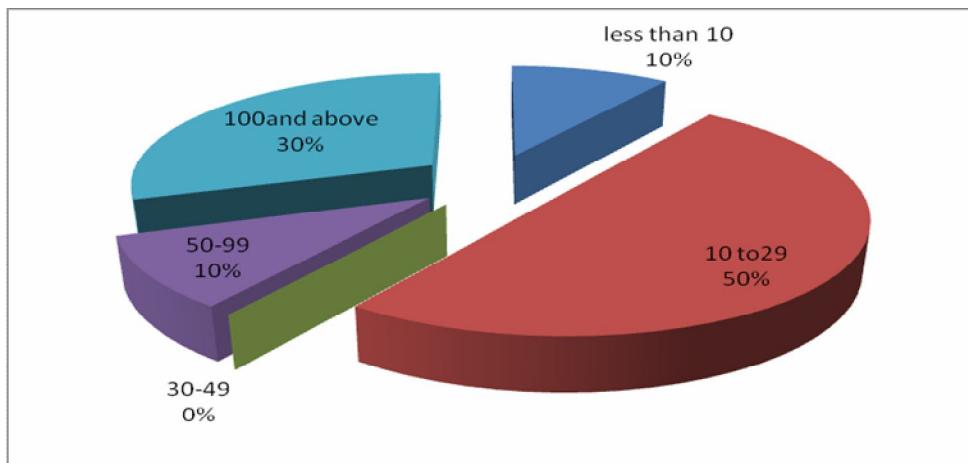
1. Bank of Africa (K) Limited
2. Bank of Baroda (K) Limited
3. Bank of India
4. Barclays Bank of Kenya Limited
5. CFC Stanbic Bank of Kenya Limited
6. Citibank N.A. Kenya
7. Diamond Trust Bank Kenya Limited
8. EcoBank Kenya Limited
9. Habib Bank Limited
10. Habib Bank A.G Zurich
11. Standard Chartered Bank (k) Limited
12. UBA Bank Limited Kenya

**Source:** Central Bank of Kenya (2009). Financial Institutions Supervision. Department (FISD) Annual Report Nairobi.

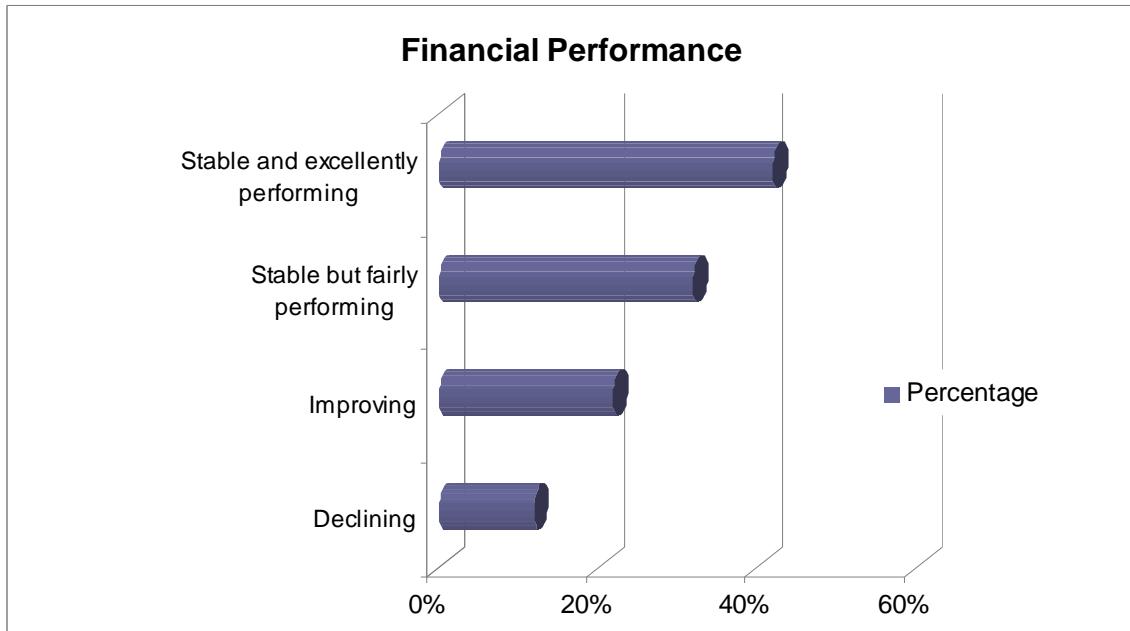
## **Appendix II: Length of time the bank has been operational in Kenya**



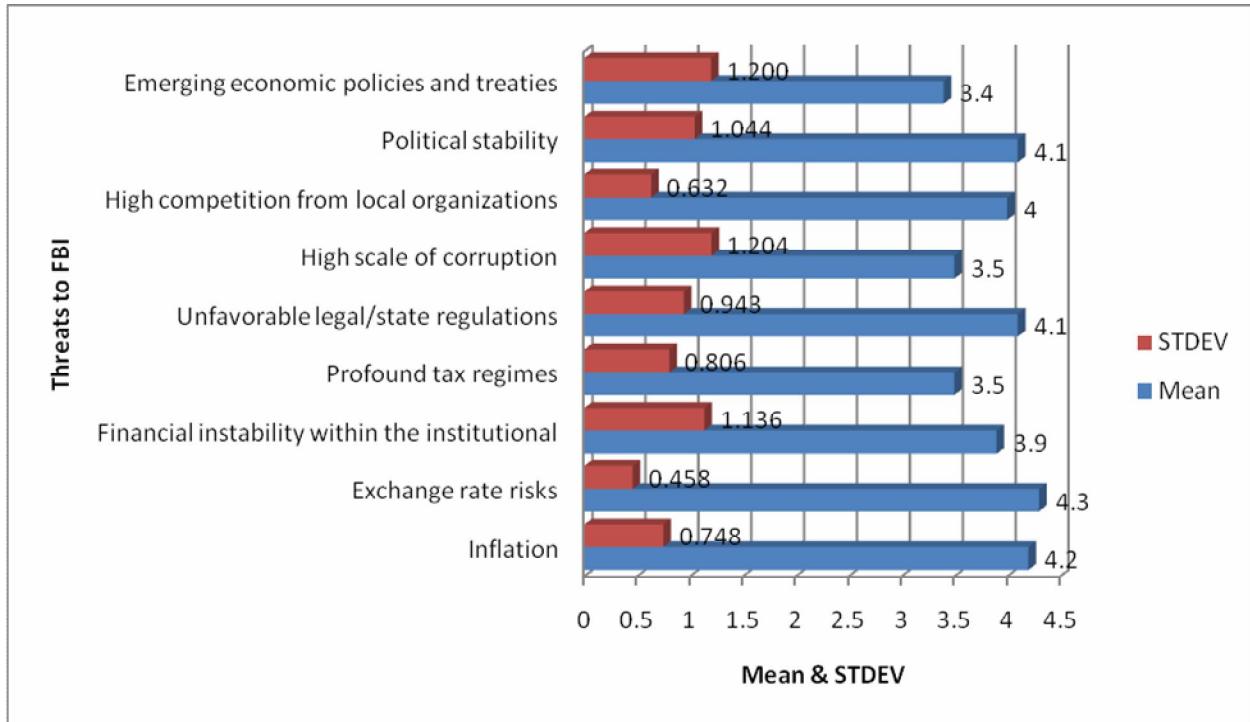
## **Appendix III: Number of Countries the Bank is operating**



#### **Appendix IV: Financial Performance of Kenyan Branches in Comparison with other countries**



## Appendix V: Factors That Threaten Foreign Bank's Survival



The 5-point Likert scale has the following scale values:

1. Not at all,
2. Little extent,
3. Moderate extent,
4. Great extent,
5. Very great extent.